Bank of Botswana

Annual Report
and
Economic Review
2001

BANK OF BOTSWANA

Governors' Office
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Private Bag 154
Gaborone
Botswana

Ref: RD 10/1/1

March 28, 2002

Honourable B. Gaolathe
Minister of Finance & Development Planning
Private Bag 008
Gaborone

Honourable Minister

In accordance with Section 57 (1) of the Bank of Botswana Act, 1996, I have the honour to submit, herewith, the *Annual Report* of the Bank of Botswana for 2001, which covers:

(i) a report on the operations and other activities of the Bank during 2001;

(ii) a copy of the Bank's annual accounts for the year ended December 31, 2001 certified by the external auditors and approved by the Board on March 22, 2002; and

(iii) a review of the economy in 2001, a special feature on the role of the financial sector in Botswana's economic growth and a statistical section.

Yours sincerely

Linah K. Mohohlo
GOVERNOR

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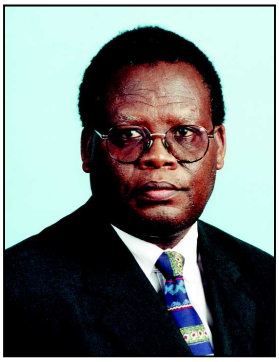
BOARD MEMBERS

as at December 31, 2001

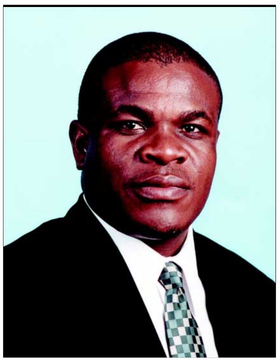
L. K. Mohohlo
Governor and Chairman of the Board



S. S. G. Tumelo
Board Member

G. K. Cunliffe
Board Member

D. N. Moroka
Board Member

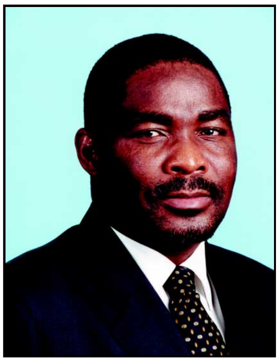


R. G. M. Mmutle
Board Member

N. H. Fidzani
Board Member

T. C. Moremi
Board Member

DEPUTY GOVERNORS



O. A. Motshidisi
Deputy Governor

K. R. Jefferis
Deputy Governor

BOARD MEMBERS

as at December 31, 2001

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Governor and Chairman of the Board

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Board Member

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Board Member

N. H. Fidzani
Board Member

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Board Member

D. N. Moroka
Board Member

T. C. Moremi
Board Member

CONTENTS - PART A

Statutory Report on the Operations and
Financial Statements of the Bank

CONTENTS - PART B

APPENDICES, BOXES, CHARTS, TABLES AND FIGURES

Appendices

Boxes

Charts

Tables

Figures

Abbreviations Used in the Report

ATMs	Automated Teller Machines
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BEDIA	Botswana Export Development Investment Authority
BEDU	Botswana Enterprise Development Unit
BIS	Bank for International Settlement
BMC	Botswana Meat Commission
BNPC	Botswana National Productivity Centre
BoB	Bank of Botswana
BoBCs	Bank of Botswana Certificates
BoBCSS	Bank of Botswana Clearing and Settlement System
BR	Botswana Railways
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
BTB	Botswana Tourism Board
BTC	Botswana Telecommunications Corporation
CAA	Civil Aviation Authority
CEDA	Citizen Entrepreneurial Development Agency
CEMAEF	Citizen Entrepreneur Mortgage Assistance Equity Fund
EFTPOS	Electronic Funds Transfer at Point of Sale
CIUs	Collective Investment Undertakings
CPI	Consumer Price Index
CPSS	Committee on Payment and Settlement Systems
CRSA	Control Risk Self Assessment
CSO	Central Selling Organisation
DTC	Diamond Trading Company
ECH	Electronic Clearing House
EU	European Union
FAP	Financial Assistance Policy
FCAs	Foreign Currency Accounts
FCI	Foreign Companies Index
FI	Financial Intsitutions
FNBB	First National Bank Botswana
GDP	Gross Domestic Product
IFSC	International Financial Services Centre
IIP	International Investment Position
IMFC	International Monetary and Financial Committee
IMF	International Monetary Fund
IT	Information Technology
LEA	Local Enterprise Agency
LVTS	Large Value Transfer System
MFDP	Ministry of Finance and Development Planning
MICR	Magnetic Ink Character Recognition
MTR	Mid-Term Review
NAMPAD	National Master Plan for Agricultural Development
NEER	Nominal Effective Exchange rate
NBFIs	Non-Bank Financial Institutions

Abbreviations Used in the Report *(cont.)*

NCSS	National Clearing and Settlement Systems
NDB	National Development Bank
NDP	National Development Plan
NPC	National Payment Council
NPH	National Policy on Housing
NPS	National Payment System
NPTF	National Payment Task Force
NSCs	National Savings Certificates
OPEC	Organisation of Petrolium Exporting Countries
PDSF	Public Debt Service Fund
PMS	Performance Management System
PEEPA	Public Enterprise Evaluation and Privatisation Agency
POS	Point of sale
Repos	Repurchase Agreements
REER	Real Effective Exchange Rate
ROAA	Return on Average Assets
ROE	Return on Equity
RTGS	Real Time Gross Settlement
SACU	Southern African Customs Union
SADC	Southern African Development Community
SDR	Special Drawing Rights
SLF	Secured Lending Facility
SMMEs	Small Medium and Micro Enterprises
TIPA	Trade and Investment Promotion Agency
USA	United States of America
VAT	Value Added Tax
PPADB	Public Procurement and Asset Disposal Board

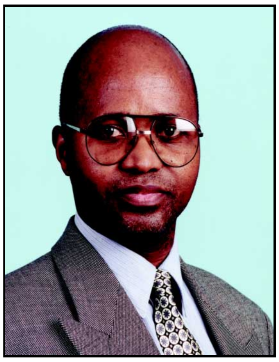
PART A

STATUTORY REPORT ON THE OPERATIONS OF THE BANK 2001

BANK OF BOTSWANA

HEADS OF DEPARTMENT

as at December 31, 2001

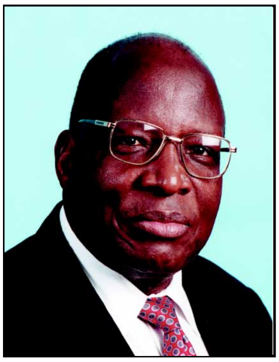


O. Mabusa
Banking Department

R. H. Nlebesi
Administration Department

M. D. Pelaelo
Banking Supervision Department

N. A. Mabe
Accounting Department



H. P. Bandawe
Research Department

F. K. Ntsayagae
Information Technology Department
(Acting)

O. Modisa
Financial Markets Department
(Acting)

PART A: STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK

1. AN OVERVIEW OF THE BANK

Objectives of the Bank

1.1 The primary objective of the Bank, as stated in the Mission Statement, is to promote and maintain monetary stability. The Bank also ensures that the payments system is efficient and that the banking system is sound. These functions of the Bank support the broad national macroeconomic objectives, including sustainable economic diversification. The Bank s main responsibilities, its organisational structure and the framework for its activities are described below.

The Bank s primary objectives are to promote monetary stability, ensure efficient payments system and a sound financial system

Functions of the Bank

1.2 As prescribed by the Bank of Botswana Act, 1996, the major responsibilities of the Bank include the conduct of monetary policy; provision of banking services to the Government, banks and selected public sector organisations; regulation and supervision of banks and other financial institutions; issuance of currency; implementation of exchange rate policy; management of foreign exchange reserves; and provision of monetary and financial policy advice to the Government.

Primary responsibilities are prescribed by legislation

(a) Conduct of Monetary Policy is directed mainly at achieving the primary responsibility of the Bank, as well as the promotion and maintenance of monetary stability. This requires the achievement of low and sustainable inflation, which contributes to the promotion and maintenance of domestic and external monetary and financial stability. This objective, together with fiscal, wage, trade and exchange rate policies, fosters macroeconomic stability, which, is a crucial precondition for achieving sustained development, high rates of employment and rising standards of living for Batswana.

(b) Central Banking and Payments System Services are mainly provided for the Government, commercial banks and other selected institutions. The Bank also operates a clearing system for the banking sector.

(c) Supervision of Banks and Other Financial Institutions is conducted in accordance with the Banking Act, 1995, and other relevant statutes. The purpose of prudential regulation and supervision is to ensure the safety, solvency and proper functioning of the banking system and overall financial sector.

(d) Issuance of Currency (banknotes and coin) of high quality is an essential ingredient of an efficient payments system which, in turn, facilitates economic activity.

(e) Exchange Rate Policy is implemented on behalf of the Government in the overall context of sound macroeconomic management. The objective of the policy is to promote export competitiveness without compromising macroeconomic stability. The Bank buys and sells foreign exchange at rates determined in accordance with the exchange rate policy.

(f) Official Foreign Exchange Reserves are managed by the Bank on behalf of the Government. The Bank ensures their safety, and return by diversifying investments within a framework of acceptable risks.

(g) Economic Analysis and Policy Advice are covered in periodic reports, published research papers and statistical documents. Most of the materials are distributed to other institutions and the public. The Bank is also represented on a number of Government-led committees and task forces.

Structure of the Bank

Minister of Finance reports to Parliament on the Bank's operations

1.3 The Bank of Botswana falls under the purview of the Minister of Finance and Development Planning, who appoints members of the Board, except the ex-officio Chairman (Governor), who is appointed by His Excellency the President. The Minister reports to Parliament on the Bank s operations and financial performance.

The Board

The Board has overall responsibility over the Bank's operations

1.4 Under the Bank of Botswana Act, 1996, and the Bank s Bye-Laws, overall responsibility for the operations of the Bank is vested in the Board of the Bank. The Board is responsible for ensuring that the principal objectives of the Bank, as set out in the Act, are achieved. It also ensures that appropriate policies, management and administrative systems as well as financial controls are in place at all times in order for the Bank to achieve its objectives in an efficient and effective manner. Accordingly, the Board has a direct role in the strategic planning of the Bank, and in determining the broad policy framework. In this regard, the Board approves the annual budget, monitors the financial and operational performance, reviews reports of the external auditors and may call for any policy review.

The nine-member Board is required to meet at least once each quarter

1.5 The Board comprises nine members and is chaired by the Governor as required under the Bank of Botswana Act, 1996. As at the end of 2001, seven members were in place and there were two vacancies. The Permanent Secretary of the Ministry of Finance and Development Planning is an ex-officio member; the other members are drawn from the public service (not more than two), the private sector and academia in their individual capacities.

1.6 The Board is required to meet at least once each quarter, although typically it meets more frequently. The Audit Committee of the Board is chaired by a non-executive Board member, and its main responsibility is to ensure that accounting policies, internal controls and financial practices are based on established rules and regulations. A report on the operations and the audited financial statements of the Bank is submitted to the Minister of Finance and Development Planning within three months of the end of the Bank s financial year[1], after approval by the Board.

The Governor

1.7 In addition to chairing the Board, the Governor is the chief executive officer of the Bank, and is responsible for the prompt and efficient implementation of the decisions or resolutions of the Board. The Governor manages the Bank on a day-to-day basis, and represents the institution in its relations with the Government, domestic financial and other institutions as well as external organisations.

The Governor is the Bank's chief executive officer, supported by the Executive Committee

The Executive Committee

1.8 The Executive Committee, which is chaired by the Governor, comprises the Deputy Governors and Heads of Department, and may include co-opted senior staff. Its responsibility is to advise the Governor on the day-to-day management of the Bank as well as the development of the Bank s medium and long-term plans.

Departments and Divisions

1.9 In order to carry out its functions and supporting activities, the Bank is organised into Departments and Divisions. At the end of 2001, the Bank s seven Departments comprised Administration, Accounting, Banking, Banking Supervision, Financial Markets, Information Technology and Research; the three Divisions were the Board Secretariat, Security and Internal Audit. The Heads of Department report through the Deputy Governors to the Governor, as do the Heads of Security and the Board Secretariat. The Internal Audit Division reports directly to the Governor.

The Bank has seven Departments and three Divisions

Strategies

1.10 In pursuing its principal objectives of maintaining monetary stability as well as ensuring the soundness and efficiency of the financial system, the Bank has regularly reviewed and adapted its strategies to deal with the changing conditions prevailing in the financial sector. The Bank s activities are mainly in the following areas:

Maintaining monetary stability and a sound and efficient financial system are key objectives

Monetary Operations, Reserve Requirements and the Bank Rate

1.11 Monetary stability is mainly reflected in low and stable inflation. Since inflation is fundamentally influenced by monetary and credit factors, the Bank s anti-inflation strategy focuses on the control of banking system credit as an intermediate target. However, controlling inflation in a small open economy, such as Botswana, whose trading partners

[1] The Bank's financial year coincides with the calendar year.

have often experienced high and unstable levels of inflation, is a major challenge.

1.12 In implementing monetary policy, the Bank uses indirect policy instruments, particularly open market operations and the Bank Rate. The Bank may also use banking regulations and moral suasion to achieve monetary policy objectives. However, the use of Bank of Botswana Certificates (BoBCs), in both the primary and secondary markets, to control the liquidity of the financial system and influence short-term interest rates, plays a prominent role in maintaining monetary stability.

1.13 In addition to the Secured Lending Facility (SLF), the Bank also uses Repurchase Agreements (Repos) to manage short-term and overnight liquidity fluctuations in the banking system.

1.14 The Bank incorporates data on fiscal and other policies of the Government in the design of a monetary policy framework and its implementation strategy in order to ensure macroeconomic stability. Therefore, whenever necessary, monetary policy may need to be restrictive in order to counteract expansionary fiscal and wage policies that may erode monetary stability and, therefore, the nation s prospects for sustainable economic development. The broad framework of monetary policy is presented to the public in the form of annual *Monetary Policy Statements*.

Banking Services to the Government and Commercial Banks

1.15 The Bank serves as the banker to the Government, commercial banks and certain other institutions, and provides a payment, clearing and settlement system for the financial sector. In this regard, the Bank is promoting and coordinating a programme that will enhance the efficiency and security of the payments system. It is also a lender of last resort to the financial institutions under its supervisory purview.

Implementing the Banking Act and Regulations

Supervision and regulation of financial institutions are necessary for confidence and stability

1.16 Through its routine banking supervision and regulatory activities, the Bank seeks to achieve a sound and stable financial system. Accordingly, the Bank ensures that the mechanisms for sustaining the safety and soundness of licensed financial institutions are appropriate and that those institutions are managed in a prudent and safe manner. Therefore, the Bank enforces prudential standards with respect to capital adequacy, liquidity, asset quality and corporate governance of the banks.

The Bank also has responsibility for anti-money laundering policy and regulation of international financial services

1.17 Under the provisions of the Banking Act, the Bank has specific responsibilities relating to money laundering. Accordingly, the banks are required to identify customers when opening accounts, retain appropriate records, report suspicious activities and cooperate fully with law enforcement agencies in an effort to combat financial crimes and, in particular, money laundering.

1.18 The Bank has assumed the responsibility for the regulation and supervision of the International Financial Services Centre (IFSC) entities as well as the administration of the Collective Investment Undertakings Act, 1999.

1.19 The Bank also monitors commercial bank compliance with primary reserve requirements and ensures that clearing and settlement activities are conducted safely and efficiently. As the volume and value of financial transactions managed by the financial system increases, and Botswana s linkages with international financial markets expand, the Bank has to guard against systemic risks that may arise. It is for this reason that the Bank continually collaborates with private sector institutions, international organisations and the Government in introducing improvements to the safety and efficiency of the payments system.

1.20 In addition to its focus on the safety and soundness of licensed financial institutions, the Bank is responsible for ensuring that banks maintain high professional standards in their operations in order to provide efficient customer service in a transparent manner. The Bank also has a surveillance responsibility with regard to breaches of the Banking Act, 1995, by the public, especially in the form of activities that involve unauthorised deposit taking and unauthorised use of banking names.

Implementing Exchange Rate Policy

1.21 The Bank acts as the Government s agent in implementing the exchange rate policy. Under the Bank of Botswana Act, 1996, the President, on the recommendation of the Minister of Finance and Development Planning, and after consultation with the Bank, sets the framework for the determination of the external value of the Pula. At present, the Pula is pegged to a basket of currencies comprising the South African rand and the Special Drawing Right (SDR - the unit of account of the International Monetary Fund). Based on the basket, the Bank calculates the exchange rate for each business day, and quotes the buying and selling rates for major international currencies to the banks. The Bank monitors the Pula exchange rate developments regularly with a view to advising the Government on maintaining competitiveness of domestically produced goods.

Managing Foreign Exchange Reserves

1.22 As Botswana s foreign exchange reserves have continued to grow, the Bank has subdivided the reserves into two portfolios to meet different objectives. A large proportion of the reserves is invested in long-term assets (Pula Fund) with a view to maximising long-term return, while the remainder comprises the Liquidity Portfolio, which is invested in money market instruments and short-term bonds.

Foreign exchange reserves are managed to meet specific objectives

Advice on Economic Policy, Provision of Statistics and Public Education

The Bank serves as advisor to Government

1.23 In addition to its responsibilities of formulating and implementing monetary policy, the Bank serves as economic and financial advisor to the Government on a wide range of issues. These include exchange rate policy, financial sector development, taxation, industrial development and trade.

1.24 The Bank conducts annual briefings on economic trends and publishes macroeconomic statistics and a research bulletin. The Bank has also formulated and is implementing a public education programme on banking and financial matters.

Meeting the Needs for Banknotes and Coin

The Bank is the sole supplier of notes and coin

1.25 The availability of a safe and convenient currency is essential for an efficient payments system. For this reason, the Bank routinely ensures that there is an adequate supply of high quality notes and coin in circulation by withdrawing soiled and damaged currency and replacing it with new notes and coin. The Bank maintains stringent standards in the design and production of both notes and coin to ensure their acceptance as a medium of exchange and to deter counterfeiting and other forms of debasement.

2. REPORT ON THE BANK’S OPERATIONS

Introduction

2.1 This section highlights the main activities of the Bank during 2001. The activities relate to the Bank s progress in implementing its annual work programme.

Structure of the Bank

The Bank was restructured in early 2001

2.2 With effect from February 1, 2001 the organisational structure of the Bank was changed; this included changes to the designations of some Departments in order to reflect more accurately their core responsibilities. The International Department was renamed the Financial Markets Department; the Financial Institutions Department was renamed Banking Supervision Department; the Management Systems Department was renamed Information Technology Department, and the designation of the Finance Department was changed to Accounting Department. The Support Services Department was abolished and its components reassigned; the Board Secretariat and Security Divisions were moved to the Governor s Office while the Property Management Unit was made part of the Administration Department.

Governor’s Office

Governor s Office is focal point for Bank s external relations

2.3 During 2001, the Governor s Office continued to oversee the overall management of the Bank. The office facilitated meetings of the Bank of Botswana Board and various internal committees. Some of the major activities undertaken during the year included the publication of the Bank s *2001 Monetary Policy Statement* and its mid-year review, as well as the coordination of the Sovereign Credit Rating exercise.

2.4 The Governor s Office continued to be the focal point for the Bank s relationships with regional and international organisations through inter-alia, participation in meetings, conferences and seminars. Important international relationships included participation in meetings of the Southern African Development Community (SADC) Committee of Central Bank Governors (CCBG), the Association of African Central Banks (AACB), the Bank for International Settlements (BIS) as well as the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI). Furthermore, the Bank coordinated the IMF Outreach Meeting for African countries which discussed guidelines on best practices for the management of foreign exchange reserves. The Bank also provided logistical support for the IMF Regional Workshop on the General Data Dissemination System (GDDS) for upgrading statistical capacity in Anglophone African countries. The workshop was preceded by an IMF Mission that prepared a Report on the Observance of Standards and Codes (ROSC) in statistics. Besides representing the Africa 1 Constituency on the International Monetary and Financial Committee (IMFC), the Bank hosted two IMF Technical Assistance Missions. The Bank benefited from the service of three advisors under the auspices of the IMF.

2.5 As part of the Government s effort, to counter the adverse effects of the campaign against the so-called conflict diamonds, the Governor took part in interviews by major international television networks and newspapers on the Botswana economy and the positive role of diamonds to Botswana s development. A number of fact-finding missions were hosted, including one by members of the United States Congress.

Governor Mohohlo appointed eminent person

2.6 In October 2001, the Governor was appointed by the United Nations Secretary General as an eminent person to serve on a panel to oversee and supervise the evaluation of the United Nations New Agenda for the Development of Africa in the 1990s .

New Deputy Governor appointed

2.7 Following the expiry of Mrs J. Majaha-Järtby s contract, Mr O. A. Motshidisi was appointed to the position of Deputy Governor with effect from February 1, 2001. He took the over-arching responsibility for supervising the Financial Markets, Banking Supervision, Accounting and Administration Departments. The other Deputy Governor took responsibility for the Research, Information Technology and Banking Departments as well as the Board Secretariat and Security Divisions.

The Board met six times

2.8 The Board convened six meetings during the year, which included three Audit Committee meetings and a special Board meeting to review some aspects of reserve management policy. Other major policy decisions made by the Board during the year included the approval of the National Payments System project.

Public Education

2.9 A number of public education activities were undertaken during the year, including the Banking Week, the theme of which was Saving, One Step to a Better Future . A booklet, *Money and Banking in Botswana*, was published and distributed to school libraries and other information centres across the country.

Public Relations

2.10 The Bank s public relations during 2001 included press conferences, press releases and responding to enquiries from the media.

Financial Affairs and Auditing

Programme of control risk self-assessment implemented

2.11 The Control Risk Self Assessment (CRSA) programme has been implemented in all Departments of the Bank. CRSA involves departments identifying risks within their own operational areas and ensuring that adequate controls are in place to address these risks.

Security

2.12 The Bank continued its regional collaboration in security management through active participation in the SADC Heads of Protective Services Forum, and, domestically, facilitated the establishment of the Financial Institutions Security Managers Forum to foster the sharing of operational intelligence and improving cooperation among financial institutions.

2.13 The Gaborone Technical Security Upgrade project was completed and handed over to the Bank after successful commissioning in November 2001.

Administration of Human Resources

2.14 The Bank s authorised establishment increased during 2001 to 558. As in past years, the Bank had an active training programme, and a large number of staff members undertook both short and long-term training programmes at overseas, regional and local institutions.

2.15 The HIV/AIDS Coordinating Committee carried out a number of activities, primarily to update staff on a variety of HIV/AIDS issues, including the need for positive living for those who may be carrying the virus. In line with the Bank s HIV/AIDS Policy, some financial assistance is availed to staff undergoing specialised treatment for the illness, and there are indications that the programme is succeeding in improving the quality of life and sustaining a productive workforce.

National Payments System

Enhancing national payments system a major focus

2.16 The Payments System Project was a major component of the Bank s work throughout the year. Substantial progress was made towards the introduction of the Electronic Clearing House (ECH), including the introduction of cheques that are compliant with the new Magnetic Ink Character Recognition (MICR) standard, the procurement and installation of cheque processing machines, and the installation of hardware, software and communication equipment for the ECH. This was carried out in close cooperation with the clearing banks, all of which are participants in the project.

National Savings Certificates

2.17 A series of marketing initiatives were carried out to promote the sale of the National Savings Certificates (NSCs). These included participation in the Banking Week programme and radio advertising. A long-term NSCs marketing strategy was initiated, involving the sale of certificates through payroll deductions. Early indications are that the marketing campaign appears to be achieving the desired result.

New marketing strategy for National Savings Certificates introduced

Banking Supervision

2.18 Bank of Baroda (Botswana) Limited commenced operations in March 2001, bringing the number of licensed banks in Botswana to seven (five commercial banks and two investment/merchant banks). ABC Holdings Limited, through its offshore banking subsidiary, African Banking Corporation (International) Limited, was granted a banking licence to conduct business for non-residents, in currencies other than the Pula.

2.19 Based on the early warning system and risk profiles, four on-site examinations were conducted. Overall, the examined financial institutions were found to be solvent, liquid, profitable and prudently managed.

2.20 The Bank submitted the statutory *Banking Supervision Annual Report 2000* to the Minister of Finance and Development Planning on the state of the banking industry, including an industry-wide performance review. In addition to the quarterly bank performance reviews and management reports, bilateral meetings and trilateral meetings were held with all supervised institutions as part of the effort to improve communications. The Botswana banking system remained healthy, characterised by high levels of profitability, product and technological innovation and growth in both deposits and lending.

The banking system remains healthy

The International Financial Services Centre

2.21 Two additional applications for operations in the International Financial Services Centre (IFSC) were considered and approved by the IFSC Certification Committee. By December 2001, five companies had been established under the IFSC regulations: one banking group, one asset management company and three group treasury operations.

2.22 The revised Collective Investment Undertakings (CIU) Act, 1999, became effective on June 22, 2001 following the promulgation of the CIU Regulations by the Minister of Finance and Development Planning. Accordingly, the Bank formally assumed the supervisory role for unit trusts, mutual funds and similar operations. Three applications under this Act have since been received and are at various stages of processing.

Bureaux de Change Operations

2.23 Six bureaux de change were licensed during the year, while the licences of three were revoked for various reasons. This brought the total number of bureaux de change to 21 as at year-end (2001).

Quality of Banking Services Survey

Banking survey will be used to help improve service quality

2.24 The findings of the *National Survey on Cost and Quality of Banking Services* were disseminated to all stakeholders including the Government, media, concerned financial institutions and the public. The survey results are a basis for a continuing dialogue with the banks regarding areas that affect the quality of service.

Reserve Management

2.25 The Bank continued to manage the country s reserves in accordance with the approved investment policy and guidelines.

Open Market Operations

2.26 The Bank continued to use open market operations to sterilise excess liquidity and influence short-term interest rates. Repurchase agreements (Repos) continued to be utilised, in order to manage short-term fluctuations in liquidity.

Information Technology and Management Information Systems

2.27 The Bank undertook a number of information technology projects during the year including a review of major operational systems such as Bankmaster, ACCPAC and HiPortfolio.

2.28 The development of Business Continuity Plans which began in 2000 was completed during 2001, and the plans underwent testing by respective Departments. The main disaster recovery site was equipped and is being used for testing backup and storage of tapes to be used in the event of a disaster, and an additional disaster recovery site was established in Francistown.

2.29 A high capacity data line between Gaborone and Francistown was installed to improve data communications between the Bank s headquarters in Gaborone and the Francistown Branch.

Research and Publications

2.30 During 2001, the Bank continued its work in the areas of economic analysis and policy advice, with a focus on the core areas of monetary and exchange rate policies. One of the major ongoing projects was the development of an inflation forecasting model.

Development of an inflation forecasting model ongoing

2.31 The Bank launched the *2001 Monetary Policy Statement* in February, which was followed up with a mid-year review of the Statement. The Bank also published the *2000 Annual Report*, which had the theme The Challenge of Economic Diversification , an issue of the *Research Bulletin* and the monthly issues of the *Botswana Financial Statistics*. Six economic briefings were conducted on the *2000 Annual Report* to diverse audiences, including His Excellency the President and Cabinet Ministers, Members of Parliament, representatives of the private sector and financial institutions, members of the diplomatic corps and the press. A number of internal seminars were also held on a variety of topics.

2.32 Considerable effort was put into improving the production and dissemination of the Bank s economic and financial statistics, as part of a wider national effort to participate in the IMF s General Data Dissemination System (GDDS). Delays in the dissemination of data were reduced and greater use was made of the Bank s website. The Bank benefited from an IMF technical assistance mission to develop a comprehensive economic and financial database.

Dissemination of economic and financial statistics is improved

PART A

ANNUAL FINANCIAL STATEMENTS 2001

BANK OF BOTSWANA

CONTENTS **Page**

The Annual Financial Statements set out on pages 30 to 43 were approved by the Board on March 22, 2002, and signed by:-

Linah K. Mohohlo
Governor

Nozipho A. Mabe
Director, Accounting Department

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Deloitte & Touche

REPORT OF THE INDEPENDENT AUDITORS
TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the accompanying financial statements of Bank of Botswana as set out on pages 30 to 43 for the year ended December 31, 2001. These financial statements are the responsibility of the Bank s Board. 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 plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The audit included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. It also covered assessing the accounting principles used and significant estimates made by the Management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion:

(i) the Bank has kept proper books of account with which the financial statements are in agreement; and

(ii) the financial statements give a true and fair view of the state of the Bank s affairs as of December 31, 2001 and of the result of its operations, changes in shareholder s funds, and cash flows for the year then ended in the manner required by the Bank of Botswana Act, 1996.

Deloitte + Touche

Deloitte & Touche
Certified Public Accountants

GABORONE
March 22, 2002

BALANCE SHEET
December 31, 2001

	Notes	2001	2000
		P'000	P'000
ASSETS			
Fixed Assets	1	129 313	131 140
Foreign Exchange Reserves			
Liquidity Portfolio	2.1	8 343 336	4 681 319
Pula Fund	2.2	32 175 924	28 711 638
International Monetary Fund			
Reserve Tranche	3.1	194 900	123 962
Holdings of Special Drawing Rights	3.2	277 434	211 148
Administered Funds	3.4	190 438	152 119
		41 182 032	33 880 186
Other Assets	4	29 556	22 576
TOTAL ASSETS		41 340 901	34 033 902
LIABILITIES			
Notes and Coin in Circulation	5	701 095	606 489
Bank of Botswana Certificates	6	5 147 704	3 712 398
Deposits	7	761 068	1 072 065
Government Investment Account	8	27 571 718	23 580 585
Allocation of Special Drawing Rights (IMF)	3.3	38 136	30 461
Liabilities to Government (IMF Reserve Tranche)	9	194 900	123 962
Dividend to Government	10	266 500	521 722
Other Liabilities		30 082	32 490
Total Liabilities		34 711 203	29 680 172
SHAREHOLDER'S FUNDS			
Paid-up Capital	11	25 000	25 000
Currency Revaluation Reserve		4 893 980	2 423 138
Market Revaluation Reserve		110 718	305 592
General Reserve	12	1 600 000	1 600 000
Total Shareholder's Funds		6 629 698	4 353 730
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		41 340 901	34 033 902

INCOME STATEMENT
Year ended December 31, 2001

	Notes	2001	2000
		P'000	P'000
INCOME			
Interest		1 455 246	1 257 677
Net market gains on disposal of securities		203 098	817 510
Dividends		161 450	145 600
Commissions		25 367	24 481
Realised currency revaluation gains		25 098	3 650
Other income		3 820	5 498
		1 874 079	2 254 416
EXPENSES			
Interest		578 261	500 909
Administration costs		137 091	127 562
Depreciation		11 883	7 164
Unrealised market revaluation losses – Liquidity Portfolio		4 624	681
		731 859	636 316
NET INCOME FOR THE YEAR		1 142 220	1 618 100
TRANSFER FROM GOVERNMENT INVESTMENT ACCOUNT	8.1	32 326	-
NET INCOME AVAILABLE FOR DISTRIBUTION		1 174 546	1 618 100
APPROPRIATIONS			
DISTRIBUTION TO GOVERNMENT		(1 066 000)	(1 166 722)
Dividend to Government from Pula Fund		(1 066 000)	(860 000)
Share of residual net income		-	(306 722)
TRANSFER TO GOVERNMENT INVESTMENT ACCOUNT	8.1	(108 546)	(451 378)

CASH FLOW STATEMENT
Year ended December 31, 2001

	Notes	2001	2000
		P'000	P'000
OPERATING ACTIVITIES			
Cash generated by operations	13	2 347 649	1 116 390
INVESTING ACTIVITIES			
Net Proceeds from disposal of investments		82 372	-
Investments		-	(2 665 695)
Proceeds from disposal of fixed assets		232	222
Purchase of fixed assets	1	(10 087)	(16 392)
NET CASH FROM /(USED IN) INVESTING ACTIVITIES		72 517	(2 681 865)
FINANCING ACTIVITIES			
Dividend to Government	10	(1 321 222)	(945 000)
Government (Withdrawals)/Investments	8.2	(1 193 550)	2 510 803
NET CASH (USED IN)/FROM FINANCING ACTIVITIES		(2 514 772)	1 565 803
NET (INCREASE)/DECREASE IN CURRENCY IN CIRCULATION		(94 606)	328
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(606 489)	(606 817)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(701 095)	(606 489)

The Cash Flow Statement has been prepared under International Accounting Standard No. 7 – Cash Flow Statements (Revised 1992). The definition of cash in the Standard 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 balance sheet (also see Note 5). However, it has the ability to create cash when needed.

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS
Year ended December 31, 2001

	Paid-up Share Capital	Currency Revaluation Reserve	Market Revaluation Reserve	General Reserve	Accumulated Profit	Total
	P'000	P'000	P'000	P'000	P'000	P'000
Balance at January 1, 2000	25 000	1 343 958	418 309	1 600 000	-	3 387 267
Pula Fund currency gains for the year	-	2 394 121	-	-	-	2 394 121
Liquidity Portfolio currency gains for the year	-	326 710	-	-	-	326 710
Unrealised market losses for the year	-	-	(358 631)	-	-	(358 631)
Transfer to Government Investment Account	-	(1 641 651)	245 914	-	-	(1 395 737)
Net gains/(losses) not retained in the Income Statement	-	1 079 180	(112 717)	-	-	966 463
Net Income for the year	-		-	-	1 618 100	1 618 100
Transfer to Government Investment Account	-	-	-	-	(451 378)	(451 378)
Dividend to Government from Pula Fund	-	-	-	-	(1 166 722)	(1 166 722)
Balance at December 31, 2000	25 000	2 423 138	305 592	1 600 000	-	4 353 730
Pula Fund currency gains for the year	-	6 631 060	-	-	-	6 631 060
Liquidity Portfolio currency gains for the year	-	1 823 835	-	-	-	1 823 835
Unrealised market losses for the year	-	-	(1 070 464)	-	-	(1 070 464)
Transfer to Government Investment Account	-	(5 984 053)	875 590	-	-	(5 108 463)
Net gains/(losses) not retained in the Income Statement	-	2 470 842	(194 874)	-	-	2 275 968
Net income for the year	-	-	-	-	1 142 220	1 142 220
Transfer to Government Investment Account	-	-	-	-	(108 546)	(108 546)
Transfer from Government Investment Account	-	-	-	-	32 326	32 326
Dividend to Government from Pula Fund	-	-	-	-	(1 066 000)	(1 066 000)
Balance at December 31, 2001	25 000	4 893 980	110 718	1 600 000	-	6 629 698

ACCOUNTING POLICIES
December 31, 2001

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 foreign assets and liabilities and the result of the activities of the Pula Fund. The financial statements comply with International Accounting Standards, except as noted below.

ADOPTION OF INTERNATIONAL ACCOUNTING STANDARDS (IASs)

In the current year, the Bank has adopted International Accounting Standard No. 7 (Revised 1992) – Cash Flow Statements and expanded the application of IAS No.1 (Revised 1997) – Presentation of Financial Statements by incorporating the Statement of Changes in Shareholder's Funds.

International Accounting Standard No. 39 – Financial Instruments: Recognition and Measurement (Revised 2000) has introduced a comprehensive framework for accounting for financial instruments. The standard requires, among others, that investments in securities be carried at fair value. The Bank accounts for its investments on a portfolio basis as opposed to individual instrument basis, and already values its investments at fair value, based on current market values. Therefore, its application has had no effect on the amounts reported in the current or prior accounting periods, nor on the presentation of the financial statements.

The Bank has adopted a prudent approach to accounting for exchange rate gains and losses on investments, which are denominated in foreign currencies. Exchange rate gains and losses relating to investments that are sold and proceeds reinvested in foreign currency assets are treated as unrealised and are credited directly to a Currency Revaluation Reserve. This treatment does not comply with International Accounting Standard No. 21 – The Effects of Changes in Foreign Exchange Rates, which requires recognition as income, of exchange rate gains and losses realised on the sale of the investments and arising from translation of short-term investments. Compliance with IAS No. 21 would have required for an amount of P3 870 002 574 (2000 – P1 632 721 660) to be recognised in the Income Statement before appropriation to the Currency Revaluation Reserve.

FOREIGN EXCHANGE BALANCES AND TRANSACTIONS

Assets and Liabilities

Assets and liabilities denominated in foreign currencies are translated to Pula using the middle rate of exchange ruling at the close of the financial year. The resulting exchange gains and losses are taken to the Currency Revaluation Reserve.

Foreign Currency Transactions

Transactions denominated in foreign currencies are translated to Pula using the middle rate of exchange ruling at the transaction date.

ACCOUNTING POLICIES (continued)

Exchange gains and losses arising on disposal of foreign denominated financial assets are transferred to the Currency Revaluation Reserve in so far as the proceeds of disposal are re-invested in foreign assets.

Investments

Short-term and long-term investments in foreign treasury bills, securities and equities are stated at their market value at year-end. Unrealised market revaluation gains and losses on Liquidity Portfolio and profits and losses on realisation of all investments are taken to the income statement in the year in which they arise.

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

BANK OF BOTSWANA CERTIFICATES

As one of its 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 the rate of monetary growth, and also interest rates. BoBCs are issued at a discount to counterparties.

The Bank's liability in respect of BoBCs is stated at market value with movements in matured and unmatured discount recognised in the Income Statement.

INCOME AND EXPENSE RECOGNITION

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

GENERAL RESERVE

Under Section 7(1) of the Bank of Botswana Act, 1996, 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 are transferred to the Currency Revaluation Reserve.

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

ACCOUNTING POLICIES (continued)

MARKET REVALUATION RESERVE

Any changes in the value of the Bank's long-term investments held in foreign currencies 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.

FIXED ASSETS AND DEPRECIATION

Fixed assets are stated at cost less related accumulated depreciation.

No depreciation is provided on land. All other fixed assets are depreciated on a straight line basis at the following annual rates:-

	Percent
Buildings	2.50
Furniture, fixtures and equipment	20.00
Computer hardware	33.33
Computer software	100.00
Motor vehicles - Commercial	25.00
- Bullion Truck	5.00

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 (Chapter 27:03). Contributions are at the rate of 21.5 percent of pensionable emoluments of which pensionable employees of the Bank pay 4 percent. Other than the contributions made, the Bank has no further commitments or obligations to this Fund.

NOTES TO THE FINANCIAL STATEMENTS
December 31, 2001

1. FIXED ASSETS

	Freehold Land	Leasehold Land	Buildings	Capital Work -in-Progress	Other Assets	Total
	P'000	P'000	P'000	P'000	P'000	P'000
Cost or Valuation						
Balance at the beginning of the year	607	3 486	119 903	12 479	36 344	172 819
Additions	-	-	-	2 929	7 158	10 087
Disposals	-	-	-	-	(1 562)	(1 562)
Adjustments	-	-	(7)	-	(3)	(10)
Transfers	-	-	2 593	(14 923)	12 330	-
Balance at the end of the year	607	3 486	122 489	485	54 267	181 334
Accumulated Depreciation						
Balance at the beginning of the year	-	-	18 457	-	23 222	41 679
Charge for the year	-	-	3 050	-	8 833	11 883
Disposals	-	-	-	-	(1 511)	(1 511)
Adjustments	-	-	-	-	(30)	(30)
Balance at the end of the year	-	-	21 507	-	30 514	52 021
Net book value as at December 31, 2001	607	3 486	100 982	485	23 753	129 313
Net book value as at December 31, 2000	607	3 486	101 446	14 109	11 492	131 140

2. FOREIGN EXCHANGE RESERVES

	2001	2000
	P'000	P'000
2.1 Liquidity Portfolio	8 343 336	4 681 319

The portfolio is invested in money market instruments and bonds. It is meant to facilitate payments for regular transactions.

2.2 Pula Fund	32 175 924	28 711 638

This is a long-term fund intended to maximize return; it is invested in foreign financial instruments with a long-term duration.

NOTES TO THE FINANCIAL STATEMENTS (continued)

	2001	2000
	P'000	P'000
Pula Fund Balance Sheet		
Capital Employed		
Government	27 565 268	23 080 585
Bank of Botswana	4 610 656	5 631 053
	32 175 924	28 711 638
Employment of Capital		
Investments	32 175 924	28 711 638
Investments expressed in US dollars ('000)	4 607 592	5 354 720
Investments expressed in SDR ('000)	3 677 708	4 108 635
Pula Fund Income Statement		
Income		
Interest and dividends received	1 254 248	1 165 939
Net realised market gains	218 586	810 412
Sundry income	10	46
	1 472 844	1 976 397
Administration charges	(70 769)	(63 934)
Net Income available for distribution	1 402 075	1 912 463
Appropriations		
Distribution to Government	(1 174 546)	(1 311 378)
Dividend to Government	(1 066 000)	(860 000)
Transfer to Government Investment Account	(108 546)	(451 378)
Bank of Botswana's share of net income	227 529	601 085

NOTES TO THE FINANCIAL STATEMENTS (continued)

3. INTERNATIONAL MONETARY FUND (IMF)

3.1 Reserve Tranche

This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is its membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holdings of Pula by the IMF, which initially were equal to 75 percent of the quota, have changed from time to time as a result of the use of Pula by the IMF in its lendings to member countries.

	2001	2000
	P'000	P'000
Quota (SDR 63 000 000)	551 181	440 252
Less IMF Holdings of Pula	(356 281)	(316 290)
Reserve Position in IMF	194 900	123 962

	2001	2000
3.2 Holdings of Special Drawing Rights	277 434	211 148

The balance on the account represents the value of Special Drawing Rights allocated and purchased less utilisation to date.

	2001	2000
3.3 Allocation of Special Drawing Rights	38 136	30 461

This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.

3.4 Administered Funds

	2001	2000
(i) Poverty Reduction Growth Facility (PRGF) Trust	60 927	48 662

The amount represents the equivalent of SDR6 893 680 (and interest accrued thereon) lent on July 1, 1994 to the Poverty Reduction Growth Facility (formerly Enhanced Structural Adjustment Facility Trust), a fund administered in trust by the IMF.

	2001	2000
(ii) Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust	129 511	103 457

The amount represents SDR14 607 060 (and interest accrued thereon) lent on April 30, 1997 to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries Trust, a fund administered in trust by the IMF.

	2001	2000
	190 438	152 119

NOTES TO THE FINANCIAL STATEMENTS (continued)

	2001	2000
	P'000	P'000
4. OTHER ASSETS	29 556	22 576

Other assets consist of staff loans, sundry debtors, advances and special memorandum accounts.

5. NOTES AND COIN IN CIRCULATION

	2001	2000
Notes	657 429	565 876
Coin	43 666	40 613
	701 095	606 489

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.

6. BANK OF BOTSWANA CERTIFICATES

	2001	2000
Face Value	5 220 692	3 893 080
Unmatured Discount	(72 988)	(180 682)
Market Value	5 147 704	3 712 398

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

7. DEPOSITS

	2001	2000
Government	308 895	637 916
Bankers	268 399	250 781
Other	183 774	183 368
	761 068	1 072 065

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

The Government balance includes P1 589 446 in respect of the Letlole National Savings Certificate Scheme, which was launched by the Bank on behalf of the Government in 1999 as a means of encouraging savings.

NOTES TO THE FINANCIAL STATEMENTS (continued)

	2001	2000
	P'000	P'000
This is analysed as follows:		
Issues of National Savings Certificates	2 580	1 656
Less: Redemptions	976	619
Net issues	1 604	1 037
Less: Amounts awaiting collection from agents	15	2
Amount due to Government on behalf of the Scheme	1 589	1 035

8. GOVERNMENT INVESTMENT ACCOUNT

8.1 Pula Fund

	2001	2000
Balance at the beginning of the year	23 080 585	18 073 629
Transfer to Income Statement	(32 326)	-
Transfer (to)/from Government Investment Account – Liquidity Portfolio	(700 000)	3 159 841
Excess of share of Pula Fund income over distribution	108 546	451 378
Share of unrealised currency gains	5 984 053	1 641 651
Share of unrealised market losses	(875 590)	(245 914)
Investment by Government in the Pula Fund at the end of the year	27 565 268	23 080 585

8.2 Liquidity Portfolio

	2001	2000
Balance at the beginning of the year	500 000	1 149 038
Transfer from/(to) Government Investment Account – Pula Fund	700 000	(3 159 841)
Net Transfers (to)/from Government Deposit Account	(1 193 550)	2 510 803
Investment by Government in Liquidity Portfolio at the end of the year	6 450	500 000
Total Government Investment Account	27 571 718	23 580 585

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

During the year ended December 31, 2001, the distribution to the Government included an amount of P32 326 421 transferred from the Government Investment Account.

	2001	2000
9. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)	194 900	123 962

This balance represents the Bank's liability to the Government in respect of the Reserve Tranche position in the IMF (Note 3.1)

NOTES TO THE FINANCIAL STATEMENTS (continued)

		2001	2000
10.	**DIVIDEND TO GOVERNMENT**	P'000	P'000
	Balance due at the beginning of the year	521 722	300 000
	Dividend to Government from Pula Fund	1 066 000	860 000
	Government share of residual net income	-	306 722
	Paid during the year	(1 321 222)	(945 000)
	Balance due at the end of the year	266 500	521 722

The final instalment of the pre-set dividend of P266 500 000 unpaid at December 31, 2001 was provided for in accordance with Section 6 of the Bank of Botswana Act, 1996 which requires that all profits of the Bank be distributed to the shareholder, the Government.

11. CAPITAL

	2001	2000
Authorised and paid-up capital	25 000	25 000

The paid-up capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act, 1996

	2001	2000
12. GENERAL RESERVE	1 600 000	1 600 000

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.

13. CASH GENERATED BY OPERATIONS

	2001	2000
Income from operations	1 142 220	1 618 100
Adjustments for:		
Depreciation of fixed assets	11 883	7 164
Profit on disposal of fixed assets	(201)	(126)
Operating cash flows before movements in working capital	1 153 902	1 625 138
Increase in Deposits – banks and other	18 024	61 208
Decrease in Deposits – Government	(329 021)	(38 794)
Increase/(Decrease) in Bank of Botswana Certificates	1 435 306	(517 769)
Increase in other assets	(6 767)	(6 224)
Increase/(Decrease) in other liabilities	76 205	(7 169)
Cash generated by operations	2 347 649	1 116 390

NOTES TO THE FINANCIAL STATEMENTS (continued)

14. CAPITAL COMMITMENTS

	2001	2000
	P'000	P'000
Approved and contracted for	860	2 540
Approved but not contracted for	22 948	18 928
	23 808	21 468

These capital commitments will be funded from internal resources.

15. RISK MANAGEMENT POLICIES IN RESPECT OF FINANCIAL INSTRUMENTS

The risk management policies of the Bank regarding financial instruments are dealt with in regular reviews of the Bank's reserve management policies. The main risk areas are market, currency, credit and interest rates. The Bank invests in investment grade currencies (AA/Aa2) and above. Interest rate risk is managed by using modified duration, while credit risk is controlled by dealing with the best quality institutions or counterparties, as determined by international rating agencies.

16. RELATED PARTY TRANSACTIONS

The Bank provides several services to its shareholder, the Government, and to other Government owned institutions. The main services during the year to December 31, 2001 were:

(i) Provision of banking services, including holding of the principal accounts of the Government.

(ii) Management of the Notes and Coin issue, including printing of notes and coin.

The aggregate balances in Government and other public sector accounts are disclosed in Notes 7 to 10.

No charges are made to the Government for provision of these services, except for commissions charged on domestic foreign exchange transactions. These are included in "Commissions" in the income statement.

PART B

THE BOTSWANA ECONOMY IN 2001

BANK OF BOTSWANA

CHAPTER 1

THE BOTSWANA ECONOMY IN 2001

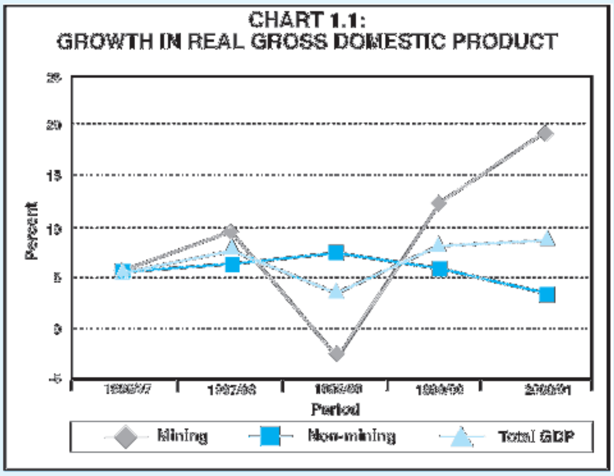
1. PRODUCTION, EMPLOYMENT AND PRICES

(a) *National Income Accounts*

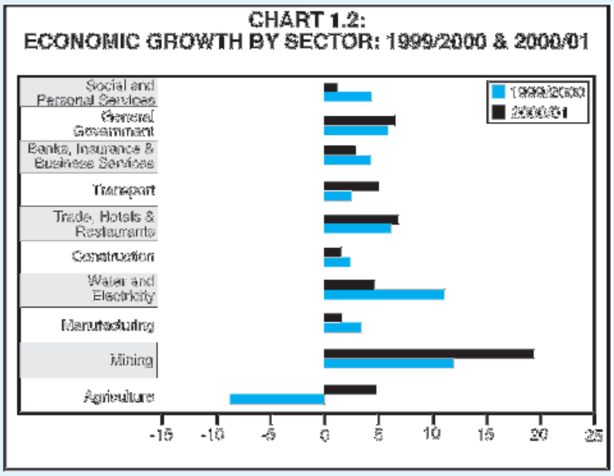
1.1 Provisional estimates of real gross domestic product (GDP) for 2000/01 indicate rapid economic growth of 9.2 percent, slightly higher than the 8.1 percent recorded in 1999/2000 (Chart 1.1). Economic performance was, therefore, in line with the Government forecast of 9 percent growth announced in the 2001 Budget Speech.

1.2 The improved growth rate was primarily the result of an exceptionally strong performance by the mining sector, which grew by 19.6 percent. Similar performances by the mining sector were last experienced during the 1970s and the first half of the 1980s when new diamond mines were being established. This time around the main reason was the expansion of the Orapa diamond mine, which doubled its output.

1.3 In contrast with mining, non-mining activity grew at a much lower rate of 4.0 percent, the lowest in six years. When both mining and government are excluded, output in the rest of the economy rose by 3.1 percent, half of the previous year's rate. Within non-mining activity, performance was mixed across the sectors. Growth in both manufacturing and construction sectors fell to 1.6 percent from 3.5 percent and 2.4 percent, respectively, in 1999/2000 (Chart 1.2). Manufacturing output was adversely affected by the poor performance of textiles, reflecting a slowdown in export orders, the impact of the closure of a major vehicle assembly operation early in 2000, and the slowdown in construction, which affects the demand for building materials. Construction was weak due to a slowdown in the implementation of the Government's development programme in the 2000/01 fiscal year. Value added in the trade, hotels and restaurants sector, however, rose at a rapid rate of 7.0 percent compared to 6.2 percent in 1999/2000; the improved performance was led by trade which expanded by 7.5 percent while output in the hotels and restaurants sub-sector increased at a slower rate of 3.1 percent.



Source: Central Statistics Office



Source: Central Statistics Office

1.4 The Government sector maintained its relatively high growth rate (6.6 percent), as a result of, *inter alia*, the expansion of health and education services.

1.5 For banks, insurance and business services, growth fell for the third consecutive year, and in 2000/01 output rose by only 2.9 percent; the sharp increase in output of the real estate sector was partially offset by reduced growth in the insurance industry, and sluggish growth in banking and business services. Similarly, in line with the overall slowdown in non-mining activity, value added for electricity and water grew at a lower rate of 6.7 percent, compared to 11.3 percent in 1999/2000 and 12.9 percent in 1998/99. Growth was lower in the water sub-sector although electricity generation rose at a faster rate than in the previous year.

1.6 Driven by the rapid rise in air transport, the transport and communication sector grew by 5.0 percent, almost double the growth rate of the previous year. Value added in air transport rose by over a third due to both buoyancy of sales and cost containment. Operating costs have progressively declined in relative terms following improvements in cargo and passenger handling, the introduction of new routes and improved marketing. However, output growth for road transport slowed down for the fourth consecutive year, as lower growth in the government transport sector (the Central Transport Organisation) offset the faster growth of private road transport services. Rail transport performed poorly, due to a substantial decline in transit traffic and to a lesser extent, local traffic. The telecommunications sub-sector expanded by 4.0 percent due to the rapid growth of the mobile telephone system, although the growth of the fixed line network slowed down considerably.

1.7 In contrast to the experience of the previous two years, agricultural output grew by nearly 5.0 percent, reversing a fall of 8.7 percent in 1999/2000. Although poor rainfall had an adverse effect on crop production, the livestock sector, which accounts for the bulk of agricultural output, performed well.

1.8 The outlook is that the economy will grow at a slower rate of around 5.0 percent, in 2001/02 and 2002/03[1], due to the expected slowdown in the rate of expansion of the mining sector. Non-mining output is, however, expected to grow more rapidly than in 2000/01, which will help to offset the impact of slower mining growth and contribute to economic diversification.

(b) Employment

1.9 In the year to March 2001, total employment rose by 5.0 percent, lower than the 6.3 percent growth experienced in the previous year. This was in line with the slower rate of non-mining economic growth. The slowdown in the rate of employment growth was shared by the private sector and parastatals: private sector employment increased by 7.6 percent, against 11.9 percent in 2000, while a decline of 1.5 percent occurred in parastatals. By contrast, employment in Central Government rose by 2.0 percent, compared to a reduction of 1.5 percent in 2000. Of the new jobs created, 83.3 percent were attributable to the private sector, against 98.1 percent in 2000. There were, however, job losses in parastatals due to the on-going staff rationalisation programmes in some institutions. Although the rate of employment growth has declined, it is encouraging that it remains above the population growth rate of approximately 2.5 percent a year. During the first four years of NDP 8 (1997-2003), employment rose by 4.5 percent a year, which was close to the projected annual growth of 4.7 percent.

(c) Inflation

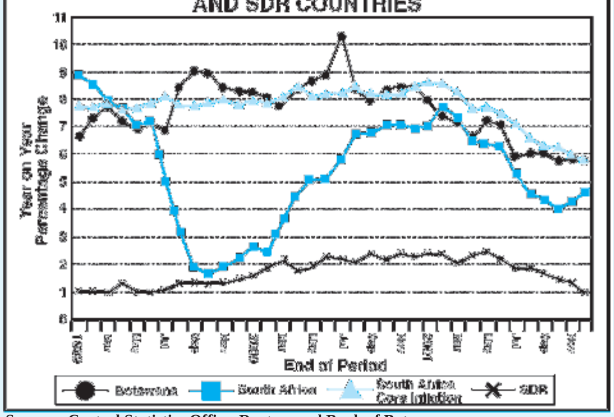
1.10 Consumer price inflation slowed down to an average of 6.6 percent in 2001, a considerable improvement on the 8.5 percent average in 2000. Lower inflation was mainly the result of an abatement of external inflationary pressures, reinforced by the tight monetary policy stance maintained throughout the year. For the last quarter of the year, inflation stabilised at 5.8 percent, compared to 8.5 percent in December 2000.

1.11 Annual price increases were reduced for a broad range of goods and services, including

[1] Ministry of Finance and Development Planning: Annual Economic Report 2002

fuel and power and transport. The cost of fuel rose at a much slower rate of 3.0 percent, compared to 22.5 percent a year ago; similarly, transport costs increased by 4.8 percent, against 15.4 percent in 2000. Lower fuel cost increases were mainly a result of the global decline in crude oil prices. Prices of furniture and appliances rose year-on-year at a reduced rate of 1.7 percent in December 2001 from 8.6 percent in December 2000. A similar trend occurred with respect to motor vehicles. However, prices rose at faster annual rates for clothing and footwear (4.2 percent in 2001, compared to 2.7 percent in 2000), leisure (4.2 percent compared to 1.4 percent), and education (3.1 percent compared to 1.6 percent).The rate of price increases for the largest single component of the consumer price index (CPI) basket, food, was 4.1 percent in 2001, the same as in 2000. However, food price inflation fell sharply in the first half of 2001, before rising in the second half; the course of food prices in 2002 will have an important impact on overall inflation.

**CHART 1.3:
INFLATION IN BOTSWANA, SOUTH AFRICA AND SDR COUNTRIES**

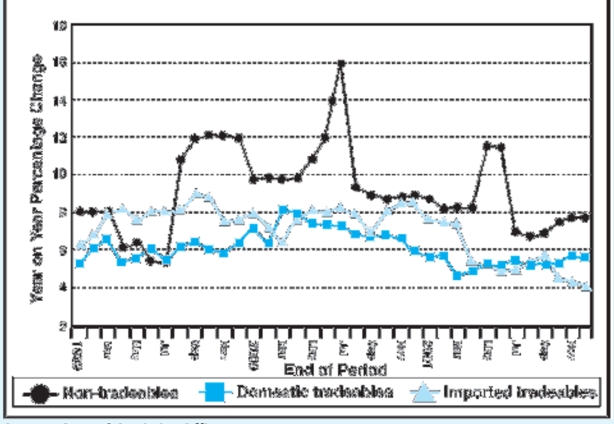


Sources: Central Statistics Office, Reuters and Bank of Botswana

1.12 Prices of imported tradeables rose year-on-year by 4.6 percent in December 2001, nearly half the rate of 8.8 percent in December 2000, due to lower global inflation and fuel prices in 2001. The deceleration in price increases for domestic tradeables was, however, less pronounced, declining only from 6.3 percent to 5.9 percent. Inflation for all tradeables, domestic and imported, fell to 5.1 percent in December 2001 from 7.9 percent in December 2000, while inflation for non-tradables slowed down to 7.7 percent, against 9.1 percent in 2000.

1.13 During 2002, it is expected that inflation will remain low in major industrial economies even as growth resumes, but South African inflation is expected to rise following the sharp depreciation of the rand towards the end of 2001. There is also concern that oil prices will rise in 2002, given the production cutbacks implemented by both OPEC and non-OPEC oil producers. In these circumstances it is likely that imported inflation will rise, in contrast to the sharply lower rate experienced in 2001. However, although there will be some domestic inflationary pressures arising from the growth of Government spending, the Bank believes that prospects are good for keeping inflation in 2002 within the desired range of 4-6 percent, as laid out in the 2002 Monetary Policy Statement.

**CHART 1.4:
CPI INFLATION BY TRADEABILITY**



Source: Central Statistics Office

2. THE 2002/03 BUDGET

(a) Public Sector Reforms

2.1 The theme for the 2002 Budget Speech was *Implementing Public Sector Reforms: a Way Forward for Sustainable Economic Diversification*. Several reform measures were proposed including the establishment of autonomous authorities and boards that would operate on a commercial basis, privatisation of some parastatals, and adoption of legislation that would facilitate private sector development.

2.2 The objectives of the proposed public sector reforms include enhancement of public sector productivity, containment of costs, and improvement in revenue collection. In particular, the reforms are expected to accelerate the rate of project implementation in order to avoid cost overruns, reduce resource waste during project implementation, and improve cost recovery.

2.3 Among the strategies to be adopted in implementing the reforms are decentralisation and computerisation of the personnel and performance management systems. In this regard, departments have been created in ministries to perform management functions including recruitment, promotion and discipline; these activities have previously been the responsibility of the Department of Public Service Management (DPSM). Further improvements in personnel management are expected following the installation, in April 2002, of computer software for leave tracking, computation of benefits, assessment of training and recruitment administration.

2.4 It is expected that the performance management system (PMS), which is being progressively introduced throughout the public sector, will be fully operational by 2004. It will require each ministry and department to develop a strategic plan, together with a programme which will be a basis for performance evaluation. So far, all ministries and most departments have produced strategic plans. The staff appraisal system will be reviewed during 2002/03.

2.5 Efforts are underway to reorganise and restructure some ministries and departments in order to improve their service delivery. In this connection, legislation will be presented to Parliament to create two new ministries of Communications, Science and Technology, and Environment, Wildlife and Tourism, in the 2003/04 financial year. Meanwhile, the Ministry of Trade, Industry, Wildlife and Tourism has been reorganised, as a result of which policy formulation and performance monitoring will be retained in the Ministry while responsibility for policy and programme implementation will be transferred to autonomous agencies. Among the commercially oriented and autonomous policy implementation authorities to be established will be the Botswana Tourism Board (BTB), which will promote and market tourism in Botswana, the Local Enterprise Agency (LEA), and the Civil Aviation Authority (CAA). Other agencies that have been recently established include the Public Enterprise Evaluation and Privatisation Agency (PEEPA), the Public Procurement and Asset Disposal Board (PPADB), the Botswana Export Development and Investment Authority (BEDIA) and the Citizen Entrepreneurial Development Agency (CEDA). Since its establishment last year, PEEPA has been preparing a privatisation master plan.

(b) *Other Initiatives*

2.6 In 2001, the performance of the public enterprise sector was mixed, and the on-going restructuring programme is expected to improve the weak performance of some enterprises. Botswana Railways (BR) continued to be adversely affected by low traffic volumes, and efforts are underway to review the marketing strategy and examine the feasibility of constructing a rail line linking Mosetse and Kazungula, which would enhance BR's ability to take advantage of transit traffic between South Africa and countries to the north. Meanwhile, the privatisation of Air Botswana has been further delayed and awaits improvement in the international aviation business environment. Nevertheless, legislation is being revised and a policy on air transportation is being developed, both of which are expected to be completed in the 2002/03 fiscal year. The finances and operations of the Botswana Telecommunications Corporation (BTC) are being restructured in order to restore its profitability and improve operational efficiency; the restructuring process is scheduled for completion in November 2002.

2.7 As part of the overall effort to improve public sector performance, a comprehensive review of the future of the BCL copper-nickel mine is underway[2]. The review, which is due to be completed in March 2002, will investigate, analyse and assess the profitability, efficiency and competitiveness of the company. In recent years the viability of BCL has been undermined by a combination of low-grade ore bodies and hence rising production costs, and falling copper and nickel prices on international markets.

2.8 Agriculture is expected to benefit from the National Master Plan for Agricultural Development (NAMPAD) on which a draft White Paper will be presented to the first session of Parliament in 2002. The white paper contains proposals for shared facilities through clustering of production units, mechanisation and improvements in farm management practices. The objective of the programme is to improve producer responses to changes in market conditions, to improve cultivation methods, lower the cost of input procurement as well as enhance access to both transport services and post-harvest technologies. Related to NAMPAD is the completion of a review of the 1973 Rural Development Policy which contains wide-ranging findings and conclusions on issues including poverty, social protection, the institutional framework as well as development and capacity building.

2.9 The renegotiation of the Southern African Customs Union Agreement (SACUA) has finally been concluded following eight years of negotiations. Botswana has approved the new Agreement, which provides for a more democratic decision making process, an improved representative institutional structure for administration of the Agreement, and a dispute resolution mechanism in addition to an equitable revenue sharing formula.

2.10 Despite Government efforts to curb the spread of the HIV virus, the HIV/AIDS situation remains serious and continues to adversely affect social indicators, including a rise in infant mortality rates and the number of registered orphans. One significant development in the fight against AIDS is the recent introduction of an Anti-Retroviral Therapy Programme in the public health sector. The programme has started in Gaborone and will be extended to other parts of the country in stages.

2.11 Another important public sector development during 2001 was the establishment of a new contributory pension scheme for Government employees. Under the previous pension scheme payments were made from general Government revenue. However, no contributions were made directly by either employees or the Government as an employer. The result was the accumulation of a large but unfunded contingent liability for Government. The new scheme has been established on a defined contribution basis, with monthly contributions by both Government and employees to pension accounts for each employee. From April 1, 2001, all new Government employees were obliged to join the new scheme, while existing employees who are members of the old scheme have been given a two-year period during which they may opt to transfer to the new scheme. The eventual membership level of the new scheme is not yet known, as it will depend on how many Government employees opt to transfer. The total liability, however, has been estimated at up to P10 billion. If most Government employees opt to transfer to the new scheme, it will more than double the size of the country's pension fund assets when fully operational. Transfers of funds to the new scheme are entered "below the line" in the Government accounts and hence do not add to budgeted expenditure.

2.12 Government also announced plans to issue a Pula-denominated bond during 2002, which should help to alleviate the shortage of long-term domestic financial assets and stimulate the development of the local capital market. The Government is also considering an international bond issue, in order to take advantage of the good investment grade sovereign credit ratings it received from Moody's Investors Service and Standard and Poor's in 2001. In a related development,

[2] BCL is a joint venture between Government and the private sector; however, it has been heavily dependent upon "emergency funding" from Government and, for this reason, is included in the review of public sector activities.

Government has taken a decision to sell the loan book of the Public Debt Service Fund (PDSF) to private financial institutions and expects that they will convert the loans into marketable securities, which then could be sold to other investors through the stock exchange.

(c) The Final 2000/01 Budget

2.13 The final outturn of the 2000/01 budget was more favourable than the revised budget forecast presented in the 2001 Budget. When compared to the revised estimates, total revenue and grants improved by 9 percent, benefiting from the better than expected outturn in respect of mineral revenues (11 percent higher than the revised estimates) and Bank of Botswana revenues (36 percent higher). Simultaneously, total expenditure, including net lending, was 3 percent below forecast, due to under-spending on the development budget, which, in turn, reflected implementation capacity constraints. The combination of faster revenue growth and a deceleration in spending resulted in a surplus of P2 579 million, compared to the revised estimate of P1 082 million and the original budget estimate (in 2000) of a surplus of P47 million.

(d) The Revised 2001/02 Budget

2.14 For the fiscal year 2001/02, the budget is expected to be in approximate balance. The projected deficit is P85 million, a reduction from the P527 million in the original budget. The lower deficit is a result of a 2 percent decline in revenue over the original budget, with a 6 percent fall in mineral revenue, while expenditure is expected to decline by 5 percent due to under-spending of the development budget. In line with the experience of 2000/01, however, it is quite possible that even these revised expenditure projections will not be achieved in 2001/02, and the eventual budget outturn will be more favourable than the small deficit currently being forecast.

(e) The 2002/03 Budget Estimates

2.15 For 2002/03, the deficit is expected to rise to P1 619 million, or 4.2 percent of GDP, as a result of an anticipated acceleration of development spending while revenue is forecast to grow more slowly.

(i) Expenditure

2.16 Total expenditure is estimated to rise by 27 percent, within which a 38 percent increase is budgeted for development expenditure and a 21 percent increase for recurrent expenditure. The rapid increase in development outlays is based upon an anticipated acceleration in the implementation of NDP 8 projects before the end of the planning period in March 2003.

TABLE 1.1: THE GOVERNMENT BUDGET: 2000/01 - 2002/03 (P million)

	2000/01			2001/02		2002/03
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	11,777.06	12,962.47	14,115.05	13,557.47	13,347.35	15,411.35
Mineral	6,287.58	7,557.26	8,367.80	7,952.96	7,462.90	8,491.95
Non-mineral	5,489.48	5,405.21	5,747.25	5,604.51	5,884.45	6,919.40
Expenditure	11,730.31	11,880.91	11,536.48	14,084.34	13,432.61	17,030.45
Recurrent	8,187.87	8,234.47	8,383.09	9,368.19	9,613.25	11,642.35
Personal Emoluments	2,631.54	2,631.62	2,743.32	2,943.47	2,966.08	3,884.16
Development	3,434.47	3,627.21	3,134.60	4,709.38	3,761.68	5,187.00
Other[1]	107.97	19.23	18.79	6.77	57.68	201.1
Balance	46.75	1,081.56	2,578.57	-526.88	-85.26	-1,619.10

1. "Other" includes FAP grants and net lending.
Source: Financial Statements, Tables and Estimates of the Consolidated Development Fund Revenues 2001/02, MFDP

The largest portion of overall expenditure (24 percent) continues to be accounted for by education, followed by economic services (18 percent), general administration (15 percent) and defence and public order (13 percent). However, the largest increase in expenditure, 57 percent, goes to health, largely reflecting the provision of anti-retroviral drugs. The projected increase in development spending may, however, be difficult to achieve and there is a danger that it will lead to overheating, especially in the construction sector, with the danger of excessive cost increases.

2.17 Public sector salaries were raised by 6 percent across the board, effective April 2002. This cost-of-living adjustment, will maintain public sector salaries in real terms, and will help to minimise the differential in salaries between the public and private sectors. The cost of the pay award is not included in the budget figures presented.

(ii) Revenue

2.18 While tax rates were un-changed, the Budget Speech confirmed that a 10 percent value added tax (VAT) will replace sales tax with effect from July 1, 2002 in line with the previously announced timetable. The VAT will cover a wider range of goods and services than sales tax, and there will be fewer exemptions; as a result, the introduction of VAT is expected to generate an increase in indirect tax revenues. VAT will be applicable to businesses with an annual turnover of over P250 000. It is also expected that, in due course, revenue collection will benefit from the establishment of an autonomous unified revenue service.

2.19 Total revenues are expected to increase by 15 percent in 2002/03. This is driven by higher expected mineral revenues due to the depreciation of the Pula against the US dollar; an anticipated 30 percent increase in non-mineral income tax revenues as a result of reforms in tax collection procedures and the additional revenue to be raised from VAT.

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

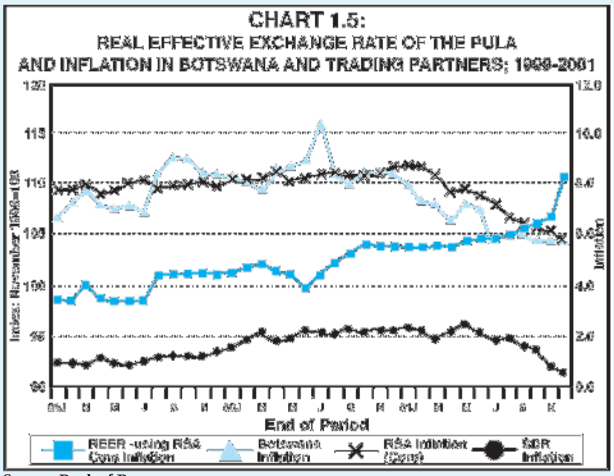
(a) Exchange Rates

3.1 The main development with regard to exchange rates for Botswana during 2001 was the rapid depreciation of the South African rand against major international currencies; over the year as a whole, the rand depreciated by 34 percent against the Special Drawing Right (SDR). As a result of the link to the rand through the currency basket, the Pula depreciated against major international currencies, losing 20.1 percent of its value against the SDR during the year[3]. However, the Pula appreciated markedly against the rand, gaining 21.8 percent over the same period. A number of factors have been identified as contributing to rand volatility, including political and economic problems in Zimbabwe; the slow pace of the privatisation programme in South Africa, and general concerns about slow economic growth; a lack of foreign exchange market liquidity towards the end of the year that accentuated price movements; and adverse investor sentiments in respect of emerging markets, which were intensified by debt repayment problems and subsequent default by Argentina.

3.2 Botswana's exchange rate policy aims to keep the nominal effective exchange rate of the Pula constant, by pegging the value of the Pula to a basket of currencies comprising the South African rand and the SDR, in proportions that broadly reflect Botswana's trade patterns. For most of the year this objective was achieved and the value of the Pula was relatively stable in nominal effective terms. However, volatility in bilateral rates, particularly towards the end of the year, caused the Pula to appreciate in effective terms, for technical reasons and, by the end of the year, the nominal effective exchange rate (NEER) of the Pula was 5.1 percent higher than at the end of 2000.

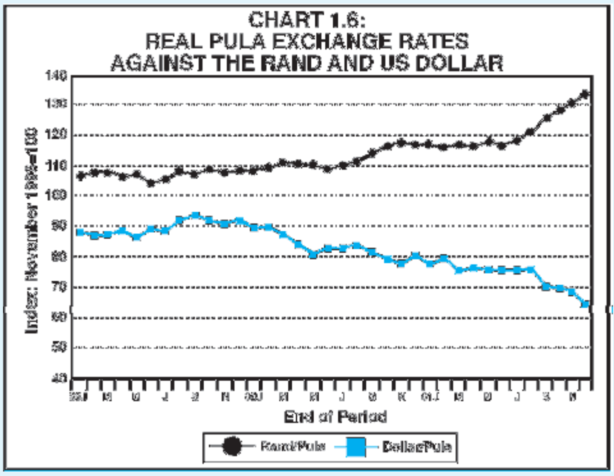
[3] The Pula depreciated by 23.2 percent against the US dollar, 21.0 percent against the pound sterling, 19.5 percent against the euro and 12.1 percent against the Japanese yen during 2001.

3.3 Exchange rate and monetary policies together aim to maintain the competitiveness of the Pula, by keeping the nominal effective exchange rate stable and Botswana's inflation rate no higher than the weighted average of the inflation rates of major trading partners. During 2001, competitiveness, as measured by the real effective exchange rate (REER)[4], deteriorated by 6.8 percent as the REER appreciated. Most of this appreciation was due to the nominal appreciation noted above, but was reinforced by a higher inflation rate in Botswana than the average for major trading partners.



Source: Bank of Botswana

3.4 Bilaterally, the real exchange rate against the rand appreciated by 21.8 percent, a similar rate to that of the nominal appreciation. Against the SDR and the US dollar, the Pula depreciated by 16.4 percent and 20.0 percent, respectively, in real terms, as the higher inflation rate in Botswana was offset by substantial nominal depreciation.



Source: Bank of Botswana

(b) The Balance of Payments

3.5 According to preliminary balance of payments for 2001, the surplus on the current account declined by 8 percent to P2 558

TABLE 1.2: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES
Nominal Exchange Rates (foreign currency per Pula)

As at end of	2000	2001	Percentage Change
SA rand	1.4106	1.7188	21.8
US dollar	0.1865	0.1432	-23.2
Pound Sterling	0.1250	0.0987	-21.0
Japanese yen	21.39	18.80	-12.1
SDR	0.1431	0.1143	-20.1
Euro	0.2008	0.1617	-19.5
Real Pula Exchange Rate Indices[1] (November 1996 = 100)[2]			
SA rand[3]	109.6	133.6	21.8
SA rand[4]	117.3	144.5	23.2
US dollar	82.8	66.2	-20.0
SDR	94.0	78.6	-16.4

1 There was a downward revision of the rent section of the Botswana index series from July 2000 to April 2001. The revision affected inflation and hence real exchange rates for that period.
2 Change of base year to November 1996 from January 1990 means that real rates quoted here are not directly comparable to those presented in this table in previous reports.
3 Calculated using core inflation. Core inflation is the all items of consumer price inflation excluding mortgage interest rate costs and prices of various volatile food items.
4 Calculated using headline inflation.

Source: Bank of Botswana

[4] The method of calculating the real effective exchange rate has been changed from a weighted arithmetic mean of real bilateral exchange rates to a geometric mean in line with international best practice.

million in 2001, from P2 782 million in 2000. This was due to a slight fall in merchandise exports, especially diamonds, and an increase in the deficit on the services and financial transactions accounts. The deficit on the financial account also increased significantly. As a result, the overall balance of P1 024 million was well below the P1 941 million recorded in 2000.

(i) *Merchandise Trade*

3.6 Following a very large surplus in 2000, the positive merchandise trade balance declined following a slight fall in exports to P13 519 million in 2001, 1 percent below P13 649 million in 2000. This was due mainly to reduced diamond sales, particularly from the second quarter of 2001. Sales of diamonds were badly affected by the global economic slowdown especially in the United States, which accounts for more than half of all jewellery sales. During the second half of the year, formal diamond export quotas were imposed by the Diamond Trading Company, to which Debswana sells its output. Exports were also adversely affected by falls in some commodity prices. For copper and nickel, US dollar prices declined by an average of 13 percent and 31 percent respectively, with an overall 35 percent decline in the value of exports of these metals. However, beef exports rose by a sharp 54 percent from P278 million in 2000 to P427 million in 2001, due to high demand in Europe, increased numbers of cattle slaughtered and the depreciation of the Pula against international currencies. The demand for local beef rose in Europe following the outbreak of foot and mouth disease in Britain. Exports of soda ash to South Africa also increased by a significant 12 percent, from P207.7 million in 2000 to P231.5 million in 2001. Merchandise imports rose by 4 percent over 2000 to P9 369.9 million, a similar rise as in the previous year. The slower growth rate of imports mainly occurred in metal and metal products, as well as vehicles and vehicle parts.

TABLE 1.3: BALANCE OF PAYMENTS: 1996—2001
(P million)

	1996	1997	1998	1999	2000#	2001*
Current Account Balance (of which)	1 644	2 364	860	2 859	2 782	2 558
Visible Trade Balance	2 493	3 269	328	3 629	4 603	4 149
Services Balance	-602	-841	-988	-721	-1 136	-1 173
Income Balance	-841	-529	505	-1 213	-1 792	-1 609
Net current Transfers	595	735	1 015	1 164	1 108	1 191
Financial Account Balance	141	20	-855	-1 127	-1 021	-1 294
Capital Account Balance	21	62	135	95	194	105
Net Errors and Omissions	-83	-398	118	-2	-15	-345
Overall Balance	1 722	2 318	256	1 829	1 941	1 024

* Provisional
\# Revised

Source: Bank of Botswana

TABLE 1.4: DIAMOND EXPORTS BY QUARTER
(P million)

	2000	2001	Difference (%)
Q1	1 842.3	3 547.3	92.5
Q2	2 952.1	2249.9	-23.8
Q3	3 683.3	2 628.4	-28.6
Q4	2 919.8	2 833.6	-3.0
TOTAL	11 397.5	11 259.2	-1.2

Source: Bank of Botswana, based on data from Debswana *(ii) Current Account*

3.7 The provisional current account surplus of P2 558 million was 8 percent lower than that in 2000 due to a decline in the trade surplus, which was partially offset by a lower deficit on the income account. Moreover, the deficit on the services account, which comprises transportation, travel and other services, was larger than in 2000, reflecting, in part, large allocations for the cost of education abroad. The deficit on services account follows a trend that has been evident over the last 8 years. However, the surplus on current transfers, of which SACU receipts and payments are the largest component, continued to increase.

(iii) Capital and Financial Accounts

3.8 The capital account covers flows related to assets of migrant workers, some technical assistance provided by international organisations and similar transactions, while the financial account, comprises direct investment, portfolio investment and "other" investment. In 2001, the capital account surplus fell to P105 million from P194 million in 2000. The deficit on the financial account widened to P1 294 million from P1 021 million a year ago, due to an increase in the outflow of portfolio assets as well as net outflows in respect of loans, trade credits, currency, deposits and other financial transactions. The bulk of the increase in the net outflows was reflected in increases in bank deposits abroad.

(iv) Foreign Exchange Reserves

3.9 Foreign exchange reserves rose by 21.5 percent to P41.2 billion at the end of December 2001, representing 39 months of import cover of goods and services. The increase in the Pula value of the reserves was, however, mainly due to the depreciation of the local currency against major international currencies. In SDR and US dollar terms, the reserves declined during 2001 and were equivalent to SDR4.7 billion and US$5.9 billion, respectively, following the slowdown in diamond exports during 2001 as well as adverse developments in some global financial markets.

(c) International Investment Position and Foreign Direct Investment

(i) International Investment Position (IIP)

3.10 The IIP records the stock of the country's foreign financial assets and liabilities including claims on/due to non-residents, monetary gold and SDR holdings. Comprehensive IIP data are available up to the end of 2000. However, preliminary estimates for 2001 indicate that Botswana's total foreign assets increased by P9 129 million, from P39 637 million in 2000 to P48 765 million in 2001. The bulk of the increase (78 percent) was in foreign exchange reserves, but there were also substantial gains in portfolio investment abroad. On the other side, total foreign liabilities were P16 914 million, a rise of P525 million from P16 389 million in 2000. Most of the increase was due to inward direct investment, although it also reflected the foreign sourcing of loans by some firms in the construction industry and other sectors.

(ii) Industry and Country Classification of Investment

3.11 As at the end of 2000, most foreign investment was in the mining industry. The indebtedness of BCL in respect of principal and accrued interest continued to form the bulk of the stock of foreign direct investment, followed by wholesale and retail trade and finance, which accounted for 8 percent and 6 percent of direct investment liabilities, respectively. South Africa was the dominant source of the stock of direct investment, accounting for 61 percent. The other important source of direct investment was the European Union countries, particularly Luxembourg, with a share of 25 percent of the stock of direct investment.

3.12 In 2000, 48 percent of other foreign investment was accounted for by general government debt while the share of the mining industry was 29 percent, with a significant proportion attributable to BCL's indebtedness to its creditors; and manufacturing accounted for 5 percent. The share of electricity, gas and water was 8 percent, a marginal decline from 1999 with most of the debt related to the loans that were contracted in 1999 for funding of the North-South Carrier Water project. By source of other investment, the bulk originated from South Africa (31 percent) followed by the European Union (12 percent). Most of the liabilities are in respect of government debt.

4. MONEY AND CAPITAL MARKETS

(a) *Monetary Policy and Liquidity Management*

(i) *Monetary Policy*

4.1 The Bank of Botswana maintained a

TABLE 1.5: STOCKS OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY (P thousand) AS AT 31 DECEMBER 2000

Direct Investment Industry*	Foreign Direct Investment Equity	Foreign Direct Investment Non-equity	Foreign Direct Investment Total	Other Investment Equity	Other Investment Non-equity	Other Investment Total
Mining	2 569 976	5 221 763	7 791 739		1 363 213	1 363 213
Manufacturing	236 058	107 439	343 49	1	233 692	233 693
Finance	516 311	102 606	618 917	4 771	135 818	140 589
Retail and wholesale	655 097	117 920	773 017		95 064	95 064
Electricity, Gas & Water					403 243	403 243
Real Estate and Business Services	122 108	39 037	161 145	230	69 390	69 620
Transport, Storage & Communication	46 571	58 606	105 177		130 214	130 214
Construction	6 726	8 896	15 622	50	25 174	25 224
Hospitality	10 197	7 174	17 371		1,261	1 261
Public Administration					2 304 430	2 304 430
Other					15 309	15 309
TOTAL	4 163 044	5 663 441	9 826 485	5 052	4 776 528	5 781 580

* Botswana Standard Industrial Classification

Source: Bank of Botswana

TABLE 1.6: STOCKS OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY (P thousand) AS AT 31 DECEMBER 2000

Direct Investment	Foreign Direct Investment Equity	Foreign Direct Investment Non-equity	Foreign Direct Investment Total	Other Investment Equity	Other Investment Non-equity	Other Investment Total
N America & Central America	7 680	89 279	96 959		242 721	242 721
United states of America	7 679	89 279	96 958		242 721	242 721
Europe	3 537 111	90 546	3 627 657	2 731	1 503 054	1 505 785
Of which						
United Kingdom	910 540	59 564	970 104		141 202	141 202
Germany					1 207 851	1 207 851
Luxembourg	2 474 597	3 745	2 478 342		82 601	82 601
Other Europe	115 598	5 226	120 824		2 731	2 731
Asia Pacific	910		910		74 217	74 217
Africa	531 587	5 467 070	5 998 657		604 979	604 979
South Africa	526 995	5 455 760	5 982 755		588 856	588 856
Middle East	85 751	16 605	102 356		9 807	9 807
Other				2 321	2 352 802	2 355 123
TOTAL	4 163 039	5 663 501	9 826 540	5 052	4 787 941	4 792 993

Source: Bank of Botswana

restrictive monetary policy stance throughout 2001 in order to contain inflation which, although declining, was for most of the year still higher than the desired level and had come largely from lower imported inflation. There were also concerns about incipient demand pressures, as the growth rates of both credit and Government expenditure were undesirably high by the end of the year, and disposable incomes had risen sharply due to public sector wage and salary increases and an effective tax cut from an increase in income tax thresholds. It was considered that these developments added to the risk of a reversal of the recent decline in inflation, especially if monetary policy was eased. The restrictive policy stance, in response to domestic conditions, contrasted with trends in major industrialised economies where monetary policy was eased in order to stimulate economic performance which was weak following a decline in business confidence and the onset of recession, tendencies which were exacerbated by the September 11, 2001 attacks in the USA.

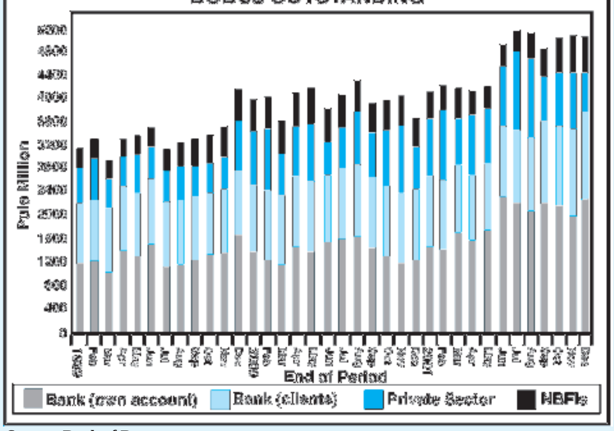
4.2 The Bank Rate was maintained at 14.25 percent, a level that was set in October 2000. As inflation declined, interest rates rose in real terms, which contributed to a further tightening of the monetary policy stance.

(ii) Primary Money Market

4.3 The Bank continued to conduct open market operations through auctions of Bank of Botswana Certificates (BoBCs). The effectiveness of open market operations was improved further with the introduction of weekly auctions and the standardisation of the BoBC maturity to 91 days. The more frequent auctions, combined with the repo facility to smooth out liquidity fluctuations between auctions, provide greater flexibility and initiative to the Bank in liquidity absorption and enhance liquidity management for banks. Furthermore, the shorter and standardised maturity lowers overall costs for the Bank, since a shorter maturity would typically attract a lower rate of interest, while creating a three-month money market benchmark rate. It is hoped that the shorter maturities of BoBCs will encourage the development of the market for longer-dated securities. Thirty BoBC auctions were conducted during 2001, with maturities ranging from 12 to 245 days.

4.4 As at the end of 2001, P5 148 million was outstanding in BoBCs, an increase of 39 percent from P3 712 million at the end of 2000, which contrasted with a decline of 12 percent during 2000. The increase in outstanding BoBCs reflected both the rise in foreign exchange earnings and the drawdown of Government deposits following the acceleration in expenditure, including disbursements of funds to the civil service pension fund. Commercial banks held the largest proportion (75 percent) of BoBCs (including both their own portfolio and those held on behalf of customers) with their holdings rising by 55 percent in 2001. Other financial institutions accounted for 12.0 percent of the market, with a 31 percent increase in their holdings during the year. Holdings by the rest of the private sector (13 percent of the total), however, decreased by 11 percent during the year.

CHART 1.7:
BOBCs OUTSTANDING



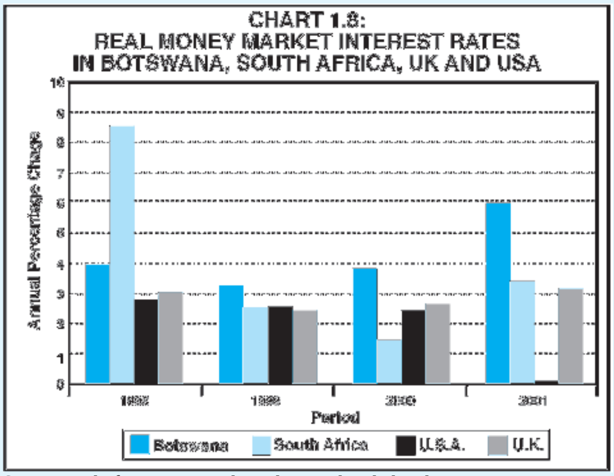
Source: Bank of Botswana

(iii) Secondary Money Market

4.5 The volume of sales and purchases of BoBCs between counterparties declined from P498 million in 2000 to P233 million in 2001. However, secondary market transactions between counterparties and the Bank of Botswana rose from P3 729 million to P5 564 million. While the Bank seeks to encourage secondary market trading between counterparties, this may be discouraged by the ease of trading directly with the Bank.

(b) Interest Rates

4.6 Nominal short-term interest rates, as measured by the three-month BoBC middle rate, were generally stable during 2001, although they fell slightly in the second half of the year. However, due to the slowdown in inflation, the real money market rate rose to 6.3 percent in December 2001 from 3.9 percent at the end of 2000. The level of the real money market rates were considerably higher in Botswana than the comparable rates for the major trading partner money markets, reflecting the need for different domestic policy responses to inflation.

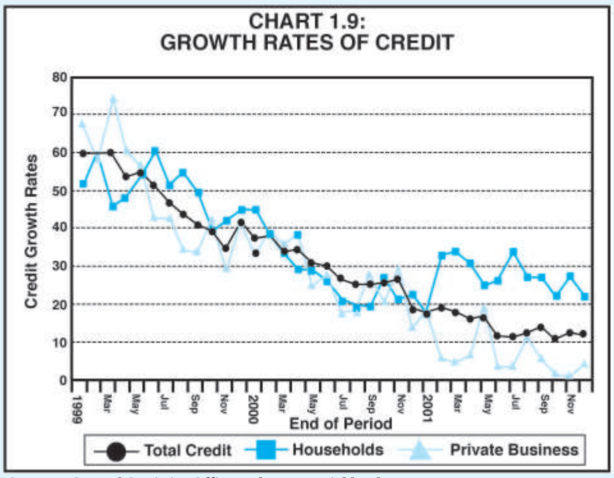


Sources: Bank of Botswana, Rand Merchant Bank and Bloomberg

(c) Banking System

(i) Domestic Credit

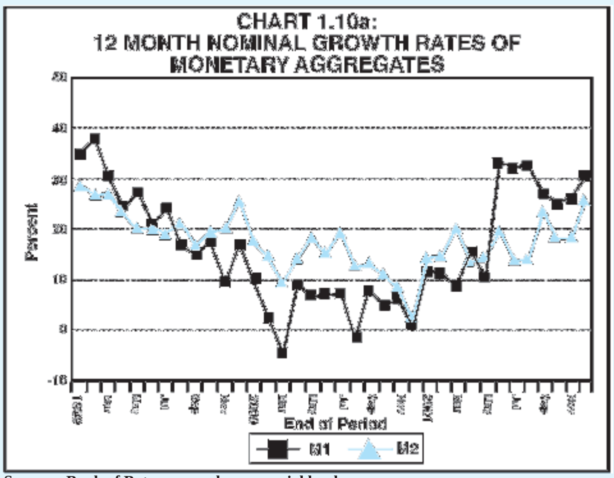
4.7 The growth rate of credit extended by the commercial banks slowed down in 2001, with average annual growth of 13.2 percent compared to 28.4 percent in 2000. By the end of 2001, the year-on-year rate of credit expansion was 10.7 percent, down from 17.7 percent at the end of 2000. However, these figures understate the underlying trend rate because of the impact of the extension and subsequent early repayment of loans, using offshore funds, by certain large borrowers. If these loans are excluded, credit growth did not slow down significantly in 2001; it remained between 15 percent and 20 percent during the year.



Sources: Central Statistics Office and commercial banks

(ii) Monetary Aggregates[4]

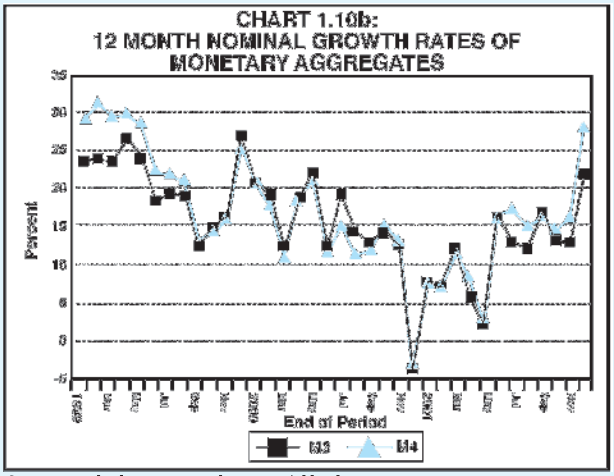
4.8 All the monetary aggregates rose at a faster rate in 2001 compared to the previous year, reflecting buoyant foreign exchange earnings following the weakening of the Pula against major international currencies and a rise in Government spending which added liquidity to the banking system. All the components of money supply grew at substantially higher year-on-year rates compared to the previous year, especially demand deposits and foreign currency balances. Net foreign assets rose by 23 percent compared to 17 percent the previous year, while Government deposits rose at a slower rate of 15 percent compared



Sources: Bank of Botswana and commercial banks

4 M1 – M4

to 22 percent in 2000, due in part, to the disbursement of P1 378 million to the managers of the new civil service pension fund.



Sources: Bank of Botswana and commercial banks

4.9 Demand deposits grew by 38 percent in the 12 months to December 2001, compared to a 4 percent reduction over the same period in the previous year, while foreign currency deposits rose by 67 percent against 8 percent in 2000. The sharp rise in foreign currency account balances is thought to be the result of hedging against exchange rate fluctuations and the depreciation of the Pula *vis-à-vis* the major international currencies. Similarly, currency outside banks and interest-earning deposits grew at higher rates of 13 percent and 23 percent, respectively, compared to 6 percent and 3 percent last year. As part of the broad definition of money supply, private sector holdings of BoBCs also rose at a faster rate of 16.0 percent, reversing a decline of 3.0 percent in the previous year.

(iii) Bank of Botswana

4.10 Total assets and liabilities of the Bank of Botswana amounted to P41 341 million at the end of 2001, a rate that was 22 percent higher than the previous year, following an increase of 17 percent in 2000. The expansion of the balance sheet was mainly attributable to a 23 percent rise in foreign assets to P41 182 million. Within the foreign exchange reserves, the Pula Fund, which is a long-term investment portfolio, continued to account for the largest share, (79 percent) at the end of 2001, although it rose at a slower rate of 12 percent compared to 17 percent in 2000. The Liquidity Portfolio grew by a substantial 77 percent in the year to December 2001, compared to 19 percent over the same period last year, as a result of a restructuring of the foreign exchange reserves, when P3 billion was transferred from the Pula Fund to the Liquidity Portfolio in order to raise the import cover for the latter from six to nine months.

4.11 With respect to liabilities, there was a sharp increase in BoBCs outstanding reflecting the need to stabilise the increase in banking system liquidity that was partly due to the rise in Government spending and the slowdown in credit growth. Deposits of Government increased by 16 percent to P28 147 million at the end of December 2001, compared to a growth rate of 22 percent in the previous year.

(iv) Commercial Banks

4.12 The number of commercial banks increased to five following the establishment of Bank of Baroda Botswana Limited in March 2001. Although the new bank began operations on a small scale, with only one branch so far, it nevertheless represents a welcome addition to competition in the banking sector.

4.13 Total assets of commercial banks grew by 29 percent in 2001 to reach P11 001 million, compared to 5 percent growth in 2000. Most of the rise was in respect of holdings of BoBCs, which increased by 43 percent, while advances grew by only 10 percent, from P4 938 million to P5 462 million. There was also a sharp rise (57 percent) in claims on foreign banks, reflecting the growth in foreign currency accounts.

4.14 With regard to liabilities, deposits rose by 34 percent to P9 233 million in December 2001, from P6 912 million in December 2000. Foreign currency account balances (FCAs) increased by 67 percent to P1 978 million at the end of December 2001, from P1 186 million in 2000. As at the end of 2001, balances in foreign currency accounts were 21 percent of total deposits, compared to 17 percent in 2000.

(v) Merchant Banks

4.15 The two merchant banks, African Banking Corporation of Botswana (formerly ulc) and Investec Bank Botswana, experienced rapid growth in 2001. Their combined assets grew by 39 percent, from P486 million at the end of 2000 to P650 million at the end of 2001, driven by a 45 percent rise in their deposit base, from P365 million to P531 million. Despite the overall slowdown in credit growth, the two merchant banks achieved significant growth in advances, which rose by 66 percent from P172 million to P285 million during the year. They also significantly increased their holdings of BoBCs, from P60 million to P173 million. At the end of 2001, the two merchant banks accounted for approximately 6 percent of the assets and 5 percent of the loans and advances of the consolidated banking sector.

(d) Other Financial Sector Developments

(i) Banking Services and Consumer Protection

4.16 A consultancy report on the quality of banking services was completed and submitted to the Bank in February 2001 (see Chapter 4). The report sets out the results of the survey on the quality of banking services, and indicated that there was a general satisfaction with the range of products offered by the banking system although there was need for improvement in the quality of services. Among issues that required to be addressed were delays in customer service at bank counters and automated teller machines (ATMs) and timeliness in responses to loan applications and information inquiries.

4.17 As a consumer protection measure the Bank has drawn up a policy on the Disclosure of Bank Charges. The policy will apply to all banks licensed under the Banking Act (1995), as well as the Botswana Building Society, Botswana Savings Bank and National Development Bank. Under this policy, the affected institutions are required to disclose service charges and other fees to the public, prior to their introduction. The key charges should be displayed in banking halls and a complete book of charges should be available to customers on request. It is also the requirement that each institution should establish and make available internal procedures for the proper handling of customer complaints.

(ii) International Financial Services Centre (IFSC)

4.18 Business activities of the IFSC, which was launched in March 2000, continued to progress in 2001. The membership of the IFSC increased with the licensing of the African Banking Corporation International Limited, a subsidiary of ABC Holdings. Three other entities, Seed Co. International Limited, which operates group treasury functions for its research and development activities, Metro Cash and Carry (Pty) Limited, and Cyberplex Holdings (Pty) Limited were issued exemption certificates that exempt them from being supervised by the Bank of Botswana. As at the end of December 2001, three further applications for IFSC Tax Certificates were under review.

(iii) Collective Investment Undertakings

4.19 In June 2001, the Collective Investments Undertakings Act, 1999, came into effect. The Act will promote the pooling of financial resources by individuals for investment in various instruments with a risk/return profile that would benefit the individual investor.

(iv) Botswana Stock Exchange (BSE)

4.20 The BSE was buoyant in 2001 with a general increase in share prices and hence a sharp increase in market capitalisation. The performance of the stock exchange reflected the generally good operating results of most of the larger listed companies. In addition, the disbursement of government funds to the new civil servants' pension scheme stimulated market activity. The domestic index rose from 1 454 at the end of 2000 to 2 445 in December 2001, while market capitalisation increased by 70 percent to P8 909 million at the end of December 2001 from P5 245 million twelve months earlier. The new

Venture Capital Board of the BSE was inaugurated with the listing of Gallery Gold, a company engaged in exploring gold deposits around Francistown. The foreign companies index, which relates to dual listings of companies that have their primary listings elsewhere, rose from 431 to 684 during a year in which De Beers was de-listed after being taken private and replaced by Anglo American. In the bond market, a P30 million bond with a floating coupon rate 125 basis points above the three-month BoBC rate, was issued by Stanbic Bank Botswana Limited in November 2001 and was fully subscribed.

(e) Non-bank Financial Institutions (NBFIs)

4.21 The Botswana Building Society recorded slower growth in its activities in 2001 with a rise of 9 percent in total assets compared to 13 percent in 2000. This was mainly due to a slowdown in the growth mortgage loans, the major asset of the society (72 percent of the total in 2001), which grew by 11 percent during 2001, compared to 21 percent during 2000.

4.22 For the National Development Bank (NDB) total assets and liabilities grew by 17 percent in the twelve months to September 2001, compared to 15 percent over the same period in 2000. Loans and advances increased by 40 percent to P325 million in September 2001, from P232 million in September 2000.

4.23 The Botswana Savings Bank (BSB) recorded an increase of 11 percent in assets over the 12 months to September 2001, compared to 5 percent in 2000. The main influence on asset growth was loans and advances to finance purchases of motor vehicles and houses by civil servants. Overall lending increased by 11 percent to P84 million in September 2001 from P76 million a year earlier and a more robust expansion of 24 percent in 2000. Customer deposits, grew by 13 percent to P115 million at the end of September 2001 from P101 million in September 2000.

4.24 Assets of the Botswana Development Corporation (BDC) grew by 6 percent over the year to June 2001, compared to 10 percent growth during the corresponding period in 2000. BDC deposits at commercial banks fell sharply by 60 percent, to P45 million from P113 million in 2000. Other assets, however, expanded significantly. Loans and advances increased by 20 percent to P488 million from P406 million, while holdings of BoBCs rose by 14 percent to P102 million from P90 million, and direct investments grew by 9 percent between June 2000 and June 2001.

PART B

THEME CHAPTERS

THEME: THE ROLE OF THE FINANCIAL SECTOR IN BOTSWANA'S ECONOMIC GROWTH

BANK OF BOTSWANA

CHAPTER 2

THE ROLE OF THE FINANCIAL SECTOR IN ECONOMIC DEVELOPMENT

1. Overview of Issues

1.1 The following four Theme Chapters of the Annual Report discuss the role of the financial sector in the broader process of economic growth and development in Botswana. The financial sector comprises a range of financial institutions, instruments and markets that mobilise financial savings and allocate those savings to the financing of investment. In Botswana's case, most savings mobilisation (outside of Government) takes place through financial institutions or intermediaries, such as banks, which accept deposits from savers and make loans to consumers and investors. A small but potentially significant role is played by financial markets, such as the stock and bond markets, where finance flows directly from savers to investors without going through an intermediary. Given this structure of Botswana's financial sector, the main focus of our analysis is on financial intermediaries, although the role of financial markets is discussed where relevant and where data are available. One of the main conclusions of the Report is that the role of the financial markets as complementary to that of financial intermediaries grows in importance as the financial sector matures, and financial sector development in Botswana is at the point where, in many respects, the shift of attention to financial markets is ready to take place.

1.2 Before the early 1970s, opinion was divided on the role of the financial sector in economic growth and, therefore, development. Some economists[1], were of the view that the financial system was important in promoting growth, while others[2] argued that a developed financial system was not necessary for economic growth, citing examples of economies that experienced significant development in the absence of well developed financial systems. The debate was whether the financial sector followed or led development; and, partly due to the uncertainties surrounding this issue, most models of economic growth for developing countries did not explicitly include the role of the financial sector.

1.3 Since the 1970s, however, considerable attention has been given to the investigation of the developmental role of the financial sector in mobilising and allocating financial resources, in addition to its importance in facilitating payments both domestically and internationally. A great deal of detailed theoretical and empirical work on the link between the financial sector and economic growth was carried out, which generated substantial evidence to suggest that the financial sector plays an important role in economic growth as mobiliser and lender of financial resources as well as facilitator of the payment mechanism[3]. As a result, it was increasingly accepted that the financial sector provides the link between savings and investment, which is critical to economic

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1 Schumpeter was one of the first economists to link the banking system, which dominates the financial systems of developing economies, to economic growth, in his studies of 1934 and 1939 (See Cameron Rondo, 1972. Banking and Economic Development: Some Lessons of History: New York: Oxford University Press).

2 Cameron, Rondo, et al. 1967. Banking in the Early Stages of Industrialisation: A Study in Comparative Economic History. New York: Oxford University Press.

3 Work in this area was done by Gurley and Shaw (1955, 1960), McKinnon (1973) and Shaw (1973), which stimulated subsequent empirical studies by Fry (1988) as well as Lanyi and Saracoglu (1983). For further readings see:

Fry, Maxwell J. 1988. Money, Interest, and Banking in Economic Development. Baltimore: The John Hopkins University Press.

(footnote 3 continued on next page)

development. First, it encourages the accumulation of financial savings through the provision of financial instruments with attractive risk-return characteristics for savers. These financial savings can then be used by financial intermediaries and markets for, inter-alia, the financing of investment. This contrasts with a situation where these savings are held predominantly in the form of physical assets - often as a hedge against inflation - which cannot be intermediated in a similar manner. Second, in the process of lending the savings to deficit sectors, the financial sector screens the quality of investment to be financed, as a result of which efficient and high return investment is promoted. High return and good quality investment raises productivity and is, therefore, growth promoting. The policy implications of the "debt-intermediation"[4] view of economic growth are that the development of the financial sector should be encouraged and that its operations should not be repressed.

1.4 In the recent past, many nations have recognised the importance of effective financial sector performance for attainment of sustainable economic development. Consequently, there has been an almost universal trend towards financial market liberalisation aimed at improving the mobilisation of domestic savings and the allocative efficiency of financial intermediation.

1.5 Botswana's development strategy, which has been implemented within the context of a series of National Development Plans (NDPs), has recognised the critical role of the financial sector in the development process. Accordingly, in NDP 7, the Government formulated a policy for the reform of the financial sector, which was implemented during 1989-1991[5].

2. Financial Sector Development: 1991 - 2000

2.1 Before the 1989-1991 reforms, Botswana's financial sector was not well diversified, with the associated lack of competition and a limited range of financial instruments. It was in this environment that, in its conduct of monetary policy, the Bank of Botswana exercised a considerable degree of direct control over the operations of commercial banks, especially with respect to maximum lending and minimum deposit rates. Until 1986, interest rates had to be set in line with the central bank's directives. The only indirect instrument of control utilised by the Bank of Botswana was the Bank Rate[6]. Other pre-reform characteristics of the financial sector included exchange controls on capital transactions, especially offshore borrowing and overseas investment by residents, and capital inflows from non-residents. During most of the 1980s and up to 1993, the financial sector was repressed in that it was constrained in its ability to generate and respond to market based prices; in the event, real interest rates were low or negative, since interest rate policy focussed on encouraging investment by maintaining low lending rates. Deposit rates were generally negative in real terms, and therefore tended to discourage the accumulation of financial savings, while low lending rates encouraged some inefficient and marginal investments. However, in spite of low and/or negative deposit rates, the growth

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(footnote 3 continued from previous page)

Galbis, Vicente. 1977. "Financial Intermediation and Economic Growth in Less–Developed Countries. A Theoretical Approach." Journal of Development Studies 13 (2, January): 58-72

Gurley, John G., and Edward S. Shaw. 1955. "Financial Aspects of Economic Development". American Economic Review, 54(4, September): 515-538.

Gurley, John G., and Edward S. Shaw. 1960. Money in a Theory of Finance. Washington, D.C. Brookings Institution.

Lanyi, Anthony, and Rusdii Saracoglu. 1983. "The Importance of Interest Rates in Developing Economies." Finance and Development, 20 (2 June): 20-23.

Shaw, Edward S. 1973. Financial Deepening in Economic Development. New York: Oxford University Press.

4 The "debt intermediation" process refers to the fact that financial intermediaries incur debt or liability by accepting deposits and intermediate or channel the mobilized resources to deficit sectors.

5 Reforms followed a financial sector study conducted by the Bank of Botswana, the Ministry of Finance and Development Planning and the World Bank (Botswana: Financial Policies for Diversified Growth, World Bank, 1989).

6 The Bank Rate is the interest rate at which the Bank of Botswana lends to commercial banks.

of financial saving was high, suggesting the importance of other factors, including the rate of economic growth, in influencing financial savings. Simultaneously, the liquidity of the banking system was high even though lending interest rates were low, perhaps reflecting a lack of lending opportunities.

2.2 The main financial sector reforms took place between 1989 and 1991, although the reform process actually began in 1986 when controls on interest rates were abandoned. The wide-ranging reforms included the introduction of a financial instrument, the Bank of Botswana Certificate (BoBC), for influencing interest rates and as a means of effecting indirect monetary control; the diversification of the institutional infrastructure through liberalisation of licensing requirements for commercial banks; reforms of non-bank financial institutions (NBFIs); enhancement of prudential supervision and improvements in the payments system. It was in this context that the financial sector has expanded.

2.3 Although many issues pertaining to the financial sector were covered in varying degrees of detail in the 2000 *Annual Report*[7], this year's theme is exclusively devoted to a review of the financial sector's role in Botswana's economy. The objective is to examine the extent to which financial institutions have met their developmental role in light of the reforms that have been implemented over the years. In particular, there is need to assess the progress that has been made in financial savings mobilisation, enhancing sustainable credit allocation and access to credit, improving the efficiency of the intermediation process and the payments system, and in general, the contribution of the sector to economic development.

2.4 Chapter 3 reviews the structure of Botswana's financial sector against a backdrop of the legal and supervisory framework as well as the growth and performance of financial institutions in mobilising and channelling of financial savings. As at the end of 2001, following substantial expansion and consolidation of its infrastructure, activities and the range of services provided during the past decade, the financial sector comprised five commercial banks, one building society, four development finance institutions, two investment banks, a stock exchange, three stockbrokers, eleven insurance companies, a large number of pension funds, asset management companies, several international financial services companies, bureaux de change and micro-lenders. The chapter observes that the expansion of the sector has mostly occurred during the 1990s, with a period of institutional consolidation through mergers and restructuring during 1991 to 1995. The chapter further reviews the performance of the financial sector with respect to attracting financial savings and their credit allocation through lending.

2.5 When the Government is excluded as both a saver and lender, commercial banks dominated other financial intermediaries in mobilisation and allocation of financial resources during the decade, accounting for an average of 89 percent of both deposits and advances. However, their geographic location was skewed, with over 90 percent of the facilities located in the urban and peri-urban centres. Nevertheless, the activities of financial intermediaries have grown very rapidly. Although dominated by commercial banks, the expansion of intermediation activities has been broadly shared among the various institutions in the financial sector.

2.6 The expansion of the resource mobilisation and allocation activities of the financial intermediaries during the decade was preceded by the earlier efforts by the Government to address gaps in the structure of the financial sector. These included the use of the Public Debt Service Fund (PDSF) for lending to parastatal enterprises and the establishment of a development corporation as well as a development bank. These funds and institutions have met the financing needs of conventionally more risky or long gestation projects in the private sector and parastatal organisations. Moreover, the

[7] Reports for 1994, 1997, 1998, and 1999 also focused in some detail on these issues.

Government has remained a major saver, as indicated by the level of government deposits, especially with the central bank, reflecting a long period of budget surpluses.

2.7 During the decade the financial sector has changed considerably, with significant diversification and growth. Among the key trends during the period are the increased importance of households as savers, the related growth of contractual savings institutions especially pension funds, and reduced prominence of Government in direct lending, matched by a greater role for commercially oriented financial intermediaries. The chapter discusses how this process of financial sector diversification can continue, with the development of the financial markets infrastructure as a complement to financial intermediaries in the mobilisation of savings and the allocation of funds for investment.

3. The Performance of the Banking System

3.1 Despite its rapid expansion during the 1991-2000 period, the banking system remained robust and sound, reflecting in part, the supervisory and regulatory role of the Bank of Botswana. The importance of the soundness and efficiency of the financial sector generally, and commercial banks in particular, determines the degree to which they can fulfil their intermediation role and facilitate the operations of the payments mechanism. The robustness and efficiency of the sector affects the confidence with which the economic agents involved in the transaction process can utilise financial institutions, not only in respect of saving but also for effecting payments. Also, financial globalisation and liberalisation have accentuated the critical interrelationship between macroeconomic policy management and financial sector performance.

3.2 In Chapter 4, the performance of Botswana's financial system is analysed by examining several ratios, especially those relating to solvency, liquidity, asset quality, profitability and efficiency. All the measures of "soundness" of commercial banks indicate improvements throughout the period, with all the banks remaining solvent, liquid and efficient with high quality assets. Although competition has increased and there have been profitability and efficiency gains associated with the adoption of technological innovations, the deposit-lending rate margins have not declined. In addition, while progress has been made in raising the ratio of advances to deposits, by international standards there is room for further improvement in this ratio.

3.3 The chapter also reports on the results of the 1997 and 2001 customer surveys on the quality of banking services in Botswana. These surveys, which focussed on customers' views on the quality and cost of banking services, underline the importance of the need for the provision of adequate and high quality services by the financial sector generally, and the banking system specifically, if it is to fulfil its role in the economy. Based on the results, the quality of banking services in Botswana was judged to be "average" although there has been an improvement during the past five years. While the overall results mask the ratings for individual institutions, there were broad based concerns regarding the provision of various services, especially the promptness with which customers are served. The dissatisfaction with delays were in respect of over-the-counter services to customers, responses to enquiries, the speed of processing loan applications and the mechanical problems of automated teller machines (ATMs). Equally important, were perceptions that bank charges were considered to be too high and not adequately disclosed.

4. The Reform Initiatives for the Payments System

4.1 Related to the concerns raised in Chapter 4 with regard to the quality of services provided by the banking system, is a wider issue of the need to improve the efficiency of the payments system. Chapter 5 describes the essential characteristics and role of a payments system, and how it functions. The main focus of the chapter, however, is the need for reforms to the existing payments system in Botswana. In particular, it is pointed out, that under the auspices of the Committee on Payment and Settlement Systems (CPSS), based in Basle at the Bank for International Settlements (BIS), there is need for Botswana to adopt and implement a set of “Core Principles For Systemically Important Payments Systems”. The objective of the core principles is to ensure international uniformity in the standards relating to payments systems.

4.2 Among the problems encountered by the Botswana payments system are delays in settlement, risk of default by its members and the absence of a clearly defined legal infrastructure dealing with payment issues. It is against this background that initiatives have been taken to reform the National Payments System (NPS) within the context of a five-year programme for the Southern African Development Community (SADC). The reforms will utilise technological advances as a springboard for introducing automation of the clearing process, improve the facilities for bulk electronic payments and large value transfer systems.

4.3 The concluding chapter broadly summarises the major findings of the theme and suggests areas where challenges remain if the financial sector is to contribute fully to the realisation of the aspirations enshrined in Botswana’s Vision 2016.

CHAPTER 3

A REVIEW OF THE FINANCIAL SECTOR AND ITS ROLE IN FINANCIAL INTERMEDIATION

1. **Introduction**

1.1 This chapter presents an overview of Botswana's financial sector and its role in the mobilisation and allocation of financial resources during the period 1990-2000. After reviewing the historical development, structure, and supervisory background of the sector, the chapter presents information on the overall sectoral sources of loanable funds and their uses and then examines the intermediation role of financial institutions. This is followed by a review of the role of Government in the mobilisation and allocation of financial resources. The conclusion draws together the main themes of the chapter and discusses the issues relating to future development of the financial sector.

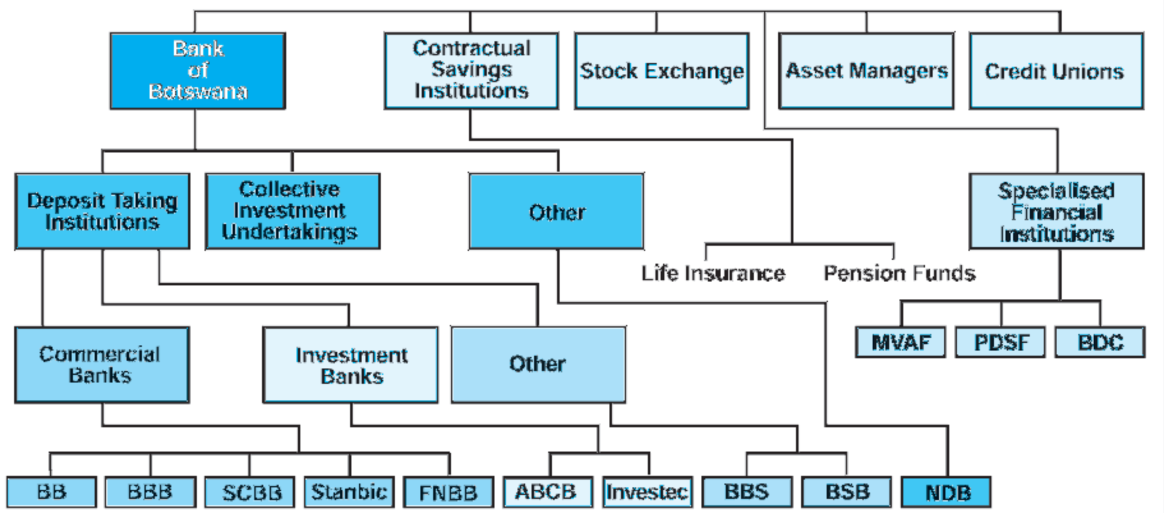
2. Botswana's Financial Sector: An Overview

2.1 The institutional structure and the type of financial services available in Botswana have been influenced by both historical factors and progressive global financial innovations over the years, assisted by advances in information technology. This section describes the structure of the financial sector in Botswana and its development over the past decade.

2.2 The financial sector in Botswana comprises the Bank of Botswana, as the central bank, commercial banks, merchant/investment banks, insurance companies, leasing finance institutions, a development bank, a savings bank, a building society, a development finance company, a stock exchange, stockbrokers, pension funds, asset management companies, collective investment undertakings (CIUs) and microlenders. Figure 3.1 summarises the broad structure of the Botswana financial sector, as at December 2000.

2.3 Although commercial and investment/merchant banks are covered by a single act (Banking Act 1995), the remainder are

FIGURE 3.1: FINANCIAL INSTITUTIONS



BB	Bank of Baroda	BBS	Botswana Building Society	ABCB	African Banking Corporation Botswana
BBB	Barclays Bank of Botswana	BDC	Botswana Development Corporation	Stanbic	Stanbic Bank Botswana
FNBB	First National Bank of Botswana	NDB	National Development Bank	MVAF	Motor Vehicle Accident Fund
SCBB	Standard Chartered Bank of Botswana	BSB	Botswana Savings Bank	PDSF	Public Debt Service Fund

established and supervised under different statutes. The commercial banks, Botswana Savings Bank (BSB) and CIUs, are by law, supervised by the Bank of Botswana, while the Ministry of Finance and Development Planning (MFDP) serves as the regulator of the National Development Bank (NDB), the Botswana Building Society (BBS), insurance companies and pension funds. The Stock Exchange Committee, under the overall supervisory oversight of MFDP, runs the Botswana Stock Exchange (BSE).

2.4 The first commercial bank in Botswana, Standard Chartered Bank[1] (formerly Standard Bank) established its first branch in Francistown in 1897, although it only operated for a few years due to difficult trading conditions. Standard Chartered also operated for a few years during the 1930s. However, the start of continuous commercial banking in Botswana came in 1950, when Standard Chartered and Barclays Bank set up agencies. These were run as part of the two banks' South African operations until 1975, when fully-fledged local subsidiaries were incorporated in Botswana and, for a long time, were the only commercial banks in the country. One more commercial bank was established in 1982, but the main changes

Box 3.1: Establishment of Botswana's Financial Institutions

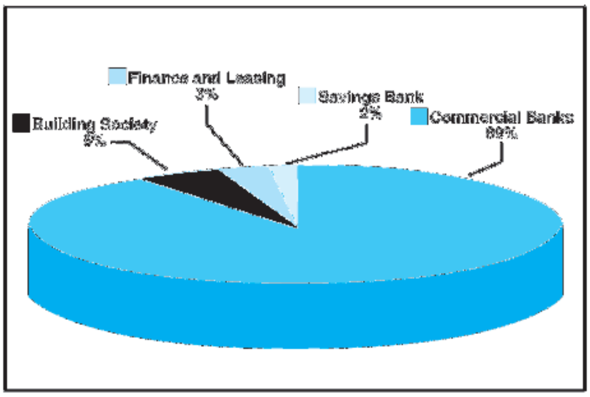
Institution	Year started operations	Year of local incorporation
Central Bank		
Bank of Botswana	1975	1975
Commercial Banks		
Barclays Bank of Botswana Limited	1950	1975
Standard Chartered Bank Botswana Limited	1950[1]	1975
First National Bank of Botswana Limited	1991[2]	1991
Stanbic Bank Botswana Limited	1992	1992
Bank of Baroda (Botswana) Limited	2000	2000
Other Financial Institutions		
Botswana Savings Bank	1911[3]	1963
National Development Bank	1964	1964
Botswana Building Society	1970	1977
Botswana Development Corporation	1970	1970
Tswelelo	1984[4]	1984
ulc (Pty) Limited	1990[5]	1990
Investec Bank (Botswana) Limited	2000	2000
Stock Exchange and Stock Broking Companies		
Stockbrokers Botswana	1989	1989
Botswana Stock Exchange	1994	1994
Investec Securities Botswana	1998	1997
Capital Securities	2000	1999
Life Insurance Companies		
Botswana Insurance Fund Management Limited	1970	1970
Botswana Life Insurance Limited	1994	1994
Regent Life Botswana Limited	1997	1997
Metropolitan Life of Botswana Limited	1998	1998
Pension Funds	...	...

Note:
1. Standard Chartered Bank opened branches in 1897 and 1934 but these only operated for a few years.
2. In 1991, FNB took over the Bank of Credit and Commerce, Botswana, which had started operations in 1982.
3. Renamed the Botswana Savings Bank in 1985, but previously known as the South African Post Office Savings Bank from 1911 and the Bechuanaland Post Office Savings Bank from 1963.
4. Tswelelo is being wound down.
5. ulc was taken over by the African Banking Corporation Holdings in 2001 and renamed African Banking Corporation of Botswana Limited.

[1] Serviced from Standard Bank of South Africa.

occurred during the 1990s, when the institutional structure of commercial banks underwent significant change arising from closures, mergers and the establishment of new institutions (Boxes 3.1 and 3.2). In addition to commercial banks, there are a number of non-bank financial institutions (NBFIs), most of which were established during the 1960s and 1970s.

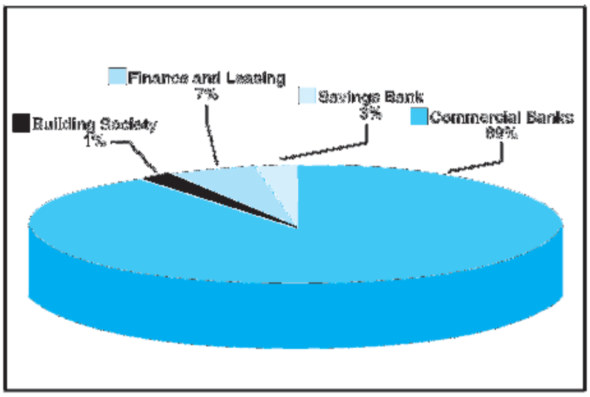
CHART 3.1:
MARKET SHARE OF DEPOSITS: 1990-2000



Sources: Bank of Botswana and respective institutions

2.5 As in most developing countries, the financial sector in Botswana is dominated by commercial banks. For instance, these banks accounted for an average share of 89 percent of both total deposits and total advances (of deposit-taking institutions) for the period 1990-2000 (Charts 3.1 and 3.2). More detailed information on the size and composition of the deposit-taking institutions is shown in Appendix 4A, Table 4A.1 in Chapter 4.

CHART 3.2:
MARKET SHARE OF ADVANCES*: 1990-2000



* Includes advances from deposit taking institutions only
Sources: Bank of Botswana and respective institutions

2.6 However, there are also important non-deposit taking financial institutions, which play an important role in providing funds for investment. These include two Government owned financial institutions (Botswana Development Corporation and the National Development Bank), and the Government's direct lending facility, the Public Debt Service Fund (PDSF). The latter, which lends mainly to parastatals, has in the past been a larger lender than the banks; its role is discussed in more detail in sections 7 and 8.

2.7 Finally, in recent years there has been considerable growth in micro-lending activities, with numerous firms engaged in making small loans from their own resources. It is believed that, although the number of such loans is large, they account for a relatively small proportion of total credit. As non-deposit taking institutions, micro-lenders

Box 3.2: Closures, Mergers and Take-overs

1991 Bank of Credit and Commerce (Botswana) Limited, a subsidiary of Bank of Credit and Commerce International, was taken over by First National Bank of Botswana Limited.

1992 Union Bank of Botswana Limited, a wholly-owned subsidiary of Standard Bank South Africa Limited, took over ANZ Grindlays. The new entity was renamed Stanbic Bank Botswana Limited.

1993 National Development Bank was restructured. The restructuring included writing off of bad debts, recapitalisation through a Government equity injection, staff rationalisation and revision of lending policies.

1993 Financial Services Company, a credit institution owned by BDC and NDB, was sold to First National Bank of Botswana Limited.

Zimbank (Botswana) Limited, a commercial bank, was taken over by First National Bank of Botswana Limited.

1995 Botswana Cooperative Bank, was put under provisional liquidation and was subsequently liquidated.

are not subject to the supervision of the central bank, and at present are subject only to self-regulation.

2.8 The financial sector has undergone considerable reform since the mid-1980s. This process has been aimed at improving efficiency, broadening the range of financial instruments, institutions and markets, and giving market forces a stronger role in the operation of the financial sector. Further details of the reforms are provided in Box 3.3.

3. Legal and Regulatory Environment

3.1 The financial sector in Botswana has never experienced the type of systemic crisis that has occurred in some other countries. Several individual institutions experienced problems in the early 1990s because of poor management or inadequate internal controls and in the case of publicly owned financial institutions, lack of effective supervision. However, as a result of timely intervention, the problems did not develop into a systemic crisis.

3.2 In any country the provision of financial services takes place within a legal framework that effectively determines the role and activities of deposit-taking institutions and non-bank financial institutions and the degree of competition in the system.

3.3 Regulation and competition, in differing degrees, are the main determinants of the range of products and services offered by financial institutions, the types of assets and liabilities they can hold and issue, as well as the legal structure of its organisation. With regard to banks in particular, the activities that they can undertake fall within a range marked at one extreme by a completely separate banking structure in which banks are not allowed to engage in any type of securities or non-financial activity and, at the other, a fully integrated banking structure where banks can offer all types of financial services, directly or indirectly through subsidiaries and even hold equity in non-financial corporations. In between these two extremes are a variety of combinations allowing a higher or lesser degree of bank involvement in securities businesses and the activities of non-financial institutions.

3.4 Box 3.4 outlines the current legal infrastructure for Botswana's financial sector, and highlights the areas considered relevant to the performance of the sector. In Botswana, the laws pertaining to the banking system provide for a complete separation of the activities of banks (commercial plus merchant/investment banking) and non-bank financial institutions. Banks are not allowed any involvement in non-bank activities, whether directly or indirectly. However, there is a grey area created by the legal frameworks of thrift institutions (BSB) and some non-bank financial institutions (NDB and BDC), which give these institutions the latitude to do banking business, directly through service provision within current structures or indirectly through equity ownership. This means that non-bank financial institutions can offer products and services that compete directly with those offered by banks, and also manage or own banks, in part or in whole. This presents a case of upstream integration, in which a non-bank financial institution owns a bank. This presents difficulties in the area of supervision, given that non-bank financial institutions are

Box 3.3: Financial Sector Reforms

Reform	Date
Removal of controls on interest rates	1986
Establishment of Stock Market	1989
Liberalisation of commercial bank licensing requirements	1990
Introduction of BoBCs	1991
Winding down of parastatals borrowing from PDSF	from 1996
Modernisation of legislation (BoB Act; Banking Act)	1995-1996

not supervised to the same extent as banks. An example of such upstream integration in the case of Botswana is BDC's part ownership of Investec Bank.

3.5 The general approach is one of phased deregulation, in view of the need to strengthen the regulatory and supervisory framework and close any gaps that might be exploited by those being regulated, while at the same time allowing for the necessary institutional development to take place. The

Box 3.4: Selected Legislation Relevant to the Financial Sector

The Bank of Botswana Act, 1975 and the Amendment Acts, 1996 and 1999

- Establishes the Bank of Botswana as a central bank and mandates it to ensure efficiency and soundness of financial markets.

The Banking Act, 1995 and Banking Regulations, 1995

- Apply to the banking industry, including commercial banks, credit institutions, investment banks and discount houses. Provide for the prudential regulation and supervision of banks, as well as timely exit of failing institutions.

- Banks are generally prohibited from engaging, directly or indirectly, in the merchandise wholesale or retail business, including import or export trade; acquiring or holding, directly or indirectly, any part of the share capital of any financial, commercial, agricultural, industrial or other undertaking; buying, acquiring or taking a lease, whether directly or indirectly, on immovable property.

The Botswana Savings Bank Act, 1992

- Establishes the Botswana Savings Bank and regulates the conduct of its operations. While the Act empowers the bank to issue financial instruments, such as bonds, certificates and notes, or offer other viable banking and financial services, it is silent on specific prohibitions.

The Building Societies Act, 1961

- Provides for the establishment of building societies, such as the Botswana Building Society. It empowers the BBS to invest in bills, bonds, certificates, debentures, stock and municipal loans. The Act is currently under review

The National Development Bank Act, 1964

- Establishes the NDB and governs its operations. The Act empowers the bank to borrow money as necessary to meet its obligations, including bond issuance. It further empowers the bank to lend to and own equity in business undertakings across all economic sectors; manage, operate or control any property, enterprise or undertaking on behalf of any person in connection with any loan or guarantee given by it; and to operate any savings scheme or any combined life assurance and savings scheme approved by its board. However, the bank may not provide financial assistance for buildings or public works in Botswana.

The Botswana Development Corporation

- The BDC was set up under the Companies Act, 1959, as amended in 1995. Its Memorandum and Articles of Association guide its operations. Of the NBFIs discussed in the report, the BDC has the widest investment and borrowing mandate. It can engage in any business as sole proprietor, in partnership or joint venture, with local or foreign investors, in all kinds of activities across all economic activities; can provide financial and management assistance to subsidiaries and associated companies; can borrow in any manner it considers necessary, which could include issuing all kinds of securities.

The Collective Investment Undertakings Act 1999 and Collective Investment Undertakings Regulations, 2001

- Apply to Collective Investment Undertakings, which include investment companies and unit trusts or mutual funds. The Act and Regulations compare very favourably with modern legislation for such undertakings found in other countries.

The International Financial Services Centre

- Provides for the establishment of IFSC companies in the following activities: exempt companies, trusts, registries of ship and aircraft, international banking and financing services (which includes deposit-taking, foreign exchange services, custodial functions), and investment business (including collective investment undertakings, personalised investment or private banking management and captive insurance.

Insurance Industry Act, 1987

- Applies to insurance business (life and non-life) and reinsurance. The Act prohibits simultaneous transacting of both general (short-term) and life (long-term) insurance business by a single company.

Box 3.4: Selected Legislation Relevant to the Financial Sector (Continued)

Pension and Provident Funds Act, 1987

- Applies to approved private Pension and Provident Funds. The public service has a separate act, the Pensions Act, for its pension arrangements. During 2001, the Government transformed the civil service pension arrangements, from a non-funded defined benefit scheme to a defined contribution scheme operating under the Pension and Provident Funds Act.

- **A Fund may not** (i) engage in or carry on any business undertaking licensed under the Trade and Liquor Act or any other business unless approved by the Registrar and (ii) invest more than 5 percent of the aggregate value of its assets in Botswana in the business of a participating employer or of an associate of a participating employer, unless exempted by the Registrar. A fund may invest up to 55 percent of its moneys accruing from contributions made in Botswana in Government or other securities.

Botswana Stock Exchange Act, 1994, Botswana Stock Exchange Regulation, 1995, Botswana Stock Exchange Listing Requirements, 1999, Botswana Stock Exchange Members' Rules 1996.

- Apply to the Botswana Stock Exchange

regulatory framework in Botswana has undergone some modernisation during the 1990s, in particular with the replacement of the Financial Institutions Act, 1986 with the Banking Act, 1995. The main change introduced with the new Act was to bring in more flexibility in the system of banking regulation and supervision, allowing it to adapt in line with international developments and best practice. Under the new Act, prudential requirements were to be prescribed through the issuance of regulations rather than by statute. In addition, the Bank of Botswana was given the responsibility for granting banking licenses, rather than the Minister of Finance and Development Planning, as had been the case under the old Act. Other new legislation during the decade includes the Bank of Botswana Act, 1996, the Botswana Savings Bank Act, 1992 and the Collective Investment Undertakings Act, 1999. Some legislation remains outdated, however, including the Building Societies Act and the National Development Bank Act, both of which were in place before independence (1966). In particular, there is a need to strengthen the regulatory framework applicable to these two institutions, as this is not adequately dealt with in the existing legislation. Work on updating these statutes is under way.

3.6 At the heart of the challenge facing financial sector regulation is the need to strike a balance between official intervention and market discipline. In particular, there must be a balance between the extent of coverage of the safety net, which aims to offer some protection to depositors and also ensure the stability of the financial system, with an encouragement of prudent behaviour by market participants. It is essential that supervisory authorities encourage market discipline and good corporate governance among financial institutions and avoid policies or such formal or informal actions that create an impression that distressed institutions would necessarily be bailed out. In Botswana, there has been a mixed record during the 1990s; on the one hand, the relevant legislation clearly requires financial institutions to take full responsibility for the prudent management of their businesses and minimise the likelihood of bailouts. One distressed financial institution, the Botswana Cooperative Bank, was liquidated when it became clear that it was insolvent. On the other hand, some NBFIs have been recapitalised by Government in order to save them from insolvency, which might create an impression that other distressed institutions would be bailed out. More generally, there has been a shift away from detailed official interventions and regulation towards a market based approach, with its emphasis on information disclosure and corporate governance.

4. Overall Sources and Uses of Funds: A Background to Intermediation

4.1 Before considering the role of financial institutions in more detail, it is useful to have an overview of the broad flows of financial savings and investment between different sectors of the economy. This can be done using flow of funds analysis, whereby the economy is divided into sectors and the accounting relationships between them are presented within a statistical framework. The sectors comprise the private sector (itself divided into households, firms and non-financial parastatals), Government and the foreign sector. Within each sector, there are likely to be both savers (economic units with surplus funds) and borrowers (deficit units). It is the financial flows between the surplus and deficit units in the different sectors that the flow of funds traces[2]. As these flows take place, savers acquire financial assets, and borrowers acquire liabilities. The flows are typically characterised as uses of funds (flows from savers used to acquire assets) and sources of funds (flows to borrowers leading to increased liabilities). The final element of the flow of funds is recording exactly how these financial flows take place through various financial institutions and markets. Therefore, the linking role of financial institutions such as the commercial banks, NBFIs, pension funds and the central bank is traced. A similar linking role is played by

Table 3.1: Sources and Uses of Funds (P million), 2000

Uses / Sources		Domestic Sectors 1 HH	2 Firms	3 NFP	4 Govt	5 Total	Financial Intermediaries 6 BoB	7 Banks	8 NBFIs	9 PFs	10 PDSF	11 Total FIs	12 Total Domestic	13 RoW	14 TOTAL
1	HH	-		435	49		-	484	484	39	523				
2	Firms					-		323	128		-	451	451	150	601
3	NFP[1]					-		(65)			(48)	(113)	(113)	300[7]	187
4	Govt[2]					-		76			-	76	76	108	184
5=1+2+3+4		-	-	-	-	-	-	769	177	-	(48)	898	898	597	1 495
6	BoB	24[3]	(187)[5]		4 541	4 378		(299)6	(5)	-	-	(304)	4 074	71[8]	4 145
7	Banks	772	(182)	509	76	1 175		-	-	-	-	-	1 175	7	1 182
8	NBFIs	22	162			184		14	-	-	-	14	198	-	198
9	PFs	563	-			563		-	-	-	-	-	563	(30)	533
10	PDSF	-	-			-		-	-	-	-	-	-	-	-
11=6+7+8+9+10	Total FIs	1 381	(207)	509	4 617	6 300	-	(285)	(5)	-	-	(290)	6 010	48	6 058
12=5+11	Total Domestic	1 381	(207)	509	4 617	6 300	-	484	172	-	(48)	608	6 908	645	7 553
13	RoW	68	110[4]	196	461	835	5 028	689		189	-	5 906	6 741	-	6 741
14=12+13	Total	1 449	(97)	705	5 078	7 135	5 028	1 173	172	189	(48)	6 514	13 649	645	14 294

Abbreviations:
HH – households; NFP – non financial parastatals; Govt. – government; BoB – Bank of Botswana; NBFIs – non-bank financial institutions; PFs – pension funds and insurance companies; PDSF – Public Debt Service Fund; FIs – financial institutions; RoW – rest of the world; BoBCs – Bank of Botswana Certificates.

Notes:
1. These include Botswana Agricultural Marketing Board, Botswana Housing Corporation, Botswana Meat Commission, Botswana Postal Services, Botswana Power Corporation, Botswana Railways, Water Utilities Corporation and Air Botswana.
2. Includes both local and central government.
3. Includes National Saving Certificates (P1 million) and currency in circulation was classified under households, as it was not possible to separate the portion held by firms, the official sector, Non-financial parastatals and NBFIs.
4. Includes foreign direct investment and foreign currency deposits.
5. Holdings of BoBCs.
6. Holdings of BoBCs plus currency in banks' vaults.
7. Represents non-financial parastatals and NBFIs, as it was not possible to separate data for the two sectors.
8. Includes deposits of international agencies at the Bank of Botswana.

Additional notes:
- Uses of Funds (in columns) represent the acquisition of financial assets, while Sources of Funds (in rows) represent the acquisition of financial liabilities by various sectors.
- Data for the Rest of the World reflects transactions of the Capital and Financial Accounts only i.e. changes in assets and liabilities and not income or earnings.
- Intra-public and intra-financial sector balances are assumed to net out.
- Numbers in parenthesis are negative and dash (-) indicates that the figure is zero.
- … indicates that data are not available.

Sources: Bank of Botswana Annual Report 2000; Bank of Botswana Balance Sheet; Commercial Banks Balance Sheets; NBFIs Balance Sheets; Ministry of Finance and Development Planning – Report of the Registrar of the Insurance Companies 2000.

2 The flow of funds does not deal with flows within sectors

Table 3.2: Summary of Sources and Uses of Funds (P million), 2000

Sources \ Uses	Private Sector	Government	Financial Sector	Rest of World	TOTAL
Private Sector	-	-	822	489	1 311
Government	-	-	76	108	184
Financial sector	1 683	4 617	(290)	48	6 058
Rest of World	374	461	5 906	-	6 741
TOTAL	2 057	5 078	6 514	645	14 294

Notes
1. Private sector includes firms, households and non-financial parastatals.
2. Financial sector includes the Bank of Botswana, commercial banks, NBFIs, the PDSF as well as pension funds and insurance companies.

Sources: Bank of Botswana Annual Report 2000; Bank of Botswana Balance Sheet; Commercial Banks Balance Sheets; NBFIs Balance Sheets; Ministry of Finance and Development Planning — Report of the Registrar of the Insurance Companies 2000.

financial markets, such as share and bond markets, which link savers and borrowers directly without the intermediation of a financial institution.

4.2 In 2000, total flows between sectors amounted to P14 294 million. Of this, P7 135 million represented flows from savers. Flows into the domestic financial sector from savers amounted to P6 300 million, the bulk of which (P4 541 million) was deposits of the Government at the Bank of Botswana. Other flows into financial intermediaries included deposits of P1 175 million at the commercial banks, P184 million at NBFIs, and P563 million paid to contractual savings institutions such as pension funds. A further P835 million flowed to the foreign sector (RoW), as savers acquired foreign financial assets. Apart from Government, the household sub-sector was the largest source of savings.

4.3 Financial intermediaries used these funds for a variety of purposes. The largest single use was the accumulation of foreign exchange reserves by the Bank of Botswana (P5 028 million), which, when combined with foreign flows from the banks and pension funds, led to a total of P5 906 million flowing offshore from financial intermediaries. Financial intermediaries used P898 million to provide credit to domestic borrowers. This was combined with foreign borrowing of P597 million to generate total sources of funds for domestic borrowers of P1 495 million.

4.4 This flow of funds exercise provides some interesting insights into the operation of the financial system. In Botswana's case, it is evident that, first, the funds derived from Government (P5 078 million) are much larger than those derived from the private sector (P2 057 million). Second, flows of domestic funds to the rest of the world (P6 741 million) remain much larger than flows of domestic funds to the private sector (P822 million). Third, of the P1 922 million flowing into domestic financial intermediaries excluding the Bank of Botswana, less than half was provided as credit to domestic private sector borrowers. The latter two points reflect a combination of a lack of domestic absorptive capacity, relative to funds generated, and perhaps insufficient development of the domestic financial system. Finally, within the private sector, the household and parastatal sub-sectors were net savers (in that they saved more than they borrowed), while the firms sub-sector was a significant net borrower. Government remains the largest net saver.

4.5 The results of this flow of funds exercise can be compared with the information provided by two previous exercises, covering the periods 1989-92 and 1995-96. The most important findings are that:

- in all three periods, flows from the domestic financial system to foreign users – mostly through the Bank of Botswana's foreign exchange reserves – represent the largest single use of funds;

- in 1989-92 and 2000, the Government was a much larger saver than the private sector, whereas in 1995-96 the position was reversed, due to a less favourable budgetary position for the Government at that time;

- in 1989-92 the household sector was a recipient of about the same quantity of funds that it generated (i.e., zero net savings), whereas in 1995-96 and 2000 the household sector was making a significant net contribution to the funds used by other sectors of the economy.

4.6 The overall picture presented by the flow of funds is that there has been some diversification of savings sources, notably with households increasing in importance, but there may be room for improvement in the intermediation of those savings to domestic borrowers.

5. Botswana's Financial Sector and Savings Mobilisation

5.1 Previous *Annual Reports*[3] of the Bank of Botswana examined the issues of the promotion of financial savings and investment, and the role of Government in savings accumulation and investment growth. The next three sections revisit selected outstanding issues in the light of more recent information and draw conclusions on these and emerging new issues.

5.2 The major role that Government has played in savings mobilisation and concerns about the relatively low savings of the household sector have been highlighted in previous *Reports*. It was observed that investment financing in Botswana was broadly not intermediated, in that most of the investment was self-financed, both by firms and Government. It was also indicated that there was a limited role of financial markets in investment financing, as reflected by the paucity of marketable financial instruments. Few bonds had been issued and the stock market was small and characterised by low liquidity.

5.3 These observations suggested the need for diversification of savings sources, development of new savings instruments, improvement of intermediation by commercial banks and NBFIs, and the development of financial markets. Furthermore, they raised questions regarding the structure of the private financial sector that would best promote savings. In particular, whereas the existing structure is dominated by commercial banks, would a shift towards capital market institutions and contractual savings institutions improve resource mobilisation? These issues are addressed in the next two sections.

5.4 The first section (Section 6), reviews factors that generally influence savings and those that apply in the case of Botswana, as well as the role played by the financial sector in financial savings mobilisation. It covers the contributions of different financial intermediaries to savings mobilisation and types of financial savings. The subsequent section covers the intermediation role of the financial sector with regard to lending activities. The overall conclusion is that there is need to encourage further development of both the money and capital markets in order to ensure that a broader range of financial instruments is available to meet the needs of both savers and investors, and hence improve the efficiency and effectiveness of the financial sector. Comparisons are made, where relevant, between the "pre-reform period" (1980-89) to the "reform period" (1990-2000).

6. Determinants of Saving and Institutional Contributions

6.1 The national savings rate is determined by a number of factors, the most important of which is growth of national income, as this affects growth of per capita income and, therefore, the saving ability of individuals. As the economy expands, incomes rise and so does saving, given appropriate incentives, such as attractive deposit interest rates. Other

[3] See Bank of Botswana Annual Reports for 1993, 1996, 1997, 1998 and 2000.

factors influencing overall savings are the public sector budgetary position, demographic structure and the extent of contractual savings, such as pension funds. Savings tend to be increased by a range of developments, including: (i) financial liberalisation, especially the ending of controls on interest rates, which generally leads to higher real interest rates; (ii) a declining demographic dependency ratio, in that the fewer dependents (children and/or the elderly) that are supported by working age adults, the higher savings tend to be from a given income; and (iii) a shift from unfunded to funded pension schemes, as, under the former, pensions are paid from current income, while under the latter a pool of assets are built up through saving in order to pay future pensions.

6.2 In Botswana, most of the identified determinants of savings supported the growth in savings during the past two decades. National output and per capita income growth have been very rapid, although income distribution has been skewed. Economic growth[4] averaged 9.3 percent a year between 1980 and 2000, while real income per person grew at an annual rate of 6.0 percent. However, the rate of economic growth slowed down considerably in the 1990s compared with the 1980s. Interest rates have risen in real terms; the capital account of the balance of payments has been liberalised, thus making a wider range of savings instruments available to savers; the demographic dependency ratio[5] has been declining, and there has been a move towards funded pension schemes in both the public and private sectors.

6.3 Although the economic environment is broadly conducive to saving, there remains a significant prevalence of poverty, which reduces the ability to save among the lower income groups. Furthermore, the HIV/AIDS scourge complicates the outlook for savings mobilization. Although the demographic dependency ratio should continue to decline in the near term, which should reduce the burden of support and free some resources for saving, the increase in the number of orphans as well as hospitalised and home-based AIDS patients needing financial support, implies increased costs at the individual, corporate and Government levels and, thus, will somewhat limit the capacity to save.

6.4 In order to attract savings, the financial sector must provide savings instruments that satisfy the risk, return, maturity and liquidity needs of savers. In a robust financial system it is expected that a variety of financial institutions will offer services tailored to the specific needs of different groups of savers, as no single institution can satisfy all the needs of all savers all the time. In Botswana, financial institutions engaged in savings mobilisation and discussed in this section are commercial banks, NBFIs (i.e., development finance and thrift institutions), and contractual savings institutions (life insurance companies and pension funds).

(i) Trends in Institutional Savings

6.5 Data on financial savings[6] mobilised by private financial institutions (commercial banks, NBFIs and contractual savings institutions) in Botswana during 1980-2000 indicates that an average of around 11 percent of non-mining GDP has been added annually to the stock of financial assets. This has led to a rapid increase in the ratio of total financial savings to non-mining GDP, from 29 percent in 1980 to over 80 percent in 2000.

6.6 An analysis of trends in financial savings shows strong growth over the past two decades. The stock of total financial savings increased by 25 percent a year in nominal terms, on average, between 1980 and 2000 (Table 3.3). However, growth was not evenly

4 Growth of real non-mining GDP.

5 Defined as the ratio of people aged below 15 and over 64 to those aged 15-64.

6 Financial savings include deposits of the general public and government at depository institutions, Bank of Botswana Certificates privately held (series starts in 1991) and call deposits at Bank of Botswana (series ends in 1990), borrowing for on-lending by non-deposit-taking NBFIs and contractual savings (i.e., life insurance company and pension funds assets). Government deposits at Bank of Botswana are excluded.

and consistently spread over the entire period. Savings growth was faster in the 1980s (pre-reform period), averaging 32 percent a year, than in the 1990s (reform period), when growth averaged 21 percent a year. This result is perhaps surprising given that financial sector reforms were aimed precisely at encouraging growth of national savings. Lower growth in the 1990s reflects a considerable slowdown in savings mobilisation by all types of financial institutions, except contractual savings institutions. The average growth rate of savings held in NBFIs fell to 12 percent from 27 percent, while the growth rate of savings held in commercial banks declined to 19 percent from 22 percent over the same period. The growth rate of privately held Bank of Botswana Certificates (BoBCs)/ deposits at BoB also slowed down substantially, from an annual average of 145 percent in the 1980s to 25 percent in the 1990s. The only area showing growth was contractual savings, which is discussed in more detail below. The changing shares of savings held by the various institutions resulting from these differential growth rates are shown in Chart 3.3.

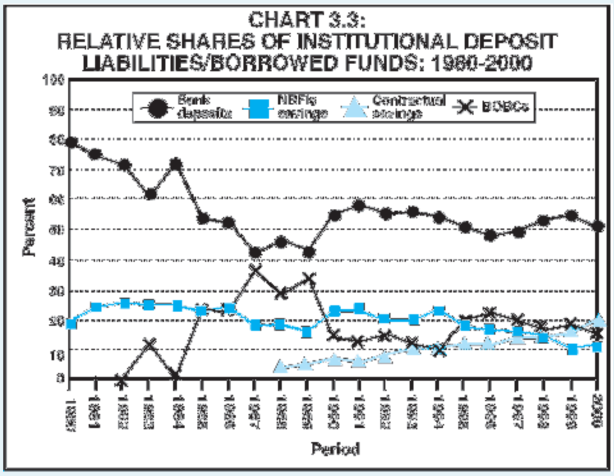
6.7 A question arises as to why the strong growth in savings seen in the 1980s was not sustained in the 1990s. There are a number of possible explanations. First, economic growth was lower in the 1990s than in the 1980s. Second, the high savings growth of the 1980s may have reflected a one-time structural change as savings held in the form of non-financial assets were shifted to financial assets; once this phase was over, more innovative approaches to collecting savings were required to encourage further movement into financial savings. Third, the operational difficulties faced by some NBFIs, leading to their restructuring in the 1990s, affected their capacity to mobilise resources during this period. The overall explanation is likely to be a combination of these, and

Table 3.3: Growth Rates and Levels of Deposit Liabilities/Borrowed Funds of all Financial Institutions

	Average Annual Nominal Growth Rates of Institutional Deposit Liabilities/Borrowed Funds (%)			
	Pre-reform Period 1980-89	**Reform Period 1990-00**	**Overall 1980-00**	**2000**
Total Financial Sector Deposits/Borrowed Funds[1]	31.6	20.6	24.8	13.6
Commercial Banks	22.4	19.4	22.9	7.1
NBFIs	27.2	12.2	20.9	28.4
Contractual savings institutions[2]		34.2	35.9	46.2
Bank of Botswana Certificates (BoBCs)/Private Deposits at BoB[3]	145.1[4]	24.7	41.0	3.4
	Levels of Institutional Deposit Liabilities/ Borrowed Funds (Pula Million)			
	1980	**1989**	**1990**	**2000**
Total Financial Sector Deposits/Borrowed Funds[1]	181.1	2 324.6	2 286.8	1 5625.4
Commercial Banks	145.6	1 032.7	1 276.4	8 120.5
NBFIs	35.5	366.8	511.7	1 898.3
Contractual savings institutions[2]		104.1	162.3	3 167.0
Bank of Botswana Certificates (BoBCs)/Private Deposits at BoB[3]	[4]	821.0	336.5	2 439.6

Notes:
1. BDC and NDB are non-deposit taking institutions. Therefore, proxies for deposits in their cases are borrowed funds for on-lending. In the case of contractual savings institutions, total assets are used.
2. Contractual savings institutions refer to life insurance companies and pension funds; the data series for these institutions starts in 1988 and the figure for 2000 is an estimate.
3. Prior to 1991, the BoBCs series consists only of privately held call deposits at Bank of Botswana and from 1991 onwards consists of privately held BoBCs only.
4. The average growth rate for this series is for the period 1981-89; the 1980 figure is not available from the source.
5. Government deposits at BoB are excluded.

Sources: Own calculations using data from various Bank of Botswana Annual Reports, Botswana Financial Statistics and annual reports of NBFIs.



Sources: Bank of Botswana and respective institutions

possibly other factors.

6.8 The slowdown in the growth of commercial bank deposits reflects lower growth rates of all categories of deposits (Government[7], business, and households) (Table 3.4). It is interesting to note, however, that household deposits grew very rapidly in 1999 and 2000. This is an important development as it may signal that household saving has begun a new phase of rapid growth, although it is too early to draw firm conclusions.

6.9 The slowdown in the growth of savings held in NBFIs results from slower growth of savings in almost all institutions in this sector, the only exception being NDB (Table 3.5).

6.10 There have also been significant changes in the composition of bank deposits. During the 1980s, savers appear to have preferred to hold short-term deposits (current, call and savings) at commercial banks, as these grew much more rapidly than long-term deposits (notice and fixed[8]) (Table 3.4). However, this changed in the 1990s, when the share of long-term deposits in total deposits grew from 9 percent in 1980 to nearly 20 percent in 2000. Another development has been the decline in the proportion of deposits held in current accounts (which are non-interest bearing), from almost half of total deposits in the 1980s to 22 percent in 2000. These developments are most likely a response to the interest rate policy adopted in the early 1990s which sought to maintain positive real deposit interest rates, as opposed to the negative real deposit rates that prevailed in the 1980s.

Table 3.4: Growth Rates and Levels of Deposit Liabilities of Commercial Banks by Holder and Type

	Average Annual Nominal Growth Rates of Commercial Bank Deposit Liabilities By Holder (%)				Levels of Commercial Bank Deposit Liabilities by Holder (Pula million)			
	Pre-reform Period 1980-89	Reform Period 1990-00	Overall 1980-00	2000	1980	1989	1990	2000
Total Deposits	21.6	20.1	22.5	2.3	136.1	866.3	1 072.3	6 912.3
Government	22.9	16.3	22.0	35.9	16.3	63.7	89.3	470.6
Business	22.1	20.6	23.1	-15.5	78.8	552.4	669.0	4 041.0
Households	20.4	19.3	21.1	47.4	41.0	250.2	314.0	2 400.6
	Average Annual Nominal Growth of Commercial Bank Deposit Liabilities by Type (%)				Level of Commercial Bank Deposit Liabilities by Type (Pula million)			
Current[1]	23.8	13.3	17.0	7.1	55.1	405.5	466.9	1 503.8
Call[1]	41.7	27.0	39.4	-4.2	11.1	203.5	314.6	3 391.7
Savings[1]	21.8	11.9	18.2	12.7	25.7	159.9	193.7	671.9
Notice[1]	7.3[2]	15.2	14.5	-33.1	29.3[2]	45.7	26.5	237.6
Fixed[1]	3.9[3]	27.0	22.2	28.8		51.5	70.7	1 107.2

Notes:
1. Current deposits refer to demand deposits; call to overnight call account deposits; savings to ordinary savings account deposits; notice to 31- and 84-day notice deposits; and fixed to deposits fixed up to six months, up to twelve months and for over twelve months.
2. The data source does not give separate figures for notice and fixed deposits for 1980.
3. The average growth rates for notice and fixed deposits are for the period 1981-89, as the data source provides a combined figure for both in 1980.

Source: Various Bank of Botswana Annual Reports, Botswana Financial Statistics and annual reports of NBFIs.

[7] Government deposits at commercial banks are primarily those of local government authorities and not of the central government.

[8] Notice deposits refer to 31- and 84-day notice deposits, while fixed deposits refer to deposits fixed up to six months, up to twelve months and for over twelve months.

(ii) ***Pension Funds and Life Insurance Companies***

6.11 By the end of 2000, there were 159 pension funds and 4 life insurance companies registered in Botswana (see Box 3.1). The flow of contractual savings into these funds, and related flows paid under life insurance policies, has been one of the most significant developments in the financial sector over the past decade. In 1988, total assets under management in the contractual savings sector were P64 million; by 2000, the total was around P3.2 billion, which was more than savings held by NBFIs. The rapid growth of contractual savings has boosted their position relative to the size of assets and liabilities held by the banks, and in particular relative to the size of deposits held by households. In 1988, pension and life assets were equivalent to only 8 percent of the assets of the commercial banks, but by 2000 this had risen to over 30 percent. Furthermore, in 1988 pension and life assets were equivalent to 35 percent of deposits held by households in the banks, whereas by 2000 pension and life assets were larger. Households have, therefore, been increasing their holdings of contractual savings assets much faster than they had been increasing their deposits in the banking system, thus marking a significant diversification of household savings held as financial assets. The growth of savings in the form of pension and life assets means that the trend of decreasing net savings with the banks by households (whereby households have become net borrowers or dissavers with the banks) is of less concern than it would have

Table 3.5: Growth Rates and Levels of Deposit Liabilities/Borrowed Funds of NBFIs and Contractual Savings Institutions

	Average Annual Nominal Growth Rates of Deposit Liabilities/ Borrowed Funds of NBFIs (%)			
	Pre-reform Period 1980-89	Reform Period 1990-00	Overall 1980-00	2000
Total NBFIs Deposits/Borrowed Funds[1]	27.2	12.2	20.9	28.4
BBS	21.2	9.0	18.8	8.4
BDC[2]	26.1	14.7	23.7	12.5
BSB	29.9	16.6	18.9	3.2
NDB	17.3	17.9	13.6	16.0
Investec[2]				452.3
Tswelelo[3]	102.8	-13.3	6.3	-46.1
Hire purchase finance & leasing companies	84.1	-2.7	34.3	8.2
Contractual savings institutions[4]		34.2	35.9	46.2
	Levels of Deposit Liabilities/Borrowed Funds of NBFIs (Pula million)			
	1980	**1989**	**1990**	**2000**
Total NBFIs Deposits/Borrowed Funds[1]	35.5	366.8	511.7	1 898.3
BBS	10.8	68.9	95.3	273.2
BDC[2]	15.0	133.1	199.3	725.2
BSB		36.4	39.1	154.6
NDB	9.2	44.7	49.9	291.5
Investec[2]				324.8
Tswelelo[3]		11.7	17.2	3.1
Hire purchase finance & leasing companies	0.5	72.0	110.9	126.0
Contractual savings institutions[4]		104.1	162.3	3 167.0

Note:
1. BDC and NDB are non-deposit taking institutions. Therefore, proxies for deposits in their cases are borrowed funds for on-lending. In the case of contractual savings institutions, assets are used.
2. Data for these institutions start later than 1990: BDC in 1992, Investec in 2000.
3. Tswelelo is being wound down.
4. Contractual savings institutions refer to life insurance companies and pension funds; the figure for 2000 is an estimate.

Sources: Own calculations using data from various Bank of Botswana Annual Reports, Botswana Financial Statistics and annual reports of NBFIs.

been otherwise.

6.12 The growth of pension funds has focused attention on the management of contractual savings assets, attention which will intensify even further with the establishment of the new Public Officers Pension Fund. From a policy point of view, the fund managers objective of ensuring good returns for pension fund members, without exposing their assets to undue risk, has to be balanced with ensuring the intermediation of these financial flows into domestic investment needs. Up to now the bulk of pension fund assets have been invested offshore, reflecting a number of factors including the need to diversify investment portfolios and a shortage of high-return low-risk domestic investment opportunities[9]. In this regard, it should be noted that pension funds generally invest a relatively large proportion of their assets in long term government bonds, as these have the risk, return and maturity profiles that match the liabilities - of funding future pensions - that such funds have. The lack of a Government bond market in Botswana is one of the factors that tends to encourage investment offshore. However, it should also be noted that pension funds represent a large pool of long-term funds, and at the same time there is a perceived shortage of long-term finance for investment in Botswana. One of the main issues that still faces the financial system is to develop in a way that facilitates the matching of these long-term funds to good long-term investment opportunities. In this regard, development of the stock market and the commercial bond market has the potential to play a very important role.

(iii) Botswana Stock Exchange (BSE)

6.14 The Botswana Stock Exchange (BSE) has a potentially important role to play in providing an alternative channel linking savers and investors. The instruments issued and traded on the BSE, corporate equities and bonds, have characteristics that are distinctively different – in terms of risk, return, liquidity and maturity - to the loans and deposits offered by the banks. As such, the BSE extends the range of choice available to savers and borrowers, and hence has the potential to improve the efficiency of the financial sector by enabling a closer matching of the preferences of savers and investors.

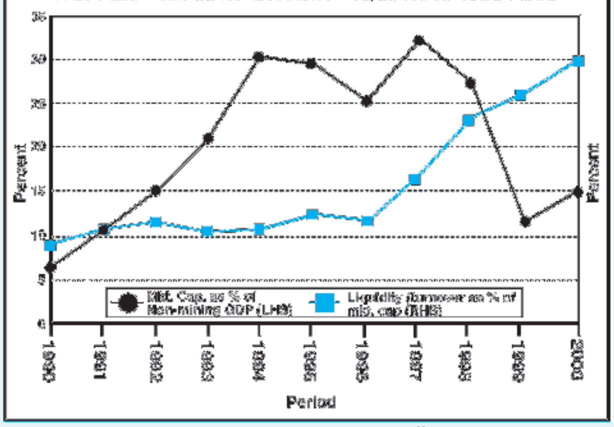
6.15 The BSE has grown rapidly since its establishment in June 1989. Between that time and the end of 2000, the number of listed domestic companies rose from 5 to 16, the domestic companies index rose from 100 to 1 454, and market capitalisation rose from P120 million to P5 245 million. Six corporate papers were also issued. The amount of money raised through share and bond issues was, however, relatively small compared to the amounts raised directly from financial intermediaries such as banks and NBFIs.

6.16 While the BSE has grown rapidly in size, it has not been particularly liquid. Liquidity, measured by the Turnover Ratio (the total value of stocks traded during a year relative to average market capitalisation), has varied between two and eleven percent since 1990 (Chart 3.4). This is around the average for stock markets in Africa, but is low by the standards of more developed markets. The liquidity of the market depends on both transaction costs and investor willingness to dispose of securities frequently; these factors influence both the availability of shares and the attractiveness of investing in shares of listed companies vis-à-vis alternative investment opportunities. Most shares on the BSE are held either by controlling interests or by local institutional investors, which contributes to low liquidity; controlling interests are unwilling to sell for obvious reasons, while institutional investors tend to "buy and hold" rather than have an active trading strategy because positions, once liquidated, can be difficult to re-establish. To this extent, low liquidity reflects a lack of alternative investment opportunities. Low liquidity may retard the deepening of the stock market and reduce its contribution to economic growth; experience elsewhere

[9] Institutional investors are required to hold at least 30 percent of their portfolios as domestic assets; the remaining 70 percent can be invested offshore. The main domestic assets held are listed equities and bonds, Bank of Botswana Certificates, and commercial property.

suggests that stock market liquidity is positively and significantly correlated with capital accumulation, improvements in productivity and economic growth.

CHART 3.4:
BSE CAPITALISATION AND LIQUIDITY: 1990-2000



Sources: Botswana Stock Exchange and Central Statistics Office

6.17 Public offerings of shares and bonds have exposed the extent of the demand for savings instruments, as all share issues and most bond issues have been oversubscribed. Although shares are held directly by a relatively small group of savers, and the BSE is relatively illiquid there is a reasonable degree of public confidence in the stock market. The listing and information disclosure requirements of the BSE (see Box 3.5) may have helped bridge informational gaps between the public/ institutional investors on the one hand and listed companies on the other and, therefore, encouraged saving in the form of share ownership. Similarly, the favourable treatment of capital gains on disposal of shares of listed companies and the absence of double taxation of dividends (see Box 3.6)

Box 3.5: Selected Listing Requirements of the Botswana Stock Exchange (BSE)

Capital: The subscribed capital should not be less than P1 million and the issued equity shares at least one million, if primary or main board listing is sought. The minimum subscribed capital required for listing on the venture capital market (VCM) is P0.5 million. The required minimum equity issued is the same as that for the main board.

Public Shareholders: The minimum number of public shareholders of listed securities is 300 for equity, 25 for preference shares and 10 for debentures. In the case of the VCM, the shareholder spread is at least 75 members of the public for equity shares, 25 for preference shares and 10 for debentures.

Proportion of Public Holding of Securities: The public holding of each class of equity shares is at least 20 percent, unless agreed with the Botswana Stock Exchange Committee. This contrasts with 30 percent public shareholding required in some stock exchanges elsewhere. For the VCM, the minimum is 5 percent of each class of equity share.

Profit History: A company proposing to list on the main board should provide a satisfactory profit history for the past three financial years, including an audited pre-tax profit of at least P1 million in the most recent year. A profit history is not necessary for listing on the VCM, however, the applicant should, in its analysis of future earnings, indicate credible returns on capital which, on a time-weighted basis, are above average.

Auditing and Accounting Standards: Five years of consolidated accounts (of which three are audited), complying with International Accounting Standards (IAS), should be provided by applicants to the main board listing.

Future Earnings: The company proposing to list should also provide forecast earnings, dividends and proforma net asset statement.

Sponsoring Broker: Applications for both the main board and VCM listing must include the name of a sponsoring broker.

Achievement History of Managers and Directors: Applicants proposing to list on the VCM must show that the majority of directors and managers of the applying entity have successful records of achievement in their respective roles. The applicant must also warn potential shareholders in its pre-listing statement or prospectus of the speculative nature of investment in such a company.

Listing requirements for Special Types of Issuers: There are other additional listing requirements relating to special types of issuer and investment entities, such as, in the case of the former, pyramid companies, warrants and bonds, and in the case of the latter, investment companies, investment trusts and unit trusts. The definitions and relevant listing requirements for special issuers are too elaborate for inclusion here. For further details see the BSE Listing Requirements.

Box 3.6: Selected Tax Legislation Applicable to the Financial Sector

- **Corporate Taxation:** Corporate entities are charged company income tax of 25 percent. However, approved IFSC companies are liable for lower company tax of 15 percent. Specified CIUs, BoB, BBS and the BSE, are exempt from corporate income tax.
- **Withholding Taxes:** Resident private companies pay withholding taxes of 15 percent on dividends distributed to residents and non-residents and on interest paid to non-resident companies. Withholding taxes can be deducted from or set off against company tax. Secondly, dividends are taxable only at the company level and not in the hands of the shareholder, so there is no double taxation of dividends. Approved IFSC companies and specified CIUs are exempt from withholding taxes on dividends and interest and public companies quoted on the BSE are exempt from withholding taxes on dividends.
- **Capital Gains Tax on Companies listed on the BSE:** There is no capital gains tax on the disposal or sale of shares of public companies quoted on the BSE.
- **Capital Gains Tax on Private Companies:** Capital gains tax is paid on sale of assets, shares and debentures of a private business. In the case of shares and debentures, only 50 percent of the gains are taxable. Capital losses cannot be offset against other income nor can losses elsewhere be offset against capital gains.
- **Interest on Bank and Building Society Deposits:** Interest of up to P2 500 accruing to individuals from banks and BBS is exempt from tax. Furthermore, interest payable by BSB, interest on NDB bonds and interest on subscription share issued by BBS are exempt from tax.
- **Pension and Provident Funds:** Pension Funds money contributed to any approved pension fund or retirement annuity scheme is deductible for tax purposes. Unapproved Pension and Provident Funds are liable for a 7.5 percent tax on their investment income (interest and net aggregate gains on disposal of property).
- **The NDB, BDC and Life Insurance Companies:** They are fully liable for the normal company income tax of 25 percent and are not exempt from withholding taxes.

may have encouraged share ownership.

7. The Financial Sector and Allocation of Financial Resources

7.1 This section reviews the record of financial institutions in allocating credit to the real sector through a variety of instruments during the past decade. The distribution of lending for the most part is determined by the legislative base of the various institutions, their sources of funds, the nature of demand for credit and credit risk assessment. The institutions covered are commercial banks, NBFIs and the Government's PDSF.

(i) Lending by Financial Institutions

7.2 In 2000, total outstanding loans and advances by banks, NBFIs and Government through the PDSF totalled P8 122 million, compared to P310 million in 1982 and P1 844 million in 1990 (see Table 3.6). Growth in lending has been rapid, averaging 20 percent a year in nominal terms during 1982 – 2000.

7.3 For many years, Government was the largest credit provider in the economy, through the

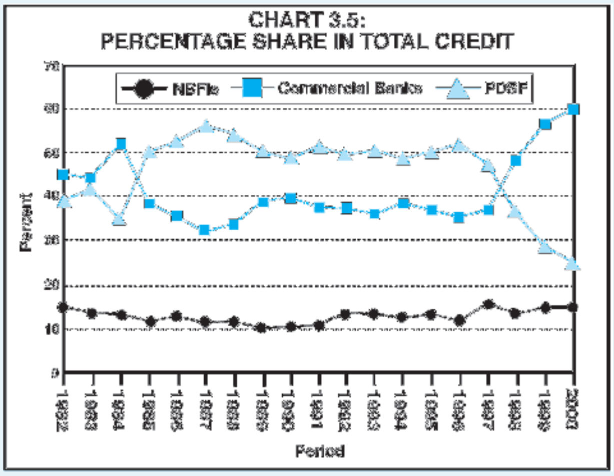
Table 3.6: Growth Rates and Levels of Lending by all Financial Institutions

	Growth of Institutional Lending				Levels of Institutional Lending			
	Pre-reform Period 1982 - 1989	Reform Period 1990 - 00	Overall 1982 - 00	2000	1982	1989	1990	2000
Total Financial Sector Lending	21.4	18.8	19.9	10.9	309.8	1 334.7	1 843.5	8 122.3
Commercial Banks	19.0	23.9	21.8	17.7	142.4	529.5	754.7	4 932.7
NBFIs	20.4	24.0	22.5	10.5	44.1	123.3	174.1	1 106.1
PDSF	27.6	12.3	18.8	-2.2	123.3	681.9	914.6	2 083.5

Source: Own calculations using data from various Bank of Botswana Annual Reports and Botswana Financial Statistics

PDSF, in some years accounting for half the finance provided by financial intermediaries. However, its share in investment funding has fallen over time. Whereas in 1990, Government lending through the PDSF amounted to 50 percent of total lending, by the end of 2000 its share was only 26 percent.

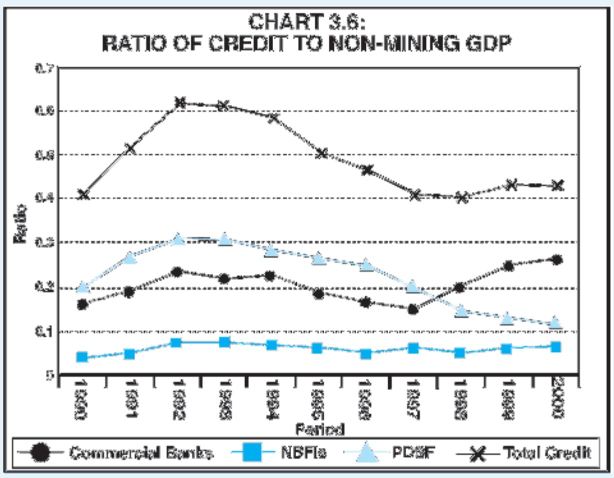
7.4 As a result of the reduced involvement of Government in investment financing, commercial banks are now the largest lenders in the economy, having overtaken the PDSF in relative importance in 1998 (see Chart 3.5). By 2000, the banks accounted for 61 percent of credit compared to 41 percent in



Sources: Central Statistics Office, commercial banks and non-bank financial institutions

1990 and 46 percent in 1982.

7.5 The growth trends of lending by NBFIs were similar to those of commercial banks. This is reflected in movements in the ratio of lending



Sources: Central Statistics Office, commercial banks and non-bank financial institutions

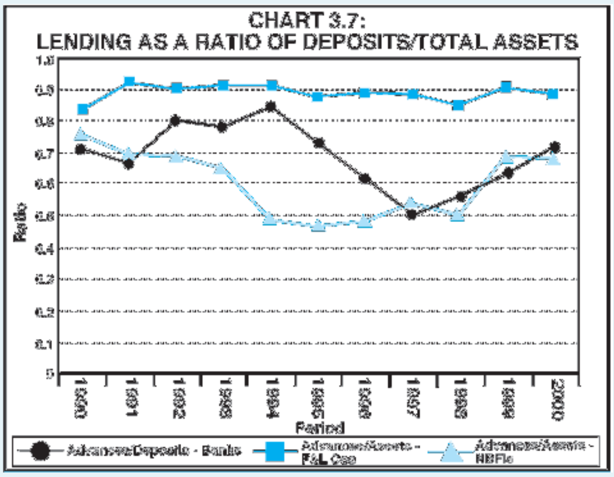
to non-mining GDP, shown in Chart 3.6.

There was a decline in the growth of lending up to the mid-1990s, followed by an acceleration, particularly for the BDC and the NDB, while the mortgage lending of the BBS rose more slowly. The dip in the mid-1990s in lending growth rates for the BDC and NDB reflected the restructuring and/or divestiture processes in these institutions.

(ii) Efficacy of Financial Intermediation

7.6 Measures of the degree to which the financial sector is effective in channelling financial resources to borrowers include a number of lending ratios. For commercial banks, the ratio of advances to deposit liabilities is generally utilised for this purpose; it measures the extent to which mobilised deposits are deployed. For developmental financial institutions, which mostly rely on borrowed or grant funds the appropriate measure of intermediation is the ratio of lending to total assets.

7.7 For commercial banks, the ratio of advances to deposits rose from 0.71 in 1990 to 0.83 percent in 1994 but fell sharply thereafter (Chart 3.7) to 50 percent in 1997. This development reflected a slowdown in bank lending while deposits continued to rise, and resulted in a considerable proportion (41 percent) of total assets being invested in BoBCs. From 1998, however, the advances to deposits ratio rose progressively, and by



Sources: Commercial banks, hire purchase finance and leasing and non-bank financial institutions

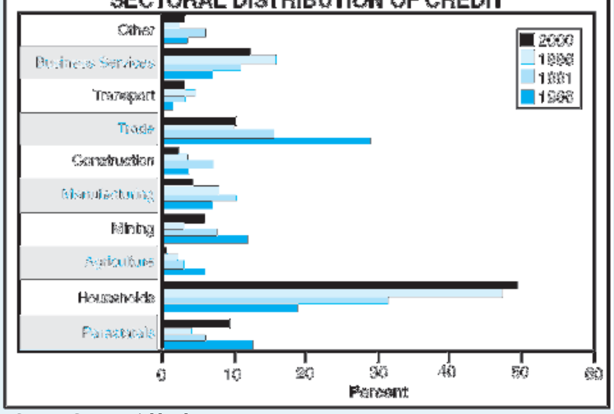
the end of 2000 it was 71 percent.

7.8 As noted above, and is apparent from Chart 3.7, the trend in lending relative to total assets for NBFIs is almost similar to that for the commercial banks. Among the NBFIs, the BBS recorded a higher ratio of lending to total assets, averaging 73 percent between 1991 and 2000, reflecting the buoyancy of the real estate and construction sector. For the NDB, the ratio averaged only 56 percent of total assets over the same period, mainly due to a major restructuring of the institution during the early 1990s. Following the completion of the restructuring, the ratio rose from 32 percent in 1995 to 82 percent in 2000.

7.9 Besides other factors, the average ratio of lending to total assets of BDC has been influenced by the fact that a part of its assets is held as equity in other companies. Even so, BDC had the largest share of NBFI lending during the past four years, while the lending to asset ratio of BSB was much lower than that of the other NBFIs, with a substantial holding of BoBCs in its asset portfolio.

7.10 The distribution of commercial bank lending to the various sectors is influenced by a combination of demand and credit risk assessment. In 1986 and 1991, the retail and wholesale trade sector dominated credit to businesses but has been overtaken in subsequent periods (1996 and 2000) by the business services sector and the parastatals

CHART 3.8:
COMMERCIAL BANKS:
SECTORAL DISTRIBUTION OF CREDIT



Source: Commercial banks

(Chart 3.8).
The rising share of the business services sector may in part, be indicative of the diversification process, while that of parastatals is a result of the phasing out of PDSF lending. Another development has been a decline in the share of lending to agriculture, mining and construction, as well as a sharp increase in credit allocation to households[10]. Although manufacturing has been promoted as a major vehicle for economic diversification, the share of total credit to the manufacturing sector has remained small, and has generally been declining during the 1990s.

7.11 Among the NBFIs, the asset portfolios of the leasing companies in 2000 had 48 percent lending to the trade and business sectors, while the NDB has over the years, shifted its portfolio composition from lending predominantly to the agricultural sector (61 percent in 1991 compared to 18 percent in 2000), with a corresponding increase in the share of the trade sector from 13 percent in 1991 to 36 percent in 2000, and an increase in real estate investment to 35 percent in 2000. NDB's lending to the manufacturing sector has been of a similar magnitude to that of the banks, increasing from 6 percent in 1991 to 8 percent in 2000.

(iii) Loan Maturities

7.12 Generally, commercial banks' lending is dominated by overdrafts and short-term loans, with a large proportion being accounted for by loans of a maturity of up to three years. Within short-term lending, however, the proportion of overdrafts has declined during the 1990s. More generally, the average duration of commercial bank lending has been increasing between 1990 and 2000 (Chart 3.9), although the trend was reversed in 1998 and 2000. The increase in lending duration is associated with a rising proportion of lending accounted for by loans of over three years maturity, from 19 percent in 1990 to 30 percent in 2000. Nevertheless, the banks continued to predominantly finance short-term cash flow requirements and payments needs rather than longer term investments. In contrast, and as expected

[10] However, as noted in the Bank of Botswana Annual Report 2000 there is a possibility of some of what is classified as household borrowing being used in household operated businesses. The dominance of household borrowing, therefore, does not necessarily reflect consumption borrowing.

given their mandate and sources of funds,

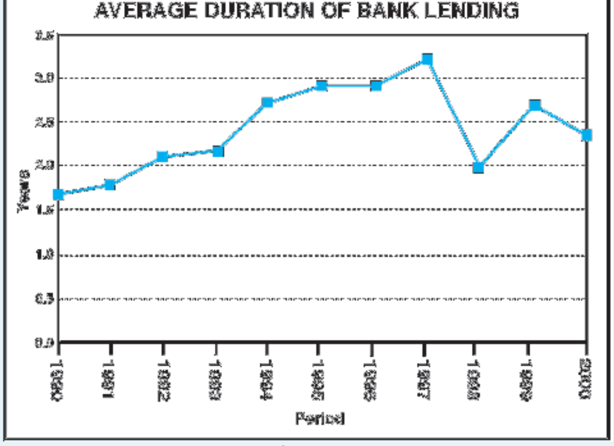


CHART 3.9: AVERAGE DURATION OF BANK LENDING

Source: Own calculations based on data from Commercial banks

lending by NBFIs has mostly been long term.

(iv) *Interest Rate Margins*

7.13 Net interest income, the difference between interest earned on assets and interest paid on liabilities, is one of the main sources of income for financial institutions. It depends mainly on the interest rate margin or spread, the difference between lending and deposit rates, which in turn reflects a number of characteristics of the intermediation process, including the degree of competition and efficiency, the riskiness of lending, and the structure of loans and deposits. In particular, spreads will tend to be high when the degree of competition is low, leading to low deposit rates relative to lending rates. Spreads will also rise along with the riskiness of lending and the level of bad debts, as the higher the level of arrears and defaults, the more income has to be earned to pay for these. Furthermore, deposit rates will be lower, the higher the proportion of interest-bearing deposits in total deposits, and lending rates will depend on the average size of loans, amongst other things.

7.14 The trend in interest rate margins has generally been upwards during the 1990s for most financial institutions, except for leasing companies (Chart 3.10). This has, perhaps surprisingly, occurred at a time when financial sector policy has focused on fostering competitiveness and when, according to various measures, the degree of competition has increased, which would have been expected to reduce interest margins[11]. However, other explanatory factors are important in explaining the trend in spreads. In particular, the interest margin for banks rose sharply in the mid-1990s, which was a time when the level of arrears on advances also increased significantly. There were also changes in the structure of deposits over this period, with a sharp decline in the proportion of bank deposits accounted for by (non-interest bearing) current accounts, and in the structure of advances, with a rising proportion of (relatively small) loans to households. Further work is needed to disentangle the various influences on interest rate spreads, and to establish their relationship with the

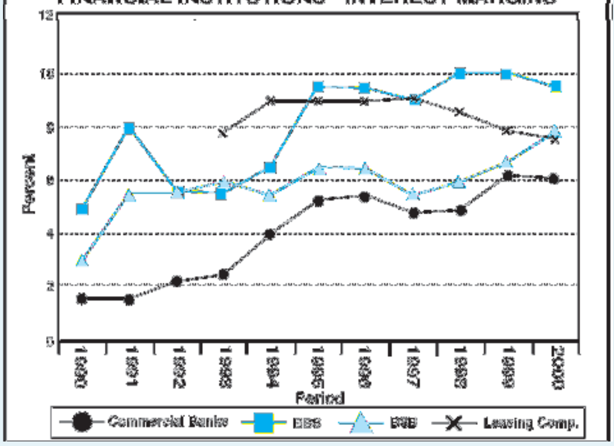


CHART 3.10: FINANCIAL INSTITUTIONS - INTEREST MARGINS

Sources: Commercial banks, non-bank financial institutions and hire purchase finance and leasing companies

efficiency of financial intermediation.

8. The Role of Government in Saving and Investment Financing

8.1 This Section examines the Government's saving and investment financing record. The coverage includes the determinants of Government savings, the contribution by Government to financial sector savings and investment financing, and the effect Government's role has had on the behaviour of private financial institutions.

8.2 Government affects overall saving directly through the accumulation of budgetary surpluses and indirectly through its various policies, especially with respect to personal income and corporate tax policies and other

[11] See *Annual Report 2000*, chapter 5 for more detail

incentives.

(i) Government Saving and Investment

8.3 During 1990-2000, Government spent, on average, 90 percent of its revenues, resulting in sizeable budget surpluses. As a result of these surpluses, Government has accumulated substantial deposits at the Bank of Botswana, amounting to P24 847 million at the end of 2000, an average increase of 24 percent a year since 1990. These deposits are approximately three times the size of the deposit base of the commercial banks.

8.4 Government is a major saver not only in absolute terms, but also in relative terms. In the year to June 1990, Government accounted for over half of gross domestic savings, although by June 1995[12] its share had fallen to just below 30 percent. Government's share in gross domestic investment followed an opposite trend, rising from 29 percent in 1989/1990 to 48 percent in 1994/1995.

8.5 Government's savings performance mostly depends on the revenues of the mining sector, which in the fiscal year 1999/2000 contributed well over half of total Government revenue. The risks of over-dependence on mineral revenues have been recognised and, therefore, initiatives have been taken to progressively broaden the indirect tax base, including the introduction of value added tax in July 2002. However, as the economy diversifies and the share of mining in total GDP is reduced, it is likely that Government revenues and savings will decline. This is because the rates of tax applicable to non-mining activities are likely to be significantly lower than those applicable to the highly profitable mining sector.

8.6 The large Government contribution to both saving and investment has had both positive and negative influences on the financial sector. The positive effect relates to the fact that some of the resources at the disposal of Government have been channelled directly into private sector investment, posing a challenge to financial institutions to compete. Government has also directly financed physical and social infrastructure, which promotes income growth and, therefore, further saving. Moreover, by self-financing its own investment programme, Government has not crowded out the financial resource requirements of the private sector.

8.7 However, there are also potential negative aspects to the role of Government in using its large surplus funds to provide subsidised finance to parastatals and private companies, whether as loans or grants. The availability of subsidised finance will have diverted some funding away from private financial institutions and, therefore, held back the development and growth of these institutions. Furthermore, governments are generally not well placed to evaluate the risk and/or viability of commercial projects, and this may be reflected in poor project selection and low returns on investments. Private financial institutions tend to be more efficient in intermediating finance for investment. Therefore, the net benefit of using its own resources to subsidise its lending vis-à-vis the gains to the economy from market-related commercial bank project financing are not clear-cut. The poor performance of some NBFIs and some Government investment financing programmes in Botswana may be reflective of the limitations of a direct role for Government in financing business investment. Quite apart from this, it is possible that little net new productive investment was created, that is, over and above that which would have been created anyway through financing by private financial institutions in the absence of Government funding.

(ii) Government Financing of Private and Parastatal Sector Investment

8.8 Government has, over the years, implemented a variety of schemes aimed at providing finance for investment by private and parastatal sector enterprises. These schemes have had a number of objectives, including the achievement of economic diversification, supporting the economic empowerment of citizens, and filling a perceived gap in the

[12] The latest year for which full national accounts data are available.

financial sector in the financing of long gestation and high risk but economically justifiable projects.

8.9 The largest Government financing scheme has been the PDSF, which has been a major source of financing for parastatals, and to a lesser extent, local authorities. However, outstanding loans under the scheme have declined in recent years both as a result of very little new lending (P0.6 million in 2000) and steady loan repayments. The sharp reduction in lending reflects Government's policy of shifting parastatal funding towards commercial sources of finance. Loan repayments have been accelerated by new Government equity injections into both financial and non-financial parastatals as part of the restructuring process. Reducing the role of the PDSF is consistent with plans to privatise a number of parastatal enterprises, including some NBFIs.

8.10 There remains, however, a significant amount of outstanding PDSF loans that will mature over the long-term. Meanwhile, Government is exploring the option of securitisation of the outstanding loans with the expectation that the PDSF should revert to its original function of supporting the servicing of the public debt. Securitisation is expected to have a beneficial effect on the development of the domestic capital market and could attract foreign capital inflows.

8.11 There have been two other important Government schemes for the provision of finance to private sector enterprises. The first is the Financial Assistance Policy (FAP), established in 1982, which provided grants to approved new or expanding enterprises. The second is the Small, Medium and Micro Enterprises (SMMEs) scheme, established in 1999, which provided subsidised loans to approved borrowers. Although FAP is considered to have been reasonably successful in promoting enterprise growth in its early years, especially in the manufacturing sector, by the late 1990s it had grown substantially (costing well over P100 million a year) and had become less cost-effective. Due to diminishing cost-effectiveness, in part a result of increasing abuse of the scheme, FAP has been wound up with effect from mid-2001. There have also been concerns about the effectiveness of the SMME loan scheme, given the rapid draw-down of its initial capital and substantial arrears. Both FAP and SMME have been replaced with a new agency, the Citizen Entrepreneurial Development Agency (CEDA), which provides subsidised loans to commercially viable enterprises, and is also intended to run a venture capital scheme.

8.12 The test of CEDA's success will be in the extent to which productive investment is created and sustained, and this will, in turn, depend on the ability of the implementing agencies to evaluate risks and projects; the ability of potential entrepreneurs to meet the minimum equity contribution required to access funds; and the degree to which the associated skill training and project monitoring will impact on the viability of CEDA-funded projects.

9. Summary and Conclusions

9.1 An examination of the trends in the financial sector has shown that savings and lending grew at high rates between 1980 and 2000. While their growth was somewhat higher in the earlier part of the period than in the latter, both were broadly supported by rapid economic growth and financial sector liberalisation.

9.2 There has been considerable structural change in the financial sector over this period with respect to both the accumulation of savings and financing of investment. An important development in respect of savings has been the increasingly important role of households as savers. While Government remains the largest saver in the economy, household savings have grown rapidly, becoming in recent years the main contributor to the growth in the deposit base of the banking system and providing the basis for the dramatic rise of contractual savings institutions. The latter phenomenon is a particular characteristic of the 1990s; the contractual savings institutions were virtually non-existent in the 1980s, but by the end of the 1990s they commanded access to resources larger than those of the NBFI sector. This reflects both their own growth and the relative decline in the financial resources available to NBFIs.

9.3 There have been changes as well in financial intermediation during this period. Importantly, the Government's role as an intermediary in the allocation of finance for investment (through the PDSF) is much reduced. Its indirect role (through financial parastatals) remains important, but these institutions have been subject to considerable reform during the 1990s, which has led them to operate on more market-based principles. The overall impact of these changes has been to reduce the role for non-market based allocation of funds in the financial sector, market-led financial intermediaries playing a progressively more important role in the allocation of finance for investment. The position of banks has in particular strengthened during the 1990s, accounting now for a significantly larger share of total lending. Although they remain a source of predominantly shorter-term funds, the maturity of their lending has gradually increased. More generally, the range of financial institutions, broadly defined, has increased significantly; the number of banks has doubled, there is more specialisation, and new businesses such as brokers and asset managers have emerged.

9.4 Although there has been a considerable shift towards the allocation of finance by financial institutions operating along commercial lines, it is nonetheless the case that the allocation of finance for investment is still dominated by bank-like financial intermediaries, with other elements of capital markets relatively undeveloped. Stock and bond markets remain small and illiquid, with relatively few new issues. Hence investment funds are generally being made available in the form of loans, with relatively short maturities. In that sense the financial sector remains underdeveloped.

9.5 As welcome as these developments in savings and intermediation are, a financial system dominated by bank-like financial intermediaries is less likely to develop financial instruments that will cater for the new forms of savings. For example, the risk-return preferences of contractual savers require access to equities and longer-term bonds, rather than bank deposits. Without access to a good broad range of instruments on the domestic capital markets, savings are likely to continue to flow offshore, and, to the extent that they are required to remain onshore, increase the danger of asset market bubbles (particularly for shares and property) as growing funds chase a limited supply of assets. Such a structure is not conducive to the efficient intermediation of contractual savings funds to long-term investment financing.

9.6 There are good prospects that the coincidence of needs between savers and borrowers will stimulate the emergence of such capital market instruments. For instance, companies (including parastatals in line for privatisation) should find it increasingly attractive to consider listing on the BSE or issue longer term debt in the knowledge that pension funds are actively seeking such domestic investments. The announcement in the 2002 Budget that the Government is to considering a bond issue is potentially an important step in the development of the capital market in Botswana. In many countries, Government bond issues provide a risk-free benchmark against which private sector issues could be priced, and in so doing have contributed to stimulating domestic bond market activity. More generally, it will be important, going forward, to foster the development of a fully-fledged financial sector by promoting the emergence of more active capital markets that can deliver longer maturity funds in general, and equity (risk) capital in particular.

9.7 A larger role for capital markets in the financial sector and a wider range of savings and borrowing instruments raises a variety of policy issues for the Bank and Government, most notably with regard to regulation and supervision. As was noted in a previous *Annual Report*, it is important that developments in the institutional arrangements for prudential regulation and supervision of the financial sector in Botswana keep pace with growth and change in the financial sector. While this has generally been done in recent years in the case of financial intermediaries, the growth in importance of capital markets will require a further strengthening of the regulatory and supervisory framework. And as before, there is a need to ensure that regulatory and supervisory change does not undermine market discipline and stifle financial innovation while seeking to achieve an orderly, sound and stable financial system.

CHAPTER 4

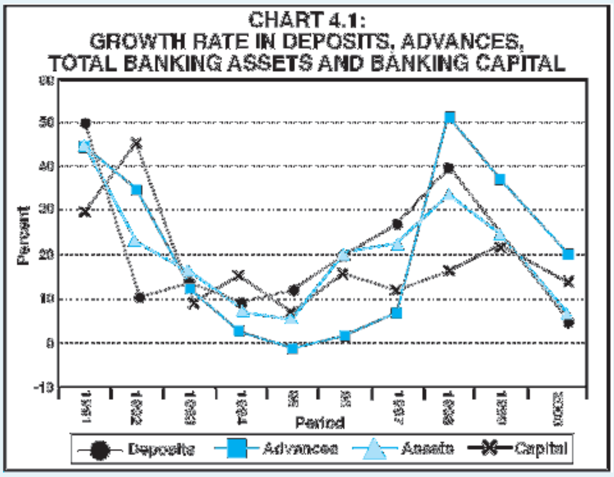
BANK PERFORMANCE, MODERNISATION AND QUALITY OF BANKING SERVICES

1. Introduction

1.1 In most countries banks have a unique combination of roles; they are creators of money, principal depositories of public financial savings, primary allocators of credit, and managers of the country's payment system. Because of this, weaknesses in the banking sector[1] can threaten financial stability and hence undermine public confidence. In fulfilling these roles, banks need to operate in a safe, prudent and sound manner in order to ensure public confidence.

1.2 This Chapter reviews the performance of Botswana's banks during the last decade in order to ascertain how well they have performed these roles, their profitability and their "soundness". In particular, the Chapter highlights the trends in the banking sector's efficiency and solvency. Also reported are the results of the surveys on the quality of banking services conducted in 1997 and 2001.

1.3 The activities of banks have expanded rapidly during the past decade. Chart 4.1 shows the growth rates for total banking assets, capital, deposits and advances. As indicated in the chart, growth rates were low in the middle of the decade but rose through to 1998 before slowing down in 2000. A number of factors explain this trend. There was a substantial growth in credit from the late 1980s to the early 1990s, leading to concerns that the rate of expansion was unsustainable. By the mid-1990s, however, the rate of increase in credit was severely curtailed through interest rate increases, a slowdown in economic growth and a rise in arrears and bad debts.



Source: Commercial banks

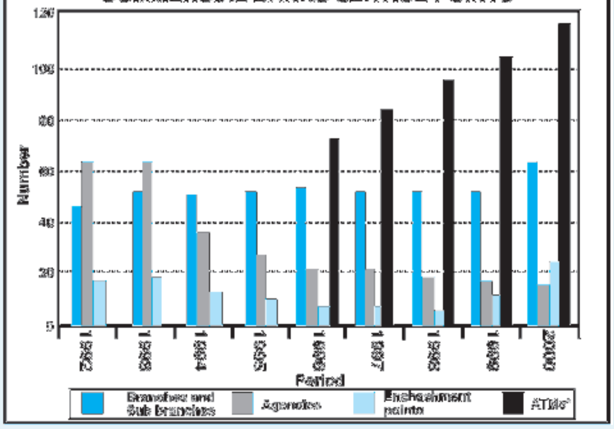
1.4 Private sector credit surged again in 1998, following large public sector salary increases in July of that year, rapid growth of Government spending and a reduction in lending rates. In an effort to contain inflation, the Bank Rate was increased twice in 1999 and twice in 2000, following which there was progressive deceleration in the rate of credit growth.

1.5 There has also been considerable expansion in the range of banking outlets during the 1990s. Chart 4.2 gives the composition of commercial bank business points (branches, agencies, encashment points and automatic teller machines (ATMs)) over the years. As at December 2000, the four commercial banks had between them, 59 branches and sub-branches, 17 agencies, 6 encashment points and 112 ATMs countrywide. The introduction of ATMs in the early 1990s has had a major and beneficial impact on the provision of bank services, mainly by enabling an increase in the number of business points and an extension of their hours of availability. However, the number

[1] In this chapter, the term banking sector refers to all institutions licensed and supervised by the Bank of Botswana, including commercial banks and investment/merchant banks, unless otherwise stated.

of agencies has declined either because of closure or upgrading to full branches. The banking services provided by encashment points and agencies, such as making deposits, cash withdrawals, checking account balances and other services can be provided much more cheaply and efficiently by ATMs.

CHART 4.2:
COMMERCIAL BANKS SERVICE POINTS



*** Data on the number of ATMs is not available prior to 1996**
Source: Commercial banks

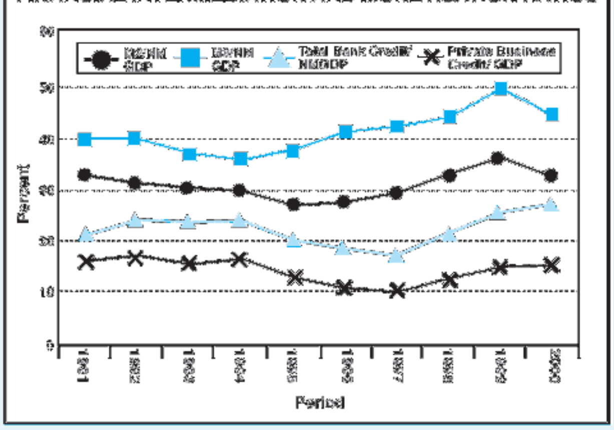
1.6 Of the 59 branches and sub-branches, 43 were in urban areas with the remainder in major villages and rural areas, indicating a concentration in urban areas. While this partly reflects the changing population distribution and increasing urbanisation[2], there are concerns that substantial segments of the population do not enjoy effective access to banking services. Providing such access in a cost-effective manner will be one of the main tasks facing the banks in the future.

1.7 Data on the number of accounts held at commercial banks indicates that there has been an improvement in the proportion of the population served by the banking system. In 1990, the banks held a total of 235 100 accounts, representing 320 accounts for every 1 000 adults in the country. By 2000, the number of accounts had nearly doubled to 400 475, representing 430 accounts for every 1 000 adults.

(i) Growth of Banking Sector Activities

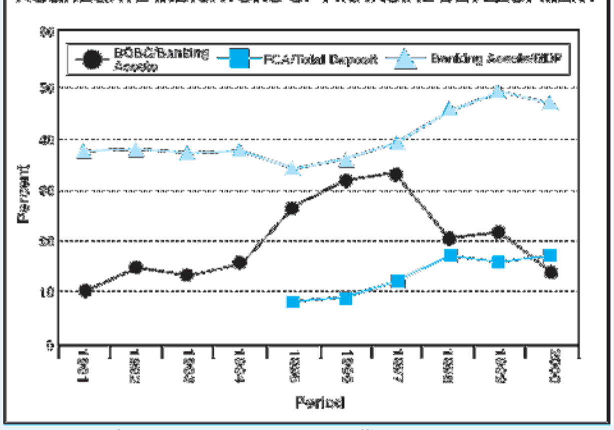
1.8 Trends in banking sector activities are assessed by intermediation ratios, finance ratios and monetary ratios. Charts 4.3 and 4.4 show the components of these ratios as percentages of non-mineral GDP[3] (NMGDP). In the early stages of economic development, these ratios are expected to rise as an increasing proportion of resources flow through the banks and the financial sector expands and deepens.

CHART 4.3:
FINANCIAL INTERMEDIATION AND MONETISATION RATIOS



Sources: Bank of Botswana and Central Statistics Office

CHART 4.4:
AGGREGATE INDICATORS OF FINANCIAL DEVELOPMENT



Sources: Bank of Botswana and Central Statistics Office

1.9 *Broad money (M2)/Non-mining GDP*: The ratio of money supply (M2[4]) to non-mining GDP provides a simple measure of the size

2 Preliminary results of the 2001 Population Census indicate that over half of the population reside in areas classified as urban, peri-urban or urban village.

3 Non-mining GDP is used to avoid the distortions brought about by the fluctuations and dominance of the mining sector in the Botswana economy.

4 M2 = M1 (currency outside banks plus demand deposits) plus call, savings, notice and time deposits.

of the financial sector in relation to the economy (financial depth). The ratio declined in the first half of the 1990s, but rose steadily between 1995 and 1999 before falling back in 2000. The fact that the ratio has not increased significantly over the decade suggests limited development and deepening of the financial sector in Botswana over this period. However, the broader measure of money, M3[5], as a proportion of GDP does show a trend increase during this period, providing a more positive picture of financial deepening that is consistent with the data on financial sector development presented in chapter 2.

1.10 *Private Sector Business Credit/Non-Mineral GDP*: The ratio measures the extent to which commercial banks allocate credit to the private business sector. The ratio of private sector credit to GDP was 13.2 percent in 1991. After a downward trend from 1995 to 1997, the ratio has been rising for the past three years, a reflection of increased financial intermediation and more bankable projects during the latter part of the period under review.

1.11 *BoBCs/Assets*: The introduction of Bank of Botswana Certificates (BoBCs) in 1991 was another important development in the financial sector (Chart 4.4). The certificates were introduced to absorb excess liquidity that had characterised the Botswana banking sector since the 1980s. Since BoBCs are an alternative to lending by banks, the ratio of BoBCs to total banking assets moved in the opposite direction to credit, increasing from 43 percent in 1992 to a peak of 78 percent in 1996. Since then, it has been declining and was 46 percent in 2000 (Appendix 4A Table 4A.1). The downward trend in the share of BoBCs in the banks' asset portfolio was partly a result of a progressive reduction in Government lending to parastatals through the PDSF, enabling banks to increase

Table 4.1: Selected Key Performance Ratios for Banks

RATIOS	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	AVERAGE
1. Solvency											
1.1 Core Capital to Total Capital Ratio			90.2	92.1	92.7	94.3	95.3	93.8	94.8	94.4	93.5
1.2 Capital Adequacy Ratio*						19.8	19.1	16.0	17.2	27.1	19.9
2. Liquidity											
2.1 Liquid Assets to Total Assets	33.5	29.7	30.3	26.0	35.3	39.1	41.0	29.5	27.5	21.5	31.3
2.2 Liquid Assets to Deposits	40.7	38.7	39.6	35.5	45.2	50.6	51.0	35.3	33.2	26.6	39.6
2.3 Advances to Deposits	65.6	79.9	77.8	80.5	70.2	58.7	47.9	53.9	60.3	70.5	60.0
3. Profitability											
3.1 Return on Equity			17.7	28.2	16.5	33.6	36.9	43.1	46.4	37.7	32.5
3.2 Return on Average Assets			1.7	2.2	1.7	3.1	3.3	3.3	3.4	3.9	2.8
3.3 Interest on BoBCs to Income						21.4	26.3	20.7	15.2	12.9	19.3
3.4 Interest to Income							78.4	77.2	79.6	79.3	78.6
3.5 Interest Income to Average Total Assets					12.3	12.3	11.6	10.5	12.4	9.2	9.4
4. Asset Quality											
4.1 Bad Debts Provisions to Advances					2.9	3.0	3.3	3.3	3.2	1.7	2.9
4.2 Past Due Advances (NPL) to Total Advances					2.6	4.6	4.6	2.4	3.9	1.7	3.3
4.3 NPL less Provisions to Unimpaired Capital					7.1	14.2	13.2	8.0	10.3	4.7	9.6
4.4 Unimpaired Capital to Total Advances					23.2	26.6	30.9	25.1	20.7	8.8	22.6
5. Efficiency of Operations											
5.1 Cost to Income			72.9	67.1	66.8	56.3	48.8	45.2	43.9	35.2	54.5
5.2 Staff Cost per Employee (P' 000)						48.7	50.6	53.9	66.8	79.1	59.8
5.3 Assets per Employee (P million)						1.7	2.2	2.9	3.7	3.8	2.9
5.4 Non-Interest Expense to Average Total Assets			6.4	5.9	6.0	5.3	4.3	3.6	4.0	3.0	4.8
5.5 Average Cost of Deposits			9.1	8.2	8.0	7.8	6.8	6.2	8.1	6.6	7.6

* The Bank adopted the risk-based capital criteria late 1995 but implemented it in 1996

Source: Commercial Banks

[5] M3 = M2 plus non-bank holdings of BoBCs.

lending to parastatals such as the Water Utilities Corporation and Botswana Telecommunications Corporation, as well as increased lending to households.

2. Banks' Performance: Financial Ratios

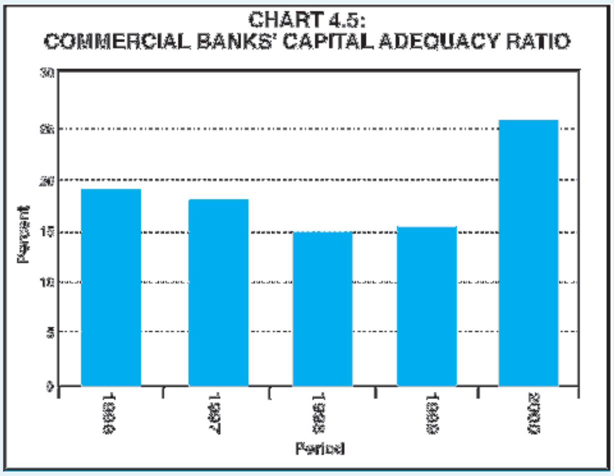
2.1 This section provides a financial interpretation of Botswana's banking sector's solvency, liquidity, asset quality, profitability and operating efficiency ratios. Although prudential standards and requirements may differ between countries, the use of financial ratios provides useful early indications of systemic problems. Table 4.1 summarises some of the key performance ratios. The aggregation of the data (using simple averages) for the banking sector may mask performance of some individual institutions as measured by some criteria.

(i) Solvency

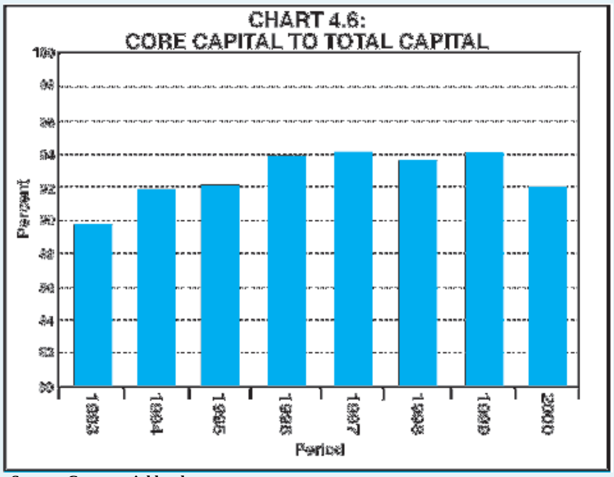
2.2 The key measure of solvency of a bank is the level and quality of its capital, since the capital is the resource base available for absorbing losses that a bank may incur. It is, therefore, important that the capital adequacy of banks is assessed on a regular basis.

2.3 Up to 1995, the capital adequacy ratio, measured as the ratio of total capital funds to total assets, was 6 percent, as provided for in the Financial Institutions Act, 1986. However, this measurement of adequacy does not take into account the riskiness inherent in assets. In order to allow for this, the Banking Act, 1995 incorporated the internationally recommended framework for capital adequacy measurements and standards for banks, commonly known as the Basel Committee's Capital Accord. According to this framework, capital adequacy is measured by the ratio of unimpaired capital[6] to risk-weighted assets[7]. As a result of the adoption of this approach, the banks have become sensitive to the risk profiles of their individual categories of assets. The statutory capital adequacy ratio requirement was set at a minimum of 8 percent for the unimpaired capital to risk-weighted assets ratio. In 1998, the banks were obligated to maintain a ratio at or above 15 percent, which was considered a more prudent level for banking in the Botswana context.

2.4 Over the years, the banking sector has been solvent as measured by the ratio of unimpaired capital to risk weighted assets. The quality of capital held is measured by the core capital[8] to total capital ratio (Charts 4.5 and 4.6). All the banks have been adequately capitalised with capital and reserves



Source: Commercial banks



Source: Commercial banks

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6 Unimpaired capital means the absence of any legal or technical covenant, term, restriction or encumbrance which would otherwise render such capital not to be freely available for distribution to depositors or other creditors in the event of liquidation or dissolution of a bank and the absence of any condition or arrangement which would diminish the value of the whole or any portion of the capital of a bank.

7 Assets value after adjusting for the risk inherent in each asset for both on-balance sheet and off-balance sheet items.

8 Banking supervisors divide capital (owners equity) into two categories, core capital and supplementary capital. Core capital is an aggregate of share capital, share premium, general reserve and retained earnings. It represents the most stable and permanent form of capital.

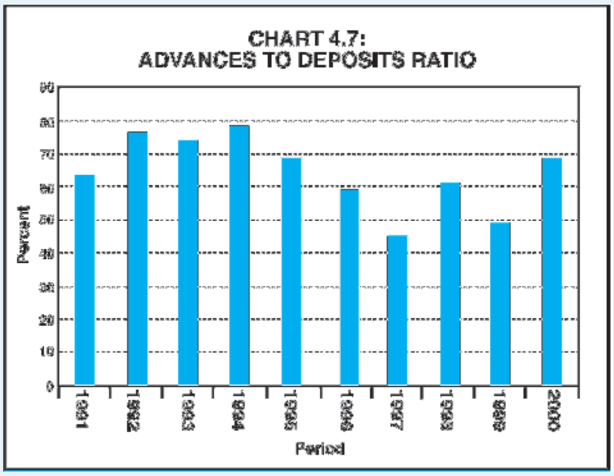
substantially in excess of the minimum statutory floor of 8 percent and also the 15 percent as prescribed by policy for banks in Botswana[9]. Furthermore, banks held good quality capital with the ratios of core capital to total capital well in excess of the 50 percent minimum statutory requirement.

(ii) Liquidity

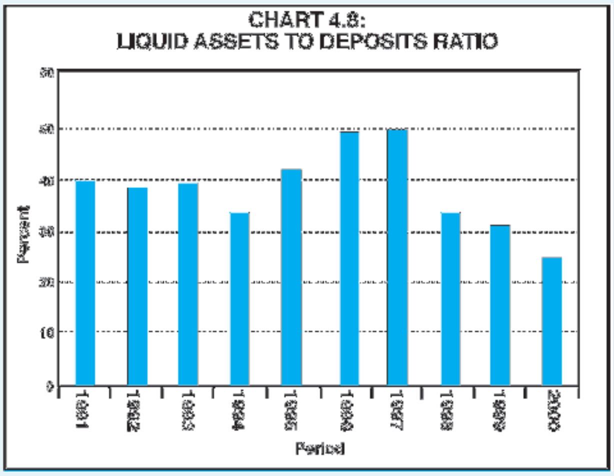
2.5 Banks are required to hold a proportion of their assets in liquid form[10], i.e., cash and low risk securities that can generate cash quickly to enable them to meet their obligations. Some of the important ratios used to measure liquidity are the liquid assets-to-deposits ratio, advances-to-deposit ratio, and liquid assets-to-total assets ratio.

2.6 A high advances-to-deposits ratio exposes a bank to liquidity risks, while a low ratio could suggest under-trading and, therefore, low earnings. A ratio of 80 percent to 90 percent is generally regarded as a sound balance between liquidity and earnings. However, in highly efficient markets, a ratio of close to 100 percent[11] would be considered normal. In Botswana, the advances-to-deposits ratio has fluctuated during the past ten years averaging 68 percent (Chart 4.7). There was generally an upward trend from 1991 to a peak of over 80 percent in 1994. From 1994 to 1997 the ratio showed a downward trend; thereafter, it improved from 47.9 percent in December 1997 to 70.5 percent in December 2000, indicating that the banking sector has been under trading to some extent.

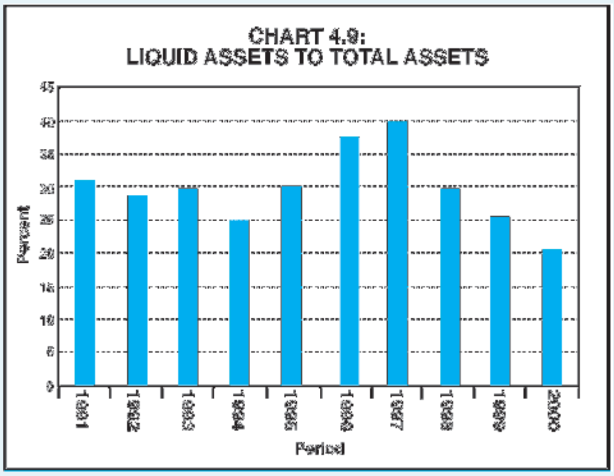
2.7 Commercial banks remained liquid throughout the decade (Charts 4.8 and 4.9). The liquid assets-to-deposits ratio consistently far exceeded the 10 percent minimum requirement, with an average of 40 percent during the past five years. After rising to 51 percent in December 1997, the ratio declined to 27 percent by the end of 2000 in response to higher credit demand.



Source: Commercial banks



Source: Commercial banks



Source: Commercial banks

[9] The sharp increase in the capital adequacy ratio during 2000 was due to the unusually high ratio for one of the banks.

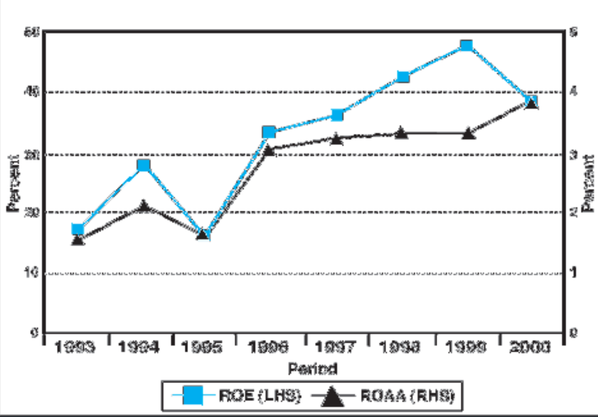
[10] The concept of liquidity is generally understood to mean the ease with which an asset can be exchanged for cash, in a particular time frame and at a reasonable cost.

[11] Such a high ratio would not take into account reserve or liquid asset requirements that may be imposed by a central bank or regulatory authority.

(iii) Profitability and Efficiency of Operations

2.8 Despite the low advances-to-deposit ratios and high liquidity ratios, the banking sector has been profitable. The two ratios used to measure a bank's profitability are the return on average assets[12] (ROAA) and return on equity (ROE). The ROAA ratio measures the capacity of an asset to generate earnings; it also indicates the effectiveness of management lending decisions (Chart 4.10). During the decade, the ROAA ratio averaged some 3 percent and has risen from 3 percent in 1996 to approximately 4 percent in 2000, an indication of the improvements in asset selection and increased profits. The ROE ratio relates after-tax profits to shareholders' funds and is, therefore, of critical importance to shareholders. Since 1995 the ROE ratio has followed an upward trend in line with increased profits of banks, pointing to the sustainable robustness of the banking system. However, in 2000 the ratio decreased significantly, due to large provisions made by some banks in respect of non-performing assets and increased overhead costs, although profitability remained high by international standards.

CHART 4.10:
RETURN ON EQUITY AND RETURN ON AVERAGE ASSETS

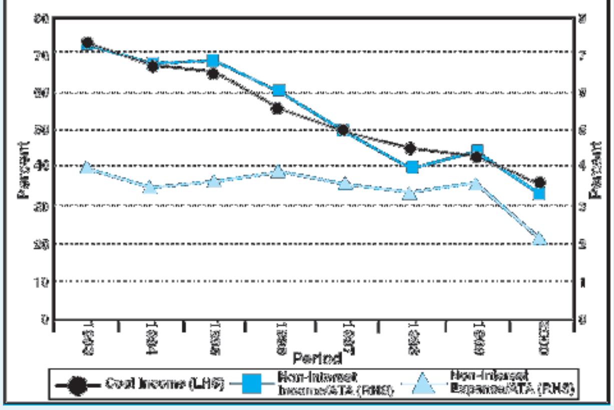


Source: Commercial banks

2.9 The efficiency of banking operations has been proxied by the ratios of total cost to total income, non-interest expenses to average total assets, the value of assets to employees, as well as staff costs per employee.

2.10 The ratio of total cost to total income averaged 53 percent during the past ten years, with fluctuations between 51 percent and 58 percent (Chart 4.11). In the latter part of the decade, the ratio declined, reflecting efficiency gains following the computerisation of banks' operations. There was also a fall in the non-interest expenses to average total assets ratio, in line with improvements in efficiency. Although there were fluctuations, the ratio averaged 6 percent with a downward trend.

CHART 4.11:
EFFICIENCY RATIOS



Source: Commercial banks

2.11 Within non-interest cost, staff costs per employee rose steadily from P48 000 in 1996 to P79 000 in 2000, as a result of wage increases over the period. Simultaneously, however, the value of assets per employee rose steadily from P1.7 million in 1996 to P3.8 million in 2000, a trend which supported efficiency gains following the staffing rationalisations which took place in the banking sector during the period under review.

(iv) Asset Quality

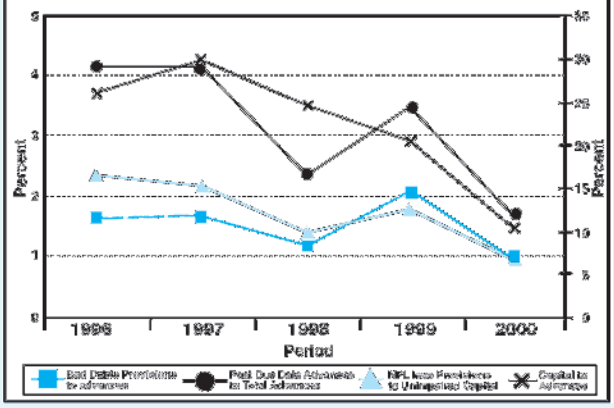
2.12 The major determinants of the quality of a bank's assets are the ability of its borrowers to service and repay loans. In this regard, problems with asset quality are very often a main cause of bank failure as losses may be too large to be absorbed by capital. The primary measure of asset quality is the ratio of adversely classified assets[13] to total assets.

12 Average assets is equal to the average monthly assets for the year.

13 Adversely classified assets means loans or other assets that are at risk of default.

The ratio has normally varied between 1 percent and 4 percent, with a ratio of 1-2 percent being regarded as normal (Chart 4.12).

CHART 4.12:
COMMERCIAL BANKS' ASSET QUALITY RATIOS



Source: Commercial banks

2.13 There has been an improvement in the asset quality of banks over the past five years, as indicated by the decline in the ratio of past due advances to total advances and in the provisions for bad debts to advances. The reduction in these ratios indicates mainly the effectiveness of risk management strategies while expanding lending activities to support rising demand for borrowing on the banking sector.

3. Quality of Banking Services

3.1 One of the key components of financial sector development is the degree of efficiency of the financial intermediation process, including perceptions of the general quality of delivery of banking services, convenience of banking services, cost to the customer, and the responsiveness to customers' complaints. With regard to the quality of banking services in Botswana, the general perception has been that there is need for some improvement. Among the aspects that require attention are speedy service at counters and Automated Teller Machines (ATMs), as well as the level and disclosure of bank charges. In response to persistent unfavourable public perceptions of the quality of banking services over the years, the Bank of Botswana undertook two surveys in order to ascertain the concerns of the public, and based on the results, to address the issues in order to ensure the efficiency and effectiveness of the financial intermediation activities of the banking industry.

3.2 The first survey conducted by the Bank to evaluate customers' perceptions of the quality and cost of commercial bank services took place in 1997. The overall results indicated that most customers had concerns in respect of the quality and levels of costs of banking services. However, the findings were considered preliminary due to a low response rate to the survey and some technical deficiencies. The Bank, therefore, commissioned another survey from November 2000 to February 2001. The survey focused on customer satisfaction with the products and services offered by the banking industry, and bank charges/tariffs, in order to ascertain customer perceptions of their "reasonableness", the extent to which banks disclose charges/tariffs, and customer awareness of established complaint procedures. A total of 1000 retail (personal) customers, spread over 25 branches, and 110 corporate customers were interviewed in this survey.

4. Summary of Findings of the 2001 Survey

(i) Quality of Service

4.1 Customers rated their satisfaction with the quality of services provided by commercial banks as "average", although there were significant differences in the ratings among banks. Overall, the banking industry was perceived to have made slight improvements in the quality of services they provide over the previous five-year period. Table 4.2 presents a summary of responses on the quality of banking services. It is interesting to note that while customers express general satisfaction with the banking system, they are less satisfied with their own banks and even less so with their particular branches (as shown by the increase in rank 5 across the three categories).

Table 4.2: Degree of Satisfaction with the Quality of Banking Services

Ratings[1]	Extent satisfied with the quality of services of commercial banks Responses (% of Total)	Extent satisfied with the quality of services of the commercial bank where account exists Responses (% of Total)	Extent satisfied with the quality of services of this branch Responses (% of Total)
1	11.8	10.7	11.8
2	15.1	19.8	17.7
3	40.7	30.8	29.9
4	19.7	22.9	22.7
5	10.5	15.3	17.2
Do not know	2.2	0.5	0.7

[1] A rating of 1 indicates highly satisfied while 5 signifies complete dissatisfaction.

Source: Bank of Botswana, Quality of Banking Services Survey, February 2001.

4.2 Retail banking customers indicated general "satisfaction" (Table 4.3) with the range of products and services provided, but pointed out the need for improved debit and credit card facilities at banks.

4.3 While 70 percent of retail bank customers used ATMs, many felt that services were unsatisfactory due to frequent malfunctioning and unavailability of paper for transaction printouts (Table 4.4).

4.4 Cheque accounts were held by 40 percent of retail bank customers. The common complaints regarding cheque accounts included delays in the issuance of cheque books and the processing of cheque deposits. Related to concerns on the service delivery time was dissatisfaction with the time taken to process loan applications at month end, but less than ten minutes during the month.

4.5 Moreover, queuing was considered too long at month-ends, but reasonable during the month. A queuing period of 5-30 minutes in banking halls at month-end was considered reasonable (Table 4.5 and 4.6).

4.6 For corporate customers the overall quality of corporate banking services was considered "moderately satisfactory". However, it was observed that branch managers lacked the authority to make decisions. The range of products and services offered by banks were considered "adequate" by 80 percent of corporate customers. Nevertheless, there was concern about the lack of debit and credit card facilities at some banks. It was also considered essential to design corporate loan facilities with attributes that are suited to individual customer requirements and that the use of more technology to improve banking products and services was required.

4.7 On disclosure and the level of charges, the findings were that even though banks seem to comply with the Bank of Botswana Policy on Disclosure of Bank Charges, 40 percent of customers (40.5 percent retail and 39 percent corporate) were not fully aware of the

Table 4.3: Perceptions of the Range of Products and Services available

	Responses (%)
Adequate	89.0
Inadequate	10.5
Do not know	0.5

Source: Bank of Botswana, Quality of Banking Services Survey, February 2001.

Table 4.4: Opinions Regarding ATMs in Botswana			
	Agree Responses	Disagree Responses	Does not know
	(% of Total)	(% of Total)	Number of Responses (% of Total)
The time taken by the bank to issue the ATM card is reasonable	71.1	26.7	2.2
In general, ATMs are in working order	58.2	39.7	2.1
In general, paper is available for print outs	49.1	48.5	2.4
Cards can be used without risk of being swallowed by the machine	55.2	42.3	2.5
Security around ATMs is well maintained	61.4	35.9	2.6

Source: Bank of Botswana, Quality of Banking Services Survey, February 2001.

fees and charges (Table 4.7). Bank tariff structures were considered to be complex and not easily understandable. Further, three out of five customers viewed the fees as "expensive" and in some cases, "very expensive".

4.8 A comparison of bank charges for domestic banks and banks in Mauritius and South Africa showed that banks in Botswana charged higher fees and were also increasing fees annually despite relatively higher levels of profitability.

5. The Effects of the Survey and Policy Issues

5.1 The outcome of the two surveys indicated areas of banking operations that need improvement. In particular, deficiencies were identified in the timeliness of delivery of banking services, especially in banking halls and at ATMs, loan processing and cheque clearing time, tariff structures and the development of new banking products tailored to specific business needs.

Table 4.5: Waiting Time in Queues in Banking Halls		
	End of month	During the month
	Responses (% of Total)	Responses (% of Total)
Less than 5 minutes	5.0	38.4
5 — 10 mins	21.2	38.3
10 — 20 mins	29.9	14.6
20 — 30 mins	23.0	5.9
30 — 40 mins	7.6	1.3
40 — 50 mins	3.3	0.1
50 — 60 mins	4.4	0.7
More than 60 mins	5.5	0.4
Do not know	0.1	0.3

Source: Bank of Botswana, Quality of Banking Services Survey, February 2001.

Table 4.6: Waiting Time in Queues at ATMs at the end of the Month	
	Number of Responses (% of Total)
Reasonable	25.0
Quite long	30.9
Much too long	42.3
Do not know	0.8

Source: Bank of Botswana, Quality of Banking Services Survey, February 2001.

Table 4.7: Perceptions of the Information Given in Relation to the Fees Charged (retail)

	Responses (% of Total)
Sufficient	58.4
Insufficient	40.5
Do not know	1.1

Source: Bank of Botswana, Quality of Banking Services Survey, February 2001.

5.2 The challenge to the Government and the Bank of Botswana from these findings is the need to evaluate the adequacy and effectiveness of current policies on consumer protection issues, while at the same time pursuing policies aimed at promoting competition in the financial sector on a sound and sustainable basis.

5.3 Since the 1997 evaluation of the quality of banking services there have been some improvements in banking products and services. To some extent, the developments benefitted from an increase in the number of licensed financial institutions in addition to the introduction and wide usage of ATMs, as well as the adoption of other new technologies.

5.4 Furthermore, there has been a general awareness of the need to provide quality services in the industry. In this regard, the Bankers Association of Botswana has initiated a Code of Good Banking Practices for the banking industry that sets expected standards of behaviour for member banks. It is intended that a banking Ombudsman will be appointed to assist bank customers in understanding bank tariffs and resolution of queries arising from bank customer relationships.

5.5 It is also expected that improvements in the technological infrastructure, favourable legislative developments, together with positive responses to the findings by the banking industry, will provide impetus to the enhancement of quality banking services.

6. Conclusion

6.1 The expansion of the institutional infrastructure of the banks in the 1990s has culminated in the operation of five sound and solvent commercial banks and two merchant/investment banks. Simultaneously, the volume, quality and cost-effectiveness of the financial intermediation process have improved significantly reflecting, in part, new financial institutions, coupled with the introduction of new technology based lending and deposit products. However, there remain challenges in improving the efficiency of customer service and attention to complaints, the level of bank charges, and the expansion of banking services

6.2 With regard to the latter point, there are expectations that the banks will progressively expand their service networks to encompass a greater proportion of the population, both geographically and in terms of income groups. The potential for doing this depends on a range of factors, including demand patterns and the use of technology to reduce costs. The traditional model of banking – with services delivered through physical branch networks with high staffing levels – is expensive, and not well-suited to the type of low-cost service provision that will be necessary if a larger proportion of the population is to be served profitably. New products and business models will be required. In recent years, there have been some examples of how this might be done. On the lending side, the costs of providing small loans can be reduced by automated credit scoring, by teaming up with other service providers (such as micro lenders), and by more extensive use of automated deductions for loan repayments. On the deposit side, technology has enabled the costs of account provision to be reduced, for instance by handling withdrawals through ATMs rather than tellers within branches.

6.3 The combined impact of changes in banking and telecommunications technology may provide a good opportunity for extending services geographically. The high costs of providing a physical branch network will always make it expensive to provide traditional banking facilities in more remote and less densely populated areas. Nevertheless, the combination of progressive electrification of villages, and the extension of the telecommunications network – especially that facilitated by wireless technology – will enable more areas to be linked to banking networks and hence more services to be provided at low cost. It is likely that ATMs will be the medium through which banks will improve access to banking services, especially as the sophistication of ATMs and card-based payment services improves. These developments are closely tied in with the development of the broader payments system, in which banks play a central role, and which is discussed in more detail in the next chapter.

Table 4A.1: Financial Sector Assets, Advances and Deposits

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average
Deposits (P million)											
Commercial Banks	1 574.4	1 750.6	2 005.8	2 217.6	2 465.3	2 972.1	3 841.5	5 423.8	6 756.5	6 912.3	3 592.0
Building Society	117.1	167.9	170.3	174.0	175.8	186.1	193.8	209.0	224.4	242.4	186.1
Finance and Leasing[1]	177.8	96.1	86.5	47.7	55.2	62.9	69.7	87.3	96.8	103.1	88.3
Savings bank	n/a	33.6	39.7	41.8	46.4	60.4	69.5	87.6	100.9	105.8	65.1
Total	1 869.3	2 048.2	2 302.3	2 481.1	2 742.7	3 281.5	4 174.5	5 807.7	7 178.6	7 363.6	3 931.5
% Growth	49.5	9.6	12.4	7.8	10.5	19.6	27.2	39.1	23.6	2.6	20.2
Market Share of Deposits											
Commercial Banks	84.2	85.5	87.1	89.4	89.9	90.6	92.0	93.4	94.1	93.9	90.0
Building Society	6.3	8.2	7.4	7.0	6.4	5.7	4.6	3.6	3.1	3.3	5.6
Finance and Leasing	9.5	4.7	3.8	1.9	2.0	1.9	1.7	1.5	1.3	1.4	3.0
Savings bank		1.6	1.7	1.7	1.7	1.8	1.7	1.5	1.4	1.4	1.6
Advances (P million)											
Commercial Banks	1 032.9	1 397.9	1 560.1	1 784.7	1 731.7	1 743.9	1 838.6	2 922.1	4 076.7	4 872.3	2,296.1
Building Society	191.0	243.5	261.3	252.1	237.3	214.8	220.7	223.4	259.2	310.9	241.4
Finance and Leasing	207.9	250.3	265.1	57.2	62.7	70.8	76.6	91.0	106.8	114.9	130.3
Savings bank		26.8	26.5	25.6	30.5	35.7	47.4	63.2	64.2	75.7	44.0
Total	1 431.8	1 918.5	2 113.0	2 119.6	2 062.2	2 065.2	2 183.3	3 299.7	4 506.9	5 373.8	2 711.8
% Growth	44.41	33.99	10.14	0.31	-2.71	0.15	5.72	51.13	36.59	19.23	19.9
Market Share of Advances (Percent)											
Commercial Banks	72.1	72.9	73.8	84.2	84.0	84.4	84.2	88.6	90.5	179.7	84.7
Building Society	13.3	12.7	12.4	11.9	11.5	10.0	10.1	6.8	5.8	5.8	8.9
Finance and Leasing	14.5	13.0	12.5	2.7	3.0	3.4	3.5	2.8	2.4	2.1	4.8
Savings bank		1.4	1.3	1.2	1.5	1.7	2.2	1.9	1.4	1.4	1.6
Total Assets (P million)											
Commercial Banks	1 913.7	2 280.0	2 616.9	3 027.1	3 150.7	3 841.5	4 777.9	6 508.2	8 161.4	8 553.8	4 483.1
Building Society	232.2	292.2	324.9	334.0	334.4	346.4	349.2	363.4	377.1	424.2	337.8
Finance and Leasing	225.5	277.7	292.9	62.6	71.3	79.9	87.0	106.6	118.1	130.2	145.2
Savings bank		42.9	64.7	73.8	83.5	101.9	116.9	138.9	151.7	156.9	103.5
Total Assets	2 371.4	2 892.8	3 299.4	3 497.5	3 639.9	4 369.7	5 331.0	7 117.1	8 808.3	9 265.1	5 059.2
% Growth	45.33	21.99	14.06	6.00	4.07	20.05	22.00	33.50	23.76	5.19	19.6
Market Share of Assets (P million)											
Commercial Banks	80.7	78.8	79.3	86.6	86.6	87.9	89.6	91.4	92.7	92.3	86.6
Building Society	9.8	10.1	9.8	9.5	9.2	7.9	6.6	5.1	4.3	4.6	7.7
Finance and Leasing	9.5	9.6	8.9	1.8	2.0	1.8	1.6	1.5	1.3	1.4	3.9
Savings bank	0.0	1.5	2.0	2.1	2.3	2.3	2.2	2.0	1.7	1.7	2.0

1. Effective 2000, the finance/leasing company changed to a merchant bank.

Source: Commercial Banks

Table 4A.2: Selected Liquidity, Financial Intermediation and Monetisation Ratios

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Levels (P million)										
1. M2	1 677.7	1 856.2	2 086.4	2 357.7	2 410.4	2 848.0	3 560.2	4 759.3	5 961.6	5 960.0
2. M3	2 109.4	2 428.1	2 588.6	2 880.1	3 537.3	4 489.0	5 316.1	6 679.0	8 486.2	8 399.6
3. M4					3 756.3	4 785.0	5 797.9	7 618.4	9 581.8	9 585.5
4. Bank Advances	1 038.9	1 396.0	1 560.0	1 842.9	1 776.5	1 797.0	1 897.7	2 950.6	4 176.0	4 930.4
5. PDSF, RSF and DF	1 445.3	1 888.9	2 225.5	2 364.6	2 444.6	2 689.0	2 483.9	2 256.3	2 131.0	2 083.5
6. BoBCs held by Banks	207.1	343.7	360.8	493.0	831.9	1 192.4	1 571.9	1 322.1	1 717.7	1 241.1
7. Non-mining GDP at Current Prices	5 217.2	6 037.4	7 085.2	8 116.9	9 403.9	10 832.0	12 498.0	14 830.9	16 973.3	18 589.3
8. Total Banking Assets	1 913.7	2 280.0	2 616.9	3 027.1	3 150.7	3 842.0	4 777.9	6 508.2	8 161.4	8 533.8
Ratios (Percent)										
1. M2/NMGDP	32.2	30.8	29.5	29.1	25.6	26.3	28.5	32.1	35.1	32.1
2. M3/NMGDP	40.4	40.2	36.5	35.5	37.6	41.4	42.5	45.0	50.0	45.2
3. M4/NMGDP					39.9	44.2	46.4	51.4	56.5	51.6
4. Bank Advances/NMGDP	19.9	23.1	22.0	22.7	18.9	16.6	15.2	19.9	24.6	26.5
5. PDSF, RSF and DF/NMGDP	27.7	31.3	31.4	29.1	26.0	24.8	19.9	15.2	12.6	11.2
6. BoBCs/Banking Assets	0.0	43.3	47.0	49.4	64.6	77.9	72.5	51.1	54.4	45.5
7. Banking Assets/NMGDP	36.7	37.8	36.9	37.3	33.5	35.5	38.2	43.9	48.1	45.9

Sources: Bank of Botswana, Central Statistics Office and Commercial Banks

CHAPTER 5

KEY ISSUES IN THE DEVELOPMENT OF THE NATIONAL PAYMENTS SYSTEM

1. Introduction

1.1 The payments system represents one of the most important but perhaps least visible components of the overall financial system. While members of the public are aware of the attributes of the payments system – how quickly their cheques are cleared or their salaries are paid into their bank accounts – few have any personal or direct contact with the system. Indeed, at its heart, Botswana's payments system involves only the Bank of Botswana and the commercial banks. Nevertheless, there is a broad range of stakeholders that participate in the payments system, including other financial service providers, the Government, businesses, investors, the general public and foreign entities involved in the economy. The aim of this chapter is to provide an overview of how the payments system facilitates the operations of the financial sector, and to present information on the ongoing reform and modernisation of the National Payments System, which is intended to boost its contribution to the effectiveness of the financial sector and economic activities in general.

1.2 The role of the payments system has gained prominence among central banks in the developing world in recent years due to increasing globalisation, and the need for developing economies to improve the efficiency of their payment systems so as to allow them to integrate effectively into the global market.

1.3 Equally, in more developed countries, efforts are being made to continuously improve payments systems in response to financial and technological developments and innovations. Payments systems form a vital part of the structures used by central banks to manage their economies. The safety and operational efficiency of a payments system affects consumer and business confidence both nationally and internationally; conversely an inefficient payments system could lead to undesirable consequences, such as the refusal by participants and the public to use it, or the total collapse of the financial system arising from financial contagion. Furthermore, the effective control and implementation of monetary policy requires an efficient payments system that will facilitate the transmission of monetary policy signals and also enable the accurate and timely assessment of market responses.

1.4 Botswana, like many other developing countries in the Southern African Development Community (SADC) region and elsewhere, has embarked on a reform programme to modernise the country's payments system. The programme has two main objectives. First, to establish a legal, regulatory and institutional framework that will ensure the safety and integrity of payments being processed through the payments system. Second, to facilitate the development and introduction of the physical infrastructure for a payments system in which the final and irrevocable delivery of value, following the execution of deals and trades in the real economy, is timely and achieved at economic cost and with minimum risk exposure for both individual payments and the financial system as a whole.

2. Characteristics of Payments Systems

2.1 The term "payments system" refers to the set of arrangements that allow economic agents, such as consumers, businesses, government and other organisations, to transfer funds,

Box 5.1: What is a Payment System?

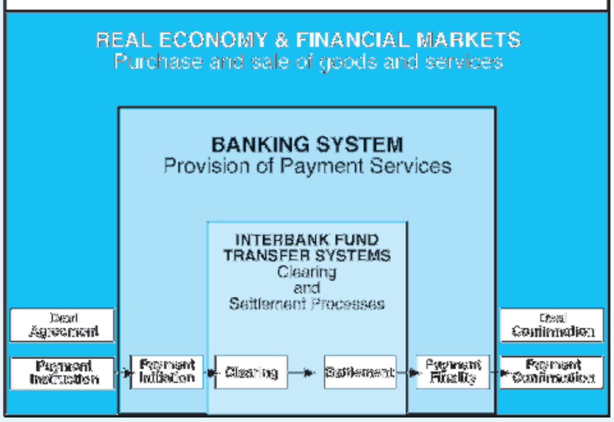
A payment system comprises a defined group of institutions and a set of instruments and agreed procedures used to effect payments transactions in the process of ensuring the circulation of money within a geographic area, usually a country

(European Central Bank)

especially those held in accounts at financial institutions, between one another (Box 5.1). These payments may stem from the purchase of goods and services, but can also result from capital transactions such as borrowing, the settlement of debts, and the transfer of financial securities. The payments process involves the initiation of a payment transaction, and the processing of that transaction through to the point where it is settled, i.e., where value is received by the recipient and the transaction cannot be undone. The payments system includes both the payment instruments used in these transactions, such as cash, cheques and electronic transfers, and the institutions and arrangements that ensure that funds flow from accounts at one financial institution to another.

2.2 The payments system is central to economic activity and supports transactions in both the real economy and financial markets. In any economy that does not solely rely on cash transactions, the banking system plays a pivotal role in the provision of payment services that result from deals agreed as a result of economic or financial activities. At the heart of the payments system is the process of clearing and settlement of transactions and the associated transfer of funds between banks (Figure 5.1).

FIGURE 5.1
PHASES OF THE PAYMENTS SYSTEM



(a) Payment Instruments

2.3 Almost all countries utilise a number of different types of payments instruments. These can usefully be divided into cash and non-cash instruments.

(i) Cash

2.4 In most economies cash is the most commonly used payment instrument, especially for small-scale retail transactions and for making payments between individuals. Although cash typically accounts for the dominant proportion of the number of payments transactions, it often accounts for only a small proportion of the total value of transactions[1]. In relative terms, the use of cash tends to diminish as economies become more developed, although the advent of ATMs has contributed to the ready availability of cash and has sustained its use. Cash also has advantages that other payment instruments cannot match, such as the anonymity associated with many cash transactions, its immediacy and finality in transactions and the absence of credit risk.

(ii) Non-cash Payment Instruments

2.5 Non-cash payments account for the bulk of the value of transactions in most economies. Non-cash payment instruments include cheques and a range of different electronic payment instruments, including credit and debit cards and direct credits and debits. Cheques are the predominant non-cash payment instrument by volume of

[1] In the G10 countries plus Australia, cash accounts for less than 5 percent of the total value of payments (Bank for International Settlement (BIS) 1999 Retail Payments in Selected Countries : A Comparative Study *p.12 (BIS, Basel Switzerland).*

Table 5.1: Characteristics of Payment Streams

Payment Stream	Users	Transactions Volume	Average Value	Technology	Settlement Speed	Failure (cause)	Other Parties Involved
Cash	Public, corporates, Govt.	Very High	Low	None	Immediate	Large transactions; Forgery	None
Cheques	Public, corporates, Govt.	High	Low-medium	Paper/ electronic	Slow (4-6 days)	Insufficient funds (payer); Insufficient clearing balances; Fraud	Banks, CB, clearing house, CSS
Card (Credit/debit ATM/POS)	Public, corporates,	High	Low	Electronic	Medium (1-2 days)	Insufficient funds (payer); Insufficient clearing balances; Telecomms failure; Fraud	Banks, CB, telcos, acquirer, CSS
Direct debit/credit Medium	Public, corporates, Govt.	Medium	Low Medium	Electronic	Medium (1-2 days)	Insufficient funds (payer); Insufficient clearing balances	Banks, CB, CSS
Bulk electronic	Govt., Large corporates	Low (aggregated) High (total)	Low	Electronic	Medium (1-2 days)	Insufficient clearing balances	Banks, CB, CSS
High value (RTGS)	Large corporates, Govt. Markets	Low	High	Electronic	Fast (completed in real time)	Insufficient clearing balances	Banks, CB, CSS
Securities	Brokers BSE Banks	Low	Medium — high	Paper or Electronic (if dematerialised with CSD)	Very Slow (paper) Medium (CSD)	Failure of script delivery; Insufficient clearing balances	Banks, CB, CSS, CSD
Foreign Exchange	Public, Corporates, Banks, Govt.	Medium	Medium — high	Paper/ Electronic	Medium (1-2 days) electronic	Insufficient clearing Balances	Banks, CB, foreign counterparties, SWIFT

Key:
CB-central bank; CSS-clearing and settlement system; CSD- central securities depository;
SWIFT-Society for Worldwide Interbank Financial Telecommunication.

transactions, but in many countries their use has been stagnant or in long-term decline. As a general trend, cheques are being replaced at the retail level by credit and debit cards, which tend to offer faster settlement and are benefiting from security enhancements that make them less prone to fraud. Other types of transactions, especially recurring ones, such as payroll and government social security payments, are increasingly made by direct (bulk electronic) credit into the recipient's bank account; such transfers tend to be fast, safe and cheap and, therefore, more efficient than using cash or cheques. In many countries, facilities have been developed for consumers to make regular payments, such as for utilities, by direct debit transfers. For high value and high priority payments, there is increasingly a preference for these to be made through a dedicated payments system, sometimes referred to as a Large Value Transfer System (LVTS). In more developed economies, LVTSs account for a relatively small number of transactions but the bulk of transactions by value, and have replaced the payment of large sums by cheque. Other important payment instruments include those used for transactions in securities, such as shares and bonds, and also for foreign exchange transactions.

(b) *Payment Streams*

2.6 The various types of payment instruments can be classified into different payment streams. A payment stream consists of a set of payment instructions that are homogeneous with respect to their basic characteristics, their legal basis, and the risk associated with them, together with their processing requirements. Examples of different payments streams and their characteristics are shown in Table 5.1.

(c) Clearing and Settlement

2.7 Most payment transactions involve two or more financial institutions and sometimes other payments service providers, such as credit card companies. Payments, therefore, have to be "cleared" between these institutions. For instance, when a cheque is drawn on one bank and deposited at another, the details of the cheque must be returned to the first bank in order to verify that the customer has sufficient funds and to debit the customer's account. The clearing process can be quite lengthy and the tasks of accelerating clearance and reducing the risk of transactions failing during the process is a major component of payments system reform. One way of achieving this is to move from debit-pull instruments (such as cheques) to credit-push instruments (such as bulk electronic credits), whereby transactions cannot be initiated unless the payer has sufficient funds.

2.8 The final stage of a payment transaction is settlement, whereby the obligations between the parties to a transaction are discharged unconditionally and irrevocably. Most transactions (except for those dealt with in specialised Large Value Transfer Systems) are not settled individually, but are aggregated and settled on a net basis between institutions. For instance, if Bank A has a number of cheques drawn on Bank B (for which Bank B would have to transfer value to Bank A), while Bank B also has a number of cheques drawn on Bank A, the total values of the transactions will be aggregated and only one transfer of value will be made, representing the net obligation from Bank B to Bank A (or vice versa). A typical clearing house will include payments originating from cheques as well as both paper based and electronic credit and debit instructions, and will calculate the net obligations between each of the participating banks. Final settlement generally takes place by the transfer of funds between the accounts of these banks at the central bank at the end of each working day. Because transactions are not settled immediately or individually, such a system is said to be based on deferred net settlement conventions. It is generally only clearing banks that are permitted to maintain settlement accounts at the central bank, and indeed the whole process of clearing and settlement is the exclusive domain of a country's banks - the supervised clearing banks and the central bank.

2.9 There are two main exceptions to the above clearing and settlement process. The first is when a payment instruction is completed within the same bank, for instance when a cheque drawn on one account in a particular bank is deposited in another account at the same bank. The provision of value is then undertaken within the bank and the transaction does not pass through the clearing house.

2.10 The second exception relates to high value payments. Large Value Transfer Systems often clear and settle such transactions on an individual basis in real time. In other words, eligible payment instructions are handled continuously as soon as they are received or at a pre-specified time (i.e., in real time rather than being deferred) and are settled in full by the paying bank, regardless of any other obligations that the recipient bank might have to the paying bank as a result of other transactions. Such Real Time Gross Settlement (RTGS) streams are more efficient, as value is received immediately rather than being delayed, at a cost that is small relative to the value of the transaction. In addition, RTGS prevents the build-up of large obligations between banks during the day, which could potentially cause settlement problems and give rise to systemic risk to the whole financial system in the event of failure to settle.

(d) Payments system reform and developments

2.11 Payment systems globally have been undergoing considerable change in recent years, with the emergence of new forms of payment instruments and improved processes for the handling of clearing and settlement. The driving forces for these changes include: technological change, especially information technology developments related to executing and processing payments electronically; economic developments, including the expansion of international trade and the removal of restrictions on capital movements, which have stimulated international financial flows; rapid increases in the volumes and values of payments, both domestically and internationally; increased complexity of transactions, requiring new payment processes; increased attention on the time-critical nature of payments, requiring early finality; an increased focus on risk considerations in payment systems, especially systemic risk; a focus on the interrelationships between payment systems and monetary policy, especially with regard to the management of liquidity; the search for increased efficiency in payment systems, focusing on such factors as the availability, safety and reliability of payment processes, the speed of settlement, and transactions costs; as well as a realisation by developing countries that there are benefits to be obtained from following relevant aspects of accepted international best practice.

2.12 With respect to the latter point, many developing countries are undertaking the automation of their payments systems which have historically been based on manual procedures (e.g. manual inputting of cheque details and physical exchange of cheques at the clearing house), and moving to machine-readable cheques and payment vouchers by establishing an electronic clearing house, together with the development of a broader and more comprehensive automated clearing and settlement system designed to embrace all payments streams.

2.13 Clearly, the development of payment systems can have a wide impact. There are implications for the efficiency of the financial system and the economy more generally, through the benefits that may be derived from reducing transactions costs, reducing settlement delays and reducing the risks of transactions failing.

2.14 It is also important to reduce the risk that payment system failures could have for the stability of the financial system as a whole. The obvious danger is that a failure by any one participant to settle its payment obligations to other participants (banks) could have knock-on effects that could, in principle, cause disturbances to the banking system that may result in them ceasing functioning. The most significant payment systems are a major channel through which shocks can be transmitted across domestic and international financial markets, and robust payment systems are, therefore, a key requirement in maintaining financial stability.

2.15 Minimising such systemic risk is an overdue component of any payment systems modernisation and reform, through measures such as reducing the build-up of large settlement balances (through the use of RTGS systems), ensuring that payment systems have a sound legal basis, clarifying the roles and responsibilities of payment system participants, and introducing clear procedures for dealing with failure to settle by any participant.

2.16 Internationally, an important driving force behind payment system development and the harmonisation of payment system standards across countries has been the Committee on Payment and Settlement Systems (CPSS), which has introduced a set of "Core Principles for Systemically Important Payment Systems" (Box 5.2). These Core Principles "are intended for use as universal guidelines to encourage the design and operation of safer and more efficient systemically important payment systems worldwide. In emerging market economies they are likely to be of particular significance, because of the efforts in training these countries to improve systems or to build new ones in order to handle better the growing payment flows from national and international financial markets"[2].

[2] Bank for International Settlement (BIS) (2001) Core Principles for Systemically Important Payment Systems, p.1 (BIS, Basel, Switzerland)

(e) *The SADC Payments System Initiative*

2.17 Within Southern Africa, the SADC Payments System Initiative has been launched under the auspices of the SADC Committee of Central Bank Governors. The aim of the initiative is to promote the modernisation of national payments systems within the region to internationally accepted standards, and the development of a cross-border payment strategy. Three stages to the process are envisaged in each country, including; a stocktaking exercise to determine the nature of the existing national payments system, and the start of an awareness raising exercise to improve understanding by the public in general and stakeholders in particular of payment system issues; the drawing up of a National Payments System Framework and Strategy document to guide the payments system modernisation process; and the progressive implementation of the National Payments System modernisation project, and the extension of the project to the region as a whole.

2.18 While the various SADC member countries are at different stages of implementation of payment system reforms, overall progress has been significant with most countries having completed the second stage and are now progressing with the implementation phase.

3. Characteristics of the Botswana Payments System

3.1 In some respects the characteristics of Botswana's payments transactions are representative of international trends. While there is no data available on the extent of cash transactions, it is believed that cash, as in other countries, accounts for the vast majority of payments. The majority of the population do not have access to, or do not make use of, banking services, and for them, cash remains the only means of making payments (although some of the unbanked population do receive payments by cheque, especially from Government).

Box 5.2: CPSS Core Principles for Systemically Important Payments Systems

I. The system should have a well-founded legal basis under all relevant jurisdictions.

II. The system s rules and procedures should enable participants to have a clear understanding of the system s impact on each of the financial risks they incur through participation in it.

III. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.

IV. The system should provide prompt and final settlement on the day of value, preferably during the day and at a minimum at the end of the day.

V. A system in which multilateral netting takes place should, as a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.

VI. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk.

VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.

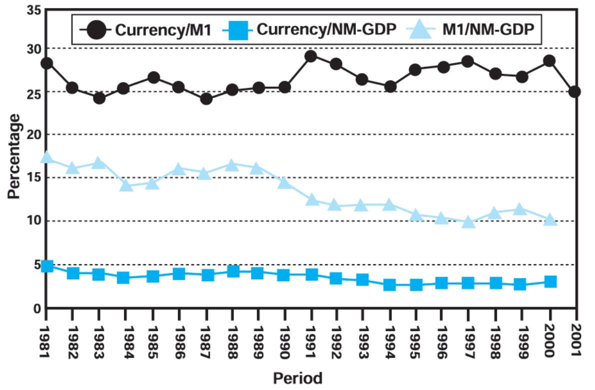
VIII. The system should provide a means of making payments, which is practical for its users and efficient for the economy.

IX. The system should have objective and publicly disclosed criteria for participation, which permit air and open access.

X. The system s governance arrangements should be effective, accountable and transparent.

3.2 Despite the predominance of cash, however, there is some evidence that its use has been declining over the past two decades (Chart 5.1). While notes and coins have accounted for a fairly steady proportion of transactions balances (M1), at around 25 percent, the importance of transactions balances in general, and cash in particular, has been declining relative to non-mining GDP. Whereas holdings of currency (outside of banks) were equivalent to 4.6 percent of non-mining GDP in 1981, by 2000 this had declined to only 2.3 percent. These outcomes are likely to be indicative of two developments. First, a reduced reliance on cash as a means of settling transactions as the economy grows in size and sophistication, and as other means of making payments become more widely available. Second, greater efficiency in the use of cash, with developments such as the introduction of ATMs, which reduce the need to hold cash balances and increase the velocity of its circulation. More generally, a lower ratio of cash to GDP indicates a more flexible and efficient payments system, in which less cash is needed to conduct a higher volume of economic activity.

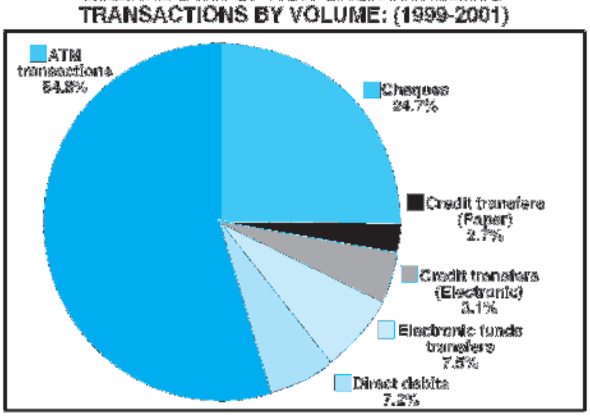
CHART 5.1:
TRENDS IN CURRENCY HOLDINGS: (1981-2001)



Source: Commercial banks

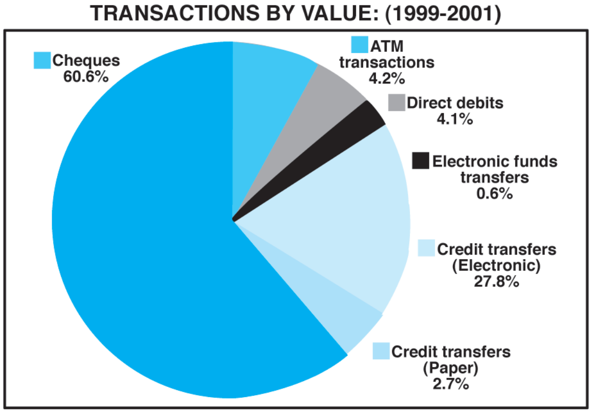
3.3 The impact of ATMs on the Botswana payments system has been considerable. Whereas in 1990 there were no ATMs in Botswana, by 2000 three of the five commercial banks had extensive ATM networks with a total of 112 ATMs across the country. During 1999-2001, there were more ATM transactions than all other forms of non-cash payment transactions put together (Chart 5.2 and 5.3). Although the average value of ATM transactions is small (P280), and as a result only account for a small proportion (4 percent) of the total value of non-cash transactions, they are nonetheless widely used[3]. The rapid growth of ATM transactions is in part due to the fact that most major employers make wage and salary payments

CHART 5.2:
BREAKDOWN OF NON-CASH PAYMENTS TRANSACTIONS BY VOLUME: (1999-2001)



Sources: Bank of Botswana and commercial banks

CHART 5.3:
BREAKDOWN OF NON-CASH PAYMENTS TRANSACTIONS BY VALUE: (1999-2001)



Sources: Bank of Botswana and commercial banks

through credit transfers, and many employees, therefore, have bank accounts, which automatically include ATM cards.

3.4 As in other countries, cheques account for the bulk of the value of non-cash transactions (61 percent during 1999-2001), but a much smaller proportion of the number of transactions. And again, as is commonly

3 "Cash" transactions are those defined as using only cash. "Non-cash" transactions may include cash and another instrument (e.g., cheque or ATM card).

observed elsewhere, cheques appear to be on the decline, with their share of the volume of transactions falling from 27 percent in 1999 to 21 percent in 2001.

3.5 Other non-cash forms of payment are also important, including credit transfers (both paper and electronic), electronic funds transfers at point of sale (EFTPOS) and direct debits; together, these account for around 20 percent of the volume of transactions and 35 percent of the value.

3.6 Overall, the trends in the usage of cash and non-cash payments instruments suggest that there is migration away from the holding of cash for transactions purposes. However, the fact that ATM transactions have grown to account for such a significant share of payments transactions suggests that cash is not going out of favour in Botswana, simply that improvements in the payments system are making it easier and more efficient to use cash while reducing the need to hold significant quantities.

4. Participants in the Botswana Payments System

4.1 The main participants in the Botswana payments system are the five clearing banks and the Bank of Botswana. Under the manual clearing system paper (cheques and other payment vouchers) is exchanged at the Bank of Botswana premises in Gaborone and Francistown. The operations of the two clearing houses are governed by a set of clearing house rules agreed to by all participants. In addition, in other towns and villages where there is more than one bank represented, the banks concerned have local clearing houses from which clearing settlement figures are sent to their respective head offices to effect interbank settlements. Instructions for large value transfers between domestic banks or between domestic and foreign banks are handled through the SWIFT system.

4.2 When a bank receives cheques and other items drawn on it at the clearing house, it forwards those items to its branches for processing payment and verification of customer account balances. The verification of account balances must take place quickly, in order that a cheque can be returned unpaid within the time allowed within the clearing house rules (currently four days for cheques drawn on banks within the local clearing area and six days for other cheques) in the event of any condition that causes the cheque not to be honoured by the paying bank.

4.3 Clearing takes place twice a day from Monday to Friday and once on Saturday. Most items are exchanged at the morning clearing, with the afternoon clearing reserved for large value items (over P50 000) and the return of unpaid items. Once the afternoon clearing has taken place, the net settlement obligations between banks can be calculated, and instructions are issued for the transfer of funds between the banks' accounts at the Bank of Botswana for settlement to be made and the obligations discharged. Should a bank have insufficient funds in its account at the Bank of Botswana to meet its clearing and settlement obligations, it can obtain funds in a number of ways. It can obtain liquidity from the Bank of Botswana by selling securities (Bank of Botswana Certificates), by entering into a repo transaction, or by borrowing overnight from the Secured Lending (Lombard) Facility. Alternatively, it can borrow overnight from another bank in the interbank market.

5. The National Payments System (NPS) Reform Initiative

5.1 Botswana has been an active participant in the SADC payments system reform process. Recognising that the existing payments system infrastructure was not sufficiently robust and secure to adequately support complex financial activities, and needed extensive reform and modernisation if it was to play its role in enabling the operation of an efficient financial sector, the Bank of Botswana has been implementing a range of payments system developments in collaboration with banks, Government, and other stakeholders. During 2001, the Botswana National Payments System

Framework and Strategy Document was completed, which is intended to provide the basis for a five year programme to develop the payments system to comply with internationally accepted standards by 2005[4].

5.2 The reform of the NPS is being undertaken under the auspices of the National Payments Council (NPC), which is chaired by the Governor of the Bank of Botswana and includes Chief Executives of the commercial banks as its other members. The Bank also chairs the National Payments Task Force (NPTF), which includes a wide range of representatives from the Government, the banks, other financial institutions and other stakeholders in the payments system. There are also a number of other committees, dealing with clearing house rules and other issues as and when they arise.

5.3 The modernisation of NPS will address, *inter alia*, the following issues that are considered to introduce risk to the payment system and constrain its efficient operation.

(i) Deferred Net Settlement

5.4 The current deferred net settlement arrangement effectively means that payments are accepted on trust until funds have been made available. Until final funds are transferred, the receiving bank faces the risk that the paying bank may not be able to provide funds in settlement of its obligations. The inability of a participant in the payments system to settle a payment instruction when funds are due, or at any time in the future, gives rise to risks in the payments system. The nature of such risks may be temporary - such as in the case where the paying participant experiences a temporary shortage of liquid funds or permanent in the case where the paying participant becomes insolvent before honouring its obligations. In the short-term, the receiver faces a liquidity risk when the paying bank is unable to meet its net settlement obligations, and an opportunity cost during the period when the funds remain unpaid. In the longer term, the receiver faces the probability of losing the full face value of the payment due.

(ii) Credit Risks to Customers

5.5 Settlement banks face credit risks in the payments system when they avail uncleared funds to their customers before receiving full value from the paying banks. In effect, by doing this, the banks take a calculated commercial risk on the basis of customer integrity. However, this does not remove the risk of non-receipt of payment. By extending limitless intra-day overdraft facilities to clearing banks, the Bank of Botswana also bears part of this credit risk, as the central bank may not be able to recover the full value of its intra-day advances to settlement banks in the case of failure. In most of the cases, intra-day overdrafts are in excess of reserve balances.

(iii) Clearing Delays

5.6 Long clearing times inevitably create an accumulation of large amounts of float in the payments system. This in turn renders the payments system inefficient as it makes the task of liquidity management more difficult by both the central bank and settlement banks. To a large degree, the long clearing times are a function of the predominantly manual nature of the Botswana payments (as indicated by the dominance of cheque instruments in the payments system).

(iv) Securities Market

5.7 The lack of synchronisation of payment transfer and delivery in the commercial securities market is an area of concern. Manual operations in the processing of securities plus the materialised nature of commercial securities often results in extended delays between payment transfer and the delivery of physical paper certificates (this problem does not apply to Bank of Botswana Certificates (BoBCs) which are fully dematerialised and are recorded on a book-entry system). Processing delays in the

[4] The NPS Framework and Strategy Document (Bank of Botswana, 2001) is available on the Bank of Botswana website (www.bankofbotswana.bw).

securities market give rise to a number of risks. A buyer of securities who pays for the securities but has to wait for some time to receive the certificates will be unable to respond to changes in market prices while the certificates remain undelivered. In addition to delivery delays, variation in the delivery period introduces uncertainty in the market.

(v) *Legal Issues*

5.8 The absence of a specific legal basis to support the operation and regulation of payments system activity constitutes a major risk that can affect market confidence. An explicit legal basis for payments system operations is necessary to provide legal backing for bilateral and multilateral netting arrangements and the settlements arising thereof.

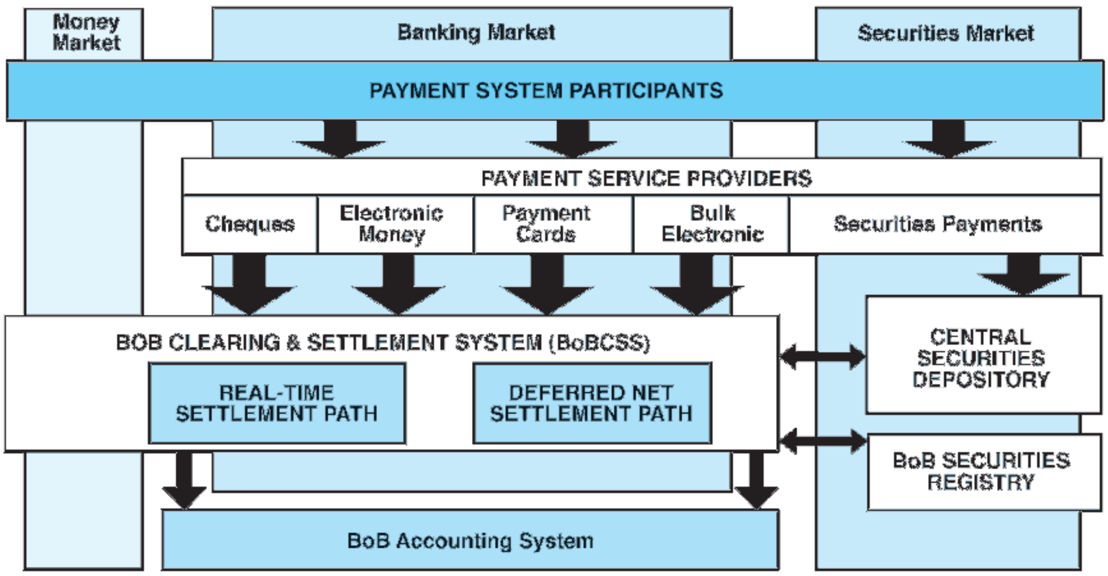
5.9 A number of initiatives are already under way to address these issues, and others will follow in the period to 2005. Major initiatives include the following:

(a) Automation of the Clearing House

5.10 The existing manual clearing system is in the process of being replaced with an automated system based on an electronic clearing house (ECH). Under the automated system, cheque details will be read electronically rather than being inputted manually into the system. The banks will submit this information to the Bank of Botswana in the form of computer data files sent over a private data network, and payments will be processed electronically at the ECH, which will in turn generate the required information for each of the participating banks, including settlement details. The various stages of clearing house automation are as follows:

- The development of standards for machine-readable cheques and payment vouchers.
- Issuing of Magnetic Ink Character Recognition (MICR) cheques to bank customers.
- Installation and testing of item processing equipment at the cheque-issuing banks (including the Bank of Botswana).
- Installation and testing of the ECH hardware and software at the Bank of Botswana.
- Installation and testing of the private data network linking the banks and the ECH.
- Amendment of clearing house rules to reflect the move to an automated system.

FIGURE 5.2: STRUCTURE OF THE PROPOSED PAYMENT SYSTEM



- Parallel testing of the whole system prior to live implementation.

- Implementation of a disaster recovery site.

5.11 As at the end of 2001, most of these steps had been completed and the system was being tested prior to scheduled live implementation early in 2002. Anticipated advantages of the automated clearing system include fewer errors and reduced clearing times. Besides leading to improved service, this will reduce the "float" of funds related to uncleared items held by the banks.

(b) Facilities for Bulk Electronic Payments

5.12 The introduction of an electronic funds transfer system for high volume low value payments (such as payrolls) based on "credit-push" principles will be pursued during 2002. It will involve a specialised payment stream for bulk electronic payments, and, being based on credit-push principles, where payments are pre-authorised and verified, settlement is quick and transaction costs are lower than those for cheques.

(c) The implementation of a Large Value Transfer System

5.13 Work has also started on planning a high value low volume electronic funds transfer system that will be specifically designed to accommodate time sensitive and high value payments. This system will be developed to accommodate Real Time Gross Settlement (RTGS) practices.

(d) Establishment of an Automated and Comprehensive Settlement System

5.14 An automated settlement system will be established that will accommodate input from the ECH and bulk electronic streams as well as external shared switches for specialised payment streams such as ATM and Point of Sale (POS) transactions together with securities and money market activities. The tentatively titled Bank of Botswana Clearing and Settlement System (BoBCSS) will accommodate both deferred net settlement and real time gross settlement paths. The overall structure of the anticipated payment system is depicted in Figure 5.2.

(e) Legislation

5.15 Existing legislation is insufficient to support the future development of the NPS. In fact, the existing payment system does not have any specific legal basis, but is based upon a set of bilateral and multilateral agreements between the participants (the Bank of Botswana and the commercial banks). Steps are being taken to strengthen the legislative and regulatory environment, and a new piece of legislation, the National Clearing and Settlement Systems (NCSS) Act is in the process of being drafted. This will formalise the role of the Bank of Botswana as the supervisor of the clearing and settlements system, and will also provide a firm legal foundation for some of the relationships between participants, their obligations, and the procedures that will be followed in the event of settlement failures. A legal review will also be undertaken of other legislation that is relevant to the payments system, including for example the Bills of Exchange Act, the Criminal Procedures and Evidence Act, the Companies Act and the Insolvency Act.

6. The Role of the Bank of Botswana

6.1 The Bank of Botswana has several key roles to play in the National Payments System and these operate at several levels. At the most general level, the Bank's role is based on Section 4 of the Bank of Botswana Act which specifies the primary objectives of the Bank. One of these objectives is stated as to "…promote and maintain monetary stability, an efficient payments mechanism and the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system in Botswana". The Bank's role is central to the National Payments System project, and indeed in some ways it is the "owner" of the project, providing overall policy guidance and co-ordination. The Bank is also responsible for ensuring that

Box 5.3: Responsibilities of the Central Bank in Applying Core Principles

A. The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.

B. The central bank should ensure that the systems it operates comply with the core principles.

C. The central bank should oversee compliance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.

D. The central bank, in promoting payment system safety and efficiency through the core principles, should co- operate with other central banks and with any other relevant domestic or foreign.

the NPS complies with the CPSS Core Principles (Box 5.3).

6.2 Beyond these general responsibilities, however, the Bank has other, more specific roles to play in the operation of the NPS. It is the de-facto operator and regulator of the payment system, and also provides settlement services to participants given that settlement takes place through the transfer of funds between accounts at the Bank. It also has an important role to play through the provision of liquidity - within established parameters - to the commercial banks in order to ensure that their settlement obligations can be met without disruption.

CHAPTER 6

CONCLUSION

1. Financial Sector Development

1.1 Botswana's recognition of the importance of the financial sector in the development process has provided the impetus for the very rapid expansion of the sector since the adoption of reforms in 1989. Despite the fast growth of financial activities, financial institutions have remained solvent, liquid and profitable. The broadly satisfactory performance of financial intermediaries was buttressed by the Bank of Botswana's supervisory role, as well as stable monetary conditions and the overall macroeconomic environment in a rapidly expanding economy. It is only when the financial sector is sound that its expansion can inspire confidence in the economy by both internal and external economic agents.

1.2 The preceding chapters have reviewed the progress made in various activities of the financial sector, particularly, the growth in the institutional infrastructure of financial intermediaries and their broad performance in respect of activities, 'soundness' and quality of service; and finally outlined their crucial role in the payments system. This chapter summarises the major findings of the theme in these important areas of the activities of Botswana's financial sector.

1.3 The financial sector has expanded since 1990 with respect to both institutional infrastructure and the monetary value of intermediation activities. The infrastructure, at the apex of which is the Bank of Botswana, was considerably more diversified in 2000 than it was at the beginning of the decade. Since 1990, additions to the infrastructure have included a commercial bank, an investment bank, a stock exchange, brokers and asset managers. Moreover, the range of services has expanded, partly in line with technological developments. The availability of ATMs, debit and credit cards has increased alongside other advanced services such as on-line (internet) and telephone banking facilities. The growth in infrastructure has, in part, led to an increased volume of activities. As measured by standard ratios, financial growth has been faster than non-mining economic growth. Deposits have risen at a faster rate than non-mining GDP, as has lending. The number of accounts provided by commercial banks has risen faster than population growth, indicating that a greater proportion of the population has access to banking services.

1.4 Financial sector growth has been accompanied by considerable changes in the structure of both savings and lending activities. Government has, however, continued to be the dominant saver, reflecting the structural characteristics of the economy and continued Government budget surpluses. Government savings are mostly held with the Bank of Botswana and they have little impact on the financial system more generally. When Government saving is excluded, commercial banks accounted for the bulk of deposits among financial intermediaries at the end of 2000, followed by contractual savings institutions especially life insurance companies and pension funds.

1.5 The growth of contractual savings institutions reflects another important change in the economy, which is the increasing importance of households as savers, and their generation of surplus funds for use by other sectors. The gain in the significance of households as savers may partly reflect a shift from saving in the form of non-financial assets (such as cattle and property) to financial assets (such as bank deposits and pension funds), as well as an increase in their overall savings rate, and suggests improvement in the overall efficiency of savings mobilisation by FIs.

1.6 Besides being the largest saver in the economy, Government has historically also been the largest lender, either directly through the use of the Public Debt Service Fund (PDSF) and other programmes, or indirectly through the financing of state-owned NBFIs. Government's lending activities reflected the difficulties faced by the private financial sector in the past in providing large, long-term loans, particularly those required by the parastatals. In addition to lending to the parastatal sector, specialised institutions such as the NDB and BDC targeted lending to specific sectors especially agriculture and manufacturing. Over time, however, lending has shifted away from these targeted sectors towards the service sector, particularly property, retail and wholesale activities. The shift in the loan allocations implies that the lending criteria adopted by these institutions is now more market driven as a result of changes following poor performance by several NBFIs in the late 1980s and early 1990s, and their subsequent restructuring.

1.7 Government has also reviewed its own lending activities, and the operations of the PDSF are being wound down. With the expansion of the banking system enabling it to make larger loans, and the beginning of the establishment of more viable capital markets, the need for Government to provide such large-scale finance to parastatals has been reduced. The provision of finance through other Government schemes, such as the Financial Assistance Policy and the Small, Medium and Micro Enterprise loan scheme, is being restructured to make it more sustainable and better able to support viable business ventures. In general, there has been recognition of the need for Government to balance the imperatives of specialised and targeted lending with efficient allocation of resources.

1.8 The combined result of a scaling down of Government's lending activities and the expansion of the financial sector, is that commercial banks had surpassed the Government as the largest source of lending in the economy by the late 1990s. In addition, the NBFIs progressively adopted a more commercial stance in their activities. These changes should have positive implications for the efficiency of both financial intermediation in the economy and investment. It is encouraging that, based on a range of criteria, the banking system has become more efficient in recent years.

1.9 The mobilisation and allocation of finance nonetheless remains dominated by financial intermediaries such as banks and NBFIs, which provide finance mainly in the form of loans of relatively short duration. The role of financial markets, such as stock and bond markets, remains limited. One of the biggest challenges facing the financial sector in coming years is to increase the size and liquidity of these markets in order to provide an increased range of financial instruments for savers and different types of finance for borrowers. The growth of pension funds, especially following the formation of the new pension fund for Government employees, should stimulate this process, as there will be considerable demand from savers for financial instruments with the risk, return and maturity characteristics that capital markets generally provide, in the form of equities and longer term bonds. In light of this demand, firms, including parastatals earmarked for privatisation, should find it more attractive to issue such instruments. The policy framework can support this process by ensuring that the supervision and regulation of capital markets conforms with modern international standards and practices. The Government's plan to undertake a bond issue will provide a risk-free benchmark for the pricing of bonds issued by private and parastatal firms. A more developed and efficient capital market will also contribute to the effective implementation of monetary policy. However, a financial sector with more active capital market will require a further strengthening of the regulatory and supervisory framework in Botswana.

2. The Quality of Banking Services and the Payments System

2.1 The ability of financial intermediaries to attract savings and allocate them efficiently to borrowers depends on the quality of the services delivered, which, in turn, builds public confidence in the system. It was in recognition of this imperative that the Bank of Botswana carried out surveys in 1997 and 2001 in order to ascertain customers' perceptions of the reasonableness of the charges and the quality of service provided. Based on the 2001 survey, the quality of service was considered "average", although improvements had occurred during the previous five years. Even so, there were a number of areas that required improvements. In particular, concerns were raised with regard to the speed with which customers are attended to at banking hall counters, the responsiveness to enquiries and loan applications, the degree of disclosure of charges and their levels, as well as frequent operational problems of ATMs.

2.2 More generally, the banking system faces challenges arising from expectations that it will provide services to a progressively larger proportion of the population. At present, banking facilities are highly concentrated in urban areas. Although this location pattern may reflect both the population trend of increased urbanisation, and presumably, the perceived locations of profitable business opportunities, there are some large peri-urban and urban villages that have no ready access to banking services, despite the fact that these have been among the fastest growing communities over the past decade. Banks will need to take advantage of emerging business opportunities in these areas.

2.3 Furthermore, technology will continue to play an important role in opening up such opportunities. Basic infrastructure development, including village electrification and the extension of telecommunications services nationwide, will facilitate the technical feasibility of providing financial services in more and more localities, and reduce the costs of doing so. However, technology is also making the traditional banking model less relevant; fully staffed branches are expensive and require a critical mass of business to sustain them, and the expansion of service provision is likely to be based on more sophisticated card-based ATM technology. In extending services to marginal areas, and beyond the middle and high-income groups that have traditionally been the banks' focus, banks will also have to move beyond a "stand-alone" approach. Alliances with related service providers will be the key to extending services, not least by employing lower-cost business models and through cost-sharing. More extensive financial service provision in the rural areas, for instance, could become economically feasible if based upon the existing network of Post Offices, with modern ATMs supported by improvements in telecommunications technology. Increasingly, when members of the public receive banking services, they may not receive them from conventional banks – as demonstrated by a newly established micro-lending scheme that is financed by one of the commercial banks but is administered by a specialised independent entity.

2.4 Technology is also bringing about rapid change in the payment system, which is an integral part of financial intermediation activities. With the expansion of the economy and the activities of the financial sector, an increasing volume of transactions is conducted through the inter-relationship between commercial banks. These transactions require a clearing arrangement of inter-bank obligations arising from the flows of receipts and payments. While commercial banks are key participants in the payment system, clearing arrangements are conducted under the auspices of the central bank. For an effective payments system, it is essential that the clearing system should be prompt, secure and minimize the risk of non-payment of obligations by the participants. These desired attributes of the payments system facilitate the smooth operations of domestic, regional and international payments. An effective payment system is also central to the quality of services provided by banks to the public.

2.5 Botswana's payments system requires improvements in the clearing facilities in order to reduce both the delays and risks associated with non-payment and fraud. Accordingly, initiatives have been taken to reform the National Payments System (NPS), covering the introduction of a legal framework, an electronic payment transfer system and other more secure payment instruments for large transactions. The reforms are, appropriately, being driven by the Bank of Botswana. An important objective of the reforms underway is to ensure that Botswana's institutional arrangements, legal framework and the instruments for the NPS are in line with those of SADC, which, in turn, will be in conformity with the international guidelines recommended by the Bank for International Settlements (BIS). Both the globalisation of financial markets and the desire to establish Botswana as an International Financial Service Centre, underscore the urgency for modernisation and efficient payments system, enhanced mobilisation of savings and allocative efficiency of the financial sector. Equally important, the objective of enhancing the effectiveness of market-oriented monetary policy can best be achieved if financial markets are competitive and stable in the context of a sound macroeconomic policy framework.