Staff Newsletter of the Bank of Botswana • Volume 11, No. 5 • August 2005

Banknotes

Inside

Productivity and Prosperity 2004 ANNUAL REPORT

The Governor of the Bank of Botswana, Ms Linah K Mohohlo, and the Minister of Finance & Development Planning, Mr B Gaolathe, waiting to welcome dignitaries to the economic briefing following publication of the 2004 Annual Report.

For the theme section of the Annual Report 2004, the Bank chose the topic, ***'Improved Productivity – the Key to Sustained Growth and Higher Living Standards for All'***, a title which is largely self-explanatory. The Bank is not alone in such thinking, of course this view is held across the broad spectrum of Botswana society. In the 2005 Budget Speech, the word 'productivity' or equivalents ('productive', etc) appeared 29 times. Furthermore, it is fully in tune with Vision 2016 where the second of the seven pillars is the creation of 'a prosperous, productive and innovative nation'.

For the Annual Report, the objective was to look at various measures of productivity and how they apply to Botswana, and to investigate the factors that are conducive for promoting growth and development. In particular, there was an emphasis on explaining why productivity is more than just a 'good thing'; that it is the essential underpinning of development and improved living standards. One simple way to see this is to consider the measure of per capita income, which is commonly used as an indicator of living standards. But per capita income is also the measure of average labour productivity in an economy. So the message is simple: average living standards cannot increase in the absence of matching increases in productivity.

The report also notes how productivity impacts on policy issues related to the core business or mandate of the Bank of Botswana. For instance, the debate on whether the exchange rate is set at an appropriate level is closely related to issues of productivity, as is the relationship between inflation and output.

...continued on page 2

The Governor welcoming the Vice President, Lieutenant Ian Khama Seretse Khama, to the economic briefing.

The review looked at the issue of productivity from the economist's perspective, while keeping technical analysis at a level that is understandable to the general reader. This is by no means an easy task. The literature on the sources of economic growth is complex, often making use of sophisticated mathematics and analytical techniques that even specialists (this writer included) find quite daunting. Particular emphasis is given to the importance of appropriate social and economic institutions in promoting growth. Botswana has featured in this part of the literature because of its long track record of sustained economic development and strong democratic traditions (although the latter is currently under considerable internal scrutiny).

There is also some discussion of how active promotion of research and development (R&D) activities can contribute to technological development, which is also of clear relevance to Botswana as the country attempts to develop and implement appropriate policies in science and technology, including establishing the second university.

The middle sections of the report review measures of productivity applied to Botswana. In particular, it updates work that first appeared in the Annual Report for 1993, which attempts to measure 'total factor productivity' (TFP). TFP examines and separates the extent to which economic growth can be attributed to the accumulation of productive inputs, and how much is due to these inputs being used more efficiently. Many economists believe that it is high rates of TFP growth that have underpinned the development of more successful economies. The conclusion here for Botswana is mixed, but it seems that the country needs to attain higher rates of TFP growth if the objectives of Vision 2016 are to be realised.

In recent years there has been a proliferation of competing indices that attempt to rank countries according to various criteria. These include measures of competitiveness, potential for growth, corruption, capabilities in information and communications technologies (ICTs), ease of doing business, etc. Botswana typically does well in these rankings, especially when compared with other African countries. But, the report rightly asks, if this really is the case, why has the progress made in attracting investment and diversifying the economy been limited? Examining some of the measures in greater detail, a more mixed picture emerges. Most significantly, while Botswana typically scores highly in terms of general indicators such as institutional quality and macroeconomic stability, at the more detailed level of the capabilities of businesses and bureaucratic impediments, the picture is less promising. This is hardly a new message, but it is, perhaps, time to take it seriously.

The report benefited by being able to include some of the main results from the 2002/03 Household Income and Expenditure Survey (HIES), which were published by the Central Statistics Office in 2004. These provide some up-to-date information on whether sustained growth has really resulted in higher living standards. Here the picture is generally encouraging, although by no means unambiguously so. Perhaps of most interest is the measure which shows that the proportion of the population of Botswana who are living below the Poverty Datum Line has fallen from 47 percent in the mid-1990s to 30 percent. Such a

The Governor and the Minister of Finance & Development Planning welcoming dignitaries to the economic briefing.

By Matthew Wright
A Deputy Director of Research,
Bank of Botswana

HE President FG Mogae, Hon Vice President Ian Khama and Cabinet Ministers listening to presenters during the economic briefing.

level of poverty is, of course, too high – any incidence of poverty is too high – but at the same time such a significant reduction is surely an achievement.

Some have suggested that the HIES results are misleading. But it is not clear on what basis this criticism is being made (especially in the absence of any alternative data). There is certainly more than a hint of moving the goal posts: for years the figure of 47 percent living below the Poverty Datum Line (PDL) has been paraded as 'exhibit A' for the case that development policies are not working, so it would seem difficult to summarily disown new figures that were prepared on a comparable basis.

The report takes the view that the HIES data suggests the benefits of a well-functioning market economy have been felt across much of the population. This is not surprising because the areas where the economy is clearly functioning best – the main urban centres – are those where poverty is lowest (poverty in the towns and cities is estimated at only 10 percent). This is not a complacent interpretation by any means. On the same criterion, the report is clear that the HIES points to imbalances in development that must be urgently addressed – notably in the rural areas where incomes have hardly risen in real terms and poverty remains very high. It is also observed that a fast pace of development itself presents many challenges, including rapid transformation of the labour force and changing patterns of employment where, inevitably, some will lose out but should be taken care of.

This review has touched on some areas covered by the theme chapter of the Annual Report. The subject area is very wide, and there are many matters which the Report itself does not cover. It does not deal, for example, with how the quest for economic prosperity interacts with concerns about the environment, although these are clearly relevant. But it is hoped that the Report provides a clear and accessible account of what productivity is, and why it cannot be ignored if the country is to continue to develop.

> For the theme section of the Annual Report 2004, the Bank chose the topic, "Improved Productivity – the key to Sustained Growth and Higher Living Standards for All"

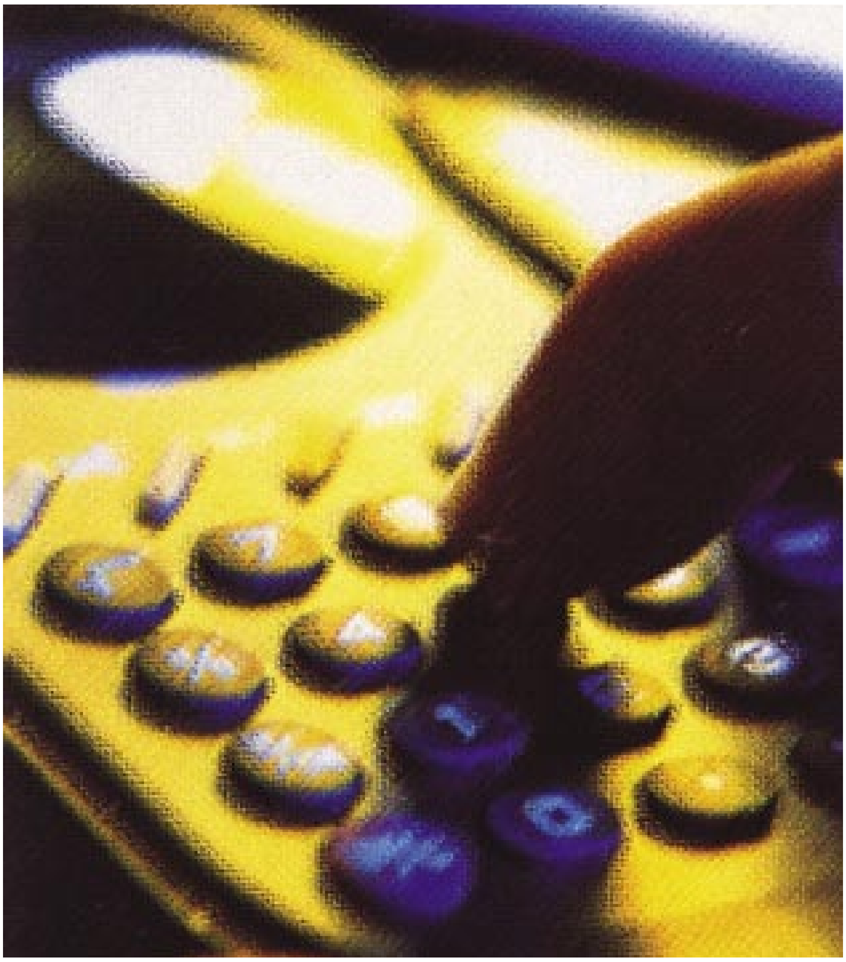

Photo by Perttu Lamsa

Photo by Dain Hubley

The 2005 Monetary Policy Statement

By Lekgatlhamang Setlhare
A Principal Economist in Research,
Bank of Botswana

INTRODUCTION

MPS – A communication tool.

The monetary policy statement (MPS) is one of the Bank's tools of communication used to enhance the public's understanding of the conduct of monetary policy and its objectives. The primary goal of the Bank is to achieve and maintain a low and sustainable rate of inflation. The MPS reports on inflation for the previous year, inflation outlook for the current year, as well as announces the current year's objective range for inflation and how policy will respond to inflation, given the current monetary policy framework.

THE MONETARY POLICY FRAMEWORK

The approach used by the Bank in conducting monetary policy.

The framework has three elements:
Instruments: i.e. Bank Rate, Open Market Operations
Intermediate target/Demand indicators: Credit growth, growth in government spending
Objective: Low and stable inflation

Monetary policy is operated, along with other macroeconomic policies (e.g., exchange rate and fiscal policies), to achieve the broader national objectives of macroeconomic stability, and, in turn, durable economic growth. In particular, through achieving the objective of low and stable inflation monetary policy helps promote international competitiveness of domestic producers.

The Bank uses interest rates to respond to inflation emanating from domestic demand pressures and may respond to anticipated second-round effects due to transitory, administered prices or supply-side factors that are not amenable to monetary policy control. Within its policy framework, the Bank aims to affect the growth of commercial bank credit to the private sector, the main determinant of domestic demand. In particular, the Bank Rate (the rate of interest charged by the Bank of Botswana on overnight loans to the commercial banks) is changed to affect the level of aggregate (domestic) demand relative to supply (or capacity), since inflationary pressures are generated by high levels of demand relative to capacity. The Bank also monitors the growth rate of government spending, the other major determinant of domestic demand, standing ready to react to any adverse impact on domestic demand. Given the significant role of Government in the economy, this serves to emphasise the need for complementarity between fiscal and monetary policy.

DOMESTIC INFLATION TRENDS AND INFLUENCES IN 2004

In spite of the 7.5 percent devaluation, inflation was close to the upper end of the 4-7 percent objective by the end of 2004.

The 7.5 percent devaluation in February 2004, coupled with increases in administered prices and the rise in international oil prices, caused inflation to maintain an upward trend during the year. It peaked at 7.8 percent, exceeding the upper end of the 4-7 percent target range in December. This reflected an increase in underlying inflation since core inflation also rose from 6.7 percent in December 2003 to 7.7 percent in December 2004.

Domestic demand pressures remained subdued – annual growth in commercial bank credit fell to 11.8 percent in December 2004 from 14.2 percent in 2003, within the restraint imposed by restrictive monetary policy and moderate growth in government expenditure. The year-on-year growth in credit was mainly fuelled by growth in household credit which, due to the 15 percent increase in the public service salaries, rose from 10.9 percent in 2003 to 21.7 percent in December 2004. Credit growth to businesses was much lower, at 0.2 percent in December 2004, compared to 10.2 percent in 2003.

On account of higher international oil prices during 2004, the average inflation for Botswana's trading partners rose from 3.2 percent in December 2003 to 3.7 percent by year-end.

MONETARY POLICY MEASURES IN 2004

Monetary policy stance remained unchanged in 2004.

In order to steadily reduce inflation (resulting from the devaluation), the Bank widened its inflation target range from 4-6 percent for 2003 to 4-7 percent, and maintained a restrictive policy stance. Thus, the Bank Rate (the Bank's main policy instrument) was unchanged from the 14.25 percent level of 2003, resulting in stable commercial bank interest rates during the year.

Open market operations (OMO) were conducted to support the stance of monetary policy. In order to increase the effectiveness of OMO, the Bank introduced a shorter-term (14-day) Bank of Botswana Certificate in November 2004.

INFLATION OUTLOOK FOR 2005

Both external and domestic inflationary pressures expected to be moderate.

Internationally, oil prices remain relatively high, but OPEC is committed to expand supply; the global economy is experiencing a rise in productivity and strong competition in goods markets; labour markets are subdued, and pre-emptive monetary policy tightening in some of the major industrial countries. Consequently, average inflation in SDR countries is forecast to decline from 2.6 percent in 2004 to about 2 percent in 2005. Regionally, South Africa's inflation is expected to remain within the target range over the medium-term. And domestically, inflationary pressures are expected to be subdued, given the restrained growth in government spending which, in turn, will help restrain credit growth. Further support to this credit growth scenario should come from the absence of a salary increase for civil servants in 2005/06. Barring any further substantial rise in administered prices, and a stable exchange rate, the combined effect of the above is expected to result in a decrease in inflation in 2005.

MONETARY POLICY STANCE IN 2005

The limits of the inflation objective range are shifted down to reduce inflation.

The objective of achieving a low and stable inflation reflects the Bank's statutory objective of maintaining monetary stability. It is also consistent with the objective of maintaining international competitiveness of Botswana's non-traditional exports to promote the national goal of export-led and durable economic growth. This implies that the annual objective of monetary policy is to achieve a level of inflation that will ensure stability in the real exchange rate. Thus, the derivation of the inflation objective is based on the inflation outlook in Botswana's trading partner countries.

The inflation objective range for 2005 is 3-6 percent, representing a 1 percent reduction in the lower and upper limits of the range set for 2004. The downward shift in the objective range reflects several factors. First, the 4-7 percent target range of 2004 was mainly

The primary goal of the Bank is to achieve and maintain a low and sustainable rate of inflation.

to accommodate the expected devaluation-induced inflation. Second, although devaluation resulted in an increase in inflation in 2004, it was mostly within the target range; inflation breached the upper margin towards year-end mainly due to increases in administered prices. Third, with stable administered prices and exchange rate, the Bank expects a decrease in both the core and headline inflation in 2005. Hence, the 3-6 percent target range was seen as appropriate and contributing to achieving relative real exchange rate stability, while contributing to the Bank's long-term objective of low and stable inflation. This inflation objective is reasonable, in the context of the supportive fiscal policy and credit growth that is consistent with the Bank's desired range of 10-13 percent. The Bank uses credit growth (to the private sector) as an intermediate target since it substantially influences the growth of consumption and investment, and hence the growth of aggregate demand. The Bank sets the desired range for credit growth based on its expectation of the growth of the non-mining sector of the economy and its inflation objective for the year, with an allowance for the process of financial deepening in the economy.

CONCLUSION

Monetary policy will continue to be restrictive to ensure that, as expected, inflation is within the inflation target range by year-end.

Developments in both the global and domestic factors imply minimal external and domestic inflationary pressures will be exerted on inflation in 2005. International factors include increased productivity among producers in major industrial countries, increased competition in international goods markets, and the recent fall in oil prices (if it will be long-lasting). Domestic factors include moderate growth in government expenditure and credit growth. Factors posing upward risk to inflation are major adverse changes in administered prices and the exchange rate.

A Review of the 2005 Budget Speech

By Geoffrey S. Ncube
A Senior Economist in Research,
Bank of Botswana

INTRODUCTION

The following is a review intended to pick up on the key issues discussed in the 2005 Budget Speech. The aim is not to reproduce the budget speech, but to give commentary on specific issues that embrace the national efforts toward achieving Vision 2016 objectives and the Millennium Development Goals (MDGs).

On February 7, 2005 the Minister of Finance and Development Planning presented the 2005 Budget Speech to Parliament. The theme topic for the speech was "Meeting the Millennium Development Goals and Vision 2016 Through a Self-Reliant Approach to Development". This theme was in recognition of the United Nations Millennium Declaration in 2000, which was adopted by Heads of State and Government. The Budget Speech theme is relevant given the Government's long-term commitment to eradicate poverty, provide education at all levels, improve health and combat HIV/AIDS.

GROWTH AND EMPLOYMENT

Economic growth for 2003/04 was positive, with real Gross Domestic Product (GDP) growing by 5.7 percent. However, given the growth rate in 2002/03 of 7.8 percent, this represents some degree of economic slow down. The slowing was due to lower output growth in the mining sector, which recorded a growth of 6.9 percent as opposed to the previous year's 10.3 percent. The growth rate of the non-mining sector also slowed, recording a growth rate of 5.1 percent in 2003/04, as opposed to 6.4 percent registered in 2002/03. Compared to the National Development Plan 9 (NDP 9) target of 5.5 percent, these figures suggest that the economy performed broadly in line with expectations. However, the GDP figures are only provisional at this stage and there appear to be some potential inconsistencies with other data sources, including employment and trade data. These indicate a further slowing in economic growth to between 4 to 5 percent for 2004/05, with a further slow-down in both mining and non-mining sectors contributing to this decline.

The Budget Speech has brought out clearly the Government's concern of the need to provide more job opportunities. It calls for a sharing of responsibility between the Government and private sector, communities and individuals, to make sure that sustainable employment is created. The Speech stressed that innovation and less dependence on government support is key in creating sustainable employment by the private sector. However, the slower growth in overall economic activity, as indicated by the GDP estimates, presents major challenges to Botswana in increasing

> "The Government has a long-term commitment to eradicate poverty, provide education at all levels, improve health and combat HIV/AIDS."

and sustaining the pace of job creation. This is especially so since, according to the recent Household Income and Expenditure Survey (HIES), in 2002/03 unemployment stood near 24 percent.

PUBLIC ENTERPRISES (PES)

The need to increase returns from the various Public Enterprises (PEs) which receive Government funding, was greatly emphasised. The Speech cautioned that these returns should not necessarily come from tariffs, but instead from productivity improvements. One way of achieving the good results is through restructuring the PEs, which the Government has already done on only a few. The good performance of parastatals is essential given their link to the other sectors in the economy, since many of them supply inputs into business activity. Hence, failure to perform by the PEs can seriously undermine the Government's initiatives towards achieving MDGs and employment creation. From now on the PEs are expected to pay 25 percent of profits to Government, which is the equivalent of paying corporation tax at the standard rate. It was also announced that the much-anticipated Privatisation Masterplan is expected to be finalized in early 2005.

SECTORAL DEVELOPMENTS

The financial services industry in Botswana is developing rapidly and the Government has found it necessary to examine appropriate regulatory and supervisory arrangements for non-bank financial institutions that do not fall under the jurisdiction of the Bank of Botswana. For its part, the International Financial Services Centre (IFSC) will continue to contribute to employment creation in the sector by attracting and licensing deserving international financial services companies.

The Government's commitment to rural development and poverty eradication still stands. Rural development will be achieved through timely completion of projects and delivery of services to the communities. Regarding poverty, the Government has gained some ground in reducing the proportion of people living below the Poverty Datum Line from 47 percent in 1993/94 to 30 percent in 2002/03. While there are continuing concerns about the extent of inequalities within the economy, this reduction in poverty is a major achievement.

There has been some success in the fight against HIV/AIDS through the various schemes available to the public, notably the Anti Retroviral (ARV) initiative. However, the impact of these various initiatives will, to a large extent, depend on people's attitude and behaviour towards HIV/AIDS. The Government has further commenced a number of infrastructural developments throughout the country in a bid to improve health services. To mitigate the problem of shortage of health staff, which was in part caused by the exodus of nurses to overseas, the Government has over time increased the number of qualified expatriate staff to help provide quality service in the sector.

Conducive trade and investment environment has been in the forefront of the Government's initiative to promote trade and attract Foreign Direct Investment (FDI). Attracting more FDI flows will depend mainly on the adoption of FDI Strategy and Competition Policy, which are still being drafted. With investment promotion efforts by Botswana Export Development and Investment Authority (BEDIA), more companies are expected to set up in the country in the near future, which will help boost the country's export capacity as well as create employment.

The agricultural sector's contribution to the overall economy continues to be very low, partly due to adverse climatic conditions but also because of underlying structural problems that undermine efficient production. Rainfall uncertainty prevents a proper outlook of the sector's performance in the near future, and an indication can only be known from the drought assessment report due this year. However, despite these problems, expectations are that productivity in the sector will be boosted with the implementation of the National Master Plan for Arable Agriculture and Dairy Development (NAMPAADD). Opening up of markets by the European Union for Botswana's ostrich meat exports should also provide opportunities for diversification in the livestock sector.

Turning to the water situation in the country, a shortage of water has not hampered the Government's efforts of providing safe drinking water. About 98 percent of the population has access to safe drinking water, a proportion that is much higher than the MDGs target of 50 percent. However, the current restrictions on water consumption in the Gaborone area will be a factor in constraining GDP growth in the short term.

Both education and improvements in technology will pave way for the strengthening of the economy through meeting emerging challenges and opportunities. By embracing various technological innovations, Botswana stands to benefit from global partnerships. On the other hand, through information and communications technology (ICT), the Government is committed to taking services to the people via improved access to radio and television.

BUDGET OVERVIEW

Due to a slow down in business activity in 2003/04, the budget recorded a more than expected budget deficit, despite the commitment to balanced budgeting in the medium term. To attain a balanced budget, the Government introduced expenditure controls as well as the adoption of additional revenue strategies, including asset sales that are not normally counted as revenue under modern accounting conventions for government finances but which have yet to be adopted in Botswana. The original 2004/05 budget indicated a surplus of P69 million, whereas the revised figures indicate a deficit of P1.4 billion. This reflects high development expenditure (which increased by 19.9 percent) vis-à-vis lower revenues. This also reflects an element of a cut in tax revenue from an estimated figure of P11.1 billion to a revised figure of P10 billion. This further reflects a slowing business activity accompanied by inadequate tax compliance. Measured as a proportion of GDP, expenditures make up 40 percent of GDP, at P20.8 billion. Government

expenditure growth, however, is seen to be on the decline, from 10.2 percent in 2004/05 to 8.6 percent in 2005/06. One of the factors that have contributed to this is the lack of increase in public sector salaries. The Bank of Botswana, in its quest to achieve price stability and keep inflation down, views expenditure restraint as positive news.

Regarding the 2005/06 budget proposals, there is caution that, for the NDP9 targets to be achieved, it is crucial to realise revenues projected over the plan period. One can perceive these revenue forecasts as ambitious at P20.6 billion, up 19 percent from the 2004/05 estimates. This high figure of revenue is based on rapid growth in mineral revenues, which make up 48 percent of total revenue and are expected to increase by nearly 30 percent.

FISCAL LEGISLATION

An in-depth review of the Incomes Tax Act is in the offing. This is viewed as a positive step towards improving Government tax revenue collections. There is also room for improvement regarding tax compliance, via intensifying income tax audit programme. This should be helped by the newly established Botswana Unified Revenue Service (BURS), which should become fully operational during the year. The Speech also cautioned against the tendency by some businesses to under-report output tax and to over report input tax for VAT, warning that heavy penalties will be imposed accompanied by interest for incorrect reporting.

CONCLUSION

The budget covered important national objectives of economic growth, diversification and employment creation. It came out clear in the budget that these three objectives can be achieved by participation of all stakeholders in the economy, mainly participation by the private sector and individuals. The speech also highlighted improved performance and delivery by public enterprises, which have a significant bearing on economic activity and, hence, growth. Combating HIV/AIDS and poverty eradication still remain key delivery challenges of the Government. On the investment front, the Government still has a long-term commitment to lure foreign investors into the country, in its continued attempts to diversify the economy. In revenue collection, the Government is committed to tightening and improving tax collections. However, in spite of all the achievements stated, challenges still remain for Government including, among others, provision of a conducive environment for private sector development, privatization and improving public sector efficiency.

CUSTOMER DUE DILIGENCE BY THE BANKS

What Does It Involve?

By Goememang Baatlholeng
A Senior Bank Examiner, Banking Supervision Department, Bank of Botswana

INTRODUCTION

Customer Due Diligence (CDD) entails ensuring that banks get all relevant information on its customers to ensure that the business being done is legitimate. The banker-customer relationship is based on confidence and trust. It is, therefore, critical that the bank thoroughly knows both savers and borrowers so that it could estimate its risk exposure to them. CDD is one way of managing that risk. The Bank for International Settlement (BIS) and other stakeholders have concluded that the key elements of CDD measures used by the banks can be categorised into the following headings:-

(a) CUSTOMER ACCEPTANCE POLICY

Banks are expected to have policies and procedures that define how they should do business with the various types of customers. We may perhaps be aware that there are sections of our society in Botswana who are still 'un-banked'. There are several reasons why this is still so. One is that banks still consider these people to be too risky or costly to do business with. Banks are required to provide banking services to the public in general without discrimination. Most banks do business with low, medium and high-income earners, including the unemployed. Other banks, however, go only to high net worth individuals who, are considered profitable, and can also be risky but the higher income and by banks from these customers minimises the risk.

Bank management should, therefore, outline customer acceptance requirements for all the different types of customers and ensure that the requirements are adhered to all the time. In particular, attention should focus on ensuring that the acceptance requirements are designed such that they accommodate the financial sophistication of the customer and his risk exposure to the bank.

(b) CUSTOMER IDENTIFICATION

The banking laws in Botswana stipulate that banks should only open accounts when they are satisfied that they have exercised due diligence in establishing the true identity of the prospective customer. Identification involves producing valid and genuine 'Omang' cards or passports for foreigners and verifying the authenticity of these documents. It also involves verifying the physical addresses of prospective customers through the perusal of utilities bill receipts or the use of other physical address verification methods, such as voter registration cards, motor vehicle registration books, letter from customary authority, etc. The bank should then obtain copies of all identification documents for record keeping. These copies should be kept in a readily retrievable format and, where information exchange agreements exist, made available to other financial institutions and competent authorities, should the need arise.

Minimum customer identification requirements as stated in the laws are expected to be the same across all banks and even for customers who wish to open accounts through the post, telephone or by electronic means. For these types of customers, the account should not be opened until the customer appears for a face-to-face interview. The Bank of Botswana has powers to take supervisory action against any bank considered to be compromising customer identification requirements.

(c) ON-GOING MONITORING OF CUSTOMER ACCOUNTS

Bank customers favour the practice of keeping their financial affairs confidential including, in particular, the sources of funds they deposit with the banks. Banks on the other hand are compelled by law to obtain details of the nature of the customer's financial transactions, the reason for opening the account, an indication of the expected turnover and the sources of funds. This information enables banks to have an understanding of normal and reasonable account activity of their customers so that they have a means of identifying transactions that might fall outside the regular pattern of an account activity. For example, a customer who earns P500 a month and always withdraws it all by month end would raise suspicion if he suddenly starts to save P500 or more every month. The banks may then need to request the customer to update them about the sources of his savings.

Suspicious transactions, which account holders cannot explain, are reported to the law enforcement authorities for further investigation to determine whether there is any criminality involved. There is no doubt, therefore, that knowing the customer's business is one of the main activities undertaken by bank management on a day-to-day basis. Customers should accordingly cooperate with banks when requested to state the sources of their funds.

THE ROLE OF THE BANK OF BOTSWANA

Ideally, the Bank of Botswana should issue guidelines on CDD measures to all commercial banks. These guidelines would provide uniformity in the application of, among others, Know Your Customer (KYC) requirements. This could ultimately reduce instances of unfairness where customers prefer to open accounts with those banks that have less stringent CDD requirements. The Banking Act (CAP:46:04) and Banking (Anti-Money Laundering) Regulations, 2003 were issued to

supplement the banks' existing CDD policies and procedures. These laws set the minimum CDD requirements for banks in Botswana.

The other responsibility of the Bank of Botswana is to monitor compliance with the issued CDD guidelines where they exist. If there are no issued CDD guidelines, the Bank would still conduct regular on-site examinations during which compliance with the banks' own CDD measures would be determined. During these visits, consideration would be given to establishing that banks have policies, procedures and appropriate internal controls, which are applied effectively to maintain high CDD standards to protect the banks' own safety and soundness. The banks' CDD measures would be benchmarked against international standards issued by the Basel Committee on Banking Supervision (a Bank for International Settlements Committee).

The Bank is also interested in the overall integrity of the domestic banking system. By promoting adherence to good CDD standards, the central bank is assisting banks to minimise reputational, operational, legal and concentration risks. Effective CDD measures coupled with strong internal controls are key to the implementation of proper risk management practices within supervised banks.

CONCLUSION

Thorough customer due diligence by banks is beneficial to banks, bank customers and the entire economy in several ways mentioned above. In order for all the stakeholders to continue to enjoy these benefits, there is need for cooperation between bank customers and bank employees when KYC information is gathered. Furthermore, the Bank and the commercial banks should embark on public education campaigns to sensitise the consumers on the new KYC requirements. Finally, while we recognise that proper customer identification is fundamental to mitigating banking risks, the Bank and the commercial banks should ensure that the appropriate implementation of the CDD requirements does not result in the denial of banking services to the financially disadvantaged sectors of the population.

Do Interest Rates Affect DEMAND FOR CREDIT?

By Dr K S Masalila
A Deputy Director of Research, Bank of Botswana

The discussion on the 2005 Monetary Policy Statement (MPS) in this publication refers to one of the central tenets of the monetary policy framework, which is that, to influence demand, the Bank would adjust interest rates and affect the rate of credit growth. There is, however, a view that for a variety of reasons, demand for credit in Botswana, particularly by natural persons (households) is not sensitive to interest rate changes. It is said that: "When asking for a loan, a typical Motswana does not ask, 'how much is the interest rate, but rather how much will be my instalment?" This much may be credible stereotyping. But does it say that the level of interest rate does not affect effective demand for credit. The reality is that, it is not attitude or wish that influences demand, but a binding income constraint, especially in the case of formal credit.

Consider this arithmetic. I earn P2000 a month deposited into my account at the commercial bank. The interest rate on a personal loan is 15 percent and the loan is repayable in 3 years. The commercial bank insists that after deducting the monthly instalment I remain with P1000 (50 percent of income). This means I can only get a loan of P29000 with which to build a small house (not of the human kind); hopefully not a trip to Disneyland. Now, interest rate increases to 20 percent, other conditions remaining, I can only get a loan of P27000, which means a smaller house (restrain your imagination). Roughly, this amounts to a 10 percent fall in my demand and indeed, other things remaining the same, for everybody else.

In fact, when business people and organisations complain about the impact of the high interest rates, this means that the level of interest rates is having an effect on both consumption (foregone sales) and investment (cost of capital) demand. Often this is exactly what the monetary authorities want to achieve; bring down demand to match supply so as to contain inflationary pressures due from demand. Conversely if conditions allow (and inflation is sustainably low) the monetary authorities may reduce interest rates to stimulate demand, thus making me qualify to borrow that P29 000 or more.

Therefore, if lower interest rates are desired it implies that low rates are necessary to stimulate demand. This is admitting that interest rates affect demand – Demand for goods and services is affected by the level of interest rates, ultimately the income constraint, not a wish or attitude. Attitude or wish can only influence what you choose to have given the income constraint, i.e., whether the small house or the trip to Disneyland.

By the way, theory is a deduction from observation and the mechanism of operation is conditional, be it in economics, psychology, physics, biology or chemistry. Nobody nowadays questions the law of gravity. Just because a falling leaf does not do so in a vertical trajectory or is chewed mid-way by a goat does not destroy the law of gravity. So it is in Economics. Responses are not always direct and immediate and sometimes the impact is cushioned or completely obliterated. It may be that a large increase in wages or a favourable exchange rate may overpower the increase in interest rates as a restraint on demand. Just because half a percent increase in interest rates does not stop me from buying a C-class Mercedes Benz is not a reason to throw away the concept of an inverse relationship between cost and demand as a basis for policy making. It may be that I got a 25 percent salary increase or the Pula appreciated considerably. The luxury cars on the roads and designer clothes on bodies are not evidence that the current levels of interest rates do not have any effect. It is evidence that people's income (however derived) can accommodate these luxury purchases given their preferences against other consumption or investment. Businesses, therefore, are concerned because once income is tied to these luxuries, they generate less sales for their other goods and services; the policy maker, on the other hand, may be content that policy is potent.

Photo by Andy Wren