Bank of Botswana

Annual Report

2009

Board Members
as at December 31, 2009

L K Mohohlo
Governor and Chairman

G K Cunliffe

S Sekwakwa

Prof. H Siphambe

C S Botlhole-Mmopi

Dr. J Sentsho

Prof. P Collier

Board Members
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2009 Statutory Report on the Operations and Financial Statements of the Bank

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Abbreviations Used in The Report

ABC	African Banking Corporation
AfDB	African Development Bank
AIDS	Acquired Immunodeficiency Syndrome
AML	Anti-Money Laundering
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BEDIA	Botswana Export Development and Investment Authority
BES	Business Expectations Survey
BFS	Botswana Financial Statistics
BISS	Botswana Inter-bank Settlement System
BoB	Bank of Botswana
BoBCs	Bank of Botswana Certificates
BPOPF	Botswana Public Officers Pension Fund
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
BURS	Botswana Unified Revenue Service
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Market Sensitivity
CFT	Combating the Financing of Terrorism
CIUs	Collective Investment Undertakings
CPI	Consumer Price Index
CPIX	Consumer Price Index Excluding Mortgage Interest Rates
CSO	Central Statistics Office
DCI	Domestic Company Index
ECH	Electronic Clearing House
EFT	Electronic Funds Transfers
FCAs	Foreign Currency Accounts
FCI	Foreign Company Index
GDP	Gross Domestic Product
HIV	Human Immunodeficiency Virus
IFSC	International Financial Services Centre
IIP	International Investment Position
IMF	International Monetary Fund
ISA	Individual Savings Accounts
IRA	Individual Retirement Accounts
LCH	Life Cycle Hypothesis

MEFMI	Macroeconomic and Financial Management Institute
MFDP	Ministry of Finance and Development Planning
MPC	Monetary Policy Committee
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NSC	National Saving Certificate
PIH	Permanent Income Hypothesis
PPP	Public Private Partnerships
REER	Real Effective Exchange Rate
REMCO	Remuneration Committee
SACCOs	Savings and Credit Cooperative Societies
SACU	Southern African Customs Union
SARB	South African Reserve Bank
SAYE	Safe-As-You-Earn
SDR	Special Drawing Right
SIPS	Systemically Important Payment Systems
TESSAs	Tax Exempt Special Savings Accounts
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax

Part A

Statutory Report on the Operations and Financial Statements of the Bank, 2009

Bank of Botswana

Deputy Governors
as at December 31, 2009

M D Pelaelo

O A Motshidisi

Heads of Department
as at December 31, 2009

D Loeto
Accounting & Planning (Acting)

A M Motsomi
Research

R H Nlebesi
Banking & Currency

O Mabusa
Banking Supervision

S M Sealetsa
Financial Markets (Acting)

J Ghanie
Technical Services

E T Rakhudu
Human Resources

O Modisa
Payments & Settlement

2009 Statutory Report on the Operations and Financial Statements of the Bank

Governor's Foreword

The Annual Report for 2009 is presented at a time when the global economy is cautiously emerging from the worst economic recession in decades. Nevertheless, the challenging policy and operational environment resulting from the global economic recession was largely in evidence throughout the year. However, the macroeconomic policy challenges in 2009 were the reverse of the previous year's experience. Overall economic growth turned negative, the balance of payments weakened and the budget deficit widened considerably while inflation fell to a low level.

In the year to September 2009, mining output was 38.4 percent lower than the comparable period in 2008 primarily due to the cessation of diamond production during some months of the year, a reflection of a fall in export demand. Overall economic activity fell by 6.7 percent. However, in contrast to mining output, non-mining production rose by 12.4 percent, with very strong performance in construction, social and personal services as well as communication sectors. Moreover, unlike the experience in 2008, inflation fell progressively throughout the year. By year-end inflation was 5.8 percent after a decline to 5 percent in November 2009, the lowest in decades, compared to 13.7 percent a year earlier, and the medium-term outlook remained positive.

The robust non-mining economic activity benefited from the start of global economic recovery in the later part of the year and expansionary fiscal policy. Furthermore, the declining inflation and favourable outlook were opportune for continued complementary monetary policy easing without compromising the Bank's 3 - 6 percent medium-term inflation objective, or weakening the balance of payments further. Accordingly, the Bank Rate, a reference policy rate, was reduced during the year from 15.5 percent in December 2008 to 10 percent at the end of the year.

The slow resumption of diamond exports later in the year together with government foreign borrowing stabilised the balance of payments. Even so, as at end of December 2009, the foreign exchange reserves were P57.9 billion, equivalent to approximately 21 months of imports of goods and services, a lower level than the P68.6 billion level that was reached (30 months of import cover) a year ago, contrasting with the previous year's rise in the reserves. The consequent fall in diamond revenues in relation to overall government expenditure explained the considerable widening of the budget deficit in the 2009/10 fiscal year which was financed by foreign borrowing, and to some extent, domestic resources including the increase in Government bond issues.

The first round impact of the international financial crisis on the domestic banking system was muted; the banks remained sound, prudently managed and profitable. In fact, the domestic banking system expanded with two market entries, one of which specialises in financing of down-stream diamond industries, while new branches, internet and mobile telephone banking in addition to other service delivery innovations, enhanced access to services and industry competition. Moreover, the efficiency and integrity of the payments system was further strengthened by a new requirement that payments in excess of P500 000 be effected electronically as a safeguard against fraudulent cheque and other paper-based payment instruments; it also generally improved the efficiency and timeliness of payment transactions. Equally significant, a new family of banknotes, that includes a P200 denomination, was introduced into circulation, with more counterfeit protection, updated security and other features. The old family of banknotes ceased to be legal tender on December 31, 2009.

The Bank owes a debt of gratitude to the stewardship of the Board, Management and all staff for the successful policy implementation and satisfactory operational results during 2009.

Linah K Mohohlo

GOVERNOR

STATUTORY REPORT ON THE OPERATIONS OF THE BANK – 2009

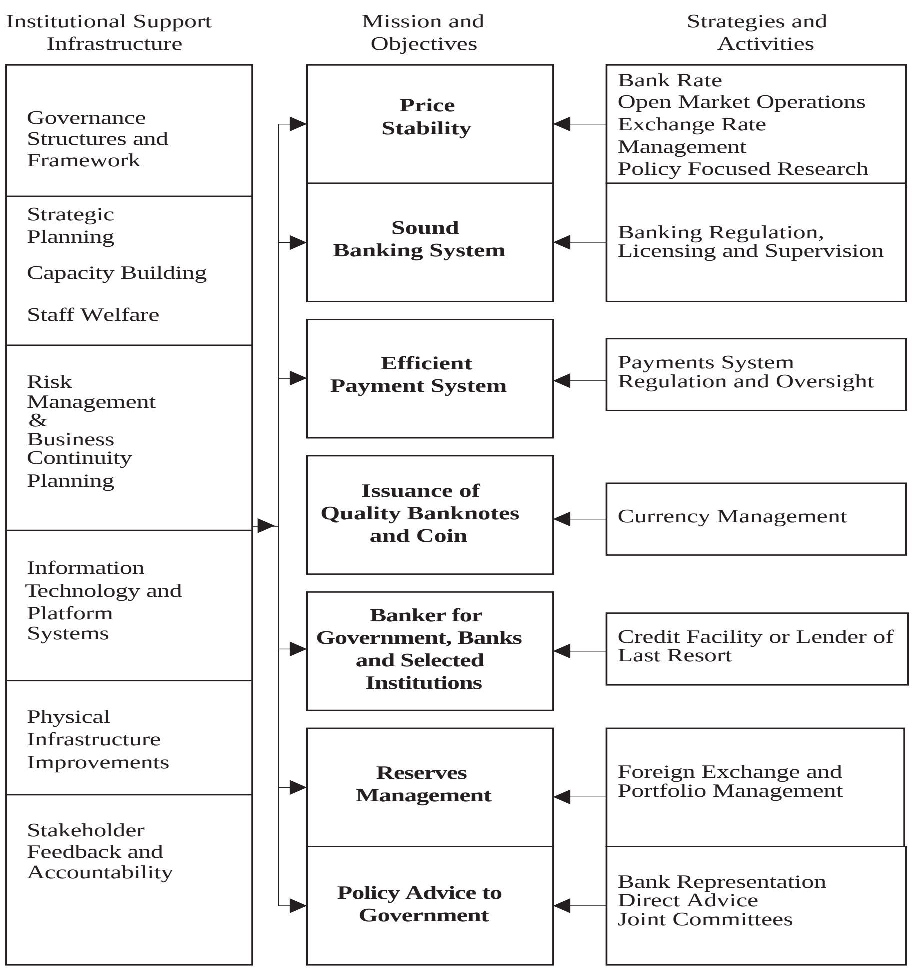
THE BANK'S MISSION AND OBJECTIVES

As provided in Section (4) (1) of the Bank of Botswana Act Cap (55:01), the Bank's mission and primary objectives are:

- to promote and maintain monetary stability, which primarily requires the maintenance of low, predictable and sustainable level of inflation;
- to ensure that the overall financial system is safe and sound;
- to regulate and oversee the payments system and ensure that it is secure and efficient; and
- in so far as it would not be inconsistent with monetary stability, to promote the orderly, balanced and sustainable economic development of the country.

Chart 1 presents the Bank's mission and objectives as well as related strategies, activities and other institutional supporting infrastructure that are utilised to achieve the Bank's objectives.

CHART 1: MISSION, OBJECTIVES, STRATEGIES AND ACTIVITIES

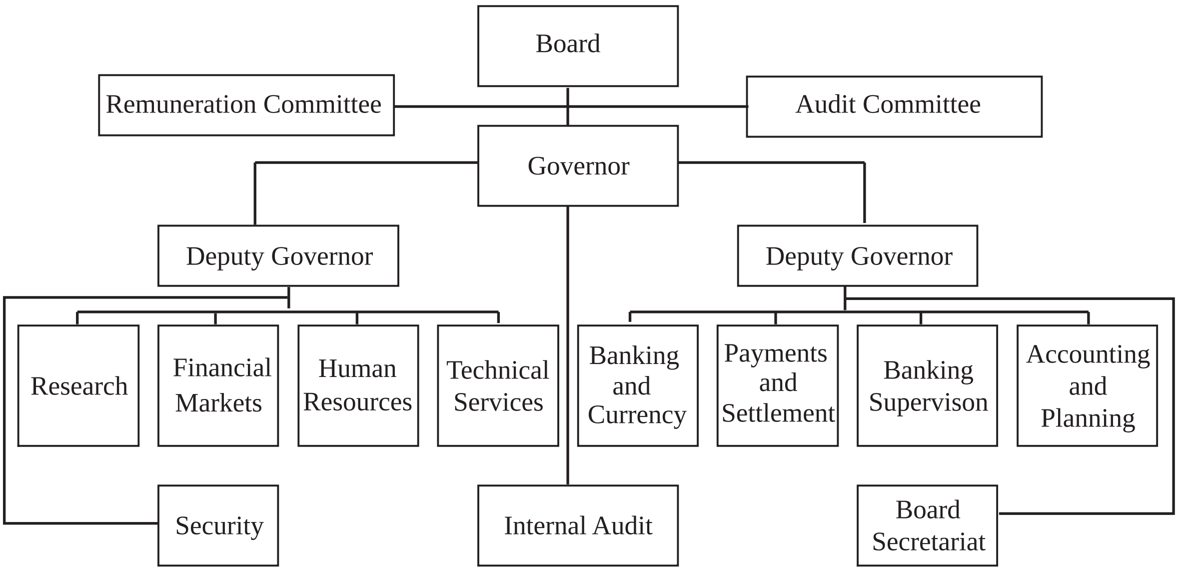


The Bank's objectives are attained by the formulation and implementation of monetary policy for the maintenance of a low, stable and predictable level of inflation; supervision and regulation of banks to foster safety and soundness of their operations and security of the payments and settlement system through oversight and regulation; efficient provision of banking services to the Government, commercial banks and selected public institutions; management of the foreign exchange reserves to underpin the country's robustness of the balance of payments; and the provision of macroeconomic as well as financial policy advice to the Government. Although the responsibilities for the delivery of the various objectives, including the supportive corporate services, are assigned to different Departments, the governance structures and framework ensure activity synergies to fulfil the Bank's overall mandate.

Governance and Organisational Structure

As provided in the Bank of Botswana Act (Cap 55:01), the Bank operates under the purview of the Minister of Finance and Development Planning who submits to Parliament the Annual Report on the operations and financial performance of the Bank. The Board, which is statutorily chaired by the Governor, is at the apex of the governance and organisational structure; then there are two Deputy Governors, eight Departments and three Divisions (Chart 2).

Chart 2: Governance and Organisational Structure as at December 31, 2009



Two sub-committees of the Board, the Remuneration Committee (REMCO) and Audit Committee (which comprise non-Executive members), consider issues pertinent to their respective mandates and report to the Board.

Board Membership and Appointments

The Board oversees the overall running of the affairs of the Bank in accordance with the Bank of Botswana Act (Cap 55:01) and the Bank's Bye-Laws. The current nine Board membership comprises the Governor (ex-officio and Chairman), the Permanent Secretary of the Ministry of Finance and Development Planning (ex-officio) and seven other members appointed in their individual capacities from different professional backgrounds.

The President appoints the Governor (and two Deputy Governors, who are not Board members), while the other Board members are appointed by the Minister of Finance and Development Planning. As indicated above, the Permanent Secretary of the Ministry of Finance and Development Planning is an ex-officio member of the Board. Only two members may be public officers. The Board held the minimum legally required six meetings during 2009.

Governor and Deputy Governors

The Governor is the Chief Executive Officer of the Bank. In addition to the day-to-day running of the Bank, the Governor submits the *Annual Report* on the operations and the audited financial statements of the Bank within three months of the end of the Bank's financial year; and the *Banking Supervision Annual Report* by June 30 to the Minister. The Governor represents the Bank at relevant local, regional and international meetings; and is the country's representative on the Board of Governors of the International Monetary Fund (IMF). The two Deputy Governors share policy oversight responsibilities for the eight Departments and one Division each. They also chair some Standing Committees and, as and when necessary, alternate in acting as Governor.

The Executive Committee

The Executive Committee comprises the Governor, Deputy Governors and Heads of Department. Senior Advisors may be co-opted Committee members. Under the Chairmanship of the Governor, the Committee meets weekly to review the status of policy implementation of the Bank's annual, medium- and long-term work programmes approved by the Board, in order to achieve the objectives. The Executive Committee also monitors general performance, coordinates and facilitates bank-wide communication.

Departments and Divisions

The responsibilities for the attainment of the Bank's mission, objectives and vision are carried out by eight Departments, viz., Accounting and Planning, Banking and Currency, Banking Supervision, Financial Markets, Human Resources, Payments and Settlement, Research and Technical Services. The Bank's three Divisions are: Board Secretariat, Internal Audit and Security. The two Deputy Governors share the direct supervision of the Departments and two Divisions. The Internal Audit Division functionally reports directly to the Audit Committee, while the Governor has responsibility over its administrative matters.

REVIEW OF THE BANK'S MAIN ACTIVITIES IN 2009

To efficiently and properly execute its mandate, the Bank carried out the following activities in 2009:

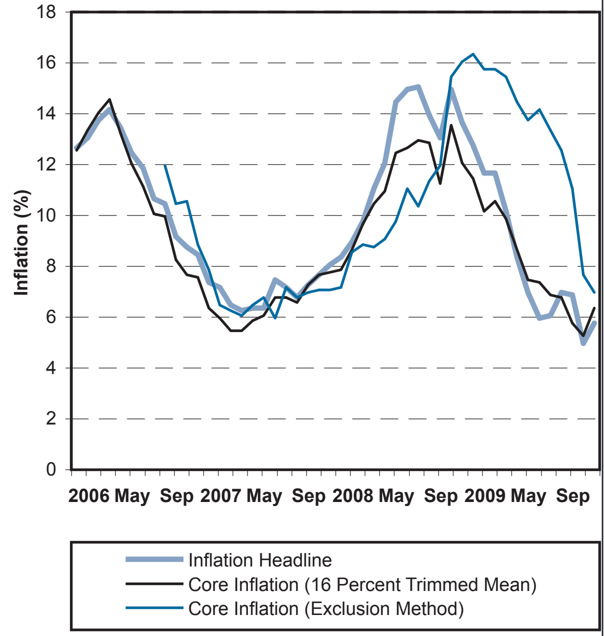
Monetary Policy, Money and Capital Market Activities

(a) Monetary Policy

The 3 – 6 percent medium-term inflation objective announced in the 2009 *Monetary Policy Statement* took into account the on-going global recession, the effects of which had begun to affect the domestic economy by the end of 2008. In particular, it was expected that the progressive fall in commodity prices, including oil, weak global demand and the consequent overall domestic economic downturn, would continue to dampen inflation during the course of 2009. This prognosis was buttressed by the improved inflation forecasting model which included use of disaggregated consumer price index (CPI) data and mining output, as well as expert input from the Monetary Policy Committee (MPC) members to the inflation forecasts. In the event, the outlook for continued overall economic downturn, led by a sharp fall in mining output, and a further deceleration of inflation, which was partly due to base effects, was reflected in the Bank's twice-yearly Business Expectations Survey, which showed a significant loss of domestic business confidence after the temporary closure of the diamond mines and uncertainty about prospects for government spending. Later in the year, economic confidence improved, as the global economic recovery got underway and diamond exports increased. The improved outlook also benefited from Parliament's approval of the 10th National Development Plan (NDP 10).

Inflation continued to decline from 13.7 percent at the end of 2008 to 7 percent by mid-2009; it was at its lowest level since the early 1970s at 5 percent in November 2009 and ended the year at 5.8 percent (Chart 3). In view of the expected further fall in inflation throughout the year and the slowdown in economic activity, monetary policy was eased by a cumulative 5 percentage-point reduction in the Bank Rate to 10 percent by year-end, the lowest in recent years. Monetary policy loosening complemented the Government's expansionary fiscal policy to shore up economic growth without rekindling inflation and weakening the balance of payments further.

Chart 3: Inflation Indicators 2006 - 2009

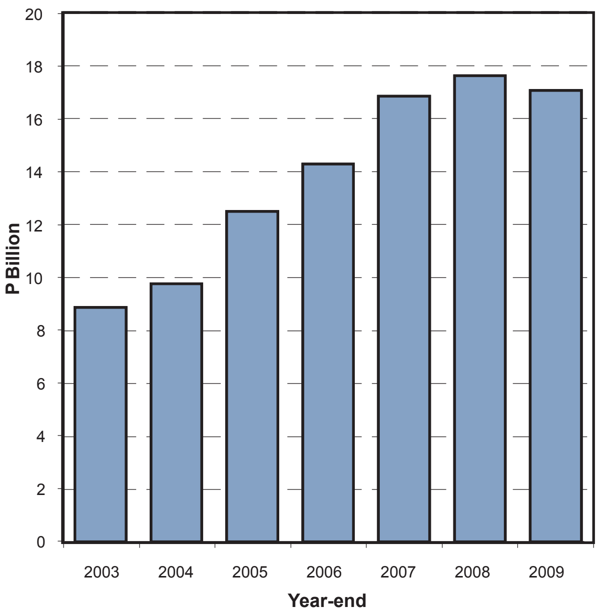


Source: Central Statistics Office

(b) Money and Capital Markets

In support of the monetary policy stance, the Bank auctioned Bank of Botswana Certificates (BoBCs) to absorb excess liquidity. However, as at the end of December 2009, the total level of BoBCs outstanding was P17 billion, marginally lower than the P17.3 billion at the end of 2008 (Chart 4), reflecting the impact of the weak balance of payments and increased issuance of Government bonds. The yield for the 14-day and 91-day BoBCs was 7.14 percent and 7.21 percent, respectively, at the end of 2009 compared to 12.6 percent and 13.1 percent, respectively, at the end of 2008. The fall in yield was in line with Bank Rate cuts during the year.

Chart 4: Bank of Botswana Certificates, end-December 2003 – 2009



Source: Bank of Botswana

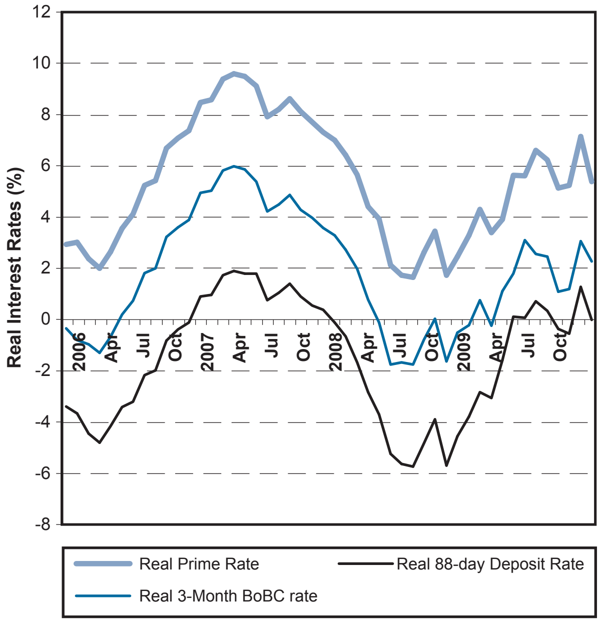
Despite the cuts in the Bank Rate, real interest rates rose due to a faster fall of inflation than nominal interest rates (Chart 5). The real prime rate increased by nearly 3 percentage points from 2.46 percent at the end of 2008 to 5.39 percent in 2009. Similarly, the 88-day real deposit rate rose from -4.55 percent to -0.01 percent, a turnaround of over 4 percentage points.

Under the P5 billion Government Note Programme, the Bank issued P1.5 billion bonds, bringing the total outstanding to P4.1 billion. A new 2.5-year bond (BW006) was issued in September 2009. Apart from the domestic financing of the deficit, the Bond Issuance Programme supported the development of the domestic capital market. Further initiatives were on-going to deepen and widen both primary and secondary bond markets activities.

Exchange Rate Policy

The thrust of the exchange rate policy continued to focus on maintaining the country's international competitiveness, through continuous adjustment of the nominal effective exchange rate (NEER). During the review period, the NEER depreciated by 2.7 percent resulting in a 1.4 percent depreciation of the real effective exchange rate (REER) in 2009. In nominal terms, the Pula weakened by 11 percent against the South African rand, but gained substantial ground against the International Monetary Fund's Special Drawing Right (SDR) and its constituent currencies. The local currency strengthened against the SDR by 11.1 percent, and recorded appreciations of 15.4 percent against the Japanese yen, 12.7 percent against the US dollar, 8.7 percent against the euro and 3.1 percent against the British pound.

CHART 5: SELECTED KEY REAL INTEREST RATES 2006 – 2009



Source: Bank of Botswana

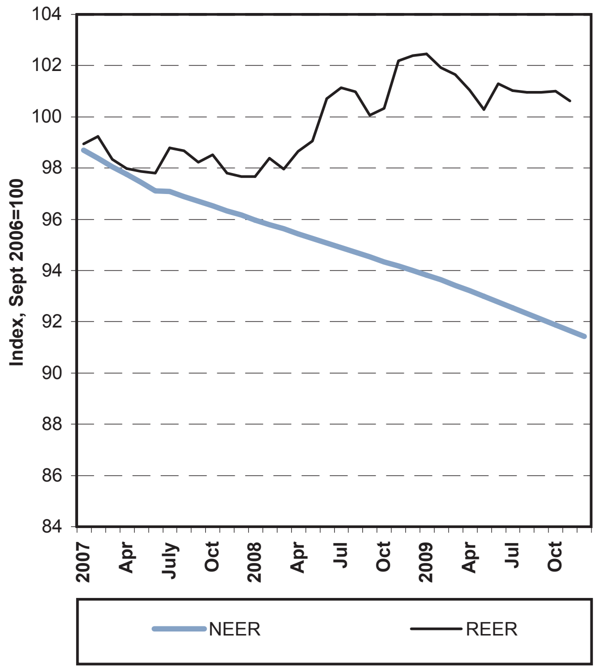
Banks and Non-Banks: Activities, Regulation (Licensing) and Supervision

(a) Bank and Non-Bank Activities

The number of banks increased to 11 with the entry of ABN AMRO Bank (Botswana) Limited and ABN AMRO Bank Botswana (OBU) Limited, subsidiaries of ABN AMRO NV headquartered in the Netherlands. ABN AMRO specialises in financing of downstream diamond-related activities in the domestic and international markets. Besides the on-going product diversification, access to banking services and competition generally benefited from the opening of five new bank branches country-wide during 2009, as well as wider customer access to mobile and internet banking facilities.

Due to the global recession, there was a net outflow in payments during the year which contributed to a reduction in banking system excess liquidity. As a result, the banks' holding of Bank of Botswana Certificates (BoBCs) declined from P17.3 billion to P17 billion. Customer deposits also declined from P40.7 billion to P37.4 billion, leading to an overall banking industry balance sheet contraction from P45.4 billion in 2008 to P44.2 billion in December 2009.

CHART 6: NOMINAL AND REAL EFFECTIVE EXCHANGE RATES (2007–2009)



Source: Bank of Botswana

The transfer of abandoned funds administered under Section 39 of the Banking Act (Cap: 46.04) from banks to the Bank rose from P1.5 million in 2008 to P4.7 million in 2009. Similarly, the balance of unclaimed funds increased from P5.8 million in 2008 to P9.2 million, despite the public announcements to encourage claims of the balances by rightful owners.

Unlike commercial banks' experience, total assets managed by the four domestically licensed management companies, viz.: African Alliance Botswana Management Company, African Alliance International Limited, Stanbic Investment Management Services (Pty) Limited and Investec Fund Managers Botswana (Pty) Limited, rose by 22 percent, from P2.8 billion in June 2008 to P3.5 billion as at the end of June 2009. Similarly, the total number of inward marketed funds increased to 23 following the entry of Investec Global Strategy Fund. A net increase of two bureaux de change was recorded during 2009 following the issuance of four new licenses and revocation of two, resulting in 52 operational entities at the end of the year.

(b) Supervision and Regulation

The international financial turmoil did not significantly affect the safety and soundness of the domestic banking system due to the low institutional inter-dependence. Based on the CAMELS (**C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity and market **S**ensitivity) criteria, all licensed banks met the regulatory requirements; they were soundly managed and profitable (Table 1).

The Bank carried out full scope on-site examinations of some commercial banks during 2009, covering asset quality appraisal and assessments of compliance with prudential and regulatory standards stipulated in the Banking Act (Cap. 46:04). In particular, the on-site examinations focused on capital adequacy, asset quality, internal controls, governance structures, earnings and profitability, liquidity management and foreign exchange operations. In general, the banks were in a sound financial condition and met the key statutory prudential criteria.

Table 1: Measures of Financial Soundness Indicators and Range of Prudential Standards for Licensed Banks, 2007 – 2009

	Prudential Standard (percent)	Range of Prudential Standards for Local Banks (percent)		
		2007	2008	2009
Capital Adequacy	≥15	15.2 – 36.9	15.8 – 32.5	15.8 - 48.4
Liquid Asset Ratio	≥10	22.0 – 63.0	30.7 – 56.2	11.0 – 73.7
Profitability (Return on Assets)	Positive	0.6 – 4.6	1.0 – 8.1	0.6 – 5.2
Profitability (Return on Equity)	Positive	6.2 – 66.0	12.9 – 57.2	2.7 – 38.3
Asset Quality (Non-Performing Loans /Total Loans)	≤2.5	2.2 – 27.1	2.3 – 17.9	2.3 – 12.4
Intermediation (Advances/Deposits)	≥50	32.3 – 81.2	37.0 – 77.1	34.5 – 74.1

Source: Bank of Botswana

In order to improve banks' operational transparency, the Bank issued guidelines on "*Banks' Audit Committee, Annual Independent Audit and Publication of Audited Financial Statements*" and "*Disclosure Framework for Deposit and Lending Rates*". The latter requires more disclosure by banks on their deposit interest rate structures in an effort to encourage financial saving and product competition.

Statutory banks, namely, Botswana Building Society (BBS), Botswana Savings Bank (BSB) and National Development Bank (NDB), were also prudently managed; they adopted appropriate internal control measures and relevant business strategies to mitigate exposure risks during the year. The strategies included diversification of liabilities and putting in place appropriate institutional structures for risk mitigation in an environment of heightened credit risks due to the impact of the global recession, which led to a temporary shutdown of diamond mining and consequent rise in unemployment, as well as increased provisioning for impaired assets.

For non-banks, on-site examinations were conducted on two management companies, viz., African Alliance Botswana Management Company (Pty) Limited and African Alliance International Limited; and a custodian, Stanbic Bank Botswana Limited. The institutions generally complied with regulatory requirements. The nine out of 52 bureaux de change examined also complied with the Bureaux de Change Regulations, with the exception of minor regulatory breaches, which warranted either supervisory warnings or imposition of monetary fines.

Central Banking Services and Currency Issue

The old family of banknotes, which had been in circulation since 1976, was replaced by a new series on August 21, 2009. Although the old banknotes ceased to be legal tender on December 31, 2009, the withdrawal process will continue until December 31, 2014. The new banknotes benefited from new printing technology that updated anti-counterfeiting safeguards; they incorporate features of the country's socio-economic characteristics and heritage. The new P200 banknote was introduced to accommodate the increase in the value of cash transactions over the years.

Generally, the fall in net issues of all the banknote denominations, except the P200, suggest "leads and lags" in the process of substituting the old for the new family of banknotes (Table 2). In addition, the demand for net issuance was affected by slower overall economic activity, the weakened balance of payments and decline in inflation compared to 2008. The combined effect of these factors was a (38.8 percent) decline in the net volume issuance of the P100 banknotes compared to 2008, a development which could also have reflected the preference for the P200 banknote in cash transactions. The volume of P10 banknotes issued fell by 22 percent. In contrast, the net volume issuance of coin increased during the year, but at a slower rate than in 2008 due to the overall economic slowdown. The 11.8 percent net issue increase for the 10 thebe, which was the largest for all coin denominations, was due, in part, to the low stock levels for the 25 thebe and 5 thebe coin denominations which were replenished in the third quarter of the year.

TABLE 2: NOTES AND COIN NET ISSUANCE BY DENOMINATION, 2007 – 2009

Banknotes (millions)						Coin (millions)					
				Change (Percent)						Change (Percent)	
Denomination	2007	2008	2009	2007-2008	2008-2009	Denomination	2007	2008	2009	2007-2008	2008-2009
P200	N/A	N/A	2.8	N/A	N/A	P5	4.8	5.1	5.5	6.3	7.8
P100	9.8	12.1	7.4	23.5	–38.8	P2	8.1	9.0	9.5	11.1	5.6
P50	3.2	3.2	2.9	0.0	–9.4	P1	13.3	16.0	16.8	20.3	5.0
P20	5.8	5.4	4.9	–6.9	–9.3	50t	13.3	14.8	15.1	11.3	2.0
P10	3.1	4.1	3.2	32.3	–22.0	25t	19.1	23.5	24.5	23.0	4.3
P5	0.5	0.5	0.5	0.0	0.0	10t	50.6	50.9	56.9	0.6	11.8
P2	0.5	0.5	0.5	0.0	0.0	5t	99.2	119.7	127.4	20.7	6.4
P1	0.8	0.8	0.8	0.0	0.0						

Source: Bank of Botswana

Payments and Settlement

Several initiatives were taken to further strengthen the integrity, security and efficiency of the clearing and settlement systems. The Bank introduced a risk-based oversight framework that ensures that the two Systemically Important Payment Systems (SIPS), comprising the Real Time Gross Settlement System [known as the Botswana Inter-bank Settlement System (BISS)] and the Electronic Clearing House (ECH), operate effectively in compliance with international best practice.

In October 2009, cheque payments were capped at P500 000 per transaction in order to encourage the usage of electronic payment systems that would include the BISS for large value and time critical payments and Electronic Funds Transfers, thus mitigating systemic risk disturbances in the financial system. As a result, cheque transactions fell by 3 percent in volume and 17 percent in value (Chart 7). The volume of transactions settled in the BISS increased by 23 percent, although the value decreased by 3 percent (Chart 8), reflecting, in part, the economic downturn. Electronic Funds Transfers (EFT) increased by 7 percent in volume and 80 percent in value (Chart 8). A new format of SWIFT messages was introduced to promote transparency in transactions processing in order to comply with Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT) standards.

Foreign Exchange Reserves Management

After a downward trend that characterised the first half of 2009, due to the fall in export demand, especially for diamonds, decline in commodity markets and capital market turbulence, there was some stabilisation in the level of reserves in the latter part of the year. The improvement resulted from a combination of the proceeds of the government loan from the African Development Bank (AfDB), slow resumption of diamond export receipts and royalties, and the rebound in equity markets as the global economic recovery got underway. Nevertheless, at P57.9 billion at end-2009, the foreign exchange reserves were 11.2 percent below the end-2008 level and covered approximately 20 months of imports of goods and services, a reduction from the import cover of 30 months of a year earlier.

Accountability, Communication and Advisory Services

(a) Publications and Public Education

As required by law, the 2008 *Annual Report* and the *Banking Supervision Annual Report* were submitted to the Minister of Finance and Development Planning by March 31, 2009 and June 30, 2009, respectively. Subsequently, various stakeholders were briefed on the highlights of the reports. After the Governor's public announcement of the 2009 *Monetary Policy Statement* on February 25, 2009, the document was published and posted on the Bank's website. Monthly issues of the *Botswana Financial Statistics* (BFS) were produced and regularly posted on the Bank's website. Other publications included the *Research Bulletin*, two brochures on the *Botswana Inter-bank Settlement System* (BISS) and the English and Setswana versions of the *Know Your Banknotes* booklet featuring the new banknotes.

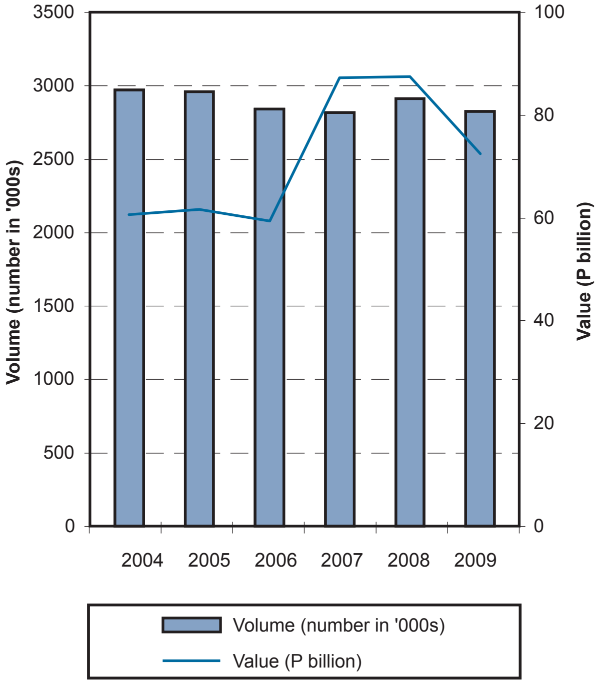
(b) Advisory Services

Apart from the normal interaction with the Government on macroeconomic policy matters and the Bank's membership in high level advisory committees, the Bank participated in international trade policy discussions. The provision of advisory services was also carried out through inter-agency committees, especially the Ministry of Finance and Development Planning/Bank of Botswana Working Group.

External Relations

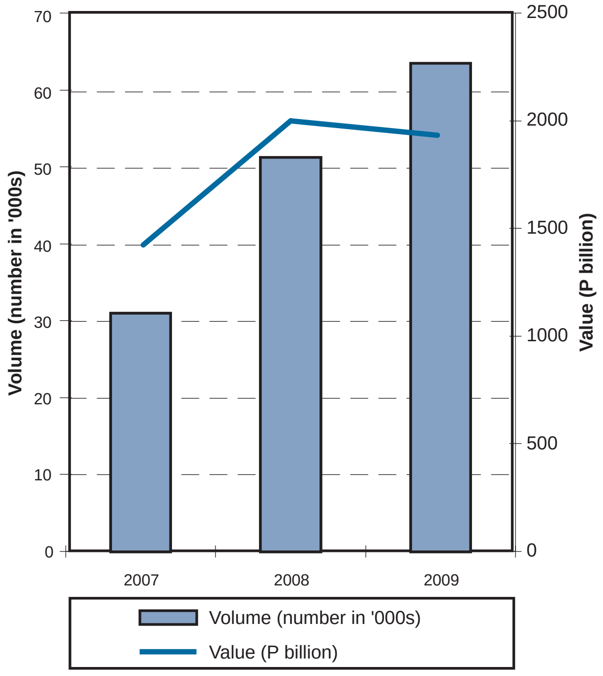
The close relations with international institutions continued throughout the year, covering technical assistance and surveillance missions. The global recession and financial crisis highlighted the need to further develop the range, quality and timeliness of national statistics, including private sector external debt. Technical assistance for this purpose was received from the International Monetary Fund (IMF), Macroeconomic and Financial Management Institute (MEFMI) and Commonwealth Secretariat. The Bank also took part at the annual meetings of the World Bank and IMF, World Economic Forum, Commonwealth Finance Ministers' and Governors' Meetings and Association of African Central Banks.

CHART 7: ELECTRONIC CLEARING HOUSE: CHEQUE PROCESSING 2004 – 2009



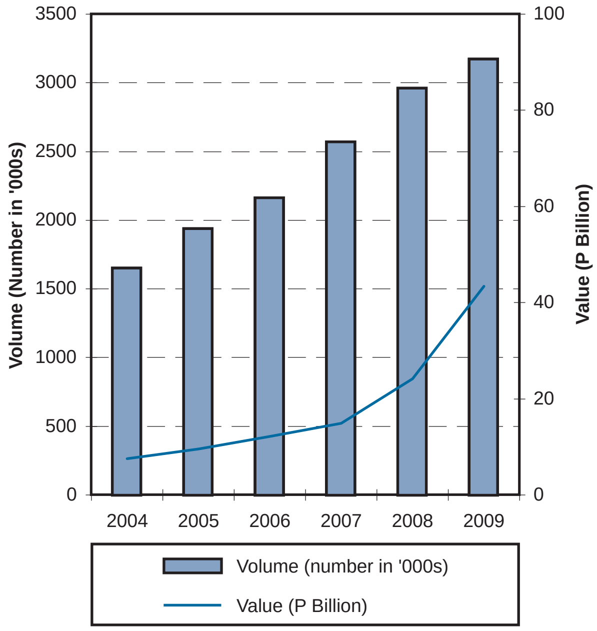
Source: Electronic Clearing House Botswana

CHART 8: BOTSWANA INTER-BANK SETTLEMENT SYSTEM (BISS) TRANSACTIONS 2007 – 2009



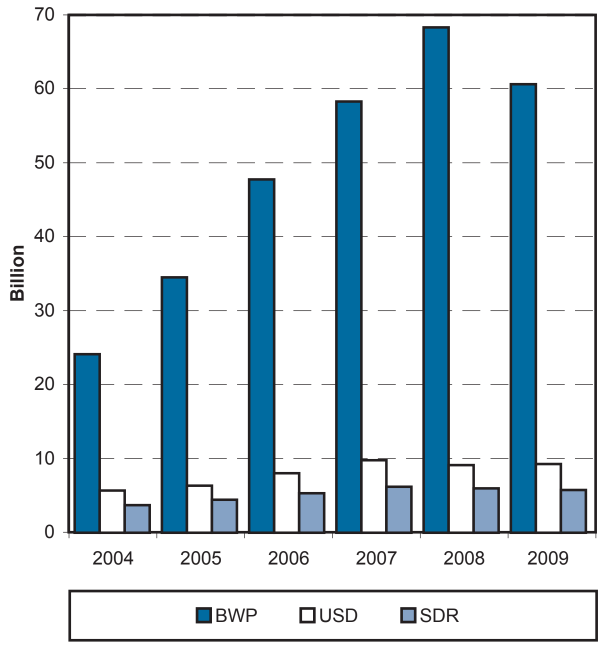
Source: Bank of Botswana

CHART 9: ELECTRONIC CLEARING HOUSE: ELECTRONIC FUNDS TRANSFERS 2004 – 2009



Source: Electronic Clearing House Botswana

CHART 10: FOREIGN EXCHANGE RESERVES 2004 – 2009



Source: Bank of Botswana

The Bank also hosted the annual review meetings of the sovereign credit rating agencies, Moody's Investors Service and Standard and Poor's. Despite the difficult external and domestic challenges, including the widening budget deficit and higher external and domestic debt, the country's credit rating was retained at A2 by Moody's Investor's Service, although the outlook was changed from "Stable" to "Negative". Standard & Poor's lowered the sovereign credit rating from A to A minus, but revised the outlook from "Negative" to "Stable".

Human Resources and Staff Welfare

The Bank's authorised Staff Establishment increased from 580 to 583 positions. The vacancy rate increased from 6.17 percent as at the end of 2008 to 6.35 percent in December 2009, partly due to the suspension of external recruitment (with the exception of selected positions) pending the phased implementation of the results of Activity Based Costing exercise. Throughout the year, training, staff development and overall capacity building continued by means of on-the-job-training, attendance at seminars, technical and post graduate degree programmes.

On matters of staff welfare, staff continued to benefit from health facilities that include counselling services and the HIV/AIDS-in-the-workplace programme.

Physical Projects, Risk Mitigation and Information Technology

In order to alleviate the expected future vault storage constraint and improve cash management, preparatory work began on the design of the new Cash Management Centre.

Audit activities increased with emphasis on self-risk assessment. In general, compliance with audit recommendations improved during the year. Based on both the assessments and conclusion by the Internal Audit and External Auditors reports, the internal control environment was generally effective and in line with best practice in both operational and governance standards.

The security infrastructure for the Francistown Branch was upgraded and the Bank continued to liaise with the national law enforcement authorities in surveying the security environment within and without the country.

ANNUAL FINANCIAL STATEMENTS

2009

BANK OF BOTSWANA

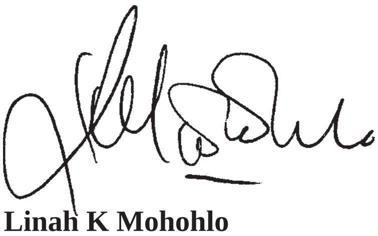
CONTENTS

STATEMENT OF RESPONSIBILITY OF THE BOARD AND APPROVAL OF FINANCIAL STATEMENTS

The members of the Board are responsible for the preparation of the annual financial statements in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01). The auditors are responsible to give an independent opinion on the fairness of the annual financial statements based on the audit of the affairs of the Bank in accordance with International Standards on Auditing.

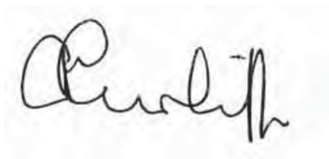
After making enquiries, the Board has no reason to believe that the Bank will not be a going concern in the foreseeable future. For this reason, the board continues to adopt the going concern basis in preparing the annual financial statements.

The members of the Board are satisfied that the Management introduced and maintained adequate internal controls to ensure that dependable records exist for the preparation of the annual financial statements, to safeguard the assets of the Bank and to ensure they are duly authorised. Against this background, the members of the Board accept responsibility for the annual financial statements and the information on pages 31 to 63 which were approved on March 26, 2010 and are signed on its behalf by:



Linah K Mohohlo

Governor



Gordon K Cunliffe

Board Member

Deloitte

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INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the annual financial statements of Bank of Botswana, set out on pages 31 to 63 which comprise the Statement of Financial Position as at December 31, 2009, the Statement of Comprehensive Income, Statement of Distribution, Statement of Cash Flows and Statement of Changes in Shareholder's Funds for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Board Members' Responsibility for the Financial Statements
The members of the Board are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the financial statements present fairly, in all material respects, the financial position of Bank of Botswana as of December 31, 2009, and of its financial performance, Statement of Changes in Shareholder's Funds and its cash flows for the year ended in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

Deloitte+ Touche

Deloitte & Touche
Certified Public Accountants

March 26, 2010
GABORONE

STATEMENT OF FINANCIAL POSITION

December 31, 2009

	Notes	2009 P'000	2008 P'000
ASSETS			
Foreign Assets			
Liquidity Portfolio	1.1	13 229 381	16 358 184
Pula Fund	1.2	43 529 661	51 626 106
International Monetary Fund (IMF)			
Reserve Tranche	2.1	118 042	97 891
Holdings of Special Drawing Rights	2.2	966 292	457 728
Administered Funds	2.3	64 692	71 814
Total Foreign Assets		57 908 068	68 611 723
Domestic Assets			
Property and Equipment	3	160 782	147 645
Government of Botswana Bonds	4	45 039	41 019
Other Assets	5	99 102	92 086
Total Domestic Assets		304 923	280 750
TOTAL ASSETS		58 212 991	68 892 473
LIABILITIES			
Foreign Liabilities			
Allocation of Special Drawing Rights (IMF)	2.4	599 118	50 756
Liabilities to Government (IMF Reserve Tranche)	9	118 042	97 891
Total Foreign Liabilities		717 160	148 647
Domestic Liabilities			
Notes and Coin in Circulation	6	1 659 187	1 593 970
Bank of Botswana Certificates	7	17 030 315	17 553 915
Deposits	8	3 868 038	3 065 303
Dividend to Government	10	250 000	325 500
Other Liabilities	11	54 158	56 778
Total Domestic Liabilities		22 861 698	22 595 466
Total Liabilities		23 578 858	22 744 113
SHAREHOLDER'S FUNDS			
Paid-up Capital	14	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		22 019 051	30 519 444
Currency Revaluation Reserve		8 842 895	12 509 032
Market Revaluation Reserve		2 147 187	1 494 884
General Reserve	15	1 600 000	1 600 000
Total Shareholder's Funds		34 634 133	46 148 360
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		58 212 991	68 892 473
FOREIGN ASSETS IN US DOLLARS[1] (000)		8 703 583	9 118 498
FOREIGN ASSETS IN SDR[2] (000)		5 564 965	5 941 775

[1] United States dollar/Pula: 0.1503 (2008: 0.1329)

[2] SDR/Pula: 0.0961 (2008: 0.0866)

STATEMENT OF COMPREHENSIVE INCOME

Year ended December 31, 2009

	Notes	2009 P'000	2008 P'000
INCOME			
Interest – Foreign exchange reserves	16	1 659 958	2 491 908
Dividends – Foreign exchange reserves	17	208 913	282 431
Interest – Government of Botswana Bonds		4 100	5 814
Net realised currency gains	19	1 329 498	7 428 337
Net unrealised currency gains	20	–	3 116 805
Net unrealised market gains	21	–	118 586
Profit on domestic foreign exchange deals		194 254	399 786
Other income		21 072	26 800
		3 417 795	13 870 467
EXPENSES			
Interest expense	22	1 649 609	2 127 809
Administration costs		301 723	278 485
Depreciation expense	3	12 288	12 723
Net unrealised currency losses	20	5 283 077	-
Net unrealised market losses	21	127 393	-
Net market losses on disposal of securities	18	114 817	526 234
		7 488 907	2 945 251
NET (LOSS)/INCOME FOR THE YEAR		(4 071 112)	10 925 216
OTHER COMPREHENSIVE INCOME/(LOSSES)			
Net unrealised currency (losses)/gains on non-monetary "available-for-sale" financial instruments		(1 409 838)	1 214 535
Net unrealised market gains/(losses) on "available-for-sale" financial instruments		711 437	(1 832 192)
Other comprehensive losses for the year		(698 401)	(617 657)
TOTAL COMPREHENSIVE (LOSS)/INCOME FOR THE YEAR		(4 769 513)	10 307 559

STATEMENT OF DISTRIBUTION

Year ended December 31, 2009

	Note	2009 P'000	2008 P'000
TOTAL COMPREHENSIVE (LOSS)/INCOME FOR THE YEAR		(4 769 513)	10 307 559
Net unrealised currency losses/(gains) on non-monetary "available-for-sale" financial instruments		1 409 838	(1 214 535)
Net unrealised market (gains)/losses on "available-for-sale" financial instruments		(711 437)	1 832 192
NET (LOSS)/ INCOME FOR THE YEAR		(4 071 112)	10 925 216
TRANSFER FROM/(TO) CURRENCY REVALUATION RESERVE	23	4 043 393	(10 069 289)
NET (LOSS)/INCOME BEFORE TRANSFER FROM GOVERNMENT INVESTMENT ACCOUNT		(27 719)	855 927
TRANSFERS FROM GOVERNMENT INVESTMENT ACCOUNT		1 027 719	446 073
Dividend to Government		1 000 000	1 302 000

STATEMENT OF CASH FLOWS

Year ended December 31, 2009

	Notes	2009 P'000	2008 P'000
OPERATING ACTIVITIES			
Cash generated by operations	26	250 045	2 478 683
INVESTING ACTIVITIES			
Net withdrawals/(investments)		6 526 354	(569 450)
Proceeds on redemption of Government of Botswana bonds (at cost)		–	98 537
Interest received from Government of Botswana bonds		4 100	7 521
Proceeds from disposal of property and equipment		308	296
Purchase of property and equipment	3	(25 810)	(17 632)
Purchase of Government of Botswana bonds		–	(59 221)
NET CASH GENERATED FROM/(USED IN) INVESTING ACTIVITIES		6 504 952	(539 949)
FINANCING ACTIVITIES			
Dividend to Government	10	(1 075 500)	(1 203 000)
Government withdrawals		(5 744 714)	(968 798)
NET CASH USED IN FINANCING ACTIVITIES		(6 820 214)	(2 171 798)
NET INCREASE IN CURRENCY IN CIRCULATION		(65 217)	(233 064)
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(1 593 970)	(1 360 906)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(1 659 187)	(1 593 970)

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS

Year ended December 31, 2009

	Paid–up Capital P'000	Currency Revaluation Reserve P'000	Market Revaluation Reserve P'000	General Reserve P'000
Balance at January 1, 2008	25 000	7 532 007	1 971 474	1 600 000
Total comprehensive income for the year	–	1 214 535	(1 832 192)	–
Transfers to/from Government Investment Account:				
Net unrealised market losses for the year	–	–	1 355 602	–
Net unrealised currency gains for the year	–	(6 306 799)	–	–
Deficit of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
Government withdrawals	–	–	–	–
Transfer to Currency Revaluation Reserve	–	10 069 289	–	–
Dividend to Government	–	–	–	–
Balance at December 31, 2008	25 000	12 509 032	1 494 884	1 600 000
Total comprehensive loss for the year	–	(1 409 838)	711 437	–
Transfers to/from Government Investment Account:				
Net unrealised market gains for the year	–	–	(59 134)	–
Net unrealised currency losses for the year	–	1 787 094	–	–
Deficit of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
Government withdrawals	–	–	–	–
Transfer from Currency Revaluation Reserve	–	(4 043 393)	–	–
Dividend to Government	–	–	–	–
Balance at December 31, 2009	25 000	8 842 895	2 147 187	1 600 000

1. The Government Investment Account, which was established on January 1, 1997, represents the Government's portion of the Pula Fund and the Liquidity Portfolio.

Government Investment Account P'000	Accumulated Profit P'000	Total P'000	
26 983 118	–	38 111 599	**Balance at January 1, 2008**
–	10 925 216	10 307 559	Total comprehensive income for the year
			Transfers to/from Government Investment Account:
(1 355 602)	–	–	Net unrealised market losses for the year
6 306 799	–	–	Net unrealised currency gains for the year
(446 073)	446 073	–	Deficit of Government Pula Fund Income over Pula Fund Dividend
(968 798)	–	(968 798)	Government withdrawals
–	(10 069 289)	–	Transfer to Currency Revaluation Reserve
–	(1 302 000)	(1 302 000)	Dividend to Government
30 519 444	–	46 148 360	**Balance at December 31, 2008**
–	(4 071 112)	(4 769 513)	Total comprehensive loss for the year
			Transfers to/from Government Investment Account:
59 134	–	–	Net unrealised market gains for the year
(1 787 094)	–	–	Net unrealised currency losses for the year
(1 027 719)	1 027 719	–	Deficit of Government Pula Fund Income over Pula Fund Dividend
(5 744 714)	–	(5 744 714)	Government withdrawals
–	4 043 393	–	Transfer from Currency Revaluation Reserve
–	(1 000 000)	(1 000 000)	Dividend to Government
22 019 051	–	34 634 133	**Balance at December 31, 2009**

SIGNIFICANT ACCOUNTING POLICIES

December 31, 2009

BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

The financial statements are prepared on the historical cost basis as modified to include the revaluation of investments in domestic and foreign assets and liabilities. The principal accounting policies stated below have been consistently applied and comply with International Financial Reporting Standards in all material respects.

ADOPTION OF REVISED STANDARDS AND INTERPRETATIONS

The following revised Standards and Interpretations, relevant to the Bank's operations, have been adopted in the current period and have affected the presentation and disclosure of amounts reported in these financial statements.

IAS 1 (as revised in 2007) - *Presentation of Financial Statements*

IAS 1(2007) has introduced nomenclature changes (including revised titles for the financial statements) and changes in the format and content of the financial statements. The changes in the financial statements titles are as follows:

(i) the "Balance Sheet" has been renamed the "Statement of Financial Position";

(ii) the "Cash Flow Statement" has been renamed the "Statement of Cash Flows"; and

(iii) where an entity elects to present income and expenses using the single statement approach, that statement is referred to as the "Statement of Comprehensive Income".

The Bank has adopted the single statement of comprehensive income approach. Consequently, the gains and/or losses on re-measuring "available-for-sale" financial assets that were previously taken directly to equity are reported in the Statement of Comprehensive Income. In addition, in order to appropriately reflect the appropriations from/(to) the Government, the Bank has prepared a "Statement of Distribution".

The comparative information for the year ended December 31, 2008 has been amended as follows to conform to the requirements of the revised IAS 1:

	2008 **P'000**
NET INCOME FOR THE YEAR	10 925 216
OTHER COMPREHENSIVE INCOME/(LOSSES)	
Net unrealised currency gains on non-monetary "available-for-sale" financial Instruments	1 214 535
Net unrealised market losses on "available-for-sale" financial instruments	(1 832 192)
Other comprehensive losses for the year	(617 657)
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	10 307 559

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

December 31, 2009

Amendments to IFRS 7 - *Financial Instruments: Presentation*

The amendments to IFRS 7 expand the disclosures required in respect of fair value measurements and liquidity risk. The Bank has elected not to provide comparative information for these expanded disclosures in the current year in accordance with the transitional reliefs offered in these amendments.

STANDARDS AND INTERPRETATIONS IN ISSUE NOT YET ADOPTED

As at the date of finalisation of the financial statements, the following Standards and Interpretations, relevant to the Bank's operations, are in issue and have not yet been adopted in the financial statements.

Standard	Annual periods beginning on or after
IFRS 5 – *Non–current Assets Held for Sale and Discontinued Operations*	July 1, 2009
IFRS 5 – *Non–current Assets Held for Sale and Discontinued Operations* – Amendments resulting from April 2009 Annual Improvements to IFRSs	January 1, 2010
IFRS 9 – *Financial Instruments*	January 1, 2013
IAS 1 – *Presentation of Financial Statements* – Amendments resulting from April 2009 Annual Improvements to IFRSs	January 1, 2010
IAS 7 – *Statement of Cash Flows* – Amendments resulting from April 2009 Annual Improvements to IFRSs	January 1, 2010
IAS 17 – *Leases* – Amendments resulting from April 2009 Annual Improvements to IFRSs	January 1, 2010
IAS 36 – *Impairment of Assets* – Amendments resulting from April 2009 Annual Improvements to IFRSs	January 1, 2010
IAS 39 – *Financial Instruments: Recognition and Measurement* – Amendments for embedded derivatives when reclassifying financial instruments	July 1, 2009
IAS 39 – *Financial Instruments: Recognition and Measurement* – Amendments for eligible hedged items	July 1, 2009
IAS 39 – *Financial Instruments: Recognition and Measurement* – Amendments resulting from April 2009 Annual Improvements to IFRSs	January 1, 2010

These amendments will be adopted in the Bank's financial statements for periods beginning on or after January 1, 2010. The potential impact of the adoption of these amendments is being assessed and shall be reported in the 2010 financial statements.

CLASSIFICATION OF ASSETS AND LIABILITIES IN THE STATEMENT OF FINANCIAL POSITION

In the current year, the Bank has classified assets and liabilities in the Statement of Financial Position into foreign and domestic. The comparative information has been amended to conform to the current year classification. This was done to better communicate the composition of the Bank's assets and liabilities.

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2009

FINANCIAL INSTRUMENTS

General

Financial instruments carried on the Statement of Financial Position include all assets and liabilities, including derivative instruments, but exclude property and equipment.

Financial Assets

Financial assets are classified into the following specified categories: financial assets as "at fair value through profit or loss" (FVTPL) (including held for trading), "available-for-sale" and "loans and receivables". The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition as detailed below.

Financial assets measured as at "FVTPL" are stated at fair value, with any resultant gain or loss recognised in the Statement of Comprehensive Income. The net gain or loss recognised in profit or loss incorporates any dividend or interest earned on the financial asset.

Short-term Investments (Liquidity Portfolio)

The Bank has designated the Liquidity Portfolio as a fund in which money market instruments and bonds are invested to facilitate payments for regular transactions.

Securities invested in this portfolio are measured "at fair value through profit or loss" and are classified as held for trading. They are initially recognised at cost and are subsequently remeasured at market value based on bid prices. All related realised and unrealised gains and losses are recognised in the Statement of Comprehensive Income.

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

Long-term Investments (Pula Fund)

This is a long-term fund intended to maximise returns and is invested in foreign financial instruments with a long-term duration. These investments, which may be sold in response to needs for liquidity, changes in interest rates, exchange rates, etc., are classified as "available-for-sale", except for derivatives. These securities are initially recognised at cost (which includes transaction costs) and are subsequently remeasured at market value, based on bid prices.

All realised and unrealised market and currency gains/losses are taken to the Statement of Comprehensive Income. However, in line with the Bank's policy, exchange gains/losses for this fund are not distributable and are, therefore, appropriated to the Currency Revaluation Reserve.

Unrealised revaluation gains and losses arising from changes in the market value of the instruments classified as "available-for-sale" are undistributable as per the Bank's policy and are appropriated to the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated market value or impairment adjustments are included in the Statement of Comprehensive Income as gains or losses from investment securities.

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

December 31, 2009

FINANCIAL INSTRUMENTS (Continued)

Government of Botswana Bonds

The Bank acquires Government of Botswana Bonds for purposes of facilitating orderly trading in the local bond market. The bonds, which may be sold in response to needs to intervene in the market, are classified as "available-for-sale" securities.

The bonds are initially recognised at cost and are subsequently remeasured at market value, based on bid prices. All unrealised gains and losses arising from changes in the market value are recognised in the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated market value adjustments are included in the Statement of Comprehensive Income as gains or losses from Government of Botswana Bonds.

All regular purchases and sales of bonds are recognised at trade date, which is the date that the Bank commits itself to purchase or sell the bonds.

Derivative Financial Instruments

The Bank uses a variety of derivative financial instruments to manage its exposure to interest rate and foreign exchange risk, including interest rate futures, foreign exchange forward contracts, cross-currency swaps and options.

Derivative financial instruments are initially recognised at cost (including transaction costs) and are subsequently remeasured at market value, based on bid prices for assets held or liabilities to be issued, and ask/offer prices for assets to be acquired or liabilities held. The resulting gain or loss is recognised in the Statement of Comprehensive Income.

Impairment of Financial Assets

Financial assets other than loans and receivables are carried at fair value. "Loans and receivables" are assessed for any evidence of impairment at each Statement of Financial Position date. Financial assets are impaired when there is objective evidence that as a result of one or more events that have occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been adversely impacted. For financial assets carried at amortised cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. In respect of "available-for-sale" equity securities, any increase in fair value subsequent to an impairment loss is recognised directly in other comprehensive income.

Financial Liabilities

All the Bank's financial liabilities are classified as other financial liabilities at amortised cost.

Bank of Botswana Certificates

As one of the primary tools for maintaining monetary stability in the economy, the Bank of Botswana issues its own paper, Bank of Botswana Certificates (BoBCs), to absorb excess liquidity in the market and thereby to influence short term interest rates. BoBCs are issued at a discount to counterparties. They are classified as "other financial liabilities".

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2009

FINANCIAL INSTRUMENTS (Continued)

The Bank's liability in respect of BoBCs is stated at offer prices on auction date, adjusted for movements in matured and unmatured discount recognised in the Statement of Comprehensive Income.

Other Financial Liabilities

Other financial liabilities are initially measured at fair value, net of transaction costs.

Other financial liabilities are subsequently measured at amortised cost using the effective interest rate method, with interest expense recognised on the effective yield basis. The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts future cash payments through the expected life of the financial liability, or where appropriate, a shorter period.

SECURED LENDING FACILITY

Under the Secured Lending Facility (SLF), the Bank provides emergency and intermittent funding to solvent financial institutions, intended to bridge overnight liquidity shortages. The advances are secured by Government of Botswana Bonds and Bank of Botswana Certificates (BoBCs), valued at market prices on the date of the transaction. Only high quality, marketable and freely transferable paper with a minimum amount of risk is acceptable as collateral at the discretion of the Bank. Government and Government guaranteed securities of any maturity and other eligible paper with a remaining maturity of 184 days or less are also acceptable as security. The Bank has the right to call for additional collateral, should the value of the security decline during the tenure of the facility. Interest earned on the advances is credited to the Statement of Comprehensive Income, while advances outstanding as at the Statement of Financial Position date are recorded under the heading "Advances to Banks".

SECURITIES LENDING PROGRAMME

The Bank takes part in a Securities Lending Programme. Where securities are lent, the Bank holds collateral in the form of cash or other securities. The securities lent continue to be recorded in the Bank's Statement of Financial Position.

The Bank's global custodian administers the Securities Lending Programme and monitors the securities lent and related collateral against requirements agreed by the Bank.

The Bank records income from lending securities as it accrues.

REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

This facility is one of the mechanisms designed to deal with short-term liquidity fluctuations in the domestic money market. It is available to primary counterparties who are solvent institutions licensed and supervised by the Bank.

Securities purchased or repurchased under the Repurchase Agreement are included or netted off against outstanding BoBCs liabilities, respectively.

The term of a repurchase agreement and reverse repurchase agreement can vary from overnight to one month, depending on the liquidity conditions in the domestic market.

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

December 31, 2009

FINANCIAL INSTRUMENTS (Continued)

Interest earned by the Bank on repurchase agreements is credited to the Statement of Comprehensive Income, while interest paid by the Bank on reverse repurchase agreements is charged to the Statement of Comprehensive Income.

FOREIGN CURRENCIES

All transactions denominated in foreign currencies are translated to Pula at the bid rates of exchange for all sales, and offer rates of exchange for all purchases, at the transaction date.

Where amounts denominated in one foreign currency are sold in order to buy other foreign denominated currency such that neither profit nor loss is realised on the transaction, mid exchange rates are used.

All assets and liabilities denominated in foreign currencies are translated to Pula using the bid and offer rates of exchange, respectively, at the close of the financial year. All exchange gains/losses realised on disposal of financial instruments and unrealised exchange gains/losses arising on translation are included in the Statement of Comprehensive Income. However, all gains and losses relating to disposals whose proceeds are reinvested in foreign assets, and all the unrealised gains/losses arising on financial instruments are not considered distributable in terms of Bank policy; they are appropriated to the Currency Revaluation Reserve.

ASSETS, LIABILITIES AND RECOGNITION OF PROVISIONS

Assets

Assets are recognised when the Bank obtains control of a resource as a result of past events, and from which future economic benefits are expected to flow to the Bank.

Contingent Assets

The Bank discloses a contingent asset arising from past events where it is probable that economic benefits will flow from it, but this will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events outside the control of the Bank.

Liabilities and Provisions

The Bank recognises liabilities (including provisions) when:

(a) it has a present legal obligation resulting from past events;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle this obligation; and

(c) a reliable estimate of the amount of the obligation can be made.

Derecognition of Assets and Liabilities

The Bank derecognises a financial asset when it loses control over the contractual rights that comprise the asset and transfers substantially all the risks and benefits associated with the asset. This arises when the rights are realised, expire or are surrendered. A financial liability is derecognised when it is legally discharged.

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2009

FINANCIAL INSTRUMENTS (Continued)

INCOME AND EXPENSE RECOGNITION

Interest income and expense and dividend income are recognised in the Statement of Comprehensive Income on an accrual basis.

OFFSETTING FINANCIAL INSTRUMENTS

The Bank offsets financial assets and liabilities and reports the net balance in the Statement of Financial Position where:

(a) there is a legally enforceable right to set off;

(b) there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously;

(c) the maturity date for the financial assets and liability is the same; and

(d) the financial asset and liability are denominated in the same currency.

GENERAL RESERVE

Under Section 7(1) of the Bank of Botswana Act, (CAP 55:01), the Bank of Botswana is required to establish and maintain a General Reserve sufficient to ensure the sustainability of future operations of the Bank. The Bank may transfer to the General Reserve funds from other reserves, which it maintains, for the purposes of maintaining the required level of the General Reserve.

CURRENCY REVALUATION RESERVE

Any changes in the valuation, in terms of Pula, of the Bank's assets and liabilities in holdings of Special Drawing Rights and foreign currencies as a result of any change in the values of exchange rates of Special Drawing Rights or foreign currencies and in realised currency gains reinvested in foreign assets are transferred to the Currency Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

MARKET REVALUATION RESERVE

Any changes in the value of the Bank's long-term investments as a result of any change in the market values of such investments are transferred to the Market Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost less related accumulated depreciation and any accumulated impairment losses.

Land and buildings are valued on a fair value basis every two years, and the recoverable (revalued) amounts

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

December 31, 2009

PROPERTY AND EQUIPMENT (Continued)

disclosed by way of a note to the Financial Statements, providing that revalued amounts are in excess of the carrying amounts. Where the carrying amounts are more than the revalued amounts, an impairment loss is recognised in the Statement of Comprehensive Income.

At each Statement of Financial Position date, the Bank reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any).

Any impairment loss is recognised immediately in the Statement of Comprehensive Income.

Where an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years.

Depreciation

Depreciation is charged so as to write-off the cost or valuation of assets less residual values, other than land and buildings under construction, over their estimated useful lives, using the straight-line method. The estimated useful lives, residual values and depreciation methods are reviewed at each year end, with the effect of any changes in the estimate accounted for on a prospective basis.

The annual depreciation rates used in the calculation of depreciation are as follows:

	Percent
Buildings	2.5
Furniture, fixtures and equipment	5 – 50
Computer hardware	25
Computer software	20
Motor vehicles – Commercial	20 – 25
– Bullion truck	5

A gain or loss arising on disposal or retirement of an item of property and equipment is determined as the difference between the net sales proceeds and the carrying amount of the asset and is recognised in the Statement of Comprehensive Income.

RETIREMENT BENEFITS

Pension benefits are provided for employees through the Bank of Botswana Defined Contribution Staff Pension Fund, which is governed in terms of the Pension and Provident Funds Act (CAP 27:03). The contribution per pensionable employee is at the rate of 21.5 percent which comprises 16 percent and 1.5 percent payable by the Bank as its contribution to the Fund and for administration costs of the Fund, respectively, and a 4 percent contribution by each pensionable employee. Other than the contributions made, the Bank has no commitments or obligations to this Fund.

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2009

FINANCE LEASES

The Bank classifies leases of land, property and equipment where it assumes substantially all the benefits and risks of ownership as finance leases. Finance leases are capitalised at the estimated net present value of the underlying lease payments. The Bank allocates each lease payment between the liability and finance charges to achieve a constant periodic rate of interest on the finance balances outstanding for each period. The interest element of the finance charges is charged to the Statement of Comprehensive Income over the lease period. The land, property and equipment acquired under finance leases are depreciated over the useful lives of the assets, on the basis consistent with similar property and equipment.

RELATED PARTY TRANSACTIONS

The Bank enters into various transactions with other wholly owned or partly owned Government institutions and its key management personnel (related parties). All related party transactions are entered into at arm's length in the ordinary course of business. The transactions with key management personnel are staff benefits provided for in the General Conditions of Service of the Bank.

SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Useful Lives of Property and Equipment

Management reviews the estimated useful lives of plant and property at the end of each annual reporting period. In this financial year, no change was made to the useful lives hence the depreciation rates provided are similar with the prior year.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

December 31, 2009

	2009 P'000	2008 P'000
1. FOREIGN EXCHANGE RESERVES		
1.1 Liquidity Portfolio		
Bonds – held for trading	4 943 263	4 835 556
Amounts Due from Pula Fund	1 050 020	1 359 185
Cash and Cash Equivalents	7 236 098	10 163 443
	13 229 381	16 358 184
1.2 Pula Fund		
Equities – available–for–sale	9 543 049	8 305 959
Bonds – available–for–sale	32 985 460	41 371 065
Derivative Financial Instruments – assets (Note 13)	18 454	2 344
Amounts Due to Liquidity Portfolio	(1 050 020)	(1 359 185)
Derivative Financial Instruments – liabilities (Note 13)	(12 950)	(27 178)
Cash and Cash Equivalents	2 045 668	3 333 101
	43 529 661	51 626 106
Statement of Financial Position		
Capital Employed		
Government	21 818 442	30 455 753
Bank of Botswana	21 711 219	21 170 353
	43 529 661	51 626 106
Employment of Capital		
Investments	43 529 661	51 626 106
Investments expressed in US dollars ('000)	6 542 508	6 861 109
Investments expressed in SDR ('000)	4 183 200	4 470 820
Statement of Comprehensive Income		
Income		
Interest and dividends	1 517 559	1 831 760
Realised currency revaluation gains	1 502 233	5 181 996
Unrealised currency revaluation gains	–	2 644 041
	3 019 792	9 657 797
Expenses		
Unrealised currency revaluation losses	(4 520 650)	–
Realised market losses	(163 457)	(561 630)
Administration charges	(97 684)	(100 923)
	(4 781 791)	(662 553)
Net (loss)/income for the year	(1 761 999)	8 995 244
Other Comprehensive Income/(Losses)		
Net unrealised currency (losses)/gains on non–monetary "available–for–sale" financial instruments	(1 409 838)	1 214 535
Net unrealised market gains/(losses) on "available–for–sale" financial instruments	707 416	(1 825 190)
Other comprehensive losses for the year	(702 422)	(610 655)
Total comprehensive (loss)/income for the year	(2 464 421)	8 384 589

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

	2009 P'000	2008 P'000
2. INTERNATIONAL MONETARY FUND (IMF)		
2.1 Reserve Tranche		
This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is the membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holding of Pula by the IMF, which initially was equal to 75 percent of the quota, has changed from time to time as a result of the use of the Pula by the IMF in lending to member countries.		
Quota (SDR 63 000 000)	655 567	727 483
Less: IMF Holdings of Pula	(537 525)	(629 592)
Reserve Position in IMF	118 042	97 891
The IMF Holdings of Pula are represented by the Non-Interest Bearing Note of P165 324 000 (2008 – P165 324 000) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in the current account held at the Bank (included in other deposits in Note 8).		
2.2 Holdings of Special Drawing Rights		
The balance on the account represents the value of Special Drawing Rights (SDR) allocated and purchased less utilisation to date.	966 292	457 728
During the year, the IMF made a special allocation as a result of the Fourth Amendment to the IMF Articles of Agreement and also made a general allocation to the Fund's member countries to supplement their foreign exchange reserves and to provide liquidity to the global economic system. Botswana was allocated P565.3 million (SDR 53.1 million).		
2.3 Administered Funds		
This relates to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust. The amount represents SDR 6.2 million (and interest accrued thereon) lent on May 20, 2008, to the Poverty Reduction Growth Facility/Heavy Indebted Poor Countries Trust Fund, a fund administered in trust by the IMF. This matures on May 20, 2013	64 692	71 814
2.4 Allocation of Special Drawing Rights (IMF)		
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana	599 118	50 756

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

3. **PROPERTY AND EQUIPMENT**	**Freehold Land P'000**	**Leasehold Land P'000**	**Buildings P'000**	**Capital Works in Progress P'000**	**Other Assets P'000**	**Total P'000**
Cost – 2009						
Balance at the beginning of the year	780	4 368	140 977	17 044	82 603	245 772
Additions	–	–	–	12 955	12 855	25 810
Disposals	–	–	–	–	(3 826)	(3 826)
Transfers	–	–	10 332	(19 428)	9 096	–
Balance at year–end	780	4 368	151 309	10 571	100 728	267 756
Accumulated Depreciation						
Balance at the beginning of the year	–	–	44 201	–	53 926	98 127
Charge for the year	–	–	3 570	–	8 718	12 288
Disposals	–	–	–	–	(3 441)	(3 441)
Balance at year–end	–	–	47 771	–	59 203	106 974
Net book value at December 31, 2009	780	4 368	103 538	10 571	41 525	160 782
Cost – 2008						
Balance at the beginning of the year	607	3 659	140 721	5 817	92 190	242 994
Reclassification	173	(173)	–	–	–	–
Additions	–	–	–	12 365	5 267	17 632
Disposals	–	–	–	–	(14 854)	(14 854)
Transfers	–	882	256	(1 138)	–	–
Balance at year–end	780	4 368	140 977	17 044	82 603	245 772
Accumulated Depreciation						
Balance at the beginning of the year	–	–	40 683	–	59 241	99 924
Charge for the year	–	–	3 518	–	9 205	12 723
Disposals	–	–	–	–	(14 520)	(14 520)
Balance at year–end	–	–	44 201	–	53 926	98 127
Net book value at December 31, 2008	780	4 368	96 776	17 044	28 677	147 645

Revaluation of Properties

Freehold and leasehold land and buildings were valued by an independent professional property valuer in December 2008 at an open market value of P179 460 000.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

	2009 P'000	2008 P'000
4. GOVERNMENT OF BOTSWANA BONDS – available-for-sale		
(i) Government Bond BW004 purchased on March 7, 2008, maturing on March 12, 2011 bearing interest at the rate of 10.50 percent, receivable semi-annually in arrears:		
Market value	20 698	19 884
Interest accrued	644	644
	21 342	20 528
(ii) Government Bond BW005 purchased on September 10, 2008, maturing on September 12, 2018 bearing interest at the rate of 10 percent, receivable semi-annually in arrears:		
Market value	23 083	19 877
Interest accrued	614	614
	23 697	20 491
	45 039	41 019
5. OTHER ASSETS		
Staff loans and advances	79 871	73 368
Prepayments	3 952	1 769
Advances to Banks	3 050	-
Other	12 229	16 949
	99 102	92 086
6. NOTES AND COIN IN CIRCULATION		
Notes	1 570 173	1 510 415
Coin	89 014	83 555
	1 659 187	1 593 970

Notes and coin in circulation held by the Bank as cash in hand at the end of the financial year have been netted off against the liability for notes and coin in circulation to reflect the net liability to the public

	2009 P'000	2008 P'000
7. BANK OF BOTSWANA CERTIFICATES – other financial liabilities		
Face Value	17 087 390	17 642 140
Unmatured Discount	(57 075)	(88 225)
Carrying Amount	17 030 315	17 553 915

Bank of Botswana Certificates are issued at various short-term maturity dates and discount rates.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

	2009 P'000	2008 P'000
8. DEPOSITS		
Government	909 779	865 924
Bankers	1 658 508	1 478 879
Other	1 299 751	720 500
	3 868 038	3 065 303

These represent current accounts of Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free

9. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)

	2009 P'000	2008 P'000
This balance represents the Bank's liability to the Government in respect of the Reserve Tranche position in the IMF (Note 2.1).	118 042	97 891

10. DIVIDEND TO GOVERNMENT

	2009 P'000	2008 P'000
Balance due at the beginning of the year	325 500	226 500
Dividend to Government from Pula Fund	1 000 000	1 302 000
Paid during the year	(1 075 500)	(1 203 000)
Balance due at the end of the year	250 000	325 500

The final instalment of the pre-set dividend of P250 million unpaid as at December 31, 2009 was provided for in accordance with Section 6 of the Bank of Botswana Act (CAP 55:01).

11. OTHER LIABILITIES

	2009 P'000	2008 P'000
Accounts payable	5 104	4 187
Other creditors and accruals	49 054	52 591
	54 158	56 778

12. CATEGORIES OF FINANCIAL INSTRUMENTS

	2009 P'000	2008 P'000
Financial Assets		
Held for trading		
Bonds		
Derivative Financial Instruments	4 943 263	4 835 556
	18 454	2 344
Available-for-sale		
Bonds	32 985 460	41 371 065
Equities	9 543 049	8 305 959
Government Bonds	45 039	41 019
Loans and Receivables		
IMF Reserves	1 149 026	627 433
Staff loans and advances	79 871	73 368
Cash and cash equivalents	9 281 766	13 496 544
Total Financial Assets	58 045 928	68 753 288
The above is disclosed in the Statement of Financial Position as follows:		
Total Foreign Exchange Reserves	57 908 068	68 611 723
Add: Derivative Financial Instruments (liabilities)	12 950	27 178
Government of Botswana Bonds	45 039	41 019
Other Assets - staff loans and advances (Note 5)	79 871	73 368
	58 045 928	68 753 288

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

12. CATEGORIES OF FINANCIAL INSTRUMENTS (Continued)

	2009 P'000	2008 P'000
Financial Liabilities		
Held for trading		
Derivative Financial Instruments	12 950	27 178
Other Financial Liabilities - at amortised cost		
Bank of Botswana Certificates	17 030 315	17 553 915
Allocation of SDR (IMF)	599 118	50 756
Liabilities to Government (IMF)	118 042	97 891
Deposits	3 868 038	3 065 303
Dividend to Government	250 000	325 500
Other Liabilities	54 158	56 778
	21 932 621	21 177 321

13. DERIVATIVE FINANCIAL INSTRUMENTS

The Bank's investment guidelines authorise the use of derivative instruments. The derivatives are held for managing risk.

The Table below shows the market values and the total notional exposures of derivative financial instruments as at year end.

		Asset 2009 (P'000)	Liabilities 2009 (P'000)	Notional Amount 2009 (P'000)	Assets 2008 (P'000)	Liabilities 2008 (P'000)	Notional Amount 2008 (P'000)
Fixed Income Futures	-Buy	–	(12 641)	463 004	–	(20 406)	1 405 133
	-Sell	15 308	–	498 594	–	(4 895)	186 510
Currency Futures	-Buy	2 399		292 324	–	–	–
	-Sell	–	–	–	479	–	38 986
Currency Options	-Sell	–	–	–	848	–	848
Other Options	-Sell	51	–	161	–	(1 877)	941
Swaps	-Buy	–	(309)	963	565	–	1 891
	-Sell	696	–	696	452	–	2 415
		18 454	(12 950)	1 255 742	2 344	(27 178)	1 636 724

The above derivatives are classified by type of asset and derivative instruments. The assets and liabilities reflect the net position between the market values and the notional amounts.

Futures
A futures contract is an agreement executed on the floor of an exchange to buy or sell a specific amount of a security or cash at a specified price and time. A fixed income futures contract would be an agreement to either buy or sell a specified amount of a fixed income security at a specified price and date, while a currency futures contract will be an agreement to either buy or sell a specified amount of currency at a specified exchange rate and date. Futures contracts are collateralised by cash or marketable securities and changes in the futures contract value are settled daily.

Options
An option is an exclusive right, usually obtained for a fee, but not the obligation to buy or sell a specific financial instrument within a specified time. A fixed income option is the exclusive right to either buy or sell specified units of a fixed income security by a specific date. A currency option is an option to either buy or sell a specified currency by a specific date.

Swaps
A swap is an agreement between two or more parties to exchange sets of cash flows over a period in the future, typically either in the form of interest rate swaps or currency swaps. The cash flows that the counterparties make are linked to the value of the underlying debt financial instrument or the foreign currency, as the case may be.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

	2009 P'000	2008 P'000
14. PAID-UP CAPITAL		
Authorised and Paid-up Capital	25 000	25 000

The capital is the amount subscribed by the Government in accordance with Section 5 of Bank of Botswana Act (CAP 55:01). The Bank is not subject to any externally imposed capital requirements. Therefore, capital is not actively managed. Management considers the Paid-up Capital and the General Reserve to be capital.

15. GENERAL RESERVE

In the opinion of the Board, the General Reserve, taken together with other reserves which the Bank maintains, is sufficient to ensure the sustainability of future operations of the Bank.

	2009 P'000	2008 P'000
	1 600 000	1 600 000
16. INTEREST – FOREIGN EXCHANGE RESER VES		
Liquidity Portfolio		
Cash and cash equivalents	179 064	758 892
Bonds – held for trading	169 119	172 210
IMF Reserves – loans and receivables	3 129	11 477
Pula Fund		
Cash and cash equivalents	28 014	128 986
Bonds – available-for-sale	1 280 632	1 420 343
	1 659 958	2 491 908
17. DIVIDENDS – FOREIGN EXCHANGE RESERVES		
Pula Fund		
Equities – available-for-sale	208 913	282 431
18. NET MARKET (LOSSES)/GAINS ON DISPOSAL OF SECURITIES		
Liquidity Portfolio		
Bonds – held for trading	48 640	35 396
Pula Fund		
Derivative instruments – held for trading	(13 485)	147 409
Bonds – available-for-sale	707 837	310 159
Equities – available-for-sale	(857 809)	(1 019 198)
	(114 817)	(526 234)

Included above are net market losses of P149 972 000 (2008 : P709 039 000 losses) which have been recycled from equity on disposal of investments classified as available-for-sale.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

	2009 P'000	2008 P'000
19. NET REALISED CURRENCY (LOSSES)/GAINS		
Liquidity Portfolio		
Cash and cash equivalents	(279 345)	1 963 549
Bonds – held for trading	106 610	282 792
Pula Fund		
Derivative instruments – held for trading	91 689	1 280
Cash and cash equivalents	(133 305)	690 703
Bonds – available-for-sale	1 102 384	3 468 245
Equities – available-for-sale	441 465	1 021 768
	1 329 498	7 428 337

Included above are net currency gains of P1 543 849 000 (2008 : P4 490 013 000 gains) which have been recycled from equity on disposal of investments classified as available-for-sale.

	2009 P'000	2008 P'000
20. NET UNREALISED CURRENCY (LOSSES)/GAINS		
Liquidity Portfolio		
Cash and cash equivalents	(36 603)	(49 761)
Bonds – held for trading	(677 099)	443 009
IMF reserves - loans and receivables	(48 725)	79 516
Pula Fund		
Cash and cash equivalents	69 438	(47 142)
Bonds – available-for-sale	(4 590 058)	2 751 792
Derivative instruments – held for trading	(30)	(60 609)
	(5 283 077)	3 116 805
21. NET UNREALISED MARKET (LOSSES)/GAINS		
Liquidity Portfolio		
Bonds – held for trading	(127 166)	83 893
Pula Fund		
Derivative instruments – held for trading	(227)	34 693
	(127 393)	118 586
22. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	1 622 466	2 062 237
Debswana Tax Holding Account	–	33 255
Reverse Repurchase Agreements	27 143	32 317
	1 649 609	2 127 809

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

	2009 P'000	2008 P'000
23. NET CURRENCY REVALUATION (LOSSES)/GAINS RECOGNISED IN THE STATEMENT OF COMPREHENSIVE INCOME		
Total net realised gains (Note 19)	1 329 498	7 428 337
Total net unrealised (losses)/gains (Note 20)	(5 283 077)	3 116 805
Total net currency revaluation (losses)/gains taken to the Statement of Comprehensive Income	(3 953 579)	10 545 142
Appropriated to Currency Revaluation Reserve:		
Net realised and reinvested in foreign assets	(1 239 684)	(6 952 484)
Net unrealised currency (losses)/gains	5 283 077	(3 116 805)
Transferred from/(to) Currency Revaluation Reserve	4 043 393	(10 069 289)
Net currency revaluation gains retained in the Statement of Comprehensive Income	89 814	475 853

24. CONTRIBUTION TO THE BANK OF BOTSWANA DEFINED CONTRIBUTION STAFF PENSION FUND

The Bank's contribution to the Bank of Botswana Defined Contribution Staff Pension Fund for the year ended December 31, 2009 is P14 312 000 (2008: P13 099 000).

25. STATEMENT OF CASH FLOWS

The definition of cash in IAS 7 is not wholly appropriate to the Bank. Due to its role in the creation and withdrawal of currency in circulation, the Bank has no cash balances on its Statement of Financial Position (also see Note 6). However, the Bank has the ability to create cash when needed.

	2009 P'000	2008 P'000
26. CASH GENERATED BY OPERATIONS		
Net (loss)/income for the year adjusted for:	(4 071 112)	10 925 216
Net realised and unrealised exchange losses/(gains)	4 043 393	(10 069 289)
Depreciation expense	12 288	12 723
Loss on disposal of Property and Equipment	77	38
Interest – Government of Botswana Bonds	(4 100)	(5 814)
Operating cash flows before movements in working capital	(19 454)	862 874
Increase in Deposits – banks and other	758 880	524 316
Increase in Deposits – Government	43 855	157 293
(Decrease)/Increase in Bank of Botswana Certificates	(523 600)	937 699
(Increase)/Decrease in other assets	(7 016)	1 399
Decrease in other liabilities	(2 620)	(4 898)
Cash generated by operations	250 045	2 478 683

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

	2009 P'000	2008 P'000
27. CAPITAL COMMITMENTS		
Approved and contracted for	3 854	19 592
Approved, but not contracted for	130 488	22 288
	134 342	41 880

These capital commitments will be funded from internal resources.

28. COLLATERAL

(i) Secured Lending Facility

There were open positions of P3.1 million (2008 : nil) under the Secured Lending Facility at the year-end, accounted for as "Advances to Banks" and corresponding collateral of P25.6 million held by the Bank at the Statement of Financial Position date.

(ii) Securities Lending Programme

Under the Bank's Securities Lending Programme, the Bank has lent securities with a fair value of P11.8 billion (2008: P11.3 billion). The Bank has accepted securities with a fair value of P12.2 billion (2008: P11.6 billion) as collateral for the securities lent under this programme.

29. GOVERNMENT OF BOTSWANA BONDS AND TREASURY BILLS

In accordance with Sections 56 and 57 of the Bank of Botswana Act (CAP 55:01), the Bank acts as agent of the Government for the issuance and management of the Government Bonds and Treasury Bills. An analysis of the bonds and treasury bills issued is provided below:-

Government of Botswana Bonds and Treasury Bills issued as at December 31, 2009

Bond/Treasury Bill Detail	BW 003	BW 004	BW 005	BW 006	BW 100310	
Date of Issue	May 6, Nov 3, 2003 and Sept 10, 2008, Mar 11 and Sept 9, 2009	Mar 12 and Sept 10, 2008 and Mar 11, 2009	Mar 12, Sept 10, 2008 and Mar 11 and Sept 9, 2009	Sept 9, 2009	Sept 9, 2009	
Date of Maturity	Oct 31, 2015	Mar 12, 2011	Sept 12, 2018	Mar 9, 2012	Mar 10, 2010	Total
Interest Rate (per annum)	10.25 percent	10.50 percent	10.00 percent	7.50 percent	7.54 percent	
	P'000	P'000	P'000	P'000	P'000	P'000
Nominal Value	1 250 000	700 000	850 000	300 000	1 000 000	4 100 000
Net (Discount)/Premium	(2 510)	3 092	26 785	539	(35 590)	(7 684)
Net Proceeds	1 247 490	703 092	876 785	300 539	964 410	4 092 316
Interest Paid to Date	617 563	94 500	95 000	–	–	807 063
Interest Accrued	21 945	22 538	26 062	7 086	22 830	100 461

(i) Net proceeds realised from the issue of the bonds were invested in the Government Investment Account.

(ii) Interest is payable on all bonds on a semi-annual basis in arrears. During the year to December 31, 2009 total interest payments of P326 903 000 were made (2008 – P210 458 000) and were funded from the Government's current account maintained with the Bank.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS

Risk is inherent in the Bank's management of financial instruments which are comprised primarily of foreign exchange reserves, which are held in various financial instruments. This risk is managed through a process of ongoing identification, measurement and monitoring that is subject to an extensive framework of risk limits and other controls. The process of risk management is critical to the Bank's ongoing operations, with the day to day management of the financial instruments being conducted by the Financial Markets Department. A key element in the risk management of the foreign exchange reserves is safety, defined as the preservation of purchasing power of the foreign exchange reserves. To this end, the Bank has continued to pursue a conservative and diversified investment strategy, with an SDR weighted currency allocation as the benchmark. The Bank's objectives, policies and procedures for managing the risk exposures and the method used to measure the risks have remained consistent with the prior year. The Bank's overall framework has served the Bank well during the challenging times in 2008 and 2009 through strict adherence to objectives and policies. The risk management framework remains sound and effective.

Risk Management Governance Structure

The Bank's risk management governance structure is broadly as follows:

(i) Board

The Board is responsible for the Bank's overall risk management and for approving investment policies and guidelines. The Bank's management reviews the risk management policies from time to time.

(ii) Investment Committee

The Investment Committee, which is chaired by the Governor and comprises representatives from relevant areas of the Bank, meets regularly to review developments in the international financial and capital markets. Where necessary, the Investment Committee makes decisions on Bank managed portfolios. The Investment Committee also monitors the performance of the external fund managers.

(iii) Financial Markets Department

The Financial Markets Department is responsible for the management of the foreign exchange reserves and has a specialised Risk Management Unit focusing on the risks associated with all the investment portfolios and ensures compliance with Investment Guidelines.

(iv) Segregation of Duties

At an operational level, the main feature of risk control is the segregation of duties relating to dealing, settlement, risk monitoring and recording. These responsibilities are split among three Departments: Financial Markets, Payments and Settlement and Accounting and Planning.

Tranching of Foreign Exchange Reserves – Liquidity Portfolio and Pula Fund

The Bank of Botswana Act (CAP 55:01) requires the Bank to maintain a primary international reserve, that is, the Liquidity Portfolio, while Section 35 provides for the establishment and maintenance of a long-term investment fund, the Pula Fund. In compliance with the statutory requirements, a major feature of the foreign exchange reserves management strategy is, therefore, to allocate a certain level of reserves to the Liquidity Portfolio, with the remaining amount invested in the Pula Fund.

Pula Fund

Investments of the Pula Fund comprise long-term assets, such as long-dated bonds and equities actively traded in liquid markets, with the expectation of earning a higher return than could be achieved on conventionally managed investments. The asset allocation between bonds and equities is determined using a combination of historical data and assumptions. Exercises are also conducted in respect of the Pula Fund risk/return sensitivity analysis, using different portfolio options, where risk is measured by a standard deviation on the rate of return.

Liquidity Portfolio

In terms of the Investment Guidelines, the Liquidity Portfolio gives priority to liquidity over return given the constant need to provide foreign exchange to finance transaction payments. While the eligible investment currencies are similar to those of the Pula Fund, the Liquidity Portfolio is largely invested in the Bank's transaction currencies.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

There are no equities in the Liquidity Portfolio and investment instruments include government bonds of eligible grade currencies issued by AAA–rated supranational and AAA–rated US agencies in eligible currencies; other liquid money market instruments are also eligible.

Types of Risk Exposure

The Bank's Investment Guidelines cover basic types of risk exposures, namely, market risk (currency risk, interest rate risk and equity price risk), credit risk, liquidity and instrument risk. These types of risk apply to both the Pula Fund and the Liquidity Portfolio, but vary in terms of interest rate risk and credit risk.

(i) Currency Risk

The foreign exchange reserves are invested in currencies that are freely convertible, less susceptible to frequent and sharp exchange rate fluctuations and are used in well developed financial markets. The Bank's policy is to invest only in currencies with high ratings assigned by Moody's Investors Service and Standard and Poor's. Through a diversified currency allocation relative to an SDR weighted benchmark, the Bank ensures that the purchasing power of the foreign exchange reserves is preserved. In terms of the Investment Guidelines, a maximum deviation from the neutral level (using the SDR weights as a benchmark) for USD and EUR of 10 percentage points is permitted, while a deviation of up to 5 percentage points on all other currencies is permitted. At the end of 2009, the Bank's total exposure to SDR and related currencies was P55.2 billion (2008: P66.1 billion).

(ii) Interest Rate Risk

Interest rate risk is the possible loss in the value of a fixed income asset resulting from an unexpected and adverse movement in interest rates and a consequent change in price. Interest rate risk is measured by modified duration, which measures the sensitivity of the price of a bond to changes in interest rates expressed in years. The Bank benchmarks the interest rate risk for the Pula Fund (fixed income assets) to reflect the long-term nature of the portfolio with emphasis on higher return. The higher interest rate risk is generally compensated by higher returns expected from longer maturity bonds. The modified duration benchmark will vary over time, as changing market conditions and index weights impact the global modified duration of the index. At the end of 2009, the average modified duration of the fixed income portion of the Pula Fund was 5.8 years (2008: 6.4 years). As the Liquidity Portfolio gives priority to liquidity over return, given the constant need to provide foreign exchange to finance transaction payments, from the Bank's perspective, this portfolio is exposed to minimum interest rate risk. At the end of 2009, the Liquidity Portfolio's average modified duration was 1.5 years (2008: 1.5 years).

(iii) Equity Price Risk

Equity price risk is the risk that the value of equities decrease as a result of changes in the level of equity indices and diminution of value of individual stocks. The geographic allocation of equity exposure follows generally the market capitalisation among the major markets. The investment guidelines stipulate the holding levels of equities. Holdings of more than 5 percent in one company are not permitted. A reasonable spread among the industry sectors is maintained in the portfolio. There are no investments in private placements or unquoted stocks. At the end of 2009, the equity portion of the Pula Fund was P9.5 billion (2008: P8.3 billion).

Market Risk Sensitivity Analysis

The set of assumptions used for each of the risk factors hereunder are not forecasts, but merely "what if" scenarios and the likely impact on the current portfolio, based on selected changes in risk variables over a one year horizon.

The Table below gives an indication of the risk sensitivities of the portfolio to various risk parameters. Assuming that the probability of the beneficial change in the risk variables are as likely to happen as an adverse change, both potential increase and decrease are shown for the indicated scenarios.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

December 31, 2009

Risk Variable	Adverse market change			Beneficial market change	
		Scenario	Effect on Statement of Comprehensive Income (P'000)	Scenario	Effect on Statement of Comprehensive Income (P '000)
Interest Rate Risk		Increase in yields by 50 basis points	(992 969)	Decrease in yields by 50 basis points	992 969
Currency Risk	SDR currencies	Strengthening of the Pula by 1%	(563 478)	Weakening of the Pula by 1%	563 478
	South African rand	Strengthening of the Pula by 1%	(15 603)	Weakening of the Pula by 1%	15 603
Equity Risk	Global Equities	Decline in global equity prices by 5%	(477 152)	Increase in global equity prices by 5%	477 152

December 31, 2008

Risk Variable	Adverse market change			Beneficial market change	
		Scenario	Effect on Statement of Comprehensive Income (P'000)	Scenario	Effect on Statement of Comprehensive Income (P '000)
Interest Rate Risk		Increase in yields by 50 basis points	(1 354 499)	Decrease in yields by 50 basis points	1 354 499
Currency Risk	SDR currencies	Strengthening of the Pula by 1%	(661 398)	Weakening of the Pula by 1%	661 398
	South African rand	Strengthening of the Pula by 1%	(24 719)	Weakening of the Pula by 1%	24 719
Equity Risk	Global Equities	Decline in global equity prices by 5%	(415 298)	Increase in global equity prices by 5%	415 298

The market risk estimates as presented in the Tables above are based on sensitivities to the individual risk factors. The correlation between the risk variables is not reflected in the effect on the Statement of Comprehensive Income.

(iv) Credit risk

This is the risk that would arise if an entity that the Bank conducts business with is unable to meet its financial obligations or in the event of an adverse credit event or default. This may be a commercial bank accepting a deposit, a sovereign, supranational or corporate entity issuing a bond or a counterparty with whom the market participant has contracted to buy or sell foreign exchange or money or capital market instruments. In the Bank's endeavour to control credit risk, it deals with only the best quality institutions or counterparties, as determined by international rating agencies.

Consistent with the Investment Guidelines, the Bank withdraws the invested funds if there has been a downgrade of any institution. In cases where the new lower rating necessitates a lower exposure, funds are withdrawn to ensure that the new limit is not exceeded.

The Bank mitigates credit risk by addressing the following underlying issues:

- Defining eligible investment instruments;
- Pre-qualifying counterparties (financial institutions, brokers/dealers, and intermediaries) doing business with the Bank; and
- Diversifying investment portfolios so as to minimise potential losses from securities or individual issuers.

The Bank has not impaired any of its assets in the current and previous period.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Exposure to Credit Risk

The Table below shows the maximum exposure to credit risk for the components of the Statement of Financial Position, including derivatives. The maximum exposure is shown gross, before the effect of the above mitigation factors.

	Notes	2009 P'000	2008 P'000
Foreign Exchange Reserves			
Liquidity Portfolio			
Bonds – held for trading	1.1	4 943 263	4 835 556
Cash and cash equivalents		8 286 118	11 522 628
Pula Fund			
Bonds – available-for-sale	1.2	32 985 460	41 371 065
Derivative financial instruments – held for trading		18 454	2 344
Cash and cash equivalents		995 648	1 973 916
International Monetary Fund – loans and receivables			
Reserve tranche	2.1	118 042	97 891
Holdings or Special Drawing Rights	2.2	966 292	457 728
Administered Funds	2.3	64 692	71 814
Government of Botswana Bonds – available-for-sale	4	45 039	41 019
Other Assets-staff loans and advances – loans and receivables	5	79 871	73 368
Total		48 502 879	60 447 329

	2009 P'000	2008 P'000
Analysis of Credit Exposure by Class:		
Measured at fair value		
Bonds	37 928 723	46 206 621
Derivatives	18 454	2 344
Government of Botswana Bonds	45 039	41 019
Measured at amortised cost		
IMF Reserves	1 149 026	627 433
Staff advances	79 871	73 368
Cash and cash equivalents	9 281 766	13 496 544
Total	48 502 879	60 447 329

While financial instruments are recorded at fair value, the amounts shown above represent the current credit risk exposure, but not the maximum risk exposure that could arise in future as a result of changes in values.

The Tables below reflect the credit exposure based on the fair value of the assets with counterparties as at December 31, 2009.

Credit Exposure on Bonds

Moodys/S&P Rating	Government (P'000)	Corporate (P'000)	Other (P'000)	2009 Total (P'000)	2008 Total (P'000)
Aaa/AAA	31 174 500	1 772 617	219 068	33 166 185	38 931 356
Aa1/AA+	929 518	289 279	37 602	1 256 399	2 065 951
Aa2/AA	3 261 535	73 301	115 472	3 450 308	4 026 879
A+	31 295	–	–	31 295	–
Other	24 536	–	–	24 536	1 182 435
	35 421 384	2 135 197	372 142	37 928 723	46 206 621

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Credit Exposure to Commercial Bank Deposits (Cash and Cash Equivalents)

Fitch Rating	2009 (P'000)	2008 (P'000)
AAA/F1+	1 500 630	-
AA	7 190	-
A+	157 053	-
A1	2 517 381	7 626 616
A/B1	547 382	104 617
A/B2	268 381	669 845
A/B4	584 232	841 018
AA-	4 462	-
B1	2 657 926	2 851 861
B2	333 516	-
B/C1	2 192	166 212
B/C2	698 549	413 378
Other	2 872	822 997[1]
	9 281 766	13 496 544

Credit Exposure on Securities Lending Programme

The Bank's global custodian manages a securities lending programme as agent of the Bank. Due to the short term nature of the securities lending transactions the collateral received under this programme changes on a short term basis. The securities lending is regulated by a securities lending agreement with the global custodian and follows the general criteria for the Bank's credit exposure. The global custodian monitors the market value of the collateral and where necessary, obtains additional collateral in line with the underlying agreement.

(v) Instrument Risk

Sovereign Bonds

In accordance with the investment guidelines, the Bank invests in eligible instruments that are direct obligations or obligations explicitly guaranteed by governments or local governments of 11 selected sovereign countries that are highly rated by Standard and Poor's and Moody's Investors Service. Exposure limits are assigned to the specific sovereign countries in accordance with the ratings assigned by the credit rating agencies.

Corporate Bonds

The Bank invests in a small proportion of corporate bonds rated Aa2/AA or higher, with the issuer being incorporated and tax resident in a country whose sovereign debt is eligible for investment by the Bank. A reasonable geographical spread of issuers is maintained.

(vi) Liquidity risk

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due, hence liquidity is an intergral part of the Bank's foreign exchange policy. To limit this risk, the Management manages the assets with liquidity in mind and monitors future cash flows and liquidity on a daily basis. The Bank is exposed to daily Pula liquidity requirements on the deposits it holds on behalf of the shareholder, Government of Botswana, the banking system and other clients holding deposits with the Bank (mainly parastatals). For the purpose of managing foreign exchange reserves, the Bank keeps some of its assets in cash, call deposits and other liquid money market instruments to enable the availability of liquidity to meet outflows without incurring undue capital loss and to provide flexibility to respond effectively to changing market requirements.

[1] The figure represents pending trades, derivatives and other receivables.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Financial Liabilities at Undiscounted Cash Flows

The Table below summarises the maturity profile of the Bank's financial liabilities as at December 31, 2009 based on contractual undiscounted repayments obligations.

December 31, 2009	Less than 3 months (P'000)	3–12 months (P'000)	1–5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	17 087 390	–	–	–	17 087 390
Deposits	3 868 038	–	–	–	3 868 038
Allocation of SDR–IMF	–	–	–	599 118	599 118
Liabilities to Government–IMF	–	–	–	118 042	118 042
Dividend to Government	250 000	–	–	–	250 000
Other Liabilities	54 158	–	–	–	54 158
	21 259 586	–	–	717 160	21 976 746

December 31, 2008	Less than 3 months (P000)	3–12 months (P'000)	1–5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	17 642 140	–	–	–	17 642 140
Deposits	3 065 303	–	–	–	3 065 303
Allocation of SDR-IMF	–	–	–	50 756	50 756
Liabilities to Government-IMF	–	–	–	97 891	97 891
Dividend to Government	325 500	–	–	–	325 500
Other Liabilities	56 778	–	–	–	56 778
	21 089 721	–	–	148 647	21 238 368

(vii) Fair value of financial instruments

Fair value of financial instruments carried at amortised cost

The Board considers that the carrying amounts of financial assets and liabilities recognised in the financial statement approximates their fair values.

Valuation techniques and assumptions applied for the purposes of measuring fair value

The fair values of financial assets and financial liabilities are determined as follows.

- The fair values of financial assets and financial liabilities with standard terms and conditions and traded on active liquid markets are determined with reference to quoted market prices (includes listed redeemable notes, bills of exchange, debentures and perpetual notes).
- The fair values of other financial assets and financial liabilities (excluding derivative instruments) are determined in accordance with generally accepted pricing models based on discounted cash flow analysis using prices from observable current market transactions and dealer quotes for similar instruments.
- The fair values of derivative instruments are calculated using quoted prices. Where such prices are not available, a discounted cash flows analysis is performed using the applicable yield curve for the duration of the instruments for non-optional derivatives, and option pricing models for optional derivatives. Foreign currency forward contracts are measured using quoted forward exchange rates and yield curves derived from quoted interest rates matching maturities of the contracts. Interest rate swaps are measured at the present value of future cash flows estimated and discounted based on the applicable yield curves derived from quoted interest rates.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Fair value measurements recognised in the Statement of Financial Position

The following table provides an analysis of financial instruments that are measured subsequent to initial recognition at fair value, grouped into Levels 1 to 3 based on the degree to which the fair value is observable.

- Level 1 fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e., derived from prices).
- Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

	Total	Level 1	Level 2	Level 3
	P'000	P'000	P'000	P'000
Financial assets at fair value through profit or loss				
Bonds	4 943 263	4 943 263	–	–
Derivative Financial Instruments	18 454	–	18 403	51
Available-for-sale financial assets				
Bonds	32 985 460	32 985 460	–	–
Equities	9 543 049	9 543 018	–	31
Government of Botswana Bonds	45 039	45 039	–	–
	47 535 265	47 516 780	18 403	82

There were no transfers between Level 1 and 2 during the period.

The fair value of financial assets categorised as Level 3 is not material to the financial statements. Consequently, the reconciliation of movements in the Level 3 fair value measurements has not been provided.

Other Risks

(viii) External Fund Managers

External fund managers are engaged to complement the Bank's reserve management activity. The fund managers are approved by the Board.

(ix) Custody

The Bank uses the services of a custodian which provides custodial services for the Bank's assets and ensures that the transactions executed by fund managers are settled in a timely manner, consistent with international best practice.

(x) Operational Risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications or lead to financial loss. The Bank cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Bank is able to manage the risks.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

31. RELATED PARTY BALANCES AND TRANSACTIONS

Balances and Transactions with the Government

The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2009, were:

(i) provision of banking services, including holding of the principal accounts of the Government;

(ii) management of the Notes and Coin in issue, including printing and minting of notes and coin; and

(iii) being the Government agent for government bonds and treasury bills.

The aggregate balances in Government accounts are disclosed in Notes 8 to 10.

No charge is made to the Government for provision of these services, except for commissions charged on domestic foreign exchange transactions, which are included in "Profit on domestic foreign exchange deals" in the Statement of Comprehensive Income. This amounted to P82 905 000 (2008: P176 340 000).

The Bank earned interest on its holding of the Government of Botswana Bonds (as described in Note 4) of P4 100 000 (2008: P5 814 000).

Other Related Party Balances and Transactions

(i) Purchases of air tickets amounting to P231 000 (2008: P390 000) were made from Air Botswana, an institution wholly owned by the Government. These were charged to Administration costs in the Statement of Comprehensive Income.

(ii) Amounts due to related parties.

Included in the balance of outstanding "Deposits – Other" in Note 8 are the following balances with Government-owned institutions.

	2009 P'000	2008 P'000
Botswana Savings Bank	4 919	5 611
Botswana Unified Revenue Service	244 038	188 464
Total	248 957	194 075

The amounts outstanding are unsecured and have no fixed repayment terms.

(iii) Remuneration of Key Management Personnel

Key management personnel comprise the Governor, Board Members, Deputy Governors and Heads of Department.

Gross emoluments of the key management personnel are:

	2009 P'000	2008 P'000
Non-Executive Board members	138	116
Executive Management		
Short term benefits	7 330	7 027
Post-employment benefits	420	428
Other long-term employee benefits	777	738
	8 665	8 309

Of the Staff Loans and Advances per Note 5, P2 005 000 (2008: P2 383 000) are attributable to Executive Management.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2009

32. POST BALANCE SHEET EVENTS

At the date of finalisation of the annual financial statements, there were no material events that occurred subsequent to the balance sheet date that require adjustment to or disclosure in the financial statements.

Part B

The Botswana Economy in 2009 and Theme Chapter

Bank of Botswana

CHAPTER 1

THE BOTSWANA ECONOMY IN 2009

1. OUTPUT, EMPLOYMENT AND PRICES

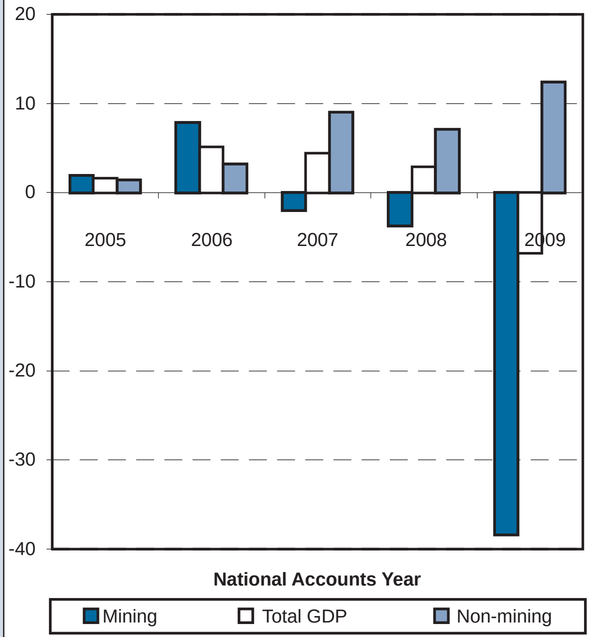
(a) National Income Accounts

Overview

1.1 Preliminary estimates indicate that in the first nine months of 2009 real gross domestic product (GDP) declined by 6.7 percent compared to growth of 2.8 percent in 2008.[1] This lacklustre performance is against the backdrop of the severe global economic recession. Although a gradual recovery has now commenced, such a contraction has a detrimental effect on growth prospects during the period of the tenth National Development Plan (NDP 10), (2009/10 – 2015/16).

1.2 The main impact of the crisis was on the mining sector which, despite some recovery in production from the second quarter onwards, contracted by 38.4 percent in the first nine months of 2009. In contrast, however, non-mining GDP performed strongly in the same period, with growth accelerating from 7.1 percent in 2008 to 12.4 percent, thus countering to some extent the downward pressure exerted on aggregate GDP by lower mining output. As a result, mining accounted for 24 percent of GDP during this period, down from 41.2 percent in 2008.[2]

CHART 1.1: REAL GDP GROWTH 2005 – 2009 (PERCENT)



Source: Central Statistics Office

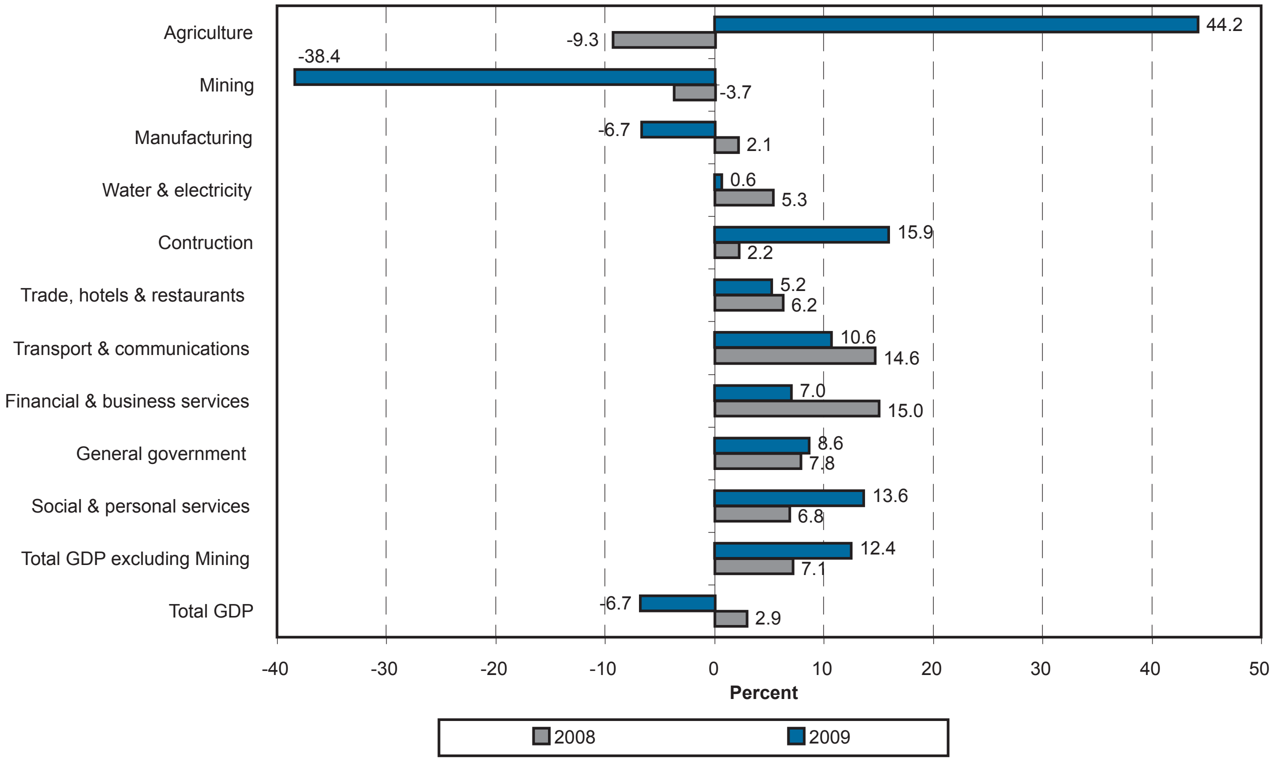
Performance by Economic Sector

1.3 While there had been some trend decline in mining output since 2006 as diamond output reached a plateau, the contraction that commenced in late 2008 was precipitous. Year-on-year, mining sector output contracted by 10.1 percent in the final quarter of 2008 and then by a further 68.6 percent in the first quarter of 2009. Between December 2008 and April 2009, diamond mining was temporarily suspended in response to the slump in external demand for rough diamonds. However, tentative signs of recovery started to emerge in the second quarter of 2009, and mining output more than doubled from the previous quarter as the diamond mines resumed production. Subsequently, prices for rough diamonds continued to strengthen, allowing production to build up more rapidly than had initially been expected. Demand for copper/nickel also improved substantially which resulted in the reopening of the Mowana mine, where

1 The Central Statistics Office (CSO) has moved to reporting annual GDP estimates on a calendar year basis (previously, the national accounts year ran from July to June). This facilitates comparison with other annual economic data and, therefore, is a welcome development. However, at the time of preparing this report, only data up to the third quarter of 2009 were available. Unless stated otherwise, year-on-year growth rates reported for 2009 refer to the first three quarters in comparison with the same period in 2008. For earlier years, the full calendar year is used. Data for the final quarter of 2009 were subsequently received. While this was too late for incorporation in the text, the relevant tables in section 1 of the Statistics Section of this Annual Report have been updated accordingly.

2 The data are in nominal prices. In constant prices, the GDP share of mining fell from 36.7 percent to 25 percent. The larger fall in nominal prices reflects the impact of lower average prices for minerals during this period.

CHART 1.2: REAL GDP GROWTH BY SECTOR 2008 – 2009 (PERCENT)



Source: Central Statistics Office

production had also been suspended. These trends are expected to have continued in the last quarter of the year.

1.4 While the non-mining sector generally performed well, a notable exception was *manufacturing*, where output declined by 6.7 percent in the first three quarters of 2009. This can also be attributed to the impact of the global recession, which undermined the domestic diamond cutting and polishing industry, as well as putting further pressure on local garment manufacturers already struggling to compete against low-cost producers elsewhere.[3] *Water and electricity*, where growth was only 0.6 percent, was also affected by the recession as demand for electricity fell sharply when the diamond mines closed. In addition, power supply continued to be constrained by regional shortages.

1.5 Otherwise, all non-mining sectors achieved significantly positive growth. *Agriculture* is estimated to have grown by 44.2 percent, albeit from a low base, as boosted by favourable weather and enhanced government support for farming. Other sectors which registered growth in excess of 10 percent during this period were *construction* (15.9 percent), *transport and communications* (10.6 percent) and *social and personal services* (13.6 percent). The largest overall contributor to non-mining growth was *general government*, which grew by 8.6 percent,[4] and provided impetus for activity in other sectors, notably construction.

(b) Domestic Economic Outlook

1.6 Since mid-2009, the global economy has shown some signs of recovery, albeit weak, with the recession being both shallower and of shorter duration than initially feared. This can be attributed to continuing growth in the major emerging economies, such as India

3 In the last quarter of 2009, the country's largest garment producer suspended production, prompting the Government to announce that it would introduce a temporary support package including wage subsidies and loan guarantees.

4 Although other sectors grew more rapidly, the large size of government means that this contributed 17.9 percent to total non-mining growth. It was followed by financial and business services (10.3 percent) and construction (9.6 percent).

and China, as well as the impact of fiscal and monetary stimulus packages in major advanced economies. As a result, forecasts have been revised upwards and the International Monetary Fund (IMF) has projected that, after contracting by 0.8 percent in 2009, global GDP will expand by 3.9 percent in 2010 and 4.3 percent in 2011. However, this is strongly dependent on continued expansion of the emerging economies. In advanced economies, the recovery is expected to be sluggish due to high rates of unemployment and slow growth in incomes continuing to constrain consumer demand.

In addition, with existing mines gradually returning to full production, prospecting activity has picked up and several new mining ventures, including diamonds, copper and uranium, are expected to commence operations in the short-to-medium term. However, the expected major coal-related developments have been substantially scaled down due to delays by the South African power utility company, Eskom, in finalising a framework to purchase electricity from independent producers.

1.9 Non-mining output is expected to continue to be robust in the short term, especially since the Government is, for the moment, maintaining an expansionary fiscal stance. A variety of businesses, mainly in the tourism sector, may be expected to derive some benefit from the 2010 Soccer World Cup tournament that is to be hosted by South Africa. However, domestic consumer spending will be constrained in the face of planned tax increases (Section 2) and the effective reduction in real incomes of public sector employees resulting from a civil service wage freeze for the second year running. The Government's diversification strategy is centred on the establishment of several sectoral hubs, which are at various stages of development. This could be supported by further initiatives to improve the business environment which recent surveys indicate continues to face significant

TABLE 1.1: GLOBAL GROWTH ESTIMATES (PERCENT) 2009–2010

	2009	2010[f]	2011[f]
Global	–0.8	3.9	4.3
Advanced economies, of which	–3.2	2.1	2.4
USA	–2.5	2.7	2.4
Euro area	–3.9	1.0	1.6
Japan	–5.3	1.7	2.2
Emerging markets, of which	2.1	6.0	6.3
Africa	1.9	4.3	5.3
China	8.7	10.0	9.7
India	5.6	7.7	7.8

f = forecasts

Source: International Monetary Fund, *World Economic Outlook*, January 2010 update.

1.7 The domestic economy performed more strongly than anticipated in 2009 and, as a result, it appears to have avoided the double digit recession that had been widely projected. However, the resulting contraction has underlined the need to make more sustained progress towards economic diversification. This is in order to reduce the dependence of the domestic economy on mining and government spending by broadening the range of markets, by product and geographically, where Botswana-based producers are able to compete.

1.8 A recovery in mining activity has now commenced and is expected to continue, although it will be some time before the major diamond mines return to full production.

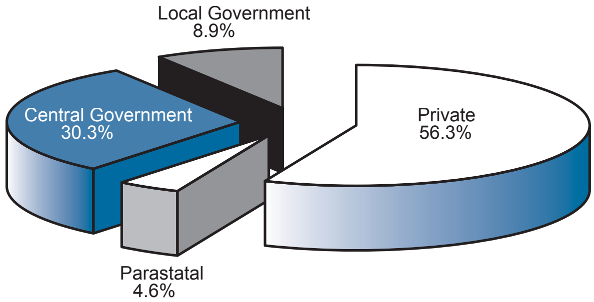
impediments.[5] This will be particularly important as the Government starts to rein in public spending. Construction, in particular, will need to rely increasingly on additional private sector investment. Manufacturing will need to be focused on areas where sustained competitiveness can be achieved and, in this regard, the longer term future of textiles production in Botswana, that appears to rely on special arrangements, remains highly uncertain. While ambitious development projects for agriculture, including major irrigation systems, are in the pipeline, planning and funding are still to be finalised.

(c) Employment

1.10 The most recent estimates for formal sector employment are for March 2009. For the first time, the employment figures include those employed through the *Ipelegeng* programme of labour intensive public works that was introduced in July 2008. However, while this adds an additional 67 000 workers to local government employment, it is important to treat them as a separate category when examining trends in employment.[6]

1.11 Formal sector employment,[7] excluding *Ipelegeng*, is estimated to have increased by 3 percent, from 309 000 to 318 000, between March 2008 and March 2009. Of these, the private and parastatal sectors employed 179 000 and 14 000 workers, respectively, thus accounting for 61 percent of total employment. However, two thirds of the growth was accounted for by Government, where employment rose by 5.1 percent from 118 000 to 124 000. In contrast, private and parastatal employment grew by only 1.8 percent.

CHART 1.3: SECTORAL COMPOSITION OF FORMAL SECTOR EMPLOYMENT (EXCLUDING IPELEGENG) - MARCH 2009 (PERCENT)



Source: Central Statistics Office

1.12 Most industries in the private and parastatal sectors show increased employment.[8] This is with the exception of mining and quarrying, where employment fell by 9.3 percent, while there was also some fall in the number of those employed in agriculture and manufacturing. The loss of jobs in mining reflects the impact of the global recession which resulted in limited layoffs in early 2009. Excluding mining, employment growth was 2.5 percent, although this appears relatively low compared to estimates of non-mining private sector GDP growth over the same period.[9]

(d) Inflation

1.13 In the context of the world economic recession, which significantly depressed demand and resulted in lower commodity prices, inflation in advanced economies fell from 3.4 percent in

5 For instance, the country is ranked 135 out of 155 countries in the World Bank's *Logistics Performance Index* for 2010. This represents a serious impediment to the development of businesses that rely on efficient transport and communications systems.

6 As the 2010 Budget Speech makes clear, the *Ipelegeng* programme differs from typical formal sector employment in crucial respects. It provides temporary work on a rotation basis and replaces work previously offered under drought relief programmes. As a programme to help tackle the consequences of unemployment, it can be misleading to include the beneficiaries in the employment estimates.

7 The estimates of formal sector employment do not include those working for businesses employing less than five people. While this is due to practical difficulties in surveying such businesses, it also means that many small scale enterprises, which are otherwise fully integrated in the formal economy, are not covered.

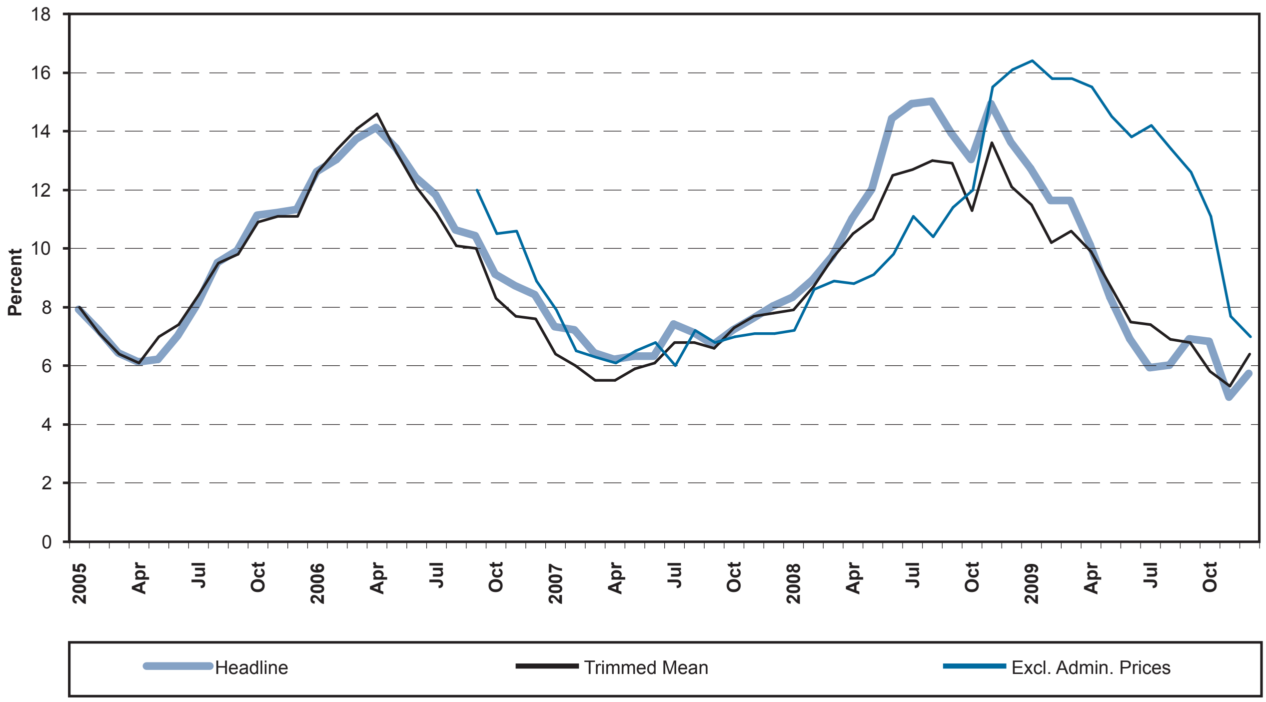
8 However, these changes are often small and may not be statistically significant.

9 Excluding both mining and government, year-on-year GDP growth in the first quarter of 2009 is estimated at 11.2 percent. It is particularly notable that while construction output grew by almost 30 percent, there was no recorded increase in employment.

2008 to 0.1 percent in 2009. Oil prices, which had reached nearly USD150 per barrel in July 2008, fell to USD38 per barrel in December, before recovering to about USD80 per barrel at the end of 2009 due to improved growth prospects, together with the weakening of the US dollar and production cuts. In South Africa, headline inflation, which replaced the CPIX measure[10] as the target of the South African Reserve Bank (SARB) in early 2009, ended the year at 6.3 percent, down from 9.5 percent in December 2008, but just outside the SARB's 3 – 6 percent target range.[11] In addition to the global slowdown, inflationary pressures in South Africa were further subdued by the appreciation of the rand. However, for the second successive year, electricity prices in South Africa increased substantially, thus adding to inflationary pressures in 2009.

1.14 In Botswana, both international and domestic factors contributed to a downward trend in inflation, which fell within the Bank of Botswana's 3 – 6 percent objective range by year-end. Headline inflation fell sharply from 13.7 percent in December 2008 to 6 percent in July 2009, as the impact of the rapid increase in fuel prices in early 2008 dissipated. Thereafter, inflation rose to 7 percent in September, mainly due to the winding down of the favourable base effects arising from fuel price reductions in the second half of 2008 and a significant increase in private (non-Botswana Housing Cooperation) housing rentals. However, these effects were more than offset by falling inflation in other categories, notably food. Inflation subsequently eased to 5 percent in November 2009, as the impact of the previous year's 30 percent special levy on alcohol dropped out of the inflation calculation. Inflation then rose slightly in December, but remained within the objective range (5.8 percent). On average, inflation was 8.2 percent in 2009, compared to 12.6 percent in 2008. Although two fuel price increases in mid-2009 are estimated to have contributed 0.6 percentage points to domestic inflation during the year, the lower cost of fuel

CHART 1.4: BOTSWANA HEADLINE AND CORE INFLATION 2005 – 2009



Source: Central Statistics Office

10 CPIX, which was revised in January 2009, refers to the consumer price index excluding owner's equivalent rent.

11 Headline inflation fell within the South African target range in October and November 2009, when it reached 5.9 percent and 5.8 percent, respectively.

compared to most of 2008 exerted substantial downward pressure on inflation. Similarly, food price inflation, which has the largest weight in the CPI basket, fell from 25 percent to 4.7 percent during the course of the year. In addition, while the trend was predominantly influenced by fuel and food prices, there was a more generalised easing of price increases across a broad range of goods and services.

1.15 The 16 percent trimmed mean measure of core inflation also decreased from 12.1 percent in December 2008 to 6.4 percent in December 2009, thus providing additional evidence of the generalised lower rate of price increases that is associated with less robust economic conditions than was the case the previous year. The measure of core inflation that excludes administered prices also decelerated sharply in the same period, from 16.1 percent to 7 percent.

(e) Inflation Outlook

1.16 In 2010, global economic activity is expected to improve markedly following the contraction in 2009 (Table 1.1). The projected improvement reflects the recovery in world economic activity as the major economies move out of recession. While sentiment about a sustained recovery has strengthened, it is expected to be uneven, depending on the severity of the impact of the crisis and the subsequent policy response. Global inflationary pressures are expected to be moderate in the context of depressed commodity prices, below-trend economic activity and low wage pressures. However, there are upside risks to the inflation outlook, in the main concerning the likely trajectory of commodity prices, including oil, which could rise sharply again if the global recovery gains momentum. In the circumstances, world inflation is forecast to rise to 3.8 percent in 2010, from 2.7 percent in 2009. For the SDR countries (Euro zone, Japan, United Kingdom and USA), average inflation is forecast to increase from zero in 2009 to 1.5 percent in 2010, while South Africa's average headline inflation is projected to fall from 7.1 percent in 2009 to 5.5 percent in 2010.[12]

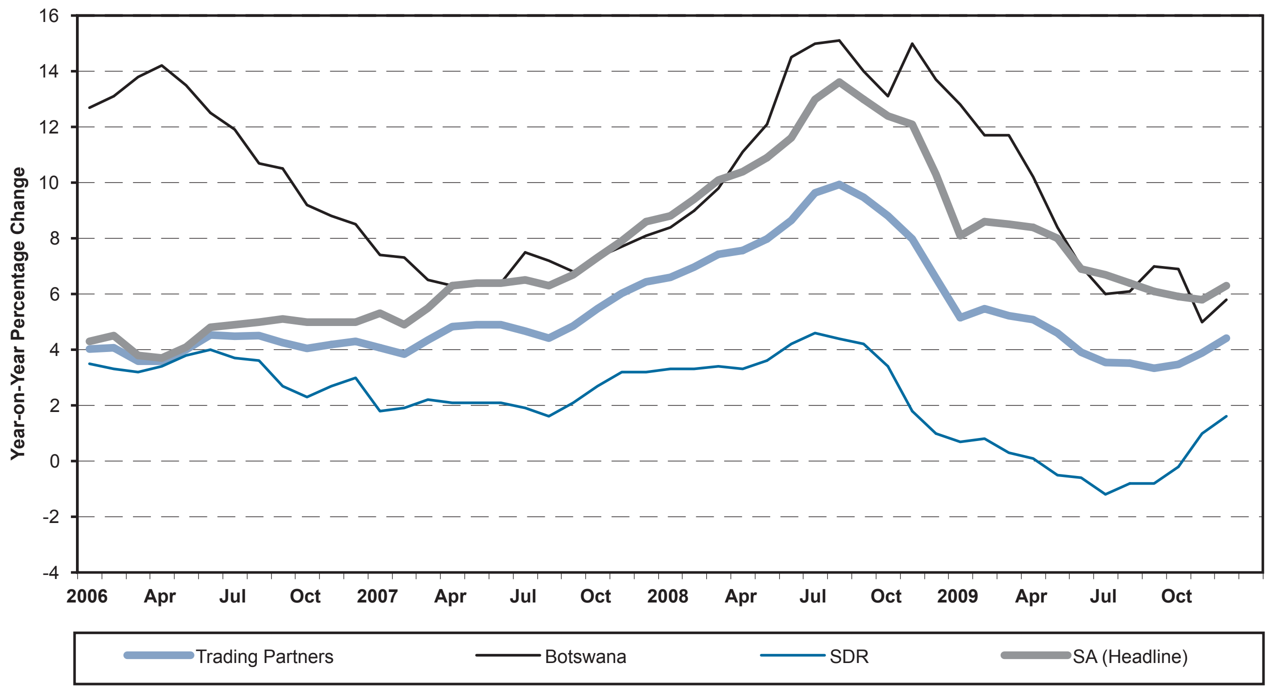
1.17 Consistent with global trends, inflationary pressures in Botswana are expected to remain moderate in 2010. The subdued growth of bank credit that prevailed towards the end of 2009 should continue, especially in the absence of a cost-of-living wage adjustment for the civil service, together with downward pressures on disposable income arising from the increase in value added tax (VAT) effective in April, and the upward adjustments to various government fees and levies. Nominal government spending is set to fall and even more so in real terms. Overall, although positive output growth is forecast for 2010, it is expected to remain below trend. The main upward pressure on inflation in the short-term will come from the increase in VAT. Nonetheless, this effect is expected to be transitory, and inflation is projected to return to the objective range by the first half of 2011.

2. PUBLIC FINANCE AND THE 2010 BUDGET SPEECH

2.1 The 2010 Budget Speech was presented in the context of the global economic slowdown which had severely impacted on Government revenues and resulted in projected budget deficits of unprecedented magnitude. Hence, the theme of the speech, '*Transforming our Economy after the Crisis: 2010 and Beyond*', was fitting as it signalled the Government's commitment to tackle the twin challenges of maintaining fiscal discipline in the medium term, while enhancing support for effective diversification of the economy. The maintenance of fiscal discipline and progress in diversifying the economy would contribute to the realisation of the goals of NDP 10 which, in turn, are aligned with the national objective of achieving 'Prosperity for All' as envisaged in *Vision 2016*. In this context, the issue of fiscal sustainability was a key focus of

12 Data on inflation forecasts are sourced from the Reuters Survey.

CHART 1.5: BOTSWANA AND TRADING PARTNER INFLATION 2006 – 2009



Source: Central Statistics Office and Bank of Botswana.

the Budget Speech, given the need to reconcile the current period of deficits with the overall constraints of spending that is envisaged for NDP 10.

(a) Budgetary Performance 2008/09 and 2009/10

2008/09 Budget Outturn

2.2 The budget outturn for the 2008/09 financial year was an overall deficit of P4.7 billion (5.4 percent of GDP), compared to an estimated deficit of P6.2 billion in the revised estimates presented at the time of the 2009 Budget Speech. The difference of P1.5 billion was largely due to underspending of the development budget by P1 billion. In addition, the deficit was further reduced by additional revenues of P774 million.

2.3 Total expenditure and net lending amounted to P35.2 billion compared to P35.9 billion in the revised budget, representing a rapid growth of 41.6 percent compared to fiscal year 2007/08. Net underspending was P726 million (2 percent) below the revised budget, with the shortfall in development spending being somewhat offset by additional recurrent spending of P391 million, 1.7 percent above the revised budget. The recurrent budget accounted for P23.9 billion (68 percent) of total expenditure. Despite underspending by 8.3 percent, development spending grew by 75 percent compared to P6.5 billion in 2007/08. While this included some exceptional items, this rapid increase may indicate that long-standing bottlenecks impeding spending had been largely overcome. At almost one-third of total expenditure and net lending, development spending was also in line with the Government's target of at least 30 percent going towards development spending.

2.4 At P30.5 billion, total revenue and grants were 2.6 percent higher than the revised budget. The boost in revenue arose mainly from a P1.5 billion increase in the collection of non-mineral taxes (both direct and indirect) that more than offset shortfalls in other major revenue sources, notably minerals and the Southern African Customs Union (SACU), which were below budget by P678 million and P548 million, respectively. Higher-than-budgeted non-mineral taxes are indicative of continued improvements in tax collections by the Botswana Unified Revenue Service (BURS).

2009/10 Revised Budget

2.5 The revised budget for 2009/10 projects a deficit of P13.5 billion, which is marginally higher than the P13.4 billion included in the original budget. This is despite a supplementary budget for additional expenditure totalling P5 billion that was approved in December 2009. The minimal increase in the projected deficit reflects higher-than-expected revenues. The deficit is equivalent to 15.1 percent of forecast GDP for 2009/10 which, as the Budget Speech acknowledged, is far in excess of international benchmarks for budget sustainability.[13] However, this is justified in the short term both as a fiscal stimulus to support domestic economic activity and to avoid the inevitable disruption and waste that could arise from a sudden implementation of spending cuts.

2.6 To finance the deficit, the Government has so far relied mainly on drawing from savings and external borrowing; in contrast, domestic borrowing through the existing bond issuance programme has been limited. Additional external borrowing in 2009/10 is projected at P7 billion, mainly reflecting USD1 billion drawn from the budgetary support facility of USD1.5 billion provided by the African Development Bank (AfDB).[14]

2.7 Total spending has been revised upwards by 9.2 percent, from P37.8 billion to P41.3 billion. The additional expenditure is spread over a range of spending programmes which had run short of funds due to expanded scope, cost increases or accelerated implementation. Most notably, the Ministry of Local Government and Ministry of Works and Transport required additional funding of P1.6 billion and P1.1 billion, respectively. Also included is a shareholder loan of P570 million to De Beers.

2.8 Resorting to supplementary budgets is generally to be avoided, other than in exceptional circumstances. Moreover, on this occasion the request for additional funding came in the context of earlier commitments to reduce spending.[15] In this respect, the Budget Speech explained that the need for additional funds was to a large extent due to growing problems in maintaining effective financial control. This is a matter of serious concern as it appears that the apparent success in addressing problems of underspending has resulted in a weakening of financial discipline in some areas. If not addressed, this could seriously undermine the cost effectiveness of public spending programmes as well as the credibility of the commitment to fiscal consolidation. It is understandable, therefore, that the Budget Speech indicated the need to introduce more effective budget controls without delay (2.14 below).

2.9 Projected revenue and grants for 2009/10 increased by P3.4 billion (13.9 percent) in the revised budget to P27.8 billion. This was mainly due to an additional P2.1 billion (56.5 percent) in non-mineral income tax, which constituted 61.9 percent of the entire increase in total revenue, a further indication of improved collections by the Botswana Unified Revenue Service (BURS). Similarly, VAT was also higher than previously budgeted, by P425 million or 13.3 percent. SACU payments increased by P870 million (12.3 percent) due to the depreciation of the Pula against the South African rand, thus contributing 25.4 percent to increased revenues.

2.10 In the first nine months of the financial year (to December 2009), total expenditure and revenue were P29.2 billion and P20.2 billion, respectively, resulting in a deficit of P9 billion. If this trend was continued for the last quarter

13 Three percent of GDP is considered a prudent limit for government deficits.

14 In addition, some project-specific loans were also arranged, e.g., with the World Bank.

15 Following the 2009 Budget Speech, the Government committed to reducing recurrent and development spending from the levels originally budgeted for 2009/10 by 7 percent and 5 percent, respectively.

TABLE 1.2: GOVERNMENT BUDGET 2008/09 – 2010/11 (P BILLION)

	2008/09			2009/10		2010/11
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	**29 889**	**29 681**	**30 455**	**24 393**	**27 782**	**27 077**
Mineral revenue	10 558	10 860	10 182	6 835	6 835	6 481
Non-mineral	19 331	18 821	20 273	17 558	20 947	20 595
Expenditure	**30 220**	**35 877**	**35 151**	**37 787**	**41 265**	**39 194**
Recurrent	21 836	23 498	23 899	27 357	26 378	27 142
Personal Emoluments	7 910	7 997	8 701	9 576	10 883	11 935
Development	8 500	12 495	11 458	10 558	14 445	12 182
Net lending	– 116	– 117	–197	– 128	442	–130
Balance	**– 331**	**–6 195**	**–4 696**	**–13 394**	**–13 483**	**–12 118**

Source: Ministry of Finance and Development Planning

of the year, the resulting deficit would be P12 billion, which is P1.5 billion lower than projected. However, it is possible that the deficit could be larger if spending accelerates following approval of the supplementary budget.

(b) 2010/11 Budget Proposals

Overall Balance and Supporting Budgetary Framework

2.11 The 2010/11 budget proposals estimate a deficit of P12.1 billion, which is P1.4 billion below the revised projection for 2009/10. Total expenditure and net lending is budgeted to fall by P2.1 billion (5 percent) to P39.2 billion; at P27.1 billion, revenues are also expected to be lower than in 2009/10 by P0.7 billion (2.5 percent).

2.12 The budgets for fiscal years 2009/10 and 2010/11 are set within the framework of NDP 10, which makes provision for a cumulative deficit of P31.9 billion (in constant prices) over the whole plan period. Initially, the intention had been to restrict the combined deficit for the two years to an average of 10 percent of forecast GDP.[16] However, the deficits for those two years are now expected to average 13.7 percent of GDP and will account for most of the deficit envisaged for the NDP 10 period, thus leaving little scope for further deficits later in the plan period. The revised objective is to restore a balanced budget by 2012/13. Even with robust revenue growth, this will require significant cuts in recurrent and development spending. To emphasise this point, the Budget Speech was accompanied by summary budget projections for the next three fiscal years (Table 1.3 overleaf).

2.13 While the Government has so far relied mainly on external borrowing to finance the deficit, this is constrained by the statutory limitation of such borrowing, including guarantees of other loans, to no more than 20 percent of GDP.[17] Partly because of this constraint, there is to be a greater emphasis going forward on borrowing from the domestic capital markets and an updated issuance programme for domestic bonds is to be considered by Parliament in mid-2010. The Government is in the process of finalising the medium-term debt management strategy that will ensure that the financing needs are met at the lowest possible cost, consistent with a prudent degree of risk.

16 This objective was included in the 2009 Budget Speech.

17 See Section 20 of the *Stock, Bonds and Treasury Bills Act.* As of December 2009, the Government's external borrowing, including guarantees, was P14.7 billion. While this remains within the limit (it is 16.5 percent of the forecast GDP for 2009/10), the Government was yet to utilise all of the additional borrowing agreed in 2009.

TABLE 1.3: FISCAL DECLINE AND CONSOLIDATION 2006/07 – 2012/13

	GDP		Expenditure & Net Lending					Budget balance	
Fiscal Year	Current prices (P Bn)	Growth Rate (%)	Total (P Bn)	Growth Rate (%)	Total spending as % of GDP	Dev. Budget as % of GDP	Revenue & grants (P Bn)	P Bn	Percent of GDP
2006/07	68.2	25.3	19.8	11.9	28.9	20.5	27.4	7.7	11.2
2007/08	79.8	16.9	24.8	25.8	31.1	26.4	28.6	3.8	4.8
2008/09	87.5	9.7	35.2	41.6	40.2	32.6	30.5	–4.7	–5.4
2009/10[1]	89.0	1.8	41.3	17.4	46.3	35.0	27.8	–13.5	–15.1
2010/11[2]	99.7	12.0	39.2	–0.5	39.3	31.1	27.1	–12.1	–12.2
2011/12[3]	110.4	10.7	39.4	–0.5	36.3	27.0	33.3	–6.1	–5.5
2012/13[3]	122.8	11.2	39.6	0.6	32.3	23.1	39.6	0	0

Notes:

1. Revised estimate
2. Budget
3. Planned

Source: Ministry of Finance and Development Planning

2.14 Financing options will be further enhanced by greater use of public private partnerships (PPPs). A policy and implementation framework for PPPs was approved in 2009 with a view to accelerating the development of public infrastructure by drawing on private sector financial resources and expertise. Related to this, the Government is working to improve the implementation of the privatisation process, where two public enterprises (Botswana Telecommunications Corporation and National Development Bank) are expected to be privatised in the near future. There is also to be an extensive rationalisation, through appropriate mergers, of public enterprises that are not considered suitable for privatisation. These include the amalgamation of the International Financial Services Centre (IFSC) into the Botswana Export Development and Investment Authority (BEDIA) and that of the Botswana Savings Bank into Botswana Postal Services.

2.15 The Budget Speech announced a range of measures to restore effective financial monitoring and control. These will include stricter enforcement of the Government Accounting and Budgeting System guidelines to ensure that spending cannot be authorised in the absence of previously approved funding, while the guidelines will also be amended to limit the discretion currently accorded to ministries for approval of smaller projects. Project appraisal procedures will also be tightened to ensure that subsequent changes in scope are fully justified in terms of enhancing the net benefits of the project. Ultimately, public officers in breach of the Finance and Audit Act will be subject to surcharges.

Revenue

2.16 Total revenues and grants for the financial year 2010/11 are forecast at P27.1 billion, which is P705 million lower than the revised estimates for 2009/10. This decline arises mainly from a projected decline in tax revenue of P1.2 billion. Both non-mineral income tax and VAT are set to grow strongly, by P697 million (13.1 percent) and P896 million (24.3 percent), respectively. As well as continued efforts to improve the efficiency and coverage of tax collections, income tax is to be boosted by a proposed simplification of the structure of company tax which also serves to increase the effective rate.[18] It was also proposed that the standard rate of VAT should be increased,

18 Previously, company income tax was based on a two-tier structure that, while facilitating the offsetting against taxes paid on dividends, was widely regarded as overly complex. The envisaged reform will involve levying a single tax on company profits of 25 percent together with a reduction in the withholding tax on dividends from 15 percent to 7.5 percent. The net effect is expected to be a 5 percent increase in collections of non-mineral income taxes.

effective April 1, 2010, from 10 percent to 12 percent,[19] while various charges and levies that have not kept up with inflation will be raised. In addition, although they do not pay tax, parastatals will henceforth be required to pay 25 percent of their profits as dividends to government, thus aligning their contributions more closely to standard company income tax from which they are exempt.[20]

2.17 However, this would not be enough to make up for the decline of P87 million (0.5 percent) in mineral taxes and P2.8 billion in SACU receipts. Projected mineral revenues are lower despite increased diamond production because of the costs associated with the "Cut 8" project which is meant to extend the life of the open pit at the Jwaneng diamond mine. The substantial fall in SACU payments is due to previous overpayments from the revenue pool which shrunk due to the global economic slowdown. Looking further ahead, the SACU member states have agreed to a further review of the customs union agreement, which may result in changes to the revenue sharing formula.

Expenditure

2.18 At P39.2 billion, total expenditure and net lending is down by P2.1 billion (5 percent) from the revised budget for 2009/10. This reflects a fall in planned development spending and net lending by P2.8 billion (19 percent), while recurrent spending is set to rise by P765 million (2.9 percent) to P27.1 billion. For the second successive year, the Government did not award a cost of living adjustment to civil service salaries in order to help curtail expenditure. Nonetheless, personal emoluments are still expected to increase by P1.1 billion (9.7 percent), although this may be less if vacant posts remain unfilled. Albeit from a low base, interest payments on public debt are set to rise sharply by 67 percent from P300 million to P500 million. However, the budget for 'other charges' is lower by P488 million (3.2 percent).

2.19 The increase in recurrent spending is concentrated in a few areas, with offsetting cuts planned elsewhere. Most notably, recurrent spending for education is to rise by P647 million (8 percent), which accounts for 85 percent of the total increase. Similarly, an additional P597 million is allocated to general government services including, in particular, government construction services and courts and legal administration. In contrast, recurrent costs are cut for a diverse range of sectors, including defence, regional development and economic services.

2.20 The allocations under the development budget are based mainly on the costs of existing commitments, with little additional spending on new projects. There continues to be a strong emphasis on the development of public sector infrastructure to support growth, including through enhanced energy and water supply. Hence, the largest share is for the Ministry of Minerals, Energy and Water Resources, which is allocated P3.5 billion or 29 percent of the total, mainly to cover five major projects, including the Government's contribution to the expansion of the Morupule power station as well as the costs, in the interim, of developing emergency power supply, together with improvements to national water supply infrastructure. Transport (including airport upgrades) and education also received high allocations. After these projects are completed, it is anticipated that development spending will be sharply curtailed.

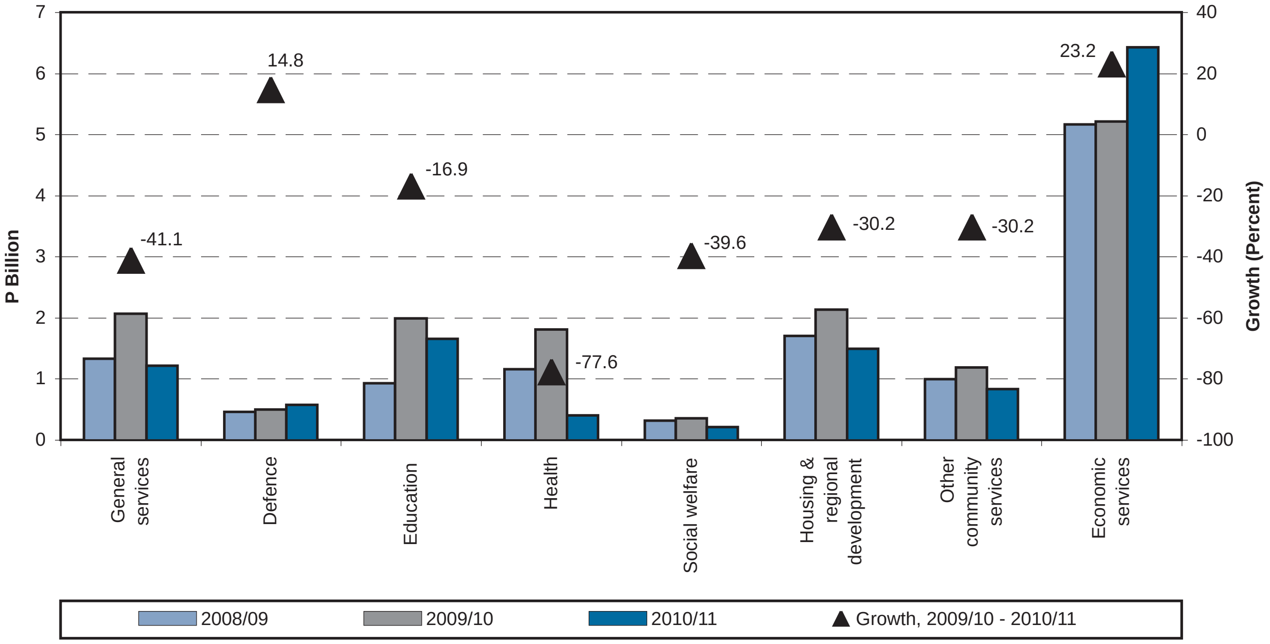
(c) Fiscal Legislation

2.21 In addition to the proposed changes to company income tax and VAT, the Budget Speech indicated that a review of the current tax regime, aimed at simplification and improved tax compliance, was completed in

19 To ease the administrative burden on small companies, the threshold for compulsory VAT registration is to be doubled from P250 000 to P500 000.

20 Payment of 25 percent of profits to Government is not the *equivalent*, however, of paying standard company tax. As the owner of the parastatals, the government is also entitled to receive after tax dividends, and is effectively waiving this right by limiting the dividends to 25 percent.

CHART 1.6: DEVELOPMENT SPENDING BY ECONOMIC SECTOR 2008/09-2010/11



Source: Ministry of Finance and Development Planning

2009 after widespread consultations. Detailed proposals for the revision of fiscal legislation in line with this review are expected to be presented to Parliament in the near future.

3. EXCHANGE RATES, BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION

(a) Exchange rates

3.1 During 2009, the exchange rate policy continued to focus on fostering national competitiveness through the maintenance of a stable and competitive exchange rate against a basket of currencies of major trading partners (comprising the South African rand and SDR), that will support local producers of tradeable goods and services. Through the crawling peg mechanism introduced in May 2005, it is intended that the stability of the real effective exchange rate (REER),[21] and hence competitiveness, will continue to be achieved through a continuous gradual adjustment of the Pula at a rate based on the differential between the Bank's inflation objective and forecast inflation for trading partner countries.

21 A trade weighted exchange rate of the Pula (against a fixed basket of currencies), after allowing for relative inflation, is considered an appropriate measure of the relative competitiveness of Botswana goods in domestic and international markets.

TABLE 1.4: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES

As at end of	2008	2009	Percentage Change
Nominal Exchange Rates (foreign currency per Pula)			
SA rand	1.2455	1.1086	–11.0
US dollar	0.1330	0.1499	12.7
British pound	0.0921	0.0932	1.3
Japanese yen	12.00	13.85	15.4
SDR	0.0861	0.0957	11.1
Euro	0.0944	0.1043	10.5
NEER (index, September 2006 = 100)	**94.0**	**91.4**	**–2.7**
Real Pula Exchange Rate Indices (September 2006 = 100)			
SA rand[1]	106.8	94.6	–11.4
US dollar	101.4	117.7	16.1
British pound	128.3	133.6	4.1
Japanese yen	79.6	98.9	24.2
Euro	90.2	104.5	15.8
SDR	96.6	111.8	15.7
REER	**102.4**	**100.9**	**–1.4**

1. Calculated using South African headline inflation.

Source: Bank of Botswana.

In line with this, during 2009, the nominal effective exchange rate (NEER) of the Pula depreciated by 2.7 percent.

3.2 In nominal terms, the Pula appreciated against all the major international currencies during 2009. Year-on-year, it appreciated by 15.4 percent against the Japanese yen, 12.7 percent against the US dollar, 11.1 percent against the SDR, 10.5 percent against the euro and 1.3 percent against the British pound. However, against the South African rand, the Pula depreciated by 11 percent, reflecting the rand's strengthening against the SDR by 24.8 percent. The strength of the rand was attributed to several factors, including investors' increased risk appetite for assets denominated in high-interest yielding currencies (e.g., rand); the significant reduction in South Africa's current account deficit (in the third quarter of 2009) to a four-year low of 3.2 percent of GDP; rising commodity prices, including for both platinum and gold, South Africa's two largest exports by value; as well as financial inflows in the build up to the Soccer World Cup.

3.3 In real terms, the Pula depreciated by 11.4 percent against the rand[22] and appreciated by 15.7 percent against the SDR during 2009. The Pula appreciated in real terms against all constituent SDR currencies, 24.2 percent against the Japanese yen, 16.1 percent against US dollar, 15.8 percent against the euro and 4.1 percent against the British pound. The REER depreciated by 1.4 percent (using the headline measure of South African inflation) during the review period, compared to an appreciation of 4.5 percent recorded in 2008. The depreciation of the REER during 2009 is due to the downward crawl of the NEER more than offsetting inflation differentials between Botswana and her major trading partners.

(b) Balance of Payments

Overview of the Balance of Payments

3.4 Calculated from changes in the foreign exchange reserves, the overall external balance for 2009 was a deficit of P4.6 billion.[23] This compares to a surplus of P7.5 billion in 2008, and reflects the adverse impact of the global economic slowdown, on visible (merchandise) exports in particular. As indicated in Chart 1.7 overleaf, the bulk of this deficit was accumulated in the first half of the year. Subsequently, there was some recovery,

TABLE 1.5: BALANCE OF PAYMENTS 2005 – 2009 (P MILLION)

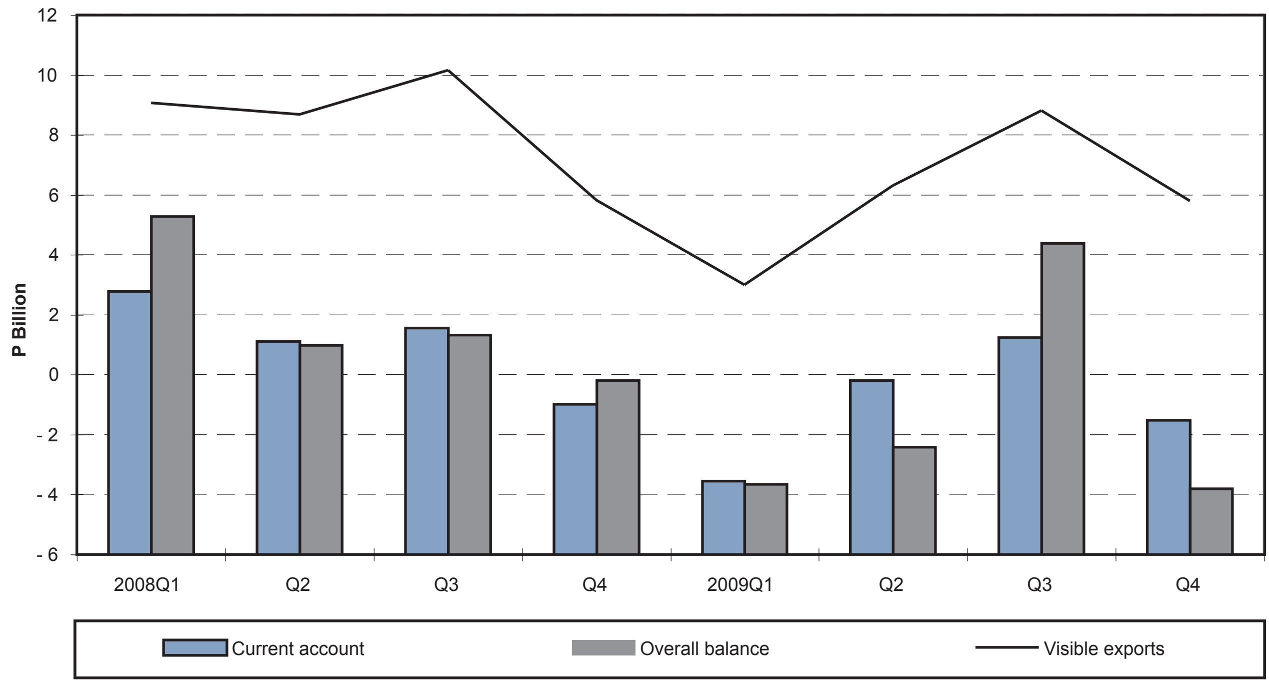
	2005	2006	2007	2008[1]	2009[2]
Current Account	7 994	11 317	11 028	3 205	–3 963
of which:					
Merchandise trade	8 982	11 115	9 878	2 248	–5 380
Services	–153	–372	–1 104	–1 390	–1 632
Income	–4 270	–4 512	–4 531	–4 756	–3 234
Net current transfers	3 437	5 086	6 785	7 103	6 283
Financial account	–774	–1 030	–1 398	3 628	8 460
Capital account	344	142	493	703	848
Net errors and omissions	–529	–174	570	–84	–9 907
Overall balance	7 036	10 256	10 694	7 452	–4 563

1. Revised
2. Provisional
Source: Bank of Botswana

22 Using South African headline inflation.

23 The balance of payments surplus (deficit) is equal to the increase (decrease) in the reserves net of the effect of any unrealised gains or losses due to market or currency revaluations.

CHART 1.7: QUARTERLY BALANCE OF PAYMENTS 2008 – 2009



Source: Bank of Botswana

including a substantial overall surplus of P4.4 billion in the third quarter where, in addition to growing export receipts, financial inflows were boosted by external borrowing by Government.

Current Account

3.5 The current account is the sum of the trade and income accounts as well as net current transfers. Preliminary estimates for 2009 indicate a deficit of P4 billion compared to a surplus of P3.2 billion in 2008.

Merchandise Trade

3.6 The merchandise trade surplus had been in decline since peaking at P11.1 billion in 2006. Initially this was due to rapid growth in imports, which doubled between 2006 and 2008 due to both increased volumes and higher prices, notably for fuel and food. However, towards the end of 2008, exports fell sharply as the impact of the global recession began to be felt, and this continued into early 2009. A partial recovery commenced later in the year, but this was from a very low base following the temporary suspension of diamond mining from mid-December 2008 to mid-April 2009. As a result, the visible trade account recorded an estimated deficit of P5.4 billion, compared to a surplus of P2.2 billion in 2008.

3.7 Total exports for 2009 are estimated at P23.9 billion, a decrease of 26.5 percent from P32.5 billion the previous year. In contrast, despite lower fuel prices and constrained consumer demand, imports slowed only moderately, by 3.1 percent to P29.3 billion, as government spending remained at high levels.

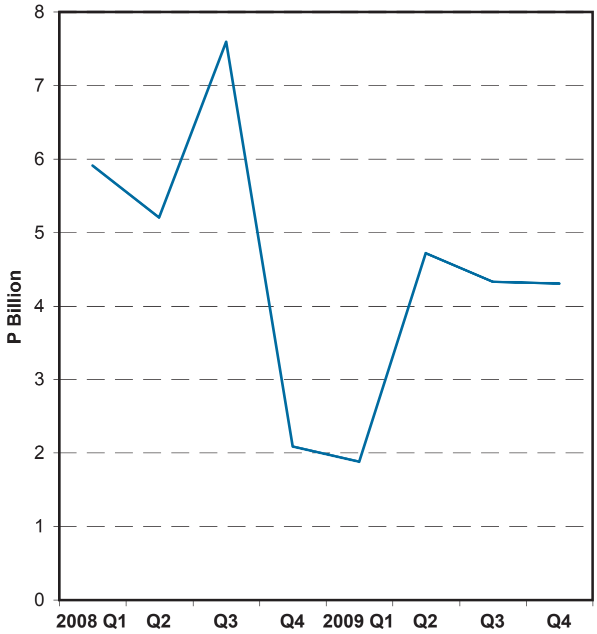
3.8 Exports of diamonds, both rough and polished, were seriously affected by the global recession, falling to P15.2 billion in 2009 compared to P20.8 billion in 2008. This contraction was due to reduced export volumes as well as lower diamond prices.[24] Overall, diamond exports declined by 26.7 percent in 2009 after growing by 1.5 percent in 2008. However, this was heavily concentrated in the first quarter of the year, and faster-than-expected recovery resulted in prices for rough diamonds strengthening in the second half of the year.

3.9 Exports of copper and nickel matte were

24 Although the sharp curtailment in sales volumes was itself a deliberate cutback in supply aimed at limiting the extent of price falls.

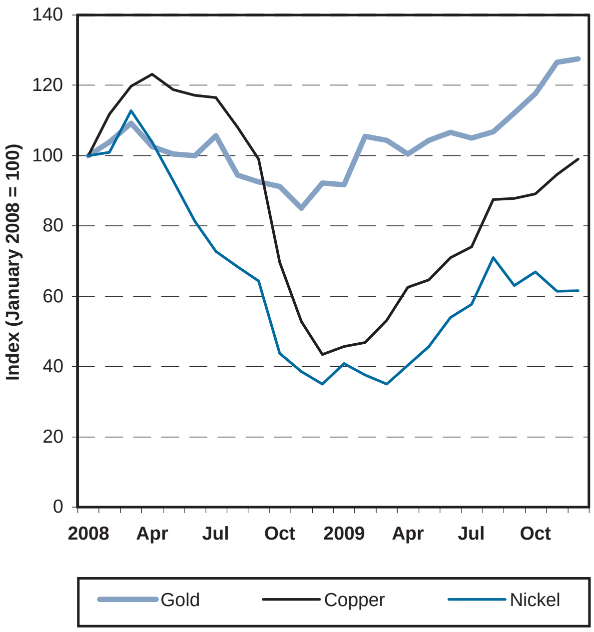
similarly affected, and contracted by 38.9 percent from P5.9 billion in 2008 to P3.6 billion in 2009. In contrast to diamonds, this was due entirely to falling prices, as production volumes rose during 2009. Compared to 2008, average prices for copper and nickel were lower in 2009 by an average of 26 percent and 31 percent, respectively. However, as with diamonds, there was a significant recovery in prices during the course of the year, with copper prices more than doubling between January and December; this was a result of strong demand, notably from China. In contrast to other commodities, the price of gold has strengthened since late 2008, and this is a reflection of its status as a safe haven investment. For all mineral exports, which are priced in US dollars, the local currency value was also negatively affected by the appreciation of the Pula against the dollar during the year.

CHART 1.8: QUARTERLY DIAMOND EXPORTS 2008 - 2009



Source: Bank of Botswana

CHART 1.9: MINERAL COMMODITY PRICES 2008-2009



Note: Diamonds are not included in this chart as there is no standardised index of rough diamond prices. In part this reflects the great variety of diamond types as well as a diversity of marketing channels, which hinders the aggregation of prices into a single index.

Source: Bank of Botswana

3.10 Beef exports contracted by 9.5 percent from P530 million in 2008 to P480 million in 2009. Textiles also recorded a decline of 22 percent in 2009 from P1.8 billion in 2008 to P1.4 billion. The textile industry has found it increasingly difficult to compete with low-cost producers elsewhere, especially once tariff concessions on inputs imported into the SACU region were withdrawn, and exports slowed noticeably towards the end of the year following the closure of a major textile producer.

3.11 Although they declined by 8.3 percent to P5.7 billion, machinery and electrical equipment remained the largest import category in 2009, accounting for 17.2 percent total of visible imports. Fuel remained the second largest import category, although it fell by 25 percent to P4.5 billion due to the lower prices prevailing in 2009. The sharp slowdown in food price inflation was evident in the value of food imports, which grew by only 2.6 percent, following 28.2 percent growth in 2008 when prices were rapidly increasing. Imports of diamonds fell by 17 percent, and this is indicative of the impact of the global recession on the domestic polishing and cutting industry.

Services

3.12 The services account has remained in deficit, and is estimated at P1.6 billion in 2009.

TABLE 1.6 IMPORT COMPOSITION 2008 – 2009*

Import Category	Value (P million) 2008	Value (P million) 2009	Growth (percent)	Share (percent) 2008	Share (percent) 2009
Machinery & electrical equipment	6 268	5 745	–8.3	17.7	17.2
Fuel	6 005	4 482	–25.4	17.0	13.4
Food	4 277	4 390	2.6	12.1	13.2
Vehicles & transport equipment	3 813	4 192	9.9	10.8	12.6
Chemical & rubber products	3 738	3 746	0.2	10.6	11.2
Diamonds	3 142	2 608	–17.0	8.9	7.8
Metal & metal products	2 797	2 388	–14.6	7.9	7.2
Other	1 303	1 368	5.0	3.7	4.1
Total	35 427	33 362	–5.8		

Source: Central Statistics Office

Note: *The breakdown of merchandise imports by commodity does not match the total shown in the balance of payments estimates. This is because further adjustments are made to the source data for balance of payments purposes. In particular, the estimated transport cost component is included as imports of services.

Transportation costs remained high in line with visible imports while other service imports, including those associated with government development spending continued to grow.[25] At the same time, service exports in the form of receipts from tourism are believed to have fallen, as the recession resulted in a reduction in tourist arrivals.

Income Account

3.13 The income account registered a deficit of P3.2 billion in 2009 compared to P4.8 billion in 2008. The credit side of this account largely comprises earnings from foreign exchange and the pension funds' offshore investments, both of which came under pressure due to the global slowdown, as well as the appreciation of the Pula against major currencies. However, this was more than offset by the lower outflows that include both actual remittances of profits and dividends and retained earnings. The latter are treated as outflows in the income account with a matching inflow treated as investment in the financial account.[26]

Current Transfers

3.14 Net current transfers were P6.3 billion in 2009 compared to P7.1 billion the previous year. The substantial surpluses reflect continuing high SACU receipts which had yet to be adjusted to recover past overpayments from the revenue pool (Section 3).

Capital and Financial Accounts

3.15 The capital account mainly consists of capital grants to Government, with a small contribution from asset transfers by migrants. The account was in surplus by P848 million in 2009, compared to P703 million in 2008.

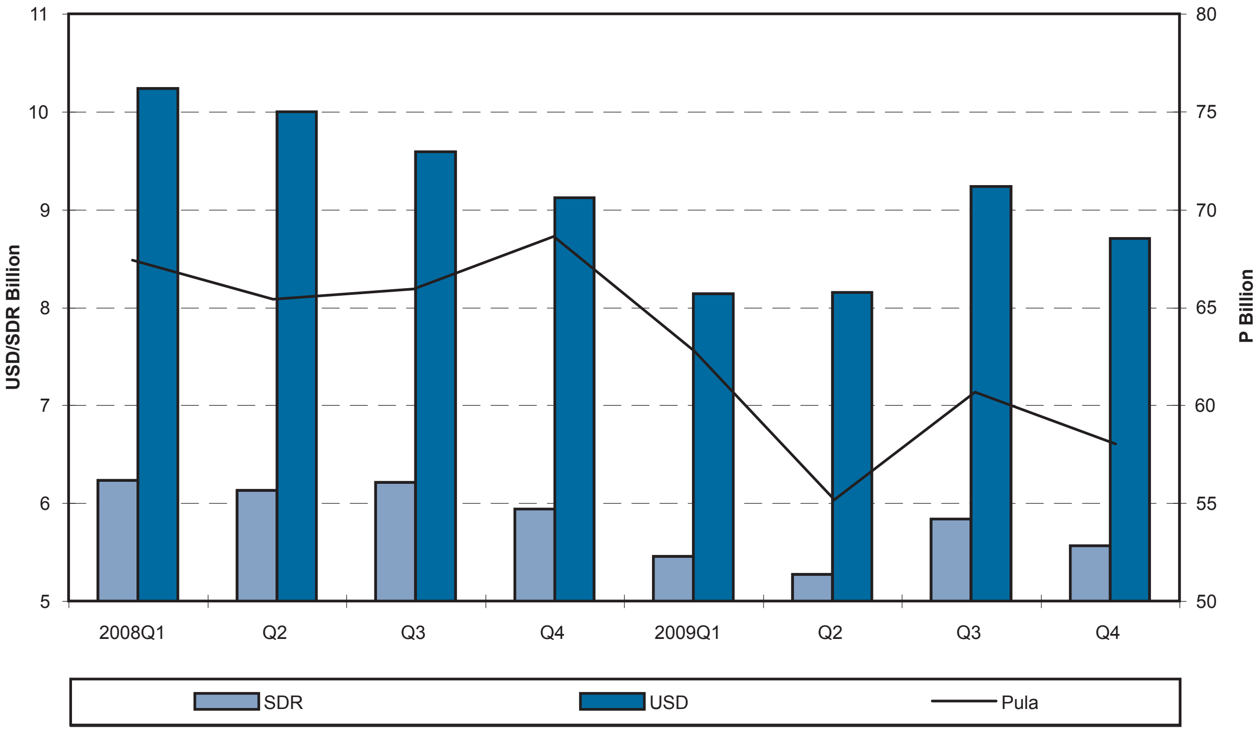
3.16 The financial account is made up of direct investment, portfolio investment and 'other' investment. In 2008, the financial account was initially estimated to have recorded a deficit of P693 million. This was revised to a surplus of P3.6 billion in line with the results of the annual balance of payments survey, which indicated higher retained earnings of around P3 billion by businesses, and counted as foreign direct investment.[27] For 2009, the preliminary estimates show a surplus of P8.5 billion, arising mainly from the Government's draw down of USD1 billion from the African Development Bank (AfDB) budget support loan. However, these estimates omit data for direct investment, either in Botswana or

25 However, as in previous years, these data should be treated with caution since part of this item relied on the foreign exchange returns submitted by commercial banks, which sometimes provide partial information.

26 For the moment, they have been assumed to be zero until reliable information from the 2009 balance of payments survey becomes available.

27 This does not affect the overall balance, as this is an imputed flow of inward investment that is exactly matched by an imputed outflow in the income account.

CHART 1.10: QUARTERLY LEVEL OF FOREIGN EXCHANGE RESERVES 2008 – 2009



Source: Bank of Botswana

abroad. This is because, until the results of the 2009 balance of payments survey have been collated, there is insufficient information to make an informed estimate.

Foreign Exchange Reserves

3.17 The foreign exchange reserves decreased by P10.7 billion (15.6 percent) from P68.6 billion in December 2008 to P57.9 billion at the end of December 2009. On the basis of preliminary estimates for trade flows in 2009, this amounts to 19 months of imports of goods and services. While the reserves were under pressure as a result of net outflows arising from the overall balance of payment deficit and, in particular, the contraction of exports, this was offset partly in the third quarter by the Government's drawing from the AfDB loan. The local currency value of the reserves was also affected by the strengthening of the Pula during 2009.[28] The decline in the reserves was markedly less pronounced when measured in US dollars and SDR (4.5 percent and 6.3 percent, respectively).

(c) Balance of Payments Outlook

3.18 Diamond exports are expected to gradually recover in the medium term, while exports are expected to be boosted by additional mining ventures coming on stream. Constrained consumer demand will serve to dampen import growth, as will planned cuts in government spending. However, the impact of the latter on capital imports could be offset, at least to some extent, by capital imports for non-government funded investments in mining and power station development. While overall, some improvement in the trade balance can be expected, the surplus on current transfers will be reduced due to lower revenues from SACU. On the financial account, inflows in support of government and non-government investments can be expected, although at lower level than previously anticipated, due to the scaling down or postponement of some projects.

28 In 2009, unrealised currency losses amounted to P5.3 billion.

(d) International Investment Position and Foreign Investment

International Investment Position (IIP)

3.19 Detailed data for the IIP, which records the stock of foreign financial assets and liabilities, are available up to 2008. For 2009, only major aggregates have been estimated using information on financial flows during the year. According to the revised figures of 2008, Botswana's foreign financial assets increased from P89.4 billion in 2007 to P96.8 billion. This was accounted for by the foreign exchange reserves which increased by P10 billion to P68.6 billion in 2008, making up 71 percent of the total foreign assets. In contrast, both direct and portfolio investment abroad declined by 48.4 percent and 13.2 percent, respectively, which is a reflection of the global economic slowdown and its negative impact on the value of investments. The preliminary estimates for 2009 show that Botswana's foreign assets decreased from P96.8 billion at the end of 2008 to P83.6 billion. The largest contributor to this downward trend was the fall in foreign exchange reserves of 15.6 percent, to P57.9 billion. There was also a significant drop in 'other' investment of 40.7 percent from P5.9 billion in 2008 to P3.5 billion, due mainly to a drop in currency and deposits held outside the country by domestic financial institutions. On the other hand, portfolio investment is estimated to have grown by 7.7 percent to P19.5 billion in line with the partial recovery in global equity markets.

3.20 On the liabilities side, the revised estimates for 2008 indicate an increase in the stock of direct investment in Botswana of 32.5 percent from P5 billion in 2007 to P6.7 billion. However, this was mainly due to retained earnings by major companies already operating in the country rather than to new investments. In contrast, portfolio investment in Botswana fell by an estimated 50 percent in 2008, a further reflection of the weakening of equity markets due to the onset of the global recession. Total foreign liabilities are estimated to have increased from P12.1 billion in 2008 to P19.6 billion in 2009. This increase of 62 percent was due to substantially higher 'other' investment arising principally from the AfDB's loan to Government. Consistent with the preliminary balance of payments estimates for 2009, the stock of direct investment in Botswana is maintained unchanged from 2008 due to the lack of information required to update the estimates. Overall, the net international investment position for 2009 indicates a decline in the net worth of the economy to P64.5 billion, from P84.6 billion in the previous year.

TABLE 1.7: FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY 31 DECEMBER 2008 (P MILLION)

	Direct Investment			Other Investment		
Industry	**Equity**	**Non-Equity**	**Total**	**Equity**	**Non-Equity**	**Total**
Mining	3 313	0	3 313	14	227	240
Manufacturing	22	53	75	0	136	136
Finance	2 692	20	2 712	163	1 308	1 472
Retail and Wholesale	54	8	62	0	401	401
Electricity, Gas and Water	0	0	0	0	103	103
Real Estate and Business Services	462	0	462	0	31	31
Transport, Storage and Communication	33	0	33	0	40	40
Construction	5	19	24	0	16	16
Hospitality	25	0	25	0	1	1
Public Administration	0	0	0	0	1 772	1 772
Other	0	9	9	0	107	107
TOTAL	**6 606**	**108**	**6 714**	**177**	**4 141**	**4 318**

Source: Bank of Botswana

TABLE 1.8: FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY 31 DECEMBER 2008 (P MILLION)

	Direct Investment			Other Investment		
Country	**Equity**	**Non-Equity**	**Total**	**Equity**	**Non-Equity**	**Total**
North and Central America	420	0	420	0	67	67
Of which						
United States	416	0	416	0	67	67
Europe	3 577	49	3 625	14	1 021	1 035
Of which						
United Kingdom	712	27	739	13	895	909
Netherlands	0	6	6	0	0	0
Luxembourg	2 861	0	2 861	0	45	45
Other Europe	3	16	19	1	81	82
Asia Pacific	62	9	71	0	0	0
Africa	2 450	50	2 500	30	1225	1 255
Of which						
South Africa	1 664	49	1 713	30	945	975
Middle East	0	0	0	0	0	0
Other	98	0	98	132	1 827	1 959
Total	**6 606**	**108**	**6 714**	**177**	**4 141**	**4 318**

Source: Bank of Botswana

Industry and Country Classification of Investment

3.21 Tables 1.7 and 1.8 show Botswana's stock of foreign liabilities at the end of 2008 classified, respectively, by industry and country. Mining and finance remain the main contributing industries to foreign direct investment in Botswana, with a representation of 90 percent. For other investment, finance and public administration represented 75 percent. Europe continued to dominate as the principal source of direct investment, as it accounted for 54 percent, with Luxembourg (corporate residence of a major mining company) accounting for 43 percent.

4. MONEY AND CAPITAL MARKETS

(a) Monetary Policy and Liquidity Management

4.1 The Bank's monetary policy objective is to achieve price stability, as defined by a sustainable, low and predictable level of inflation, within the 3 – 6 percent medium-term objective range. Low inflation contributes towards the broader national objective of sustainable economic development through promoting savings mobilisation and productive investment, while fostering international competitiveness of domestic producers.

4.2 In order to attain price stability, the Bank uses interest rates and open market operations to affect aggregate demand conditions in the economy and, ultimately, the rate of price changes. Changes in interest rates and the availability of loanable funds influence choices with respect to credit demand and saving and, in turn, aggregate demand. Apart from interest rates and credit availability, domestic demand and economic activity are also influenced by factors such as fiscal policy (decisions relating to government spending and raising revenue) and trade and exchange rate developments.

4.3 The forecast-based approach to medium-term policy formulation that is implemented by the Bank enables an assessment of the various factors that can impact on future domestic inflation. The framework allows for a differentiation of factors that are likely to lead to a longer-lasting deviation of inflation from the objective range from those that have a transitory impact, as shown by the duration of their individual effect on the inflation forecast. As part of this exercise, the Bank makes an assessment of the factors that impact on inflation, including public expectations, which could be influenced by domestic monetary policy. The Bank is, therefore, able to generate an inclusive and broad-based forecast for inflation, which informs the determination of monetary policy response. In general, monetary policy responds to a sustained deviation of the inflation forecast from the objective range in order to achieve price stability in the medium-term. A sustained level of economic performance above trend is potentially inflationary and could signify the need to increase interest rates to dampen inflationary pressures, while output below trend could require a reduction of interest rates to stimulate economic activity.

TABLE 1.9: ADJUSTMENTS TO THE BANK RATE 2009

Month	Bank Rate before Change (Percent)	Magnitude of Change (Basis Points)	Bank Rate after Change (Percent)
February	15	100	14
April	14	100	13
June	13	150	11.5
August	11.5	50	11
October	11	0	11
December	11	100	10
Cumulative change		500	

Source: Bank of Botswana

4.4 In 2009, monetary policy was conducted in an environment of the global economic recession, with domestic economic activity expected to fall below trend and with generally low inflationary pressures. On account of the favourable inflation outlook, the Bank Rate was reduced during the year on five occasions, by a cumulative 5 percentage points to 10 percent during 2009.

4.5 The Bank conducted open market operations during the year to ensure that short-term interest rates, in particular yields on Bank of Botswana Certificates (BoBCs), reflected the loosening bias of monetary policy. Hence the yield on both the 14-day and 3-months BoBCs fell from 12.55 percent to 7.12 percent. The total market value outstanding of BoBCs was P17 billion in December 2009; this represented a decline of 3 percent, compared to a growth of 4.5 percent in 2008.

(b) Interest Rates

4.6 In response to reductions in the Bank Rate and accompanying open market operations, commercial banks reduced the prime lending rate by the same magnitude, thus ending the year at 11.5 percent. The benchmark 3-months deposit rate also fell, although by a smaller amount than the Bank Rate, from an average of 8.5 percent in December 2008 to 5.8 percent in December 2009.[29]

4.7 Despite the marked decrease in nominal interest rates in 2009, inflation fell more quickly with the result that real interest rates increased. For example, the real 14-day BoBC rate increased from -1 percent in December 2008 to 1.3 percent at the end of 2009. Overall, real monetary conditions, as measured by the combination of changes in the REER and real interest rates, were relatively tight in 2009, thus contributing to the easing of inflationary pressures.

(c) Banking System

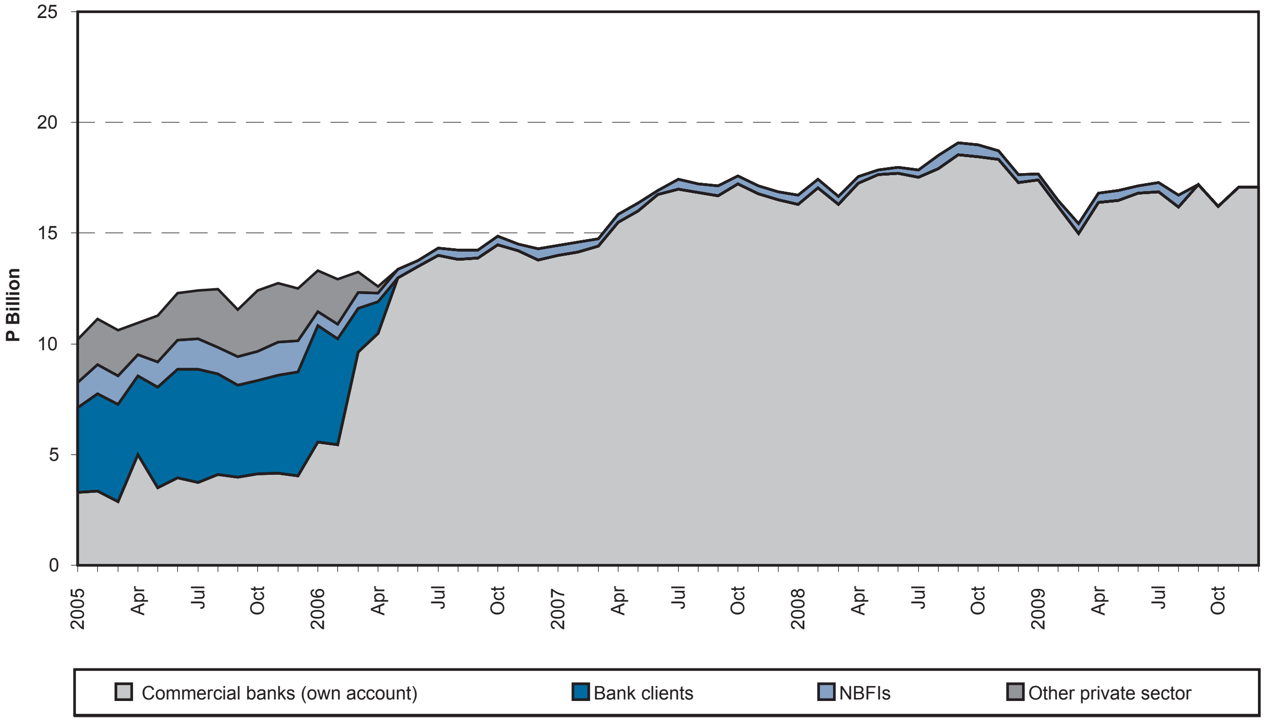
Domestic Credit

4.8 Annual growth in commercial bank credit[30] fell sharply from 27.7 percent in December 2008 to 15.2 percent in December 2009. The slowdown in credit growth during the year was

29 The smaller fall reflected a requirement that was introduced by the Bank of Botswana in May, that commercial banks must offer a 3-months deposit or equivalent product where the interest rate is a maximum of 4 percentage points below the prevailing Bank Rate. This is with a view to rewarding savers with positive real interest rates.

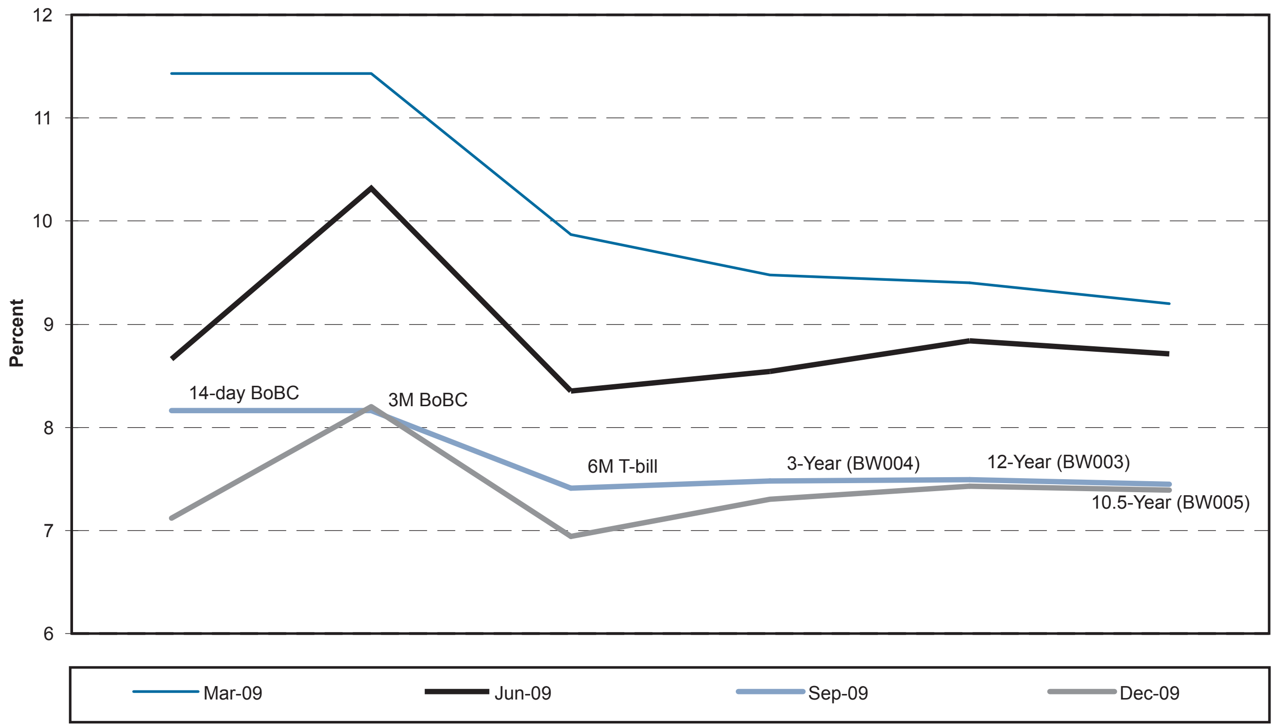
30 From September 2009, the reported credit growth is adjusted to include BancABC following its reclassification as a commercial bank.

CHART 1.11: OUTSTANDING BANK OF BOTSWANA CERTIFICATES



Source: Bank of Botswana

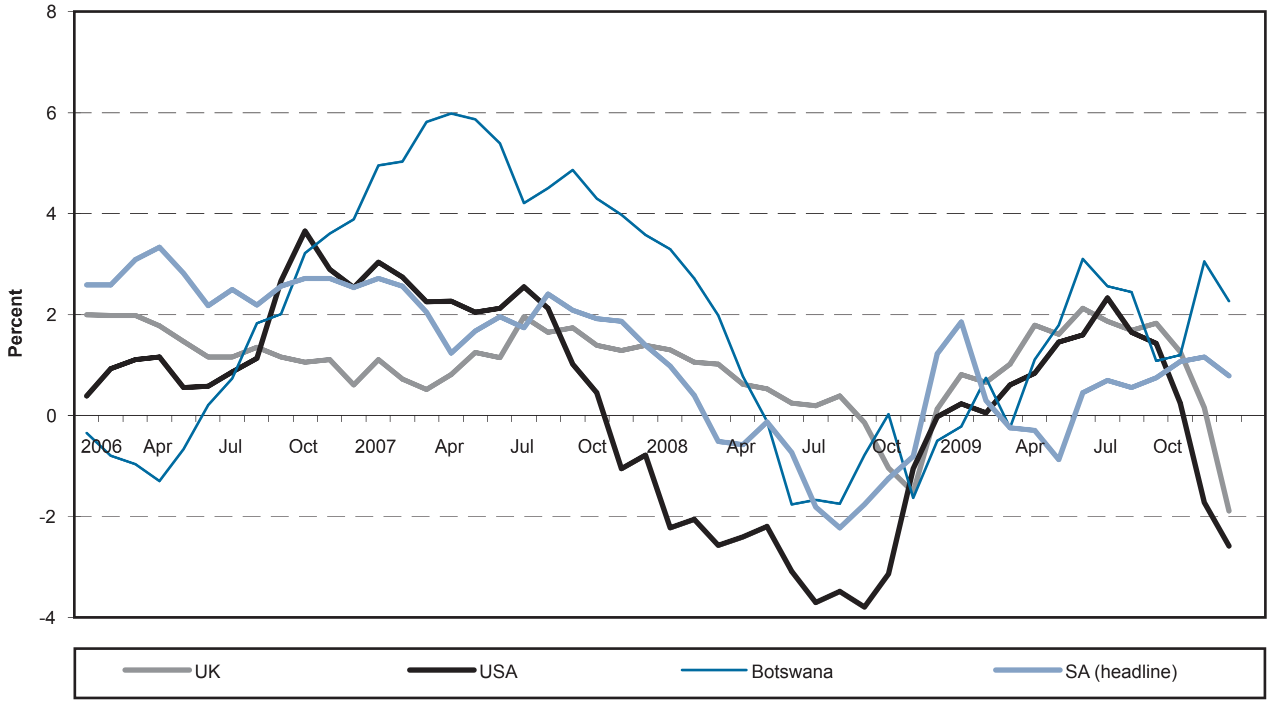
CHART 1.12: YIELD TO MATURITY ON BANK OF BOTSWANA CERTIFICATES AND GOVERNMENT BONDS



Note: The 3-year bond (BW004), 12-year bond (BW003) and 10.5-year bond (BW005) mature in March 2011, March 2015 and September 2018, respectively. Thus, the remaining period to maturity for the 12-year bond is shorter than for the 10.5-year bond.

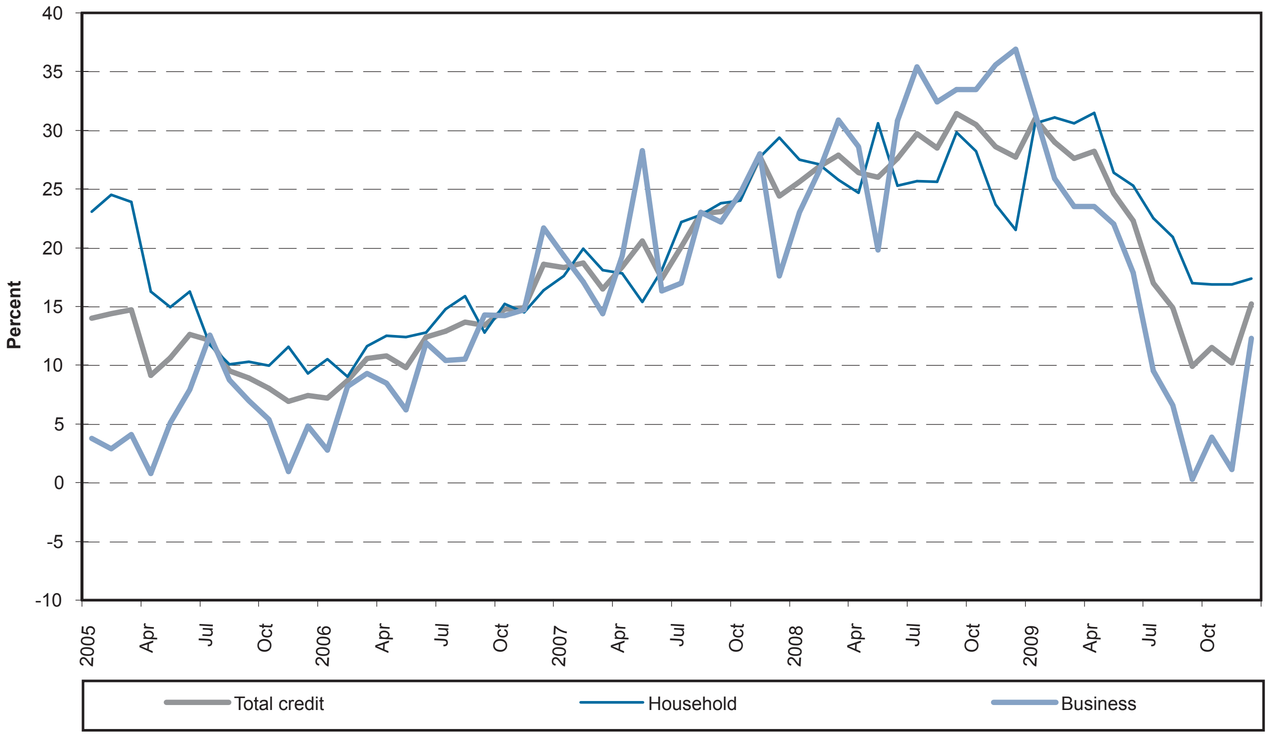
Source: Bank of Botswana

CHART 1.13: REAL INTEREST RATES - INTERNATIONAL COMPARISONS



Source: Bank of Botswana

CHART 1.14: YEAR-ON-YEAR COMMERCIAL BANK CREDIT GROWTH



Source: Bank of Botswana

due to a deceleration in lending to the business sector, from 36.9 percent in December 2008 to 12.3 percent at the end of 2009. Similarly, year-on-year growth in lending to households moderated from 21.5 percent to 17.4 percent in the same period.[31] At the end of 2009, the share of household credit in total private commercial bank credit was 57.9 percent, up from 56.9 percent in the previous year.

Monetary Aggregates

4.9 Overall, the rate of monetary expansion decelerated markedly from an annual increase of 21.1 percent in broad money supply (M3) in December 2008 to a contraction of 7.5 percent in 2009. This was due to the deterioration of the balance of payments, which resulted in a decrease in the level of foreign exchange reserves, as well as the slower rate of increase in both government spending and commercial bank credit to the private sector.

4.10 During 2009, currency outside depository corporations grew by 3.9 percent, transferable deposits declined by 14 percent, while non-transferable deposits grew by 0.5 percent. In Pula terms, foreign currency accounts (FCAs), which accounted for 27.4 percent of total deposits at commercial banks at the end of 2008, declined by 53.9 percent in 2009. The fall in foreign currency deposits was concentrated in deposits with maturities of 88-day and for fixed terms up to six months. The holding of foreign currency deposits provides a hedge against the impact of any adverse movements in the Pula exchange rate on foreign currency transactions, and the decline may reflect, in part, reduced funding available to importers due to more difficult trading conditions prevailing in 2009.

Bank of Botswana

4.11 Total assets/liabilities of the Bank of Botswana fell by 15.5 percent from P68.9 billion in December 2008 to P58.2 billion in December 2009. The contraction of the balance sheet in 2009 was largely due to a reduction of 26.9 percent in Government deposits that were used to help finance the budget deficit, while the value of BoBCs declined by 3 percent to P17 billion. On the asset side, this was matched by a contraction in the foreign exchange reserves (Section 3).

Commercial Banks

4.12 Year-on-year growth in the assets of commercial banks slowed in 2009 to 0.5 percent compared to 21.5 percent in 2008. This was despite the conversion of a merchant bank to a commercial bank during the course of the year. In spite of this, total commercial bank assets were almost unchanged at P44.1 billion in December 2009 compared to P43.8 billion the previous year. However, their composition changed significantly. While loans and advances and other assets continued to grow, by 14 percent and 43.1 percent, respectively, they were substantially offset by declines elsewhere, principally holdings of BoBCs and deposits held in foreign banks.[32] In respect of sources of funds, the small increase in overall assets was matched by movements in total bank deposits, which rose by 1.3 percent to P37.2 billion in December 2009, the largest proportion of which (54.6 percent) were held in current and call accounts.

(d) Other Financial Institutions

4.13 Asset growth for most other financial institutions was similarly sluggish compared to 2008. The balance sheet of the Botswana Building Society (BBS) increased by 7.8 percent during 2009, compared to 18.4 percent growth the previous year. Loans and advances, of which mortgage loans comprise a substantial proportion, grew by 19.3 percent to P1.5 billion. However, cash and deposits at other banks contracted by 14 percent. Due to corporate liquidations, total asset/liabilities of the Botswana Development Corporation

31 This fall would have been significantly larger, but household credit in 2009 was boosted by a reclassification in January by one bank of its credit card lending as part of domestic credit. On average this boosted household credit growth by about 6 percentage points during the course of the year.

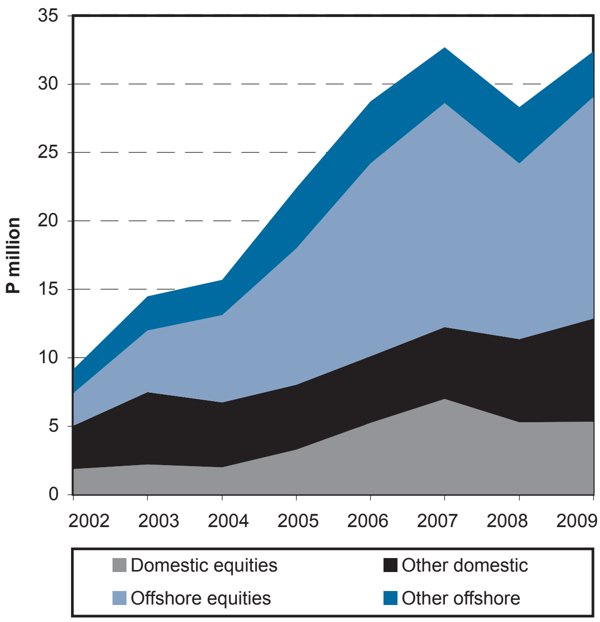
32 The volume of BoBCs reported by the banks fell by P2 billion, or 11.8 percent, which is substantially more than the fall in the total value of outstanding BoBCs (4.11). This is because of a substantial increase in the use of BoBCs as security to facilitate short-term borrowing by the banks. These 'pledged securities' are classified as 'other assets'.

(BDC) fell by 8 percent in 2009 with the fall in assets matched by a broadly equivalent decline in reserves. Regarding the National Development Bank (NDB), asset growth was 11.6 percent in 2009, up from 10 percent in 2008. But growth in lending was modest, at 2.4 percent compared to 32.8 percent in 2008, with increased cash and bank deposits being the main source of asset growth. Total assets/ liabilities of the Botswana Savings Bank (BSB) rose by 16.1 percent in 2009, compared to 20.5 percent the previous year.

4.14 The Domestic Companies Index (DCI) of the Botswana Stock Exchange (BSE) gained 206.4 points (or 2.9 percent) in 2009, albeit only a partial recovery from the loss of 391.2 points (16.5 percent) in 2008. The index trended downwards in the first part of the year, losing a further 13.5 percent by mid-May. This reflected further weakening in sentiment towards banking shares, which comprise the bulk of the DCI. The impact of the global recession on the index was, however, limited, in part because all the listed mining companies are also dual-listed elsewhere and, as such, are part of the Foreign Companies Index (FCI). Since late June, the DCI commenced a steady recovery, reaching positive territory for the year in early November. During the year, trading was active with 564 million shares valued at P852 million traded, and market capitalisation of domestic companies grew by 5.9 percent to P28.5 billion. As global economic activity showed signs of recovery, the FCI rose by 19 percent, compared to a fall of 45.8 percent in the previous year. No new companies were listed on the exchange during 2009.

4.15 Assets of pension funds were P32.4 billion in December 2009, and representing an increase of 14.4 percent from P28.3 billion in the previous year (Chart 1.15). The major contributor to this growth was the value of domestic bonds and offshore equities, which rose by 47.2 percent and 26.3 percent, respectively. This was, however, offset to some extent by a decrease of 25.6 percent in the value of offshore bonds. The increased value of foreign equities reflected the substantial recovery in global equity markets since the end of 2008. The proportion of total assets that were invested offshore rose marginally from 59.8 percent to 60.2 percent.

CHART 1.15: BOTSWANA PENSION FUND ASSETS 2002 – 2009



Source: Ministry of Finance and Development Planning and NBFIRA

4.16 In 2009, the Government continued the programme of supporting capital market development. To this end, a range of maturities continued to be issued through the Bond Issuance Programme that commenced in March 2008. These included P1 billion of six-months Treasury Bills and P300 million of bonds in March 2009, and P1 billion of six-month Treasury Bills and P500 million of bonds in September 2009. As at December 2009, the total par value of the outstanding bonds and Treasury Bills was P4.1 billion. In terms of distribution, foreign investors held P60 million worth (1.5 percent) of government securities, while the Bank of Botswana held P40 million worth (1 percent) of government securities for potential secondary market activity. The remaining 97.5 percent was held by commercial banks and their customers.

(e) Credit Rating

4.17 Both Moody's Investors Service (Moody's) and Standard & Poor's (S & P) released the country's investment grade sovereign credit ratings for 2009. The rating agencies made adjustments to the outlook in line with the global economic downturn and the resulting impact on the national finances. S & P lowered the country's rating from 'A' to 'A minus' and upgraded the outlook from 'negative' to 'stable'. On the other hand, Moody's left the overall rating unchanged, but lowered the outlook from 'stable' to 'negative'. Moody's revised the outlook for foreign currency bonds from positive to stable. Overall, Botswana continues to have the highest sovereign credit rating in Africa.

(f) Other Financial Sector Developments

4.18 Following issuance of two domestic commercial banking licences and one offshore commercial banks licence, the number of licensed banks increased to 11. Of the two domestic commercial banks licensed, African Banking Corporation of Botswana (BancABC) upgraded its merchant banking licence to that of a commercial bank. The expansion of the banking industry was also evident from the establishment of new bank branches and installation of additional automated teller machines countrywide. Continued innovation in the industry included increased utilisation of information and communication technology such as the cellular telephone, email and internet. Other developments included four new bureaux de change and six new branches of existing bureaux. Two bureaux had their licences revoked, and this resulted in 52 operating bureaux de change at the end of the year.

4.19 The number of non-bank entities operating in the IFSC remained unchanged in 2009 at 20. In September, the Bank of Botswana transferred responsibility for regulating the activities of the IFSC and Collective Investment Undertakings (CIUs) to the Non-Bank Financial Institutions Regulatory Authority (NBFIRA), while the Government commissioned a consultancy on the establishment of an efficient enabling legislation for IFSC operators. The intention is to have a single comprehensive piece of legislation that will guide IFSC activities.

CHAPTER 2

DETERMINANTS AND TRENDS IN HOUSEHOLD FINANCIAL SAVINGS IN BOTSWANA

1. INTRODUCTION

1.1 In the economic literature on saving and financial intermediation, the household sector is generally presented as being in surplus, and thus able to help meet the financing needs of the business sector and, in some instances, government activity. In the circumstances, it is imperative that economic and financial policies (and even social policies) support the mobilisation of household savings. These include, among others, the promotion and development of a variety of financial sector institutions and instruments, while incomes and tax policies should also be supportive of a saving culture. In particular, it is recognised that financial saving by households can take various forms such as bank deposits, pension and insurance contributions and investment in securities such as shares and bonds.

1.2 While the level and depth of financial sector development are important determinants of household saving, especially in the context of significant transformation in the range of financial services that are available to households, growth in personal incomes also leads to higher levels of saving. At low income levels, a greater part of income available is allocated to basic necessities. However, there is also empirical evidence indicating that periods of rapid economic growth that generate an increase in consumer confidence result in higher levels of consumption relative to saving. Such pro-cyclical effects on consumption to the detriment of savings were a major contributing factor to the recent credit crunch in major economies and the global financial crisis that followed. Financial sector development and enhanced access to financial services could also engender credit-funded consumption that reduces the saving rate. On the other hand, an increase in interest rates constrains consumption, thus leading to growth in savings. Demographic factors also have an influence on national saving, with lower rates of saving (dissaving) by younger and older age cohorts and higher rates for middle age cohorts; hence, a predominance of any group in the national age profile will influence the aggregate saving pattern.

1.3 The measurement of saving is, however, not straightforward and can take various forms. National accounts data can be used to provide a broad measure where the difference between national income and consumption constitutes savings. The evolution of this measure of saving is then evaluated against, among others, changes in incomes, the financial sector and demographic factors. On the other hand, a more revealing assessment would entail analysis of the evolution of the various forms of financial saving and the associated development of financial institutions and markets. This would be instructive in examining the impact of macroeconomic and financial policies and other institutional developments on savings trends. It is considered, for example, that, in general, the maintenance of macroeconomic stability, such as any success in enhancing predictability of inflation and attaining positive real interest rates, as well as minimising exchange rate volatility, would improve the savings rate. This applies not only to short-term bank deposits, but also to investment in longer-term securities, as expectations of a stable macroeconomic environment are entrenched.

1.4 Other significant domestic developments include the implementation of financial sector policies that promote competition and access to financial services, the transition to funded pension schemes, and capital market initiatives which also provide opportunity for financial savings. In addition, a supervisory framework that promotes stability and inspires public confidence in the financial system also contributes to growth in financial savings. Similarly, a legal environment that discourages fraudulent and unregulated mobilisation of resources and fosters enforcement of contracts would have a positive influence on saving behaviour.

1.5 The Theme Chapter assesses past trends in savings and policy developments and highlights possible initiatives that could sustain growth of financial savings as well as economic development and contribute to improvement in living standards. Section 2 provides an overview of general determinants of savings, while Section 3 analyses trends in Botswana household savings, along with some international comparisons. Section 4 addresses policy and institutional influences on household savings in Botswana, while Section 5 contains policy recommendations.

2. DETERMINANTS OF HOUSEHOLD SAVINGS

Components of National Savings

2.1 National saving is the aggregate level of savings accumulated by both the private and public sectors of a country during the relevant accounting period. It can be either measured directly or derived as the residual of national income after subtracting total private and government consumption expenditure. In the national accounts framework, saving is, therefore, the resources not used up in the current period, and as such is commonly referred to as deferred consumption. Thus, saving may be defined as a process of conserving resources for future use, which are then available to finance investment that is necessary for growth and development.

2.2 In relation to investment, savings are distinguished from the balances held in demand deposit accounts (including balances in current accounts) to facilitate consumption rather than being set aside for future use. One of the principal roles served by financial institutions is to improve the efficiency of resource allocation to investment, a process which channels funds from savers (creditors) with surplus income to borrowers (debtors), who require additional funds to finance their activities. The borrowing may be for either consumption or investment, but the latter is particularly important as productive investment underpins economic growth and the accompanying rise in living standards.

2.3 There are four potential sources of national savings in open economies, namely: government or public sector, businesses, households and the foreign sector. Public sector saving is the difference between government revenue and expenditure net of investment expenditure or revenue from asset sales, which is the equivalent of the recurrent budget surplus. The private sector component of national saving comprises the flow of savings generated by private business entities and households. Savings by businesses entail corporate retained earnings. Household saving is defined as personal disposable income less personal consumption, where personal disposable income is gross income less direct taxes. Foreign saving refers to the amount of imported savings, reflected in the current account deficit, which occurs when a country's total imports of goods and services exceed the country's total export of goods and services.

2.4 A number of possible determinants of household savings have been identified, many of which centre around the life-cycle hypothesis of smoothing consumption over the long term or the permanent income hypothesis that suggests that consumption depends on permanent rather than current income (Box 2.1 contains more details). The determinants of savings can be grouped into four main categories, viz., microeconomic, demographic, social and macroeconomic. Associated with these are the motives for saving, which include providing for retirement and/or intergenerational maintenance of wealth; funding future large outlays for

BOX 2.1: MODELS OF INTERTEMPORAL CONSUMPTION

Both the Life Cycle Hypothesis (LCH) and Permanent Income Hypothesis (PIH) focus on the intertemporal dimension of consumption, recognising that income is not necessarily all spent in the same period that it is earned. Central to both are the pattern of past income (and wealth accumulation) and expectations of future income as being of as much importance as current income for decisions regarding current consumption. Because of this, a sudden change in current income (up or down) may not alter consumption patterns much, unless it is expected to continue. While structured differently, both hypotheses share several similar implications.

(i) The Life Cycle Hypothesis

The LCH assumes that individuals plan to smooth consumption over their lifetime based on their expectations of their lifetime net wealth. A principal implication of this hypothesis is that there are periods during lifetimes when savings are predictably low or negative. In particular, on the assumption that the earning potential of an individual grows throughout much of the person's working life, it is often rational both to borrow at a younger age and then save, first to pay off accumulated debts and then build up resources to fund consumption during retirement. Because of this focus on age-related factors, the LCH is useful for analysing the impact of demographic trends on savings patterns. For example, when growth patterns mean that either older or younger age groups are increasingly important in the population, the LCH would suggest that aggregate savings rates would tend to decline.

(ii) The Permanent Income Hypothesis

The PIH, as originated by the famous economist Milton Friedman, postulates that, however variable their income, households will attempt to smooth the pattern of their consumption. It, thus, looks at the impact of current income in the context of expectations regarding longer-term or permanent income. In this context, changes in current income have a differing impact on consumption depending on whether they are viewed as permanent (such as moving to a new job, for example) or transitory (winning a prize in a raffle or lottery, for example). The implications of the model are particularly important in assessing the role of macroeconomic policy in influencing the economy, since if the impact of, for example, changes to tax rates or real interest rates is viewed as being only temporary, it may not have much effect on consumption patterns.

physical assets such as housing or services (for example, education); precautionary saving to cater for unexpected loss of income, health needs or disability; and/or the maintenance of a stable consumption pattern.

(a) Economic Factors

Income Levels

2.5 When incomes are low, the need to cover the purchase of necessities leaves little scope for savings. Thus, it might be expected that there will be such a strong positive relationship between income and saving that the saving rate (the ratio of saving to income) increases as incomes rise. At lower levels of disposable income, households are expected to consume a high proportion of their income, with consumption expenditure perhaps even exceeding income as the household borrows. However, as disposable income rises, household expenditure does not necessarily increase as fast, making more funds available for saving both in absolute terms and as a proportion of income. This is supported by both the LCH (where higher incomes are used to save for retirement) and the PIH, which also notes that the higher incomes may also have a higher transitory component in the form of non-employment income, which is more likely to be saved.

Interest Rates

2.6 A rate of interest can be regarded as a price of holding cash or non-interest bearing bank balances; it is the reward for postponing consumption. As such, it might be expected that a higher rate of interest will encourage more savings. However, this is not always the case. This is because the effect of the interest rate on saving is ambiguous, as it depends on the relative importance of two different effects identified in economic theory; these are the substitution and income effects. The "substitution effect" refers to the additional incentive to save due to the greater reward for postponing consumption arising from higher interest rates. However, the additional income earned as a result of higher interest rates means that the same future income could be achieved while saving less. The extent to which this "income effect" offsets the incentive to save more depends on individuals' preferences and is a matter for empirical investigation.[1] However, it could have an important bearing on whether individual households are responsive to changes in interest rates.

2.7 In addition, the impact of interest rate changes on previously accumulated wealth must also be considered. To the extent that higher interest rates cause a decline in asset values (lower house prices, for example), current savings behaviour may be affected, again through a combination of income and substitution effects.

Precautionary Savings

2.8 Precautionary savings are the component of saving that is unrelated to the life cycle income profile, but is intended to provide a stock of reserves that could serve as a cushion against an unexpected decrease in income, for example, due to unemployment or ill-health. Precautionary saving would also cater for unexpected expenditures, such as emergency medical treatment or those arising from rapid price increases. If the shock proves to be transitory, such savings can help preserve consumption in line with permanent income; however, if the shock is longer lasting, further adjustment to consumption and savings may be necessary. The more risk averse and/or the more pessimistic the households are about the overall economic outlook and their employment prospects, the higher the level of precautionary saving they would hold; hence, the greater the likelihood of a higher level of aggregate saving.

2.9 The importance of precautionary savings has been demonstrated in the context of the recent financial crisis and subsequent global recession. Households, businesses, governments and other related entities that had accumulated some savings and had limited their level of debt were best able to adjust to the credit crunch as financial institutions scaled back lending.

Access to Credit

2.10 The degree to which credit is available has an influence on patterns of current consumption, with a consequent effect on saving behaviour. The availability of credit reduces the need to build up savings either to fund asset purchases or to cover unexpected shocks. Thus, it will affect life cycle patterns of savings, as well as the demand for precautionary savings. This credit would have to be repaid at a future period, which would lead to a reduction in consumption at that time and, hence, an adjustment in the consumption profile over one's life cycle. However, there is a risk that households, especially when faced with new opportunities, might take insufficient account of the longer-term consequences and, as such, accumulate an unsustainable level of debt. Such behaviour was again evident in the recent "credit crunch" in the case of low income "sub-prime" borrowers.

Development and Liberalisation of the Financial Sector

2.11 The availability and accessibility of banking facilities play pivotal roles in redirecting financial resources from savers to borrowers. Financial intermediaries collect savings from various households, which, even if they may individually be small, are, in the aggregate, a significant contribution to the level of national savings. Therefore, increases in banking facilities and the variety of saving products

1 According to conventional economic theory, the substitution effect of the interest rate on saving is always positive: i.e., higher interest rates will result in higher savings, and vice versa. However, the direction of the income effect is ambiguous and can be positive, neutral or negative. While a negative income effect of a change in the interest rate may seem the most plausible, it cannot be inferred that the offset of the substitution effect is necessarily large, and the case where it completely offsets an increase in interest rates should be regarded as extreme.

have the potential to raise the savings rate. Although financial liberalisation allows the financial market to operate smoothly and efficiently, its impact on savings is ambiguous. This is because of the close association of financial liberalisation with an increase in credit availability. As explained, this may encourage consumption, especially if the availability of credit is associated with more attractive lending rates (which may well be the case if borrowing was previously only available at punitive interest rates through informal money lenders). It is, nevertheless, considered that the deepening and broadening of the financial sector can potentially provide impetus to savings mobilisation both through the provision of a wider range of more attractive standard savings products, as well as, in some instances, alternative investment vehicles that can also be relevant to households, such as listed equities, bonds and unit trusts (collective investment undertakings).

(b) Demographic Factors

Population Growth, Age Structure and Life Expectancy

2.12 Given the importance of life cycle effects on the saving decisions of individuals, a change in the population age structure is expected to affect aggregate household savings. The central result of the life cycle hypothesis is that, unless otherwise constrained, people save (accumulate assets) during their working life[2] to finance retirement, and dissave (spend their assets) during retirement. Thus, if, due to rapid population growth, the cohort of younger people outnumbers that of older people, there will be more workers accumulating assets (saving) for their retirement than there will be retirees who are drawing down their assets (dissaving). This will result in a positive amount of aggregate savings. Therefore, if other aspects remain unchanged, the more young savers there are relative to old dissavers, the greater will be a nation's saving rate (the ratio of savings to GDP).

2.13 The age structure also affects the saving profile within the working age population. Provided that the market for borrowing is sufficiently developed, younger workers are more likely to be net debtors as they borrow either to fund asset purchases, smooth consumption in anticipation of higher future income, or to improve their productivity through the acquisition of education. Moreover, the impact can change rapidly as the current younger generation ages; for example, the reduction in the saving rate in America and Europe that is associated with the aging of the so-called 'baby boom' generation of the 1950s and 1960s.

Dependency Ratio

2.14 Another important consideration is the dependency ratio of the population, i.e., the proportion of non-productive (typically young and old) people who, at least to some extent, need to be supported by the working population. A high dependency ratio will tend to make it more difficult to maintain the appropriate balance between savings and consumption, as resources that would otherwise be available for saving have to be diverted to supporting the consumption needs of dependents. To a large extent, this is determined by the age structure, but other factors are also involved. In particular, there may be a degree of dependency within the working population, especially if employment opportunities are limited. In this respect, the balance between urban and rural populations which, in turn, affects employment prospects and income levels will have an impact. Health issues are also important, as widespread ill-health can also increase dependency. In addition, social and institutional influences can vary across countries and affect the extent of direct dependency (i.e., whether working people are directly responsible for supporting non-working members of the extended family or whether there is government support).

2.15 Problems of dependency will tend to be aggravated by low income levels, as people

2 Except when they are just beginning to work, when they may borrow to accumulate assets like houses, household durables, cars and human capital.

will have less capacity to accumulate savings to cater for their old age. Moreover, this may result in further increases in dependency as low income families tend to have more children who, in turn, can share the burden of caring for the older generation. It is notable that significant declines in dependency achieved in many developing countries (including Botswana) in recent decades are often closely associated with sustained economic growth and the resulting rise in general living standards.[3]

Life Expectancy

2.16 A particularly important aspect of the changing population age structure is the increase in life expectancy or longevity. Mortality rates across the world have fallen significantly over the past one and half centuries for both developed and, more recently, developing economies. This is illustrated in Table 2.1 which shows the increase in life expectancy since 1960 for least developed and high income countries, as well as for Sub-Saharan Africa, although for the latter region the increase has been slower, partly reflecting the impact of chronic diseases such as HIV/AIDS.

TABLE 2.1: TRENDS IN LIFE EXPECTANCY 1960 – 2007

	1960	1990	2007
LDCs	40	51	57
High income (OECD)	69	76	80
Sub-Saharan Africa	41	50	52

Source: World Bank, World Development Indicators

2.17 Longevity might lead to either a rise or fall in per capita saving. The incentive to save as people live longer is attributable to the realisation that the extended life of the aging population raises the proportion of life which will be spent within the retirement period, posing a challenge to the adequacy of government social welfare systems and pension funds. This provides additional incentives for individuals to increase savings at every age during a working life to build up assets to finance consumption during retirement. In fact, contrary to the implications of the life cycle hypothesis, some people dissave very little during their retirement, especially when they become more optimistic about their life expectancy or they become more risk averse and become motivated to accumulate more precautionary savings as they age. Risk aversion generally involves the tendency to avoid exposure to excessive risk. This is common among the elderly with regard to finances since it is extremely difficult for them to get credit. Thus, they economise on the drawdown of their pension funds so that they are not caught off guard in case of substantial unexpected expenditures.

2.18 However, the longer people live, the more likely they are to dissave, because once they reach retirement age, they generally do not engage in economically productive ventures that earn them additional income. Hence, they draw down savings to supplement pensions, where applicable, to finance expenditure. Thus, as the population ages, the number of dissavers relative to savers increases, and this tends to reduce the aggregate level of savings and tends to lead to a decline in the per capita savings rate for a stationary population.

2.19 While longevity may boost savings at the household level, the positive impact on national saving is possibly temporary, since an increase in longevity implies that, for a constant population, there is a higher proportion of elderly individuals. Therefore, in the long run, a higher number of those who dissave might offset an increase in age specific saving. The issue of increased life expectancy also raises important policy questions of whether or not to increase the retirement age and the extent to which it could be raised, given that, in some instances, it was set when people were not expected to live long.

3 See "Go Forth and Multiply a Lot Less", The Economist, October 31, 2009.

(c) Social Factors

2.20 An important social factor that can influence savings behaviour is the bequest motive. This occurs to the extent that individuals accumulate assets during their working years in order to provide their children or other beneficiaries with an inheritance or endowment. It is, therefore, viewed as an incentive to save for purposes of transferring wealth across generations. Parents are more inclined to hold savings as a precaution to protect the welfare of their children in case of their untimely death. However, the strength of the bequest motive is hard to assess because the remaining wealth after death cannot, by itself, be interpreted as a sign that the individual cared greatly about the wellbeing of the living, since the bequest might have been in part unintentional as the deceased might have consumed all savings or wealth had they lived longer.[4]

(d) Macroeconomic Environment and Other Factors

2.21 Financial saving is also significantly influenced by prevailing and expected macroeconomic developments. Uncertain prospects affect the level of confidence and can have both a negative and positive impact on saving. For example, uncertain prospects about the availability of credit may induce people to save so that when credit avenues become limited, savings can be drawn down to finance expenditure. If the recent credit crunch had been foreseen more widely, more people who rely on credit, especially in the markets which were directly hit by the global credit crisis, could have restructured their expenditure patterns to build up more savings. Conversely, a negative relationship between uncertainty and savings might arise, for example, in a situation where inflation is expected to rise. In this case, potential savers may be encouraged to raise their current expenditure to avoid losing the purchasing power of their savings. It is also possible that precautionary savings (mostly in inflation hedges) may increase in response to the uncertainty that inflation creates.

2.22 In general, specific sources of macroeconomic uncertainty include fluctuations in the business cycle, volatile exchange rates, erratic inflation rates, balance of payments and trade shocks, regulatory inefficiencies and instability in the financial system. These may cause a loss of confidence in the domestic market which could lead to capital flight and act as a disincentive to save, as misgivings about realising returns and recovering savings become widespread. On the other hand, prudent and predictable policies with respect to fiscal, monetary and exchange rate policies, as well as effective financial sector regulation, contribute to a stable environment that promotes financial saving. In particular, the failure by regulators to effectively monitor and pre-empt the consequences arising from the issuance of mortgages at sub-prime rates is said to be the principal cause of the recent credit crunch and subsequent financial crisis and global recession. Thus, there is a need for regulation to find a balance between encouraging efficient and innovative financial intermediation and limiting systemic risks.

2.23 Inadequacies in the enforcement of saving contracts may substantially impair the supply of savings, when potential savers reduce or cease to operate savings accounts as a precautionary measure against the risk of financial institutions failing to pay depositors as per the terms of the contracts. The problem is exacerbated if the legal system fails to adequately protect savers or punish perpetrators in cases where financial institutions fail to honour saving contracts.

4 To the extent that many people go to considerable trouble to formally record details of their bequests in their wills, it might safely be presumed that the bequest motive is positive, if sometimes weakly so.

The role of savings in economic growth

(a) The Importance of Economic Growth in Development

2.24 Even though there are divergent views about how economic development is promoted, there is a general consensus that economic development is a process that is driven by a rise in the real per capita income within a supporting environment of social, demographic, macro and political institutional frameworks. Thus, economic growth can be thought of as the most dominant factor in determining welfare and the standard of living. The underlying factor, however, is the saving rate, as savings are used to fund investment that leads to economic growth.

(b) Can Countries Continue to Grow Faster by Simply Saving More?

2.25 By definition, for a closed economy (that is, with no external transactions in the form of trade or financial flows), the national accounts framework equates the amount of saving (S) in an economy to the amount of investment (I), that is S = I.[5] However, for open economies, national saving is a sum of investment and net exports (NX, the difference between exports and imports), thus, S = I + NX. (See Box 2.2 for the derivation of saving).

2.26 National saving is regarded as a key determinant of economic growth and the development process in general because of the close connection with investment. The availability of saved funds influences national capacity to invest in the accumulation of capital which, in turn, affects the level of production and, therefore, the growth potential of the economy.

2.27 However, this is not to suggest that generating more savings is always desirable. It is important to appreciate that the objective is not to maximise, but to optimise savings. First, with respect to saving at the individual or household level, there is clearly a cost of

BOX 2.2: NATIONAL SAVING, DOMESTIC INVESTMENT, NET EXPORTS AND NET FOREIGN INVESTMENT

National Saving (S) = Private Saving (Y − T − C) + public saving (T − G)

Therefore: $S = (Y - T - C) + (T - G)$

$$S = C + G + I + NX - T - C + T - G$$

$$S = I + NX$$

$$S = I + NFI$$

Where:

Y is national income (GDP) = (C + G + I + NX)

NX is net exports or trade balance = Exports - Imports = Net Foreign Investment (NFI), by definition,

NFI is Net Capital Flow (NCF) or the difference between foreign investment in a county and the country's investment abroad,

C is private (household + business) consumption,

G is government purchases net of public investment,

T is taxes paid by economic agents to government,

I is domestic public investment plus domestic private investment,

(Y − T) is disposable income, (T − G) is public savings, also known as the recurrent budget surplus.

5 Investment in this case includes inventory accumulation as well as acquisition of productive capital. Thus, the identity holds because postponed consumption results in a matching build up of unsold stock.

foregoing additional consumption as this depresses current living standards. This cost of saving will only be worthwhile if it is more than outweighed by opportunities, through growth, for additional consumption (both quantity and quality) in future. Thus, it is important that savings mobilisation is accompanied by effective allocation of funds to productive investment activities, through a well-functioning financial sector. Second, at the macro level there is a danger that, while it may be rational in some situations for households to save more on an individual basis, the aggregate effect of this is to reduce demand to the extent that it depresses growth. This is known as the "paradox of thrift" and is of particular importance in circumstances where economic activity is depressed. In turn, it provides one of the major justifications for policies of fiscal expansion, which entails a reduction of public sector savings, in order to counter the impact of increased household savings.[6]

2.28 Overall, the positive linkage between savings and growth on the one hand, and to economic growth and development, on the other, suggests that an important goal of economic policy in developing countries should be to promote savings. Additionally, it is notable that the slow pace of development in low income countries is usually attributed to the typically low levels of national savings, which limit capacity to invest in capital accumulation; hence curtailing prospects for output expansion. Consequently, there is a ripple effect from the limited ability of nations to invest in capital accumulation, which leads to a lower rate of economic growth and less development than would otherwise be the case.

2.29 On the other hand, standard economic growth theory suggests that, even without the possible problems of the paradox of thrift, a higher level of savings will not result in a permanent increase in the rate of economic growth. This is because, as additional investment increases the capital intensity of production, the marginal productivity of investment will decline, ultimately causing the growth rate to fall to a steady-state level in which, apart from technological progress, output grows in line with labour input and the capital-intensity of production is stable. In this case, additional growth in per capita income can only be achieved through investment that not only increases the capital stock, but also enhances its quality through technological change, through both innovation and improvements in human capital (that is, skill acquisition among workers).[7] This indicates that it is important not just to generate funds for investment, but to establish an environment where relevant technological progress is nurtured. One way is to provide direct encouragement for innovation (targets and incentives for spending on research and development, for example). But it might also be anticipated that effective financial intermediation would go at least some way towards achieving this, given that, in many instances, the adoption of new technologies will increase the viability of the investment.[8]

2.30 An alternative way of looking at the growth process, outside the mainstream of economic theory (footnote 7) is Rostow's 'Five Stages of Development'. This also recognises the importance of savings in economic growth and development as it supports the necessary build-up of capital. But, it contextualises this growth in outlining a sequence of stages from the most rudimentary (the

6 This has been an important consideration in the current global economic slowdown where fiscal stimulus packages have been introduced, in large part, to replace spending by households which, in several countries, have responded to the crisis by sharply increasing their net saving rates.

7 In the framework of the "Solow-Swan" growth model, the importance of accumulating more capital diminishes while technological innovation becomes more significant in determining long-run growth. Subsequently, work on the causes of growth, including the so called "endogenous growth theory", focuses, to a large extent, on the sources of technological development.

8 This is not inevitable, however, as, in some cases, new technologies, especially if they are largely untested, may add to the riskiness of an investment. This is one reason why it has been difficult to mobilise, without additional incentives, sufficient investment to combat climate change.

'Traditional Society') to the most advanced (the 'Age of Mass Consumption') levels of development. As with the mainstream models, this approach emphasises that, in order to achieve development, capital accumulation must not only be accelerated, but it must be increasingly focused on technological progress and investment in the most productive industries.

2.31 At some stage of development, especially at the early stages of the process, countries may well require more savings than can be generated internally. Moreover, even when, in aggregate, sufficient domestic funds are available, the type of savings may not match the risk profile of the proposed investment suitable for funding risky investments. In such cases, it will be appropriate to draw on foreign sources of savings rather than be constrained by attempting to rely on domestic sources alone. In this way, for open economies, net foreign capital inflows (foreign savings) are also critical in the relationship between savings and growth, because they can help ease the constraint on investment imposed by a shortage of domestically generated funds. This is considered to be important in the case of countries where there is a dearth of financial resources to undertake the necessary investment for sustainable economic growth. Thus, the existence of a 'savings-investment' gap necessitates a reliance on funds from abroad to supplement national savings in order to fund the investment necessary for economic growth and development. As such, a scarcity of domestically-generated savings is not necessarily a binding constraint to investment and economic growth.

2.32 As indicated above, the extent of reliance on foreign savings is measured directly by the size of the current account deficit. That there is nothing intrinsically wrong with such reliance on foreign savings is indicated by the fact that many countries, at all stages of development, run current account deficits, sometimes over long periods. However, there are some inherent problems associated with extensive financing of domestic investments with foreign savings, as this can lead to unsustainable balance of payments deficits and structural imbalances. The current account deficit that is the counterpart of imported savings is likely to reflect a negative trade balance (i.e., net imports of goods and services)[9] and this is only sustainable in the long run if the imported savings are used productively. Moreover, as capital flows into a country, it is accompanied by a rising demand for local currency, which can possibly lead to currency appreciation and potentially undermine development goals such as export competitiveness and economic diversification.

3. TRENDS IN HOUSEHOLD FINANCIAL SAVING AND GLOBAL COMPARISONS

3.1 The world economy has generally grown at a robust pace since the Great Depression of the 1930s,[10] until interrupted by the most recent financial crisis-induced economic recession. However, this was in the context of imbalances in saving rates across countries and with consumer spending providing significant impetus to innovation and economic expansion. Notably, some of the major economies, particularly the United States of America, became chronic net importers of financial resources from countries with surplus financial savings, including from East Asia.[11] Moreover, with confidence and an outlook for continuing affluence engendered by robust economic performance, the motivation for saving eased

9 If not, the deficit is made up of other financial outflows that are a similar drain on national resources.

10 The stock market crash of October 1929 is often seen as the starting point of the Great Depression of the 1930s. More recently, episodes of instability and significant slowdown were in 1973-1979 (oil crisis), 1982 (Latin American financial crisis), 1997 (the Asian financial crisis), 1994 (Mexico) and 1999-2002 (Argentina) and were largely only felt or confined to some regions/countries.

11 It is notable that to the extent that good economic performance and macroeconomic policies allow a country to attract capital (providing appropriate returns to suppliers of funds), domestic saving is not imperative.

in several countries, while the development and marketing of credit products biased consumer/household behaviour towards borrowing for current consumption, rather than saving for future consumption.[12]

3.2 Given the differences in the economic environment of developing and developed countries, it is expected that there would be variations in household behaviour. In particular, the level of development and trends in factors that influence saving, as highlighted in Section 2, differ across countries. An instructive approach would, therefore, involve comparative analysis of household saving trends across countries and/or regions. However, there are data limitations that impede such a comparison and a robust analysis. Therefore, most of the empirical studies that analyse cross-country savings behaviour concentrate on aggregate savings due to lack of consistent information on household behaviour.

3.3 Nevertheless, there has been considerable interest in the economic behaviour of households in the last few years. This is not surprising, given that household saving is an important source of funds needed for investment, while consumption by the sector has a significant influence on economic performance. Moreover, the indebtedness and the saving profile of households affect the stability of the financial system and, ultimately, its intermediation role.

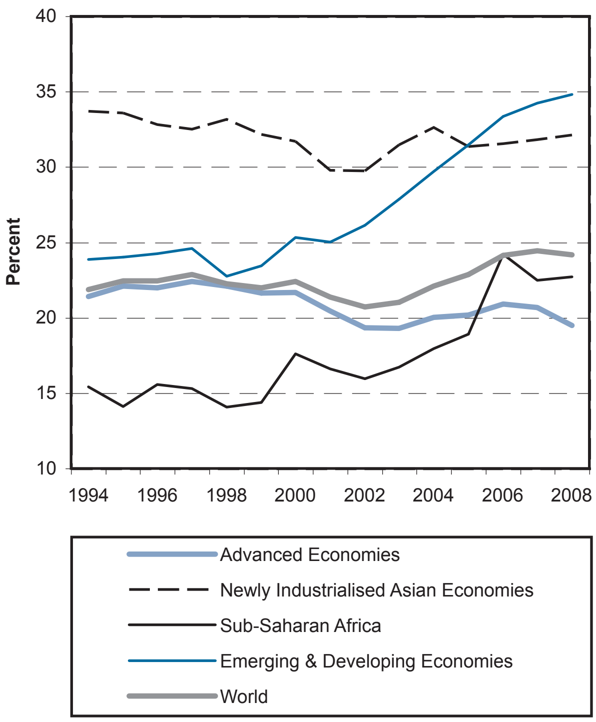
3.4 Despite the paucity of data and the associated challenge of generating conclusive analysis, this section examines trends in saving covering three broad areas, viz., developments in national saving captured in the national accounts, a narrower consideration of household saving in the banking system, and a broader analysis covering other financial instruments.

(a) Trends in National Saving

Global and Regional Developments

3.5 Globally, the world saving rate ranged between 20 - 25 percent of GDP in the period between 1994 and 2008 (Chart 2.1). Between 1994 and 1997, world savings as a percentage of GDP generally increased, but declined between 1997 and 2002, when it reached 20.7 percent of GDP, before rising to 24 percent of GDP in 2008. By region, the newly industrialised Asian economies had the highest saving rate, averaging 32 percent of GDP (between 1994 and 2008), while Sub-Saharan Africa had the lowest average saving rate of 17 percent, although increasing significantly in the later years, reflecting both higher income levels and improved management of public finances. Emerging and developing economies show consistent growth in the saving rate from 1998, and had the highest rate of 35 percent of GDP in 2008, while advanced economies experienced some reduction in the saving to GDP ratio.

CHART 2.1: GROSS NATIONAL SAVINGS AS PERCENTAGE OF GDP 1994 – 2008



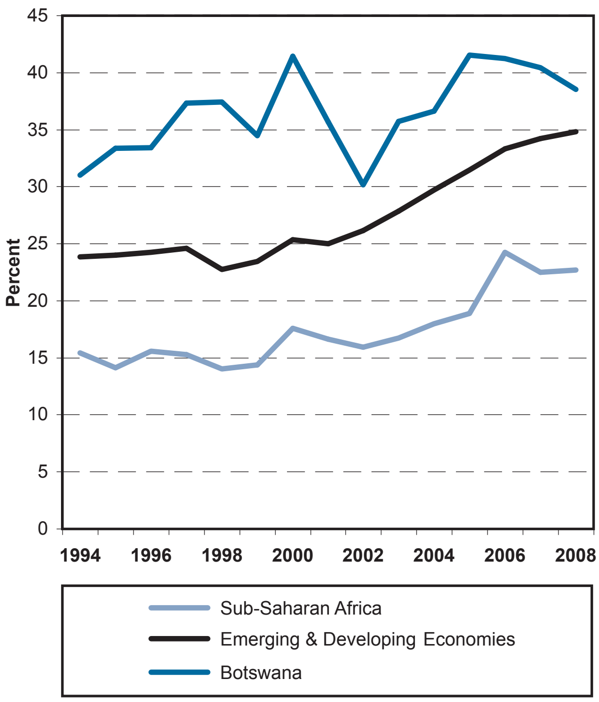
Source: World Economic Outlook, International Monetary Fund (October 2009)

12 Japelli Tullio and Mario Padula (2007), "Households' Saving and Debt in Italy", Centre for Studies in Economics and Finance, no. 183, Fisciano, Italy. This study reviewed savings trends in Italy and found that household saving had dropped significantly, with the decrease accompanied by an increase in households' liabilities and a reduction in credit constraints. The authors also found a positive correlation between debt and income.

Botswana Experience

3.6 Botswana compares favourably with, and appears to be doing better than, other countries in terms of national savings (Chart 2.2). In 1994, savings amounted to 31 percent of GDP and grew to around 41 percent in 2000. Although savings fell to around 30 percent of GDP in 2002, the saving ratio increased to 38.5 percent in 2008. However, this predominantly reflects the historical surplus position of the Government, in contrast to the experience of many countries where net saving by households helps support government operations and private sector activity. Overall, lack of saving is not a constraint to investment in Botswana. Moreover, prudent macroeconomic policies that have been implemented over time have enabled Botswana to attract both private capital inflows and debt (although on a limited scale, especially outside the mining sector). Notwithstanding the favourable position of aggregate savings, there is a need to examine household saving in Botswana and, in particular, the extent of borrowing by this sector. As shown by the recent economic downturn that has squeezed government revenues, the continuation of public sector surpluses in future cannot be taken for granted, and that the effective intermediation of government savings in support of private sector development remains a challenge.

CHART 2.2: GROSS NATIONAL SAVINGS AS PERCENTAGE OF GDP – REGIONAL COMPARISONS 1994 − 2008

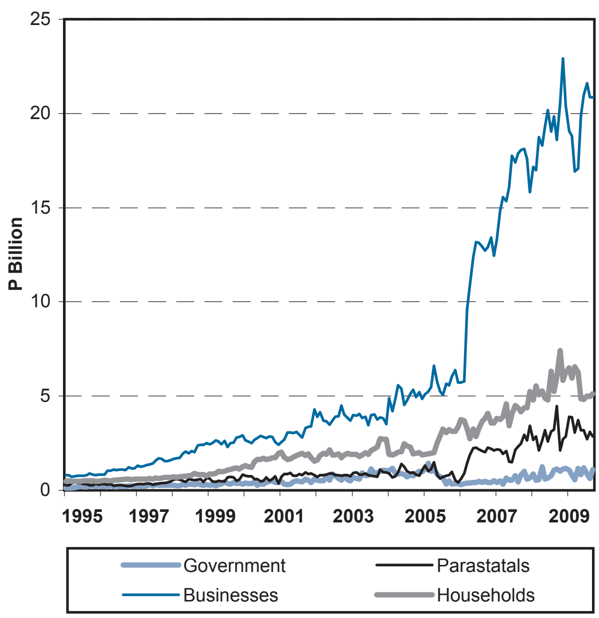


Sources: World Economic Outlook, International Monetary Fund (October 2009) and Bank of Botswana

(b) Savings in the Banking System

3.7 Analysis of commercial bank deposits (Chart 2.3) shows a general upward trend in savings[13] with the larger proportion held by the business sector, while household deposits averaged 24 percent of total deposits between 1995 and 2009 (September). The overall growth in saving is consistent with growth in incomes, albeit faster, as indicated by the increase in the ratio of deposits to nominal GDP (Chart 2.4). Notably, household deposits, which lagged growth in deposits by the business sector, grew largely at the same rate as nominal income. While the share of households in total deposits has fallen in recent years, this is largely explained by the surge in business deposits following the restriction

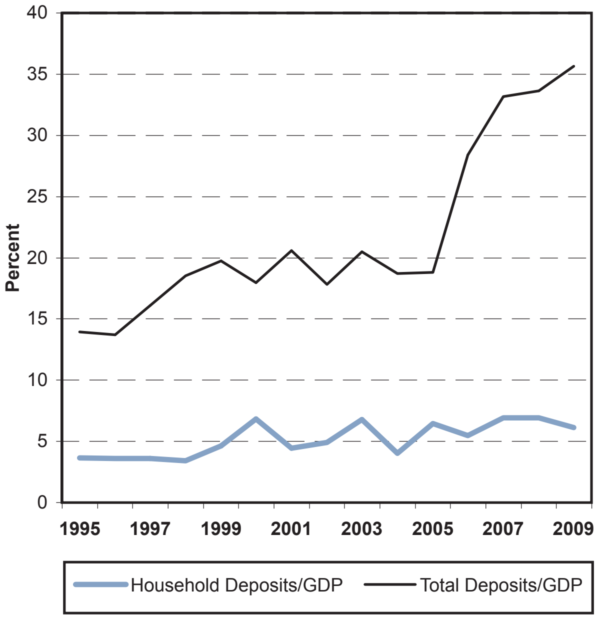
CHART 2.3: COMMERCIAL BANK DEPOSITS BY HOLDER 1995 – 2009



Source: Commercial Banks

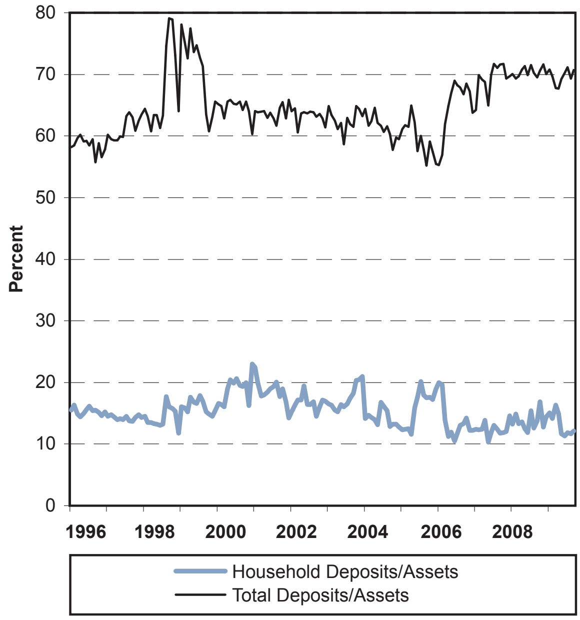
13 These exclude current account deposits, and include interest-bearing deposits.

CHART 2.4: DEPOSITS AS PERCENTAGE OF GDP 1995 – 2009



Sources: Commercial Banks and Central Statistics Office

CHART 2.5: DEPOSITS TO ASSETS RATIOS 1996 – 2009



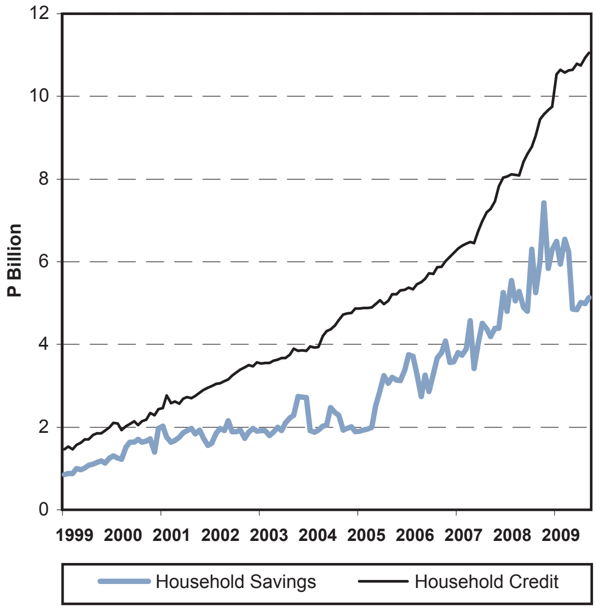
Source: Commercial Banks

introduced in March 2006 on holding of Bank of Botswana Certificates (BoBCs) being limited to banks only. Overall, household deposits increased at a lower rate compared to growth in the banking industry (measured by total assets of commercial banks). As a result, the ratio of household deposits to total assets of commercial banks fell from 15.3 percent in 1996 to 12.1 percent in 2009. However, the comparable ratio for total deposits increased from 57.9 percent to 70.7 percent (Chart 2.5).

3.8 The relatively low household saving rate at commercial banks is also apparent from the imbalance in credit and deposit trends over the past two decades or so. Whereas, prior to 1992, household savings at commercial banks were more than household credit, the household sector has been a net borrower from the banking system since the end of that year, with widening of the gap between savings and credit (Chart 2.6). While it is easy to explain this trend in terms of a supposed unrestrained appetite for borrowing coupled with the effect of aggressive marketing of loan products by banks, it is equally important to appreciate the possible economic and social factors that influence the borrowing and saving patterns, for instance, as outlined in Section 2. In terms of demographic factors, younger households entering the labour force would tend to anticipate an increase in incomes over their working lives and, therefore, undertake earlier borrowing to accumulate an inventory of assets such as residential property, automobiles, as well as durables, and purchase services such as education (both for self-development and for children). Normally it would be expected that these needs would encourage prior saving; however, with expectations of increases in incomes, the borrowing alternative could also be rational consumption smoothing over the life cycle as explained in Section 2. The robust rate of economic expansion that Botswana experienced generated confidence of a sustained increase in incomes and, consequently, welfare. Meanwhile, innovation and competitiveness in the credit market, as well as the general expansion of the financial sector, also positively influences this phenomenon.

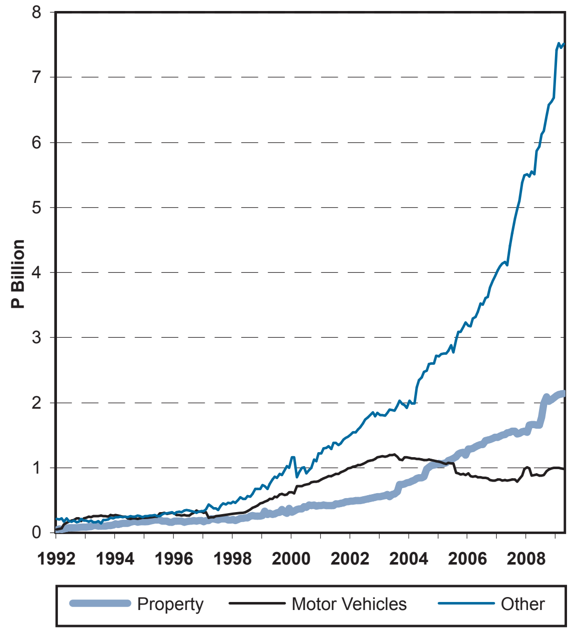
3.9 An examination of the type of bank accounts used by households suggests that deposits are heavily geared toward supporting consumption activities rather than saving. As of November 2009, about 43 percent of household deposits were held in either current or call accounts.

CHART 2.6: HOUSEHOLD DEPOSITS AND CREDIT 1999 – 2009



Source: Commercial Banks

CHART 2.7: LOANS AND ADVANCES TO HOUSEHOLDS – PROPERTY, MOTOR VEHICLES AND OTHER 1992 – 2009



Source: Commercial Banks

A further 39 percent were held in savings accounts, which may be due to substantial use of such accounts by low income households that do not qualify for current account facilities at banks. There was, however, some significant use of 6-month term deposits which accounted for 13 percent of the total.

3.10 A closer examination of household credit patterns indicates that, starting from 1996, the amount of credit extended for the unspecified use "Other"[14] category exceeded that for motor vehicles and property, with a significant widening of the difference. Nevertheless, motor vehicle credit continues to be significant, partly due to the existence of employer guarantee schemes for motor vehicle finance, facilitating employee access to commercial bank loans. Commercial banks have also been particularly aggressive in marketing motor vehicle finance. Average annual growth in this category of loans was 22 percent between 1995 and 2008.

3.11 A welcome development in terms of long-term investment in household welfare is that loans for residential property also expanded at a robust annual rate of 20 percent in the same period, with the share in total credit to households increasing slightly, from 20.3 percent in 1995 to 21.2 percent at the end of 2008. In addition, the amount of borrowing for residential property has, since 2005, been higher than that allocated to the purchase of motor vehicles. However, as indicated above, the classification is not clear cut, since the unspecified use "other" credit could be utilised for the purchase of motor vehicles and financing of residential property, as well as small-scale businesses, especially as the maximum loan limits for this category (personal loans) increased to substantial levels (e.g., up to P150 000). In particular, the recorded decline in motor vehicle lending could be attributed to the rise in imports for second hand vehicles from Asia, which cost less than the regionally assembled cars and which, up to some point, were not financed directly by commercial banks; and even when they started doing so, it was only by some of the banks.

The country comparisons in the charts above show that, while taking into account that

14 The inadequacy of having no reliable breakdown of this category is recognised and ways to improve the classification are being considered.

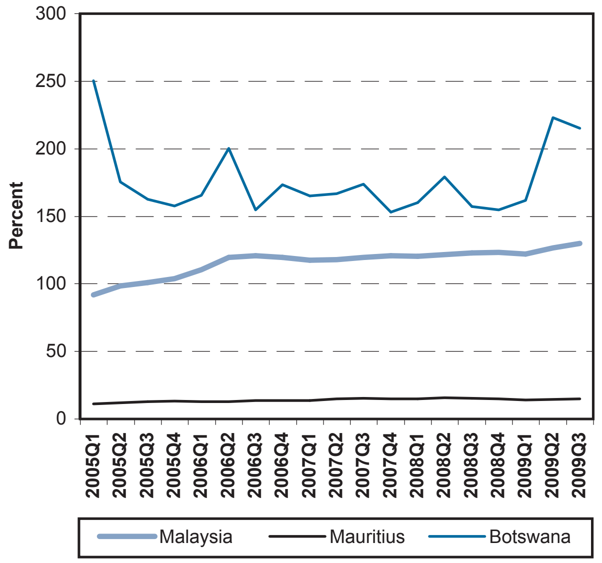
Botswana's banking sector is less developed (comparatively lower ratio of banking assets to GDP), compared to other countries, household saving constitutes a relatively small part of banking operations (indicated by total bank assets) and broad economic activity (GDP). In contrast, the ratio of household borrowing to household deposits is higher in Botswana compared to the other countries.

(c) Saving in Non-Bank Financial Institutions

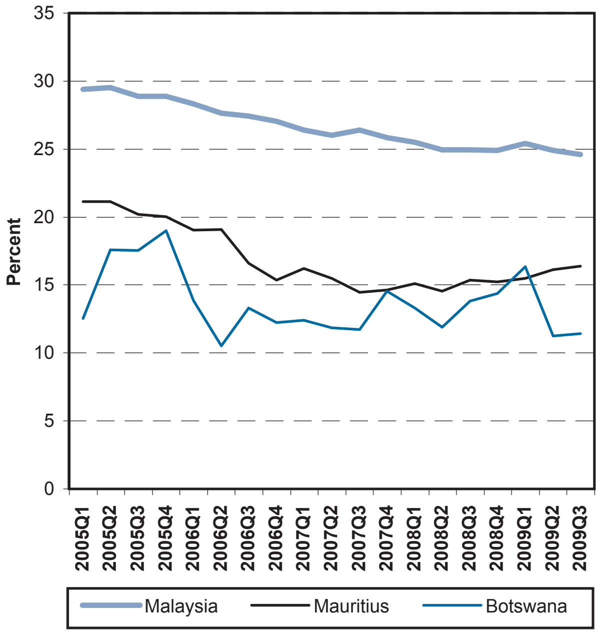
3.12 In addition to commercial banks, households also save at other depository corporations, namely, the Botswana Savings Bank (BSB) and the Botswana Building Society (BBS).

BOX CHART 2.1: INTERNATIONAL COMPARISONS

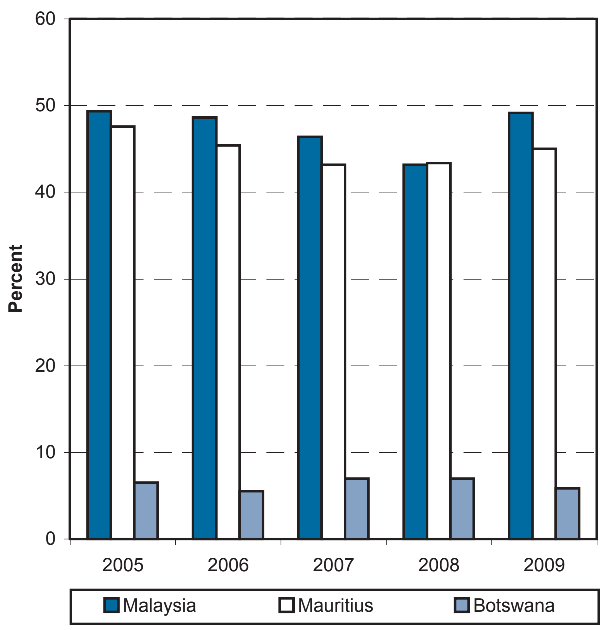
CREDIT/DEPOSIT RATIOS



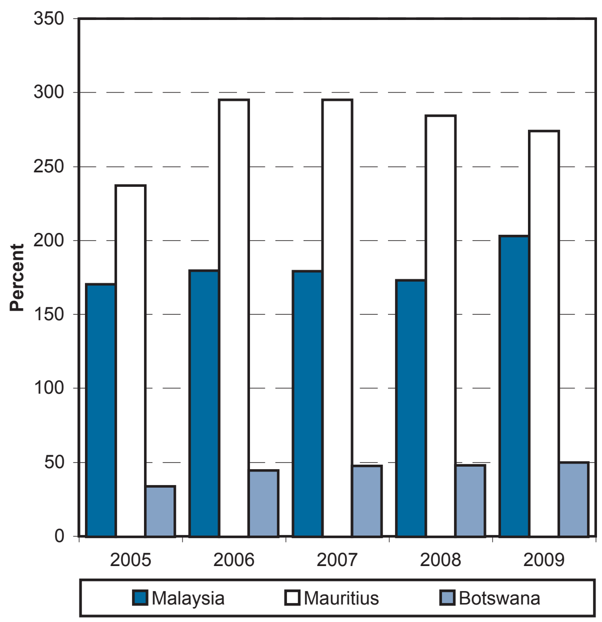
HOUSEHOLD DEPOSITS/COMMERCIAL BANK ASSETS



BANK ASSETS/GDP



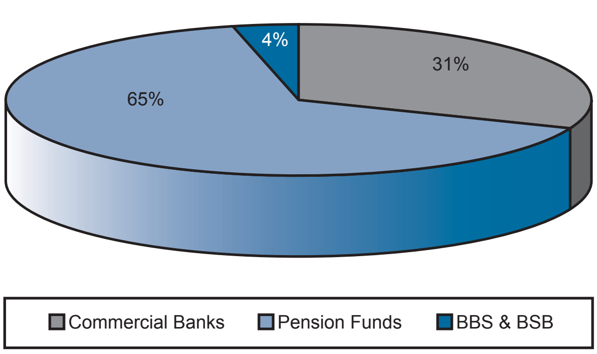
HOUSEHOLD DEPOSITS/GDP



Source: Bank of Botswana, Bank of Mauritius and Bank Negara (Malaysia)

However, household deposits at these institutions are only about 11 percent of the total of deposits at BBS, BSB plus those at commercial banks and a marginal 4 percent of estimated household savings (when contractual savings are included - Chart 2.8). As in the case of commercial banks, the rate of increase in deposits at BBS and BSB lagged overall asset growth of these institutions, as shown by the decline in the ratio of deposits to total assets (Chart 2.13).

CHART 2.8: HOUSEHOLD SAVINGS 2006



Source: Commercial Banks, Registrar of Pension and Provident Funds Report, Botswana Savings Bank, Botswana Building Society

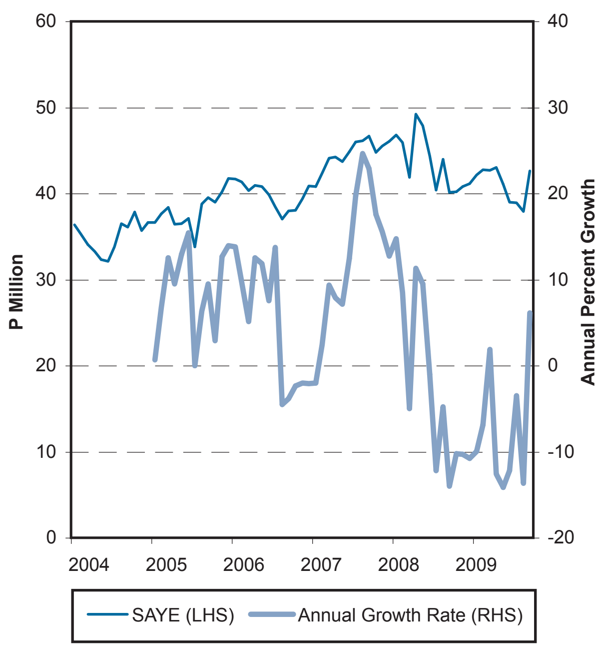
Savings at Botswana Savings Bank

3.13 The Botswana Savings Bank facilitates savings through a network of post offices and has, therefore, a wider geographical coverage than other financial institutions. In addition, BSB is more accessible to lower income groups. The bank offers a range of products, including the ordinary savings account, and special savings accounts (which are available to personal savers, group customers and small-to-medium scale businesses, with a variable rate of interest) and a *12 month* savings account offering 5 percent interest per annum. Balances in these accounts can be used as security for short-term loans. The bank also offers the *Save-As-You-Earn* (SAYE) scheme and administers the *National Savings Certificates*.

Save-As-You-Earn Scheme

3.14 This is a stop order-based (standing instruction) savings scheme that runs continuously for a fixed period of 24 months (contract period) to enable customers to make regular savings from their salaries (wages) without having to go to a bank. The minimum monthly contribution is P50, with the interest rate set at 5 percent per annum, as well as a 10 percent bonus on earned interest. However, the level of savings in this scheme remains relatively small at about P42.6 million in 2009 (September) and is approximately 10 percent of total deposits at BSB. Moreover, the level of savings in this scheme has grown by an average of only 3.9 percent per annum between 2004 and 2009, compared to national income annual growth of 15.9 percent in the same period. Chart 2.9 shows the level and growth rate of savings under the scheme. Nevertheless, while small, the scheme might be valuable to small-scale savers and low income earners; in 2008, the P46.8 million in the scheme was shared among 13 680 savers (thus, an average saving of P3 421, compared, for example, with per capita GDP of P14 247 in 2008).

CHART 2.9: SAVE-AS-YOU-EARN SAVINGS 2004 – 2009

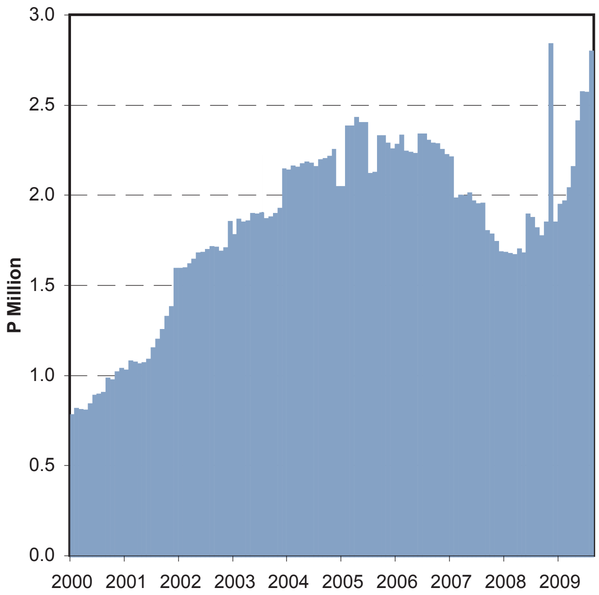


Source: Botswana Savings Bank

National Savings Certificate (NSCs)

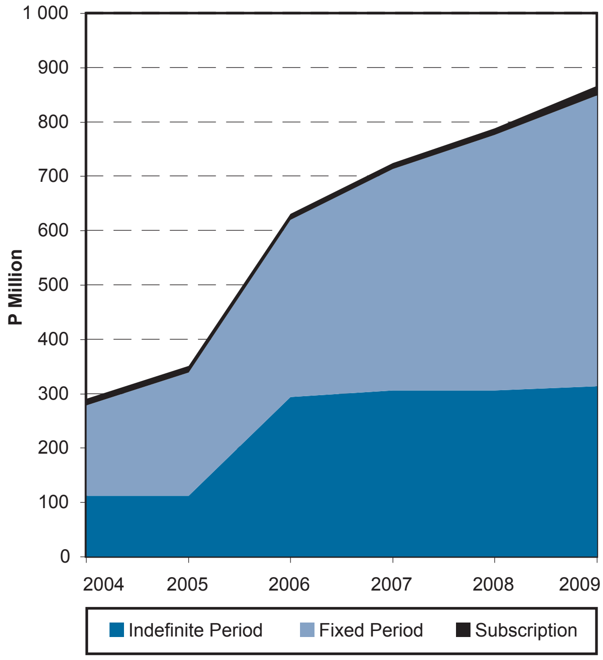
3.15 The *National Savings Certificate* programme that was introduced by the Government in 1999 was designed to harness unbanked money and provide a reasonable rate of return for small savers. At its inception, the scheme was managed by the Bank of Botswana, with distribution assistance provided by Botswana Savings Bank and Botswana Post to extend coverage nationally. In 2005, the administration of NSCs was transferred to BSB. The certificates are issued in three denominations (P250, P500 and P1000), with a minimum purchase of P250 to enable access by small savers. Chart 2.10 shows the level of deposits in NSCs. The savings earn interest at the rate of 10 percent per annum, over a period of 36 months. However, the experience with this scheme has been disappointing, with 793 savers holding P2.6 million as at the end of 2009. The possible reasons for the limited success for this scheme include a relatively low level of marketing effort, resulting in a lack of familiarity among potential savers.

CHART 2.10: NATIONAL SAVINGS CERTIFICATES 2000 – 2009



Sources: Bank of Botswana and Botswana Savings Bank

CHART 2.11: PAID UP AND SUBSCRIPTION SHARES 2004 – 2009



Source: Botswana Building Society

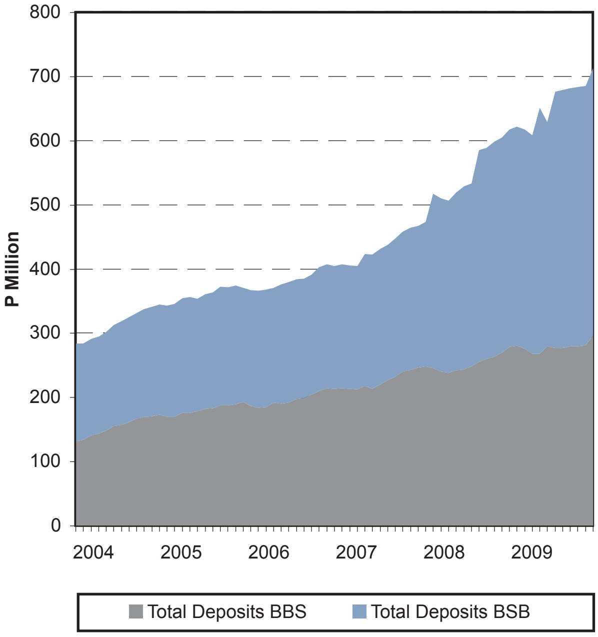
Savings at the Botswana Building Society (BBS)

3.16 Apart from the ordinary savings, BBS also operates special account types that are intended to attract deposits by varying product features. This strategy has contributed to maintenance of robust expansion of deposits at this institution (Chart 2.12 overleaf). In addition to deposits, households also own shares at BBS (indefinite and fixed period paid-up shares and subscription shares). These have grown at an average annual rate of 20 percent in the last 20 years and amounted to P867 million at the end of 2009 (September), equivalent to 47 percent of the total liabilities of the society.

(d) Financial Saving and Instruments in the Broader Financial Sector

3.17 Several other institutions provide a variety of short-term to longer-dated financial saving products, including contractual savings, to the household sector in Botswana. Most of these are capital market institutions such as pension and provident funds, insurance companies, Collective Investment Undertakings (CIUs) and the Botswana Stock Exchange (BSE).

CHART 2.12: DEPOSITS AT BBS AND BSB 2004 - 2009



Source: Botswana Building Society and Botswana Savings Bank

However, a comprehensive analysis of the extent and trends in household saving through these channels is, to a significant degree, hampered by inadequate data. This represents a serious institutional challenge with regard to the promotion of saving, as well as the assessment of developments and policy success.

CHART 2.13: RATIO OF DEPOSITS TO ASSETS (BBS AND BSB COMBINED) 2004 – 2009

Source: Botswana Building Society and Botswana Savings Bank

Pension Funds and Insurance Companies

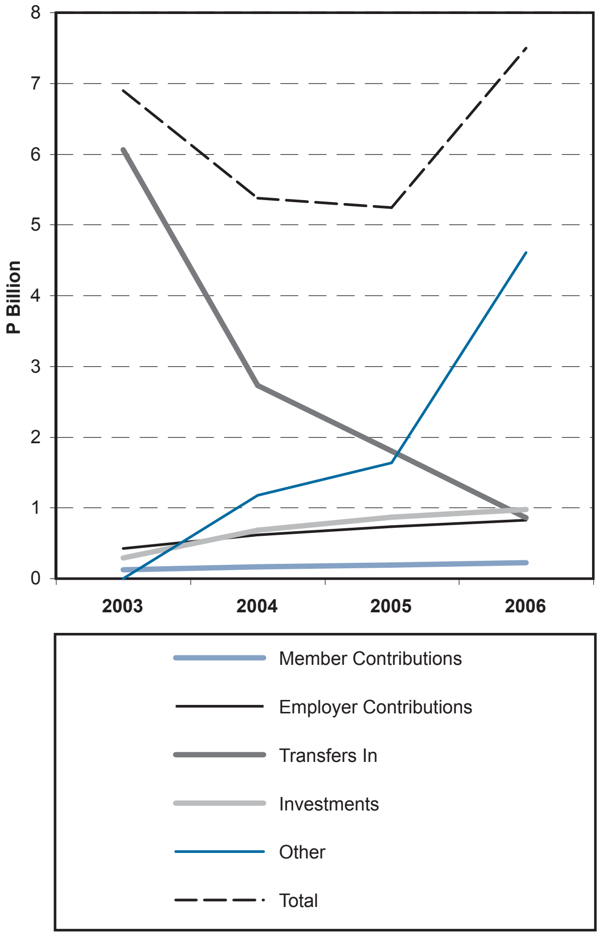
3.18 Life insurance companies, provident funds and pension schemes provide contractual savings opportunities, mostly for the precautionary motive discussed in Section 2, and are ideal for long-term savings. Savings in these institutions are generally a stable source of funds for long-term investments, including the development of infrastructure. In Botswana, pension funds have invested in property and the development of the Botswana Stock Exchange (institutional investors hold a significant amount of the shares listed on the stock exchange). A major impetus to long-term household savings was the establishment of the Botswana Public Officers Pension Fund (BPOPF) in 2001 which, along with other employer-based retirement schemes, represented a conversion from the hitherto common "defined benefit" to the "defined contribution" scheme. In the latter case, the employee has a greater role in determining the value of saving in terms of a voice in the amount of regular contributions[15] and the investment of the fund through trustees. To a significant degree, this represents forced saving (for example, up to the minimum total of the employer and employee contribution). The fund limits the lump sum that can be withdrawn upon voluntary termination of employment or retirement. The other dimension of the growth in pension contributions is the degree to which there could be substitution of saving from the banking system, including statutory banks. On the other hand, the presence of significant retirement savings could engender confidence to borrow, given that post employment needs would be met.

3.19 The largest of the pension funds is the BPOPF for government employees, and there are

15 This is possible through both collective bargains for emoluments and benefits and employment contract negotiations; for example, through the total contributions as a proportion of salary and through the option to augment the employee contribution.

similar arrangements for parastatals and large corporations. As at December 2008, there were 97 pension funds, with a total membership of around 139 000 divided into approximately 122 000 active members, 10 400 deferred members and 6 600 pensioners. For active members, this represents 38.7 percent of the total estimated employees in the formal sector (or 18.7 percent of the labour force). On average, pension contributions are 20 percent of earnings, normally divided between the employer and the employee, with the former contributing a higher share; employees usually have the option to raise their contribution above the minimum. As a result of the recent economic recession, the value of local and offshore assets declined by 16 percent and 18 percent, respectively, leading to a 17 percent fall in the total value of the pension fund assets. Overall pension fund assets were P30.5 billion at the end of 2009; hence the average saving per member is approximately P220 000. In addition to member and employer contributions (number and Pula value as incomes increase), the growth in pension fund assets has been due to an increase in 'other income'.[16]

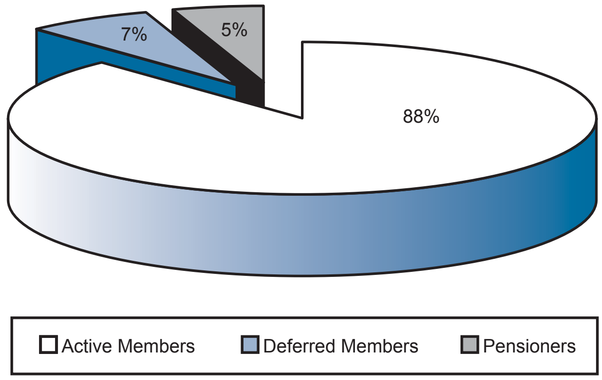
CHART 2.14: MAJOR SOURCES OF INCOME FOR PENSION FUNDS 2003 – 2006



Note: "Transfers In" refers to the amount received on transfer from other funds.

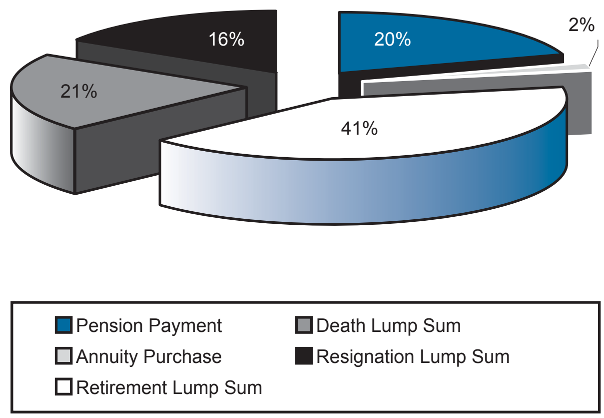
Source: Registrar of Pension and Provident Funds Report

CHART 2.15: MEMBERSHIP PROFILE OF PENSION FUNDS



Source: Registrar of Pension and Provident Funds report

CHART 2.16: BENEFITS PAID OUT BY PENSION FUNDS IN 2008



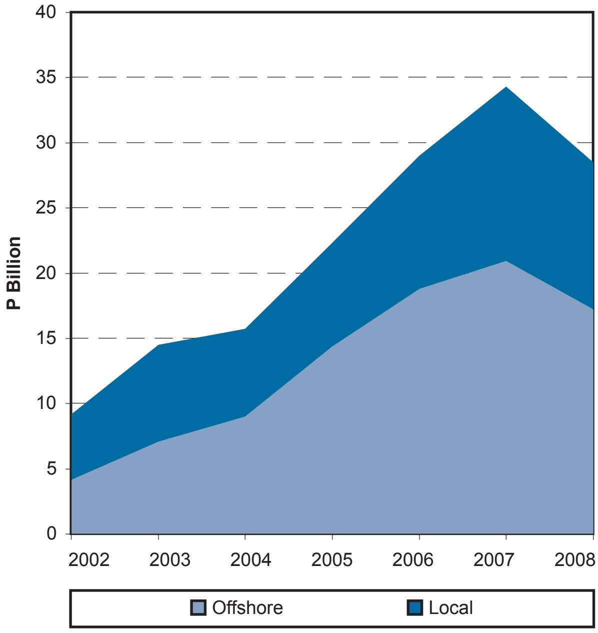
Source: Registrar of Pension and Provident Funds report

Household Investment in Securities

3.20 While data on holding of securities by households is limited, Table 2.2 shows share transactions on the Botswana Stock Exchange in 2009, which reveals the relatively low participation by households.

16 This includes changes in market values of investments, net surplus on sale/redemption of investments and other sundry incomes, e.g., reversal of overpayments, overprovision for the death benefit account.

CHART 2.17: BOTSWANA PENSION FUND ASSETS 2002 – 2008



Source: Registrar of Pension and Provident Funds report

low income earners. In the circumstances, households find alternative informal saving options and credit facilities. These alternatives include cash hoarding, informal group saving arrangements and, more formally, the savings and credit cooperative societies (SACCOs). Moreover, aspects of cattle rearing, preservation of harvest and accumulation of land and other physical assets are also forms of saving. Apart from data limitations, it is not easy, with respect to these activities, to distinguish the pure saving motive from speculation and asset building to generate profits; hence, an analysis of this would extend the discussion beyond the scope of the present topic. Box 2.3 provides some details on livestock rearing in Botswana.

TABLE 2.2: CENTRAL SECURITIES DEPOSITORY ACCOUNTS TRANSACTIONS IN 2009

Client Classification	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Brokers	13 487 441	10 759 173	21 758 643	7 942 914
Local Companies	336 391 129	74 532 089	178 835 151	184 397 613
Foreign Companies	262 407 391	100 975 001	113 488 975	95 789 606
Foreign Individuals	19 791 511	23 723 080	19 179 061	26 076 363
Foreign Residents	7 759 201	2 126 521	2 963 637	3 665 636
Foreign Juniors	4 848 539	847 615	464 846	2 368 570
Local Individuals	95 691	153 989	359 953	302 494
Local Juniors	0	21 424	3 675	11 500
Total	**644 780 903**	**213 138 892**	**337 053 941**	**320 554 696**

Source: Botswana Stock Exchange

Other Forms of Household Saving

3.21 There are other ways in which households save, besides financial savings. It is recognised that most of the financial savings alluded to above exclude the savings of lower income earners and those with limited opportunities for earning cash income. In addition, research shows that access to formal financial services, as well as the cost of such services, the perceived low return of financial savings, and limits to accessing deposited funds constitute obstacles to promoting savings by households. This is particularly true for rural area dwellers and

4. POLICY AND INSTITUTIONAL INFLUENCES ON HOUSEHOLD SAVINGS

4.1 As indicated above, financial saving is essential for funding expansion of the capital stock, in terms of both quantity and quality and in developing human capital which, in turn, can foster a sustainable increase in output. Saving also contributes to smoothing of consumption and mitigating costly financial and economic instability. Investment in capital that supports a sustainable and stable growth

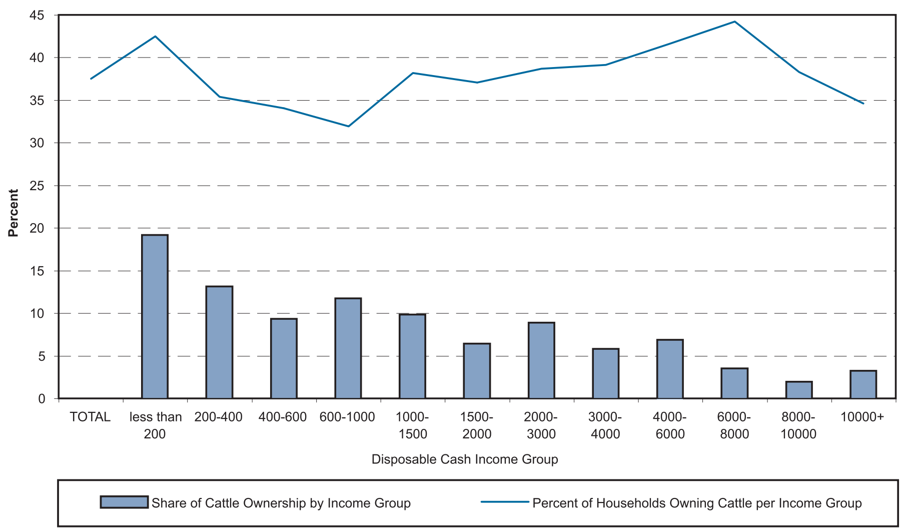
BOX 2.3: DISTRIBUTION OF CATTLE OWNERSHIP

Disposable Cash Income per month (Pula)	Total	**<200**	**200-400**	**400-600**	**600-1000**	**1000-1500**	**1500-2000**	**2000-3000**	**3000-4000**	**4000-6000**	**6000-8000**	**8000-10000**	**10000+**
Households	394 272	66 772	54 934	40 526	54 494	38 111	25 658	34 083	22 019	24 416	11 734	7 606	13 920
Number of Cattle													
None	246 335	38 398	35 504	26 719	37 100	23 566	16 147	20 898	13 404	14 253	6 544	4 694	9 107
1-9	77 885	15 186	11 280	7 798	10 631	7 945	5 017	6 978	4 112	4 215	2 874	833	1 015
10-19	33 312	7 713	5 101	3 154	3 387	3 286	2 405	2 773	1 755	2 187	509	408	634
20-39	20 880	3 189	1 493	1 725	2 202	2 399	1 109	2 026	1 886	1699	1122	721	1 310
40-59	7 889	1 321	1 123	629	561	420	641	667	376	946	242	371	593
60-79	2 921	210	104	181	287	238	165	499	227	468	235	102	207
80-99	1 143	126	0	81	0	131	0	48	98	162	50	71	376
100-149	1 380	232	249	49	66	0	94	101	0	218	0	209	162
150-199	495	0	0	38	144	0	0	0	60	82	32	0	140
200+	2 033	398	81	152	115	126	81	93	101	187	126	198	377

Source: Central Statistics Office

The data above show the distribution of cattle ownership by number of households and the level of disposable income based on the 2002/03 Household Income and Expenditure Survey data. From this, it is evident that the notion that cattle ownership is widespread, such that it can be a substitute for inadequate financial saving, is not substantiated by the data. It is shown, for instance, that only 38 percent of households in Botswana own cattle (i.e., 62 percent of households do not own any cattle). This is supported by the 2001 Population and Housing Census which found that only 39 percent of households owned any cattle, only just higher than the 37 percent that owned no livestock at all, while larger proportions of households owned poultry (42 percent) and goats (41 percent). Among cattle owning households, the majority (53 percent) had less than ten cattle, while only 1.4 percent (0.5 percent of all households) had "large herds" of more than 200. However, although the number of households owning "large herds" is small, 19.5 percent are in the lowest cash income category (less than P200 per month), a similar proportion to those with disposable income of over P10 000 per month (18.5 percent). This suggests that cattle ownership remains of some importance as a form of asset holding in the non-monetised sectors of the economy.

BOX CHART 2.2: HOUSEHOLD CATTLE OWNERSHIP BY INCOME GROUP



path potentially leads to a durable increase in living standards for the population as a whole. Households are expected to be a principal source of the saving. However, in recent times, a key concern for policymakers has been indications of a significant decline in the household saving rate, which occurs alongside faster growth in household borrowing and resulting in substantial net indebtedness.

4.2 In response, and given the importance of saving in economic development, governments generally adopt policies and initiatives geared towards encouraging saving and reversing the increase in indebtedness. The important policy influences on savings include the conduct of macroeconomic, financial and social policies, as well as regulation of financial services and the impact of legislation and its enforcement. In addition, authorities recognise and support institutional measures that can positively influence saving, such as the level of development of the financial sector and markets, access to savings institutions and financial instruments, including physical proximity and connectivity, availability of information, as well as incentives and facilitation.

Policy Influence on Household Saving

4.3 The conduct of monetary policy influences choices with respect to financial instruments and expectations on the future value of savings. Fiscal policy entails, *inter alia*, the issue of debt instruments, such as bonds and treasury bills that can be purchased by households, while the tax regime could also affect the incentive to save and the choice of instruments. Expectations regarding the future direction of fiscal policy are also likely to be important given the role of savings in smoothing consumption, notably in relation to prospects for tax rates,[17] maintenance of social safety nets and the coverage of involuntary saving programmes. Public policy can also influence the extent to which the general public participates in the funding of quasi-government organisations (parastatals) and, beyond that, in the privatisation process. The exchange rate policy (including the regime, transparency and predictability) can also affect the choice of currency instruments and the cross-border flow of savings. An appropriate legal environment and regulatory framework for financial institutions minimises the risks of financial loss arising from poor returns and fraud and can inspire public confidence in entrusting savings to other entities.

4.4 The challenge for policymakers is to adopt policies that optimise household saving. In this regard, a developing economy that aims to grow rapidly would seek to encourage savings and ensure that they are channelled into productive investment. The policy initiatives would generally be long-term, but with possible short-term variations to respond to ongoing developments. Thus, the promotion of saving could be anchored on a favourable tax regime and the maintenance of positive real interest rates as a long-term strategy, which, however, does not rule out deviations (such as a reduction in interest rates to stimulate demand) in response to immediate economic conditions. The challenge, in this regard, is to avoid a situation where the short-term consideration continually dominates the long-term objective.

4.5 For Botswana, policy and institutional development has always recognised the need to promote household saving. The financial sector development strategy in the seventh National Development Plan (1991 – 1997) mapped the path for the evolution of financial policy and infrastructure that also included initiatives for encouraging household saving. In terms of funding national investment

17 According to the 'Ricardian equivalence' theorem, the use of fiscal policy by government to influence demand in the economy will be ineffective as it will be substantially offset by opposite movements in private savings which take into account expected changes in future tax obligations. Such considerations have been relevant to discussions concerning the effectiveness of fiscal stimulus packages aimed at countering the current global economic slowdown. In the case of Botswana, a perception that the Government has abundant saving could have contributed to the relatively low saving rate.

requirements, the Government has been a source of saving for a long time, thus helping to fund development infrastructure, as well as business support programmes. However, there are a number of reasons why there is need to encourage household saving. As demonstrated in 2009/10, government capacity to fund investment can be interrupted by exogenous shocks to revenue sources, which could potentially also adversely affect its ability to sustain unfunded social support programmes. Moreover, inadequate saving accompanied by high indebtedness can swiftly lead to bankruptcy in the event of loss of regular income. Apart from funding investment, saving can also contribute to financial sector expansion, including the development of institutions, instruments and technology.

(a) Macroeconomic Issues

Fiscal Policy, Government Operations and Household Saving

4.6 There are several channels through which fiscal policy and broader public policy could affect both national and household saving behaviour as highlighted below.

Funding Government Operations

4.7 The need for financial resources by the government represents an opportunity for domestic surplus sectors to save through government instruments such as treasury bills and bonds. Conversely, a budget surplus environment provides little incentive for government to issue debt instruments that can contribute to the promotion of saving. It is for this reason that treasury bills in Botswana were discontinued in 1981 when it was recognised that the Government had surplus resources. However, these were re-introduced in 2008 (after the Government started issuing bonds in 2003) as part of the bond issuance programme aimed at promoting the development of the capital market, while at the same time they were used to fund part of the government expenditure programme. However, as discussed in the previous section, most of the government securities are held by businesses (mostly insurance and pension funds and fund managers), while only a small proportion is held directly by households. There is, nevertheless, an indirect interest by households in that they contribute to pension funds and have investments in unit trusts. Therefore, even in Botswana, government funding requirements contribute to the accumulation of household saving; hence there is scope for deliberate policy intervention to optimise the participation of households.

Tax Regime

4.8 The taxation of interest income and capital gains can also influence domestic saving by households, especially to the extent that such taxation differs from tax on other sources of income. Other things being equal, higher tax rates on interest income could discourage financial saving. Tax policy could also be used to favour particular saving instruments and institutions, for example, a lower tax rate on interest earned on government instruments to provide incentives for lending to government; while there could also be favourable treatment for investments in the stock market to encourage the development of capital markets or to facilitate the provision of capital to industry.

4.9 In Botswana, there are various tax incentives on interest income, dividend income and capital gains. Interest income on bank deposits includes a tax-free allowance,[18] while interest on deposits at the BBS and BSB is exempt from tax, as is also the case with the *National Savings Certificates*. The development of the financial sector, including the expansion of activities of commercial banks and government-owned institutions (especially the BBS), places them in competition in many areas, meaning that the differential tax treatment of interest payments might be seen as an unfair competitive advantage in favour of the BBS and BSB. As well as interest income, other forms of return

18 Currently, this is set at P6 000 per year.

on savings include dividends and capital gains and, in this regard, disposal gains on bonds and debentures issued by the Government, Bank of Botswana, parastatals and special purpose vehicles, which are formed for the securitisation of public debt, are exempt from tax.[19]

Policy on Contractual Saving Schemes/ National Saving Programmes and Social Safety Nets

4.10 Several jurisdictions protect loss of regular business or employment income by establishing unemployment benefit funds that make regular payments to individuals that are out of employment. The Australian experience with the compulsory superannuation and tax incentives for voluntary schemes highlights the positive role of national and government promoted initiatives.[20] It is reported that, as a result of this programme, retirement funds almost quadrupled between 1988 and 2000; hence the conclusion that the introduction of compulsory pension accounts resulted in a significant growth of household wealth and retirement saving. The voluntary element also appeared to increase, albeit slightly, possibly due to the added convenience afforded by accessibility, which enabled contributions to be made directly into these pension accounts.

4.11 Apart from the national schemes, large employers usually have pension funds to which they jointly contribute with their staff to provide income after retirement. In Botswana, the major government intervention in this area has been the establishment of the BPOPF. In addition to putting the funding of government pensions on a more sustainable basis, this has demonstrated the importance of savings mobilisation for financial sector development. The growth of the pension contributions has underpinned the expansion of the domestic fund management industry, which now has financial assets comparable to those of commercial banks. Nevertheless, Botswana is in the category of countries that do not have a funded national pension scheme; but employees of larger entities benefit significantly from employer-based pension funds.[21] Notwithstanding this, there has been some concern that there are some large employers that do not have pension funds and that, in some instances where they exist, they are voluntary for staff members. In the circumstances, there is no facilitating mechanism for employees to save part of their wages.

Parastatal Operations and Privatisation

4.12 While parastatals and other quasi-government entities have previously depended on government for funding, they are now encouraged to fund themselves by issuing instruments (bonds, certificates of deposit, credit notes, etc.) that enable saving by households. This has already been the case for parastatals such as the National Development Bank, Botswana Building Society, Botswana Development Corporation, Botswana Telecommunications Corporation, Water Utilities Corporation and the Botswana Vaccine Institute that have issued bonds and notes to augment their funding. The other example is the securitisation of part of the Public Debt Service Fund loan book and issuance of bonds by Debt Participation Capital Funding Ltd. However, the participation of households in these saving instruments

19 There is also exemption with respect to income accruing from the disposal of a principal private residence where the proceeds are re-invested in another residential property within 24 months of the disposal of the principal private residence.

20 Connolly, E., and Kohler, M., (2004), "The Impact of Superannuation on Household Saving", Research Discussion Paper 2004-01, Economic Research Department, Reserve Bank of Australia. This research highlights the fact that making pension funds accessible can influence both mandatory and voluntary saving.

21 The debate on the 2008 Parliamentary motion that proposed the establishment of a mandatory, broad-based national pension scheme for all workers was adjourned for further consultations within government. In arguing for the proposal, it was indicated that there was no law that compelled employers to set up pension arrangements for their employees. It was also argued that, left on their own, employees are not likely to invest in long-term pension schemes.

is limited (in part reflecting high minimum purchase requirements) and largely indirect, through institutional investors holding these securities.

4.13 Individual saving could also be promoted through specialised share ownership schemes in corporations and in government entities that are being privatised. Notably, Botswana's privatisation policy, which was published in 2000, followed by the Privatisation Master Plan in 2005, provides options (including the formation of pooled shares/trusts) that would facilitate citizen participation and ownership of shares in the privatised parastatals. Although privatisation of state-owned bodies is currently more common, governments could also create (or take over) institutions which would have the mandate to address gaps in the market and facilitate access to financial services, especially for geographical areas and low income earners that are unattractive to commercial profit-oriented enterprises. The Botswana Savings Bank is an example of such an entity.

Monetary Policy and Household Saving

4.15 In setting interest rates, central banks are cognisant of the desirability, in most circumstances, of maintaining positive real interest rates. Positive real interest rates help to mitigate the erosion of the value of financial savings that may be due to inflation, while they also promote investment in productive projects and, at the same time, restrain borrowing for consumption.

4.16 In addition to the benefits of positive real interest rates, the focus of monetary policy on price stability minimises volatility of the cost of money that could destabilise the broader economy. The attainment of price stability also ensures that real interest rates can be stabilised (as they do not need to be raised so frequently to help control inflation) at a level that does not make finance too costly, which could result in low levels of investment. Meanwhile, the predictability of inflation stabilises expectations with respect to future returns, for both saving and investment projects. On the other hand, apart from the erosion of financial saving, high inflation could also lead to disintermediation, whereby economic agents would tend to protect their wealth through a portfolio shift to physical assets, precious materials and increased holdings of less inflation-prone foreign currency (so called "dollarisation") and external assets.

4.17 Monetary policy also serves to ensure an appropriate balance between saving and borrowing. For example, monetary policy tightening (an increase in interest rates) would reduce the rate of borrowing when it is deemed to be excessive and, at the same time, provide an incentive for an increase in saving. Conversely, where a high level of saving (and low demand for credit) constrains investment and growth, the reduction in interest rates helps to foster the use of financial resources in fuelling economic activity.

Exchange Rate Policy

4.18 The exchange rate regime can also have an impact on domestic saving; and, as in the case of monetary policy, credibility, transparency and predictability are key to optimising household savings and minimising volatility of resources.

4.19 For Botswana, the crawling band exchange rate arrangement has, among others, three important elements that potentially have a positive influence on saving. First, the Pula exchange rate is fixed to a basket of currencies;[22] as movements between these various currencies are offsetting, the bilateral fluctuations against the Pula are moderate; hence the Pula exchange rate is less volatile. Second, the predetermined direction and rate of crawl that are based on initial assessment of fundamentals preclude the need for discretionary one-off large adjustments. Third, there is market knowledge of the currency composition (although not the weights) of the Pula basket and the direction, as well as

22 The basket comprises the rand and the SDR (i.e., the US dollar, euro, pound sterling and Japanese yen).

approximate rate of crawl, which facilitate the formation of expectations. Overall, given the liberal environment, combined with increased certainty engendered by the crawling band mechanism, it does not appear that the exchange rate regime adversely affects saving.[23] Moreover, the absence of exchange controls and allowing residents to maintain foreign currency accounts both domestically and abroad engenders confidence and, at the same time, widens the savings channels, with the added benefit of providing scope for enhancing financial literacy. In addition, as well as being conducive to both foreign direct investment and portfolio flows, the liberal environment creates space for growth of the financial sector, which potentially would have a positive impact on the saving rate. The focus on attaining stability of the real effective exchange rate (thus, promoting international competitiveness of domestic industry) also enhances the investment climate, where savings can be productively invested.

4.20 Maintaining a stable exchange rate without resorting to the use of foreign exchange controls, as is the case in Botswana,[24] facilitates the efficient flow of international savings between countries with excess national savings and those with insufficient financial resources. It also improves the efficiency of financial intermediation by improving the matching of risk profiles for savers and borrowers. This is particularly important for a small country such as Botswana where the range of investments is limited. For this reason, it is appropriate that local pension funds are permitted to invest a substantial proportion[25] of their assets offshore, as this helps with the portfolio diversification that is necessary for such investments. At the same time, diversification of the domestic economy is supported by effective access to sources of potential foreign investment in Botswana.

Financial Sector Policies and Regulation

4.21 Both the financial sector policies and the supervisory framework have a bearing on the prospects for sectoral development and the degree to which savers are protected. Financial sector policies could impact on the range of institutions and instruments, as well as both the geographical spread of institutions and the access to financial services by individuals. These factors could be influenced by the licensing policy, through measures such as the delineation of the range of services, requirements for minimum capital, as well as provisions with respect to branch network. Specific to banking, there are some jurisdictions that promote community banks with the aim of widening access to financial services beyond the urban centres; while it is also considered that the development of capital markets opens up channels for long-term savings. Table 2.3 illustrates the link between aspects of policy and some developmental variables for the financial sector. For Botswana, specific measures to promote financial sector development and access to financial services include the promotion of competition in the banking sector, encouraging parastatals to reduce reliance on government funding and to access the private market, the issuance of securities by the Government, providing legislative coverage for various segments of the financial sector and the shift from defined benefit to defined contribution pension schemes.

4.22 Effective supervision of the financial sector enhances credibility of the system and the safety of depositors' funds, thereby helping to attract savers. Such oversight extends to the ability to intervene and undertake remedial action to forestall loss of savings. It is notable that, while the recent financial crisis has

23 It should, however, be noted that there was substantial market dissatisfaction with the effect of the 12 percent devaluation of the Pula in 2005 that coincided with the redemption of one of the government bonds. Therefore, to the extent that aspects of the exchange rate policy are not disclosed and subject to potentially unanticipated policy discretion, it constrains the formation of expectations and might have a negative influence on saving and investment decisions.

24 Foreign exchange controls in Botswana were abolished in 1999.

25 Up to a maximum of 70 percent.

TABLE 2.3: EXAMPLES OF POLICY INFLUENCES ON THE FINANCIAL SECTOR

	Size of institutions	Geographical coverage	Range of institutions	Range of instruments	Access
Capital requirements	◙				
Delineation of licences	◙	◙	◙	◙	◙
Stipulation on branch network	◙	◙			◙
Direct government participation		◙	◙	◙	◙
Strategic policy intervention	◙	◙	◙	◙	◙

undermined the integrity and credibility of both the operations and supervisors of financial institutions, there has been no widespread loss of retail deposits in the banking system. However, this is not to deny the potential diminution in the value of financial assets generally, especially arising from erosion of the value of shares and the sharp fall in housing prices. In terms of possible remedial action, some countries operate deposit protection schemes that partially or fully compensate savers for loss of deposits arising from bank failure.

4.23 Even in the absence of such a deposit protection scheme, it is deemed that the role of the financial sector in the economy is of such importance that its integrity needs to be maintained; while it is also important for both social and economic reasons to mitigate widespread erosion of wealth (loss of financial assets). Hence, it is almost taken for granted that there is an implicit guarantee by the Government of public deposits in banks, although there is some uncertainty as to the extent and scope of the guarantee. However, the problem with implicit deposit protection is that it exacerbates uncertainty in the event of a financial crisis. With an explicit deposit protection scheme, there is certainty of the extent of coverage. It, therefore, reduces the potential cost to governments while it, usually, has some form of co-insurance and involves the participation of financial institutions. Moreover, the payout formula, in terms of the proportion of deposits to be compensated and the maximum amount that can be insured, is determined *ex ante*, which informs the assessment of the risk of deposits vis-à-vis other instruments.

4.24 A major criticism of deposit insurance is the moral hazard it creates and the fact that resources are never adequate in the event of a systemic banking crisis. Consequently, it is argued that bank management would be less vigilant where the protection of depositors' funds is transferred to an insurance scheme, while depositors could also be lackadaisical in the choice of saving instruments and financial institutions. So far, in Botswana, there is a reliance on the robust supervision of the banking system by the Bank of Botswana, where, historically, there has been a proper management of takeovers and exit of failing institutions. Meanwhile, the establishment of the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) has helped to bring an increasing number of financial sector operators within the regulatory ambit. More intense supervision of pension funds and insurance companies by NBFIRA, in particular, helps to protect long-term savings, while it also addresses concerns about the integrity of the insurance industry. The attention on microlenders also potentially protects individuals against bankruptcy arising from unfair practices by lenders.

4.25 Another important consideration in financial sector supervision and the protection of domestic savers is the extent and influence of foreign linkages, especially the involvement of domestic banks with external parties. It is notable that the domestic banking system was insulated from the recent financial crisis due to the limited exposure to external markets, as well the absence of sophisticated financial products and derivatives that were common in major markets.

Legal Issues

4.26 The legal environment is also significant in influencing saving behaviour and engagement in financial contracts. Among the important aspects in this regard is monitoring and discouraging unregulated mobilisation of resources and promoting the enforcement of contracts. Any proliferation and (inevitable) subsequent collapse of fraudulent activities could adversely affect the confidence of the public in saving schemes. A relevant example is the introduction of pyramid schemes that promise large returns, which are not derived from investment of the deposits, but rather are based on contributions of new members being disguised as profits and paid to older members.

4.27 It is, therefore, critical that, in addition to ongoing supervision, there should be vigilance in monitoring the emergence of unregulated financial and/or fraudulent operations, as well as to expeditiously bring relevant and important financial operations under legal supervision. There continues, however, to be a role for informal operations where formal supervision would not be cost effective. It is notable that the 2007 Financial Sector Assessment Programme (FSAP) report recommended enhanced supervision of savings and credit cooperative societies (SACCOs) involving the Bank of Botswana. There was concern with a lack of adequate regulatory and supervisory framework for SACCOs, since they are expanding rapidly and given the significant number of complaints with respect to their governance, including the absence of credit policies and the undertaking of risky investments. The FSAP report also indicated that the SACCOs are potentially important as an alternative provider of financial services for sections of the population facing access constraints. The authorities, however, felt that concerns about the operations of the SACCOs could be handled under the consumer protection ambit, as their overall scale of operation was not significant in terms of potential systemic impact.

Institutional Influence on Household Saving

4.28 In addition to the policy influences, institutional and market developments also play a role in enabling access to financial services, as well as the growth and stability of household financial savings.

(a) Access to Financial Saving Instruments

4.29 Among financial institutions, banks are the primary focus for the mobilisation of saving and interaction with the general public. However, households also have opportunities to access the capital markets and pooled saving schemes (unit trusts).[26]

4.30 In the less developed economies, limited access to formal saving opportunities can encourage households to resort to the informal financial sector or holding wealth in non-financial assets. For example, in Ghana, of the 20 percent of household assets that are held in financial instruments, 12 percent are in the informal sector and only 8 percent in the formal sector. The reasons given for this state of affairs include limited access to savings institutions, mismatch between financial instruments and requirements of customers (especially low income earners), and lack of trust in formal financial institutions.[27] In Botswana, the 2004 study by Finmark Trust found that 48 percent of the population were not using banking facilities due to lack of employment income and limited financial knowledge, the cost of services and distance from institutions.

4.31 Access to financial services also entails prospects for obtaining credit, which could

26 In some countries, both developing and developed, as in Botswana, post offices have been used to provide banking services, thus taking advantage of their typically extended networks. These are not necessarily small operations: the Japan Post Bank, for example, is one of the largest banks in the world.

27 Aryeetey, E., (2004), "Financing Africa's Future Growth and Developmnent: The Hard and Soft Options", Mimeo, University of Ghana.

also be used for smoothing consumption over a life cycle.[28] Enhanced access to borrowing can reduce the amounts of voluntary saving, both for precautionary purposes and for funding major purchases. In many instances, this may be appropriate behaviour; but in some situations it can lead to over-indebtedness of households, which can be especially likely if households have inadequate appreciation of the cost of borrowing or if the lender does not properly assess a household's capacity to borrow.[29] This has been the case in some of the major economies, including both the United Kingdom and the United States, where households, at least until recently, increased borrowing at the expense of saving. However, as part of inculcating the saving culture and minimising the risk of over-indebtedness, there could be requirements for an increase in deposit contributions to access loans. This would tend to encourage saving prior to purchasing big value goods and services. Requirements for a deposit are legally stipulated in some jurisdictions, while they are a normal market practice for certain categories of credit, for example, mortgages and asset financing, where there is a risk of the value of the asset that is used as security falling below the outstanding loan amount.

4.32 Technology deployment is also having a positive impact on the mobilisation of financial resources and the conduct of transactions, including remote access to accounts through internet connectivity and use of mobile phones. While the internet is providing value to the higher end of the market, the low income segment is benefiting from the widespread access to mobile phones. Notably, the observation that the number of mobile phone users may already exceed the number of banked people in many low income countries presents a market opportunity for financial institutions, while availing prospects for public policy to influence access to financial services (Box 2.4 illustrates the use of mobile phones in facilitating transactions).

(b) Facilitation and Tax Incentives

4.33 In addition to promoting the establishment of funds for long-term saving, traditionally governments also provide special tax arrangements for designated saving schemes. In the USA, the widely used schemes are Individual Retirement Accounts (IRAs)[30] and 401(k)[31] plans. An important attribute of both the schemes is that taxes on earnings and growth of savings (interest, dividends and capital gains) are deferred until the funds are withdrawn at retirement. The contributions are also tax deductible, which reduces the savers' tax burden. However, there is a penalty for withdrawal before the retirement age. The scheme is not tied to employment or employers, hence, individuals are in full control of their accounts. The 401(k) plans are employer-based and are available for individuals employed in entities that are participants.

4.34 The UK has a long track record of using tax incentives to encourage saving in various forms. Prominent examples are the Tax Exempt Special Savings Accounts (TESSAs) and the Individual Savings Accounts (ISAs), which

28 Notably, borrowing against deposits and contributions is not only limited to retail banking, but is also the practice for some insurance products and pension funds. In the latter case, there is a risk of undermining the value of the ultimate pension payout.

29 Both factors were at work in bringing about the recent "sub-prime" lending crisis that led to the global financial crisis and recession. Most importantly, while lenders would usually be expected to restrain excessive borrowing as this could put their funds at risk in the event of default, the widespread use of securitised lending products to finance, for example, mortgages, weakened the link between the originator of the loan and the ultimate lender.

30 An Individual Retirement Account (IRA) is a retirement plan account that provides some tax advantages to the retirement savings in the United States. It should be noted, however, that, although substantial resources flowed into the new accounts, there has been no conclusive proof that the introduction of the IRAs was the dominant factor influencing the growth of saving in the USA.

31 The 401(k) plan (named after a section of the Internal Revenue Code) is an employer-sponsored retirement savings scheme in the USA, in which the contributions made by an employee and the employer can be invested in a variety of approved designated funds.

Box 2.4: The Role of Cell Phones in Payments

Technological innovation has increased the scope of trade and access to, among others, the household market through the use of internet, emails and cell phone facilities. The rapid growth in users of cell phones and widening of network coverage has enhanced the potential use of this medium in a wide range of services, including banking. The use of cell phones in payments and banking is generally referred to as "Mobile Payments" or (M-payments) and "Mobile Banking" or (M-banking). The combination of M-payments and M-banking allows for branchless banking service and provides opportunities to extend services to un-banked communities, especially in developing countries. M-banking facilitates the provision of banking services, such as checking of bank balances and general account transactions and money transfers, using the cell phone. Cell phone users can also be enabled to pay for goods and services from merchants using pre-paid balances or credit in place of cash, cheque and debit/credit cards.

A widely cited example is the Kenyan mobile payments system, where customers can transfer funds using a network of approved agents that includes airtime resellers and retail outlets acting as agents of banks. The use of cell phones as a medium for extending banking services is also growing significantly in Botswana. While the use of pre-paid airtime from mobile service providers to purchase goods and services is not yet developed locally, it is important to recognise the potential benefits of this model. Among others, use of cell phone air time credit reduces the costs associated with handling cash, while it alleviates the risk of unauthorised overdrawing, fraud and processing expenses that is linked with cheques. The model also has an advantage over debit and credit cards in that it has larger potential market/usage. In particular, the stricter criteria pertaining to issuance of bank cards and the link with operation of accounts at banks does not apply. The presence of cell phone facilities also eases the need for costly physical presence of banking facilities such as branches, ATMs and card reading machines and also alleviates the related telecommunication and processing expenses. Moreover, unlike card based processes, the model is less prone to the risk of fraudulent use of cards and identity theft. The overall effect of increasing usage of the cell phone is that it potentially enhances access to banking services across income groups and with much wider geographical coverage.

Meanwhile, the supervision of M-payments/banking is evolving and care is being taken that such regulation does not stifle innovation. However, operators are subject to vetting procedures to guard against payments systems risks that can lead to financial losses with consequences for financial stability. In particular, M-payments for which final value is settled outside the payment infrastructure poses systemic risk and should not be allowed.

provide opportunities for both short-term and long-term saving for retirement. Similar to the IRAs for the USA, income accruing to the funds, including capital gains, is free of tax, and so the schemes aim to promote private saving by facilitating a higher net rate of return. For Botswana, while there may be some tax breaks on aspects of saving, there is no facilitation for individual retirement accounts. There is, therefore, scope to augment existing employer-based retirement schemes with incentives for individual-focused facilities. Such facilitation schemes are undertaken in recognition of the fact that not all employers provide for pension schemes and, usually, this affects low income earners, who naturally are constrained in their saving capability.

(c) Specification of Balances and Limitations to Account Activity

4.35 Some savings accounts and schemes in banks and other financial institutions require maintenance of minimum balances, as well as restrictions on withdrawals. This enforces the essence of the savings scheme, in addition to minimising the administrative burden associated with small and frequent transactions. Such conditions, however, tend to exclude low income earners who are most in need of relevant channels for saving. For banks in Botswana, the minimum that could be maintained in an ordinary savings account ranges between P75 to P6 000 and there are virtually no limitations on frequency of withdrawals, although there could be penalties.

(d) Availability of Information and Financial Literacy

4.36 Financial literacy entails understanding the relative costs and benefits of saving, spending and borrowing, as well as features of the various financial instruments. Such knowledge could be reinforced by appropriate marketing by financial institutions, targeted public education, as well as general literacy. Apart from the potential to induce an increase in saving, financial literacy also facilitates an informed and appropriate response to the alternative initiatives to promote saving instruments and credit products, as well as the ability to evaluate financial advice. Overall, low levels of financial knowledge can be linked to lack of retirement planning and deficient wealth.

4.37 In order to improve financial knowledge, the authorities in South Africa have introduced financial literacy courses at elementary level in schools, while the credit legislation requires creditors to ensure that borrowing decisions are made with full information. In addition, the National Credit Regulator undertakes credit counselling, among other responsibilities. In Botswana, the banking community has, for the past 10 years, been augmenting other literacy improvement efforts through a biennial observance of a thematic banking week. In the recent past, the focus was on "Customer Education: Informed, Wiser and More Disciplined Banking" (2005), "Facilitating Wealth Creation and Safeguarding Financial Security" (2007) and "Coping with the Current Global Financial and Economic Crisis" (2009). The typical banking week programme entails public interaction with banking practitioners and dissemination of information relevant to the theme. In addition, the Bank of Botswana has a public education programme that disseminates information on money matters. Nonetheless, there remains considerable work to be done in this regard, including exploiting modern information technology more in a bid to enhance the effectiveness of disseminating the relevant information on financial matters.

5. LOOKING AHEAD – INITIATIVES TO PROMOTE FINANCIAL SAVING

5.1 Although there are differences, it is apparent that the concern over low saving rates and high levels of indebtedness of households is widespread, and includes some of the more affluent countries, such as the USA. Therefore, the mobilisation and optimisation of household saving remains a concern for many countries across the spectrum of economic development. Policy development continues to entail initiatives to promote saving by households while counteracting the potential for excessive indebtedness. It is also recognised that policy and institutional development has to be relevant to the specific country situation. It would, nevertheless, appear that the critical elements in the mobilisation of household saving are maintenance of appropriate macroeconomic policies, access to financial services (including making appropriate use of new technologies), facilitation programmes and financial literacy. However, some facilitation programmes involving government, such as tax incentives, fall in the broad public policy arena and their use may have adverse welfare implications.

5.2 From the earlier discussion, it is apparent that financial sector development in Botswana has always been an integral aspect of fostering diversified economic growth. In addition to the financial sector policies that Botswana has pursued, the macroeconomic policies, including a favourable tax regime, a liberal foreign exchange control environment and the objective of maintaining positive real interest rates have generally been supportive of financial saving. At a broad national level, investment has not been constrained by inadequate saving, because of substantial government financial resources. However, data from commercial banks suggest a deterioration in the saving rate for households, alongside a significant increase in indebtedness of the sector. Of particular concern is the fact that, as recorded, much of that debt is not asset backed (notably, the relatively small proportion of mortgages in bank credit to households).

5.3 On this basis, the household sector is vulnerable to income shocks, with potential to adversely affect operations of the banking system. While limited to a short period, it is noted that the recent downturn in economic activity (last quarter of 2008 to first quarter of 2009, in particular) arising mainly from the difficulties in the mining sector, resulted in a 0.7 percentage point increase in provisions from 1.8 percent of total loans and advances to 2.5 percent. Although job losses in the mining sector were, in the event, limited and, in any case, the sector accounts directly for less than four percent of formal employment, there could have been ripple effects on other sectors (notably for suppliers to the mining industry). Furthermore, the freeze in civil service salaries could also have been a contributory factor, especially in disrupting spending plans (including consumption, borrowing and saving decisions) that had hitherto been based on generally realised expectations of steadily growing incomes.

5.4 The concern over the health of the household sector and the implications this has for policy is widespread globally, with the USA providing a relevant example. In this case, buoyed by the wealth effect arising principally from the increase in property prices, households felt little need to accumulate financial savings. At the same time, access to borrowing for households previously seen as uncreditworthy expanded rapidly due to a combination of financial innovation and the low return on traditional investment products (the so-called "search for yield") that resulted in the creation of "toxic assets". As a result, world growth prospects were significantly undermined. Similarly, debt service difficulties and inadequate saving by households would not only affect individuals and the banking system, but would also adversely impact on the broader economy.

5.5 However, it has also been demonstrated that the saving rate could be underestimated if saving outside the banking system is excluded, particularly with the advent of defined contribution pension schemes and targeted savings products by the insurance providers. In addition, the importance of informal forms of financial savings should not be ignored, with the recent Finscope Survey reporting that households are as likely to keep large sums of money at home as in bank deposits. This, however, does not negate the concern about the apparent high level of indebtedness where, even at an aggregate level, there might be an imbalance between saving and borrowing. Borrowing by households is even higher if loans by microlenders are included;[32] and it could be argued that it is the more vulnerable group of households (without collateral) that would resort to such credit. In addition, some employers also provide significant credit facilities. Thus, in terms of the theoretical discussion in Section 2, there should be concern if future net incomes are likely to be lower due to excessive earlier borrowing for consumption. In this regard, borrowing against pension funds or designated saving products

32 These include relatively large lenders such as Letshego (Micro Provident Botswana), which is listed on the Botswana Stock Exchange and Blue. Both of these lenders have significant representation in the region, and have arrangements with employers, including government, for direct deduction of monthly instalments from wages.

should be discouraged as it potentially erodes the value of such saving, as there may be some reluctance to replace compulsory savings.

5.6 Moreover, while it has been suggested that there is anecdotal evidence of bank credit being used for long-term investments, other aspects of loan procedures and administration make appropriate attribution difficult. The complicated procedures for asset and mortgage finance, as well as business financing, might bias borrowing towards personal credit for unspecified use, even if it is ultimately used to finance assets or businesses. This is quite probable given access to increasingly larger amounts for this category of loans. In addition, and with regard to housing, the land tenure system and the lengthy and costly process for conversion from tribal to common law tenure needed for mortgage financing could discourage appropriate attribution of credit use (and increase the chances of misallocation to consumption); a similar effect has also been noted for the finance of cheap motor vehicle imports. In any case, if this perception holds, it represents a costly choice being made by households, given that personal credit is substantially more expensive than mortgage finance and vehicle finance. For example, in 2009 (from the first to the third quarter), the average mortgage rate charged by commercial banks was only 0.1 percentage points above the prime rate, while the average return earned by the banks on their loans and advances was three percentage points higher.

5.7 Overall, there is scope to optimise household saving given that there is little threat of this giving rise to the paradox of thrift, where a reduction in consumption would depress the economy. The following discussion, therefore, examines the range of policy initiatives and measures to strengthen existing arrangements towards improving financial saving by households and also to reduce their vulnerability to debt. In this regard, the experiences of other countries indicate the positive impact of tax incentives, provision of financial literacy and legislation that governs borrowing.

(a) Facilitating Access to Saving for Retirement (and/or Loss of Income)

5.8 The options for facilitating access to saving for retirement include variants of a compulsory national scheme where all income earners (possibly with the support of employers) contribute a minimum proportion of income towards retirement, as well as the designation of retirement accounts, normally with tax benefits. In Botswana, the only formally structured option is the employer-based pension funds, which cover approximately 40 percent of those in employment and 20 percent of the labour force. However, even in this case, there are instances where participation is voluntary and/or there is no specification of the minimum contribution. To promote saving for retirement, it is suggested that the authorities should continue to encourage employers to establish pension funds with full staff coverage, as well as stipulate a minimum proportion of income to be contributed to the scheme.

5.9 While there are clear benefits to this approach, there are complex issues regarding both coverage and funding. For example, there is a problem of how to treat smaller employers who might find it difficult to afford contributions to a pension fund, while there is need for a separate mechanism to cater for the unemployed and self-employed (and more widely those in the informal sector and traditional agriculture). Although the latter could be handled through contributions to unemployment insurance, it could be considered as “double tax” by those already contributing to a pension scheme. Consideration could also be given to replacing the five yearly gratuity for industrial class employees with a contribution to a mandatory national pension scheme.[33] There is also a case for raising the retirement age in order to reduce costs to society associated with a high dependency ratio,[34] while individuals

33 Others, at a higher level of employment, that do not participate in pension funds, but get end of contract/term gratuity, might also benefit from facilitation of contribution to a pension scheme.

34 Despite the impact of HIV/AIDS, it is apparent that those

staying longer at work would contribute to national savings. Meanwhile, the promotion of individual retirement accounts, with deferred taxation of income could also improve saving and, as in the USA, this could be facilitated by employers; hence it could cater for employers who might be loath to set up an individual pension fund and/or that would find it difficult to participate in a national scheme.

(b) Tax and Budget Financing

5.10 Currently, there is tax discrimination between interest earned on deposits at BBS and BSB, which is tax exempt, while interest on deposits at other financial institutions which is above P6 000 is taxed at the full rate applicable to the income earner. This disparity is unwarranted as these two institutions increasingly undertake operations similar to banks. From this perspective, such discrimination is also inconsistent with the encouragement to commercial banks and other private financial institutions to extend their operations to cater for low-income savers and non-urban centres.

5.11 A running theme of this Chapter is the potential role of households in funding both government activities and private businesses by holding various forms of financial instruments. There should, therefore, be greater effort made to market the government bond programme to the public. So far, reliance on banks (primary dealers) to inform their customers of this alternative saving instrument does not appear to be succeeding; hence the need to explore other mechanisms for making the general public aware and increase their participation.[35]

(c) Participation in the Privatisation Programme

5.12 Apart from the more general issues surrounding citizen empowerment and retaining local ownership of important industries, the privatisation of parastatals and government activities presents an opportunity for saving/investment that augments future incomes. Options such as special allocations for employees, direct purchases and pooled share schemes should, therefore, continue to be pursued in the privatisation programme. In this regard, independent participation by institutional investors further enhances household saving. It is sometimes argued that, for households, this does not represent long-term savings as such, because they can quickly sell their shareholding for a windfall gain. However, it is hoped that such gains facilitate a purchase of other assets that would contribute towards an increase in wealth.

(d) The Quality and Cost of Banking Services

5.13 The consideration of individual retirement accounts, in particular, has to be linked to the quality and cost of banking services. There is some evidence that an important reason for not accessing financial services, especially by low income individuals/households and small firms, is that banking is considered costly and does not accommodate their needs.[36] The authorities should, therefore, continue to engage banks and other financial institutions with a view to ensuring that requirements, such as minimum thresholds for deposits and other conditions, do not stand in the way of access to saving facilities and that account maintenance fees and other transaction costs do not erode income from saving.

(e) The Balance between Saving and Credit

5.14 There is concern about possible over-indebtedness, which could make households vulnerable to bankruptcy in the event of adverse shocks such as loss of employment and ill-health. On the other hand, widespread

who escape infection live longer as a result of advances in other health areas.

35 It is accepted, nevertheless, that there is a degree to which the long-term savers benefit through the participation of institutional investors.

36 See, for example, the regional Finscope Surveys. Also Claessens, S. (2006), "Access to Financial Services: A Review of the Issues and Public Policy Objectives", World Bank Research Observer vol. 21 no.2.

defaults by borrowers could also threaten the health of the financial system and interrupt development policies, as well as give rise to financial costs to the government. A continuous monitoring of saving and credit trends is, therefore, critical to forestall the emergence of an unsustainable household debt situation. There should as well be focused research on sustainable debt and optimal saving for Botswana. Among the practical measures that could lead to improved balance between saving and borrowing is the requirement for deposit contributions (equity contribution) to access loans.[37] As evidenced by the recent financial crisis, as well as the more immediate developments in South Africa and Botswana, the sources of the savings/credit imbalance include, among others, the development and marketing of financial services that are biased towards selling credit. It is recognised, nevertheless, that lending is the main source of income and profitability for banks. However, in addition to the adverse effect on individuals and the broader economy, banks also stand to lose from excessive lending; hence it is in their interest to also support campaigns for responsible borrowing. Therefore, moral suasion, including indicative guidelines[38] to financial institutions, the sharing of customer credit data by financial institutions and financial literacy campaigns, could be used to augment the requirement for a deposit contribution.

5.15 The regulation of credit could also be helped by a modernisation of the Hire Purchase Act, to bring it in line with contemporary developments, particularly relating to the sharing of credit information, equity contribution, cost of finance (hire purchase), vendor and customer duties and responsibilities and disclosure of effective financing costs.

(f) Expanding the Range of Institutions and Instruments

5.16 For commercial banks, the Bank's Licensing Policy regulates market entry, which entails minimum requirements that may constitute non-financial barriers to trading in banking services. While the Licensing Policy does not discriminate between indigenous and international banks, to date only majority-owned subsidiaries of international banks have established a presence in Botswana. These largely serve the urban and larger village communities. However, more recently, smaller regional banks have also entered the market, but they still try to attract the salaried middle-income and urban-based households and businesses. In essence, except for small satellite extensions of the larger banks, the rural communities have limited access to financial services. Among other initiatives, this gap could be addressed by licensing of community banks that have greater affinity to local conditions and whose presence also improves financial literacy.

5.17 Services utilising new technology could be embraced; these include the use of non-banks, such as retail shops and other facilities, as a base for banking services. There is clearly further scope to utilise mobile phones in facilitating banking services. It is also notable that banks already successfully place themselves in car show rooms and furniture stores to market credit.

(g) Legal Issues

5.18 Easier processes of converting tribal land to common law land tenure (leasehold) would improve access to borrowing for residential,

37 It is accepted that it is possible for customers to simply take another loan (personal loan) to fund a deposit. Moreover, in addition to borrowing to fund the deposit requirement, it is also notable that there is anecdotal evidence that this requirement and the onerous cost do not deter people getting store credit for household durables.

38 While legislation is also an option, it entails an administrative burden and capacity requirements that could stretch the regulatory resources and possibly dilute the focus on systemic regulation. For Botswana, a specific focus of the consumer protection function in the Ministry of Trade and Industry on financial services and enhanced collaboration with the supervisory authorities and the Banking Adjudicator might be necessary, especially in formulating and applying the broad guidelines on lending practices.

business and farming property in rural areas. It would also lower the cost of finance (mortgage finance is cheaper than personal loans), while offering better security and minimising risk to lending institutions. Review of this legal process could be explored alongside government initiatives to improve the housing situation in the country (rural areas in particular) and productivity of the agriculture sector. More generally, arbitration and legal resolution/enforcement tend to be protracted; hence, there is need for improvement in order to generate confidence and certainty of contracts.

(h) The Case for a Deposit Protection Scheme

5.19 The feasibility of a deposit protection scheme, as conceived in the past, could be reconsidered as it would offer some protection of deposits in the event of a bank failure. This would further encourage saving in the banking system. In the event of a bank failure, deposit insurance would entail reimbursement of depositors in full or in part. It is recognised that deposit insurance schemes have some disadvantages. However, given that governments generally implicitly protect depositors and will inevitably intervene in the event of a banking crisis, a deposit insurance fund helps to provide certainty of payment to depositors and generally protects government funds.

(i) Enhancing Financial Literacy

5.20 Access to formal financial services will be enhanced if consumers are financially literate. Hence there is need to sustain an education campaign with a view to spreading and increasing knowledge on financial and economic issues. The banking sector's biennial thematic banking week makes a meaningful contribution in this respect by way of, among others, promoting financial services. In addition, the enforcement of disclosure requirements and the complaint resolution procedures foster financial literacy, as these processes entail the provision of important information on financial products. Overall, there is need to reflect on the broader strategy for enhancing financial literacy and the possible involvement of other stakeholders, such as the consumer protection unit of the Ministry of Trade and Industry and other community institutions.

(j) The Role of Informal Arrangements

5.21 Except for criminals, fraudulent entities and microlenders that prey on vulnerable individuals/households and charge usurious interest rates, it should be accepted that informal arrangements are the market residual reflecting the gap between demand and supply of relevant financial services; hence, there is need to avoid undue regulatory intrusion and over-protection in this area. Rather, it might be important to be passively supportive of such informal arrangements, which not only facilitate financial services, but also have the potential to contribute to financial literacy.

(k) Policy Environment and Data Issues

5.22 It is expected that the maintenance of a liberal and transparent policy environment, as well as implementation of needed improvements, especially with respect to trade and capital flows and macroeconomic policies, tends to sustain confidence in governance and the performance of the economy. Such a policy posture should, therefore, continue to be helpful in promoting domestic financial saving and in attracting savings and capital from abroad, as well protecting the economy from potentially destabilising large fluctuations in financial flows.

5.23 The compilation of appropriate data for monitoring financial sector developments and to inform policy analysis and response is also of paramount importance. The preceding analysis falls short in some respects due to the absence of appropriate institutional and published data, while there is a challenge in getting responses to data requests over a relatively short period. There is, therefore, a case for establishing a coordinated framework for maintaining and facilitating access to important performance monitoring and analytical data by the Central Statistics Office and the regulatory institutions, such as the Bank of Botswana, NBFIRA, Botswana Stock Exchange and Ministry of Finance and Development Planning. The respective regulatory bodies appear to adequately compile relevant data for their operations and supervisory mandates. However, there is scope to assess the availability, accessibility and policy and strategic relevance of data, with respect to the broad financial sector performance and vulnerabilities, broad categories of saving, the holding of financial instruments and borrowing across the range of money and capital market institutions. The framework should also facilitate assessment of the relationships between financial variables and national accounts data (e.g., household income/disposable income, asset stocks, etc.). Some progress is being made in this regard through the gradual development of cooperation between the Bank of Botswana and NBFIRA in survey work across a broad range of financial institutions.