BANK OF BOTSWANA

ANNUAL REPORT

2005

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BANK OF BOTSWANA

Governor's Office
Tel : (267) 360-6371/67/79
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Private Bag 154
Gaborone
Botswana

March 31, 2006

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

Honourable Minister

In accordance with Cap 55:01 of the Bank of Botswana Act, 1996 (Section 68 (1)), I have the honour to submit the Annual Report of the Bank of Botswana for 2005, which covers:

(a) a report on the operations and other activities of the Bank during 2005;

(b) a copy of the Bank's annual accounts for the year ended December 31, 2005 certified by the external auditors and approved by the Board on March 21, 2006; and

(c) a review of the economy in 2005, a theme chapter on *The Role of Capital Markets in Economic Development - Botswana's Experience* and a statistical section.

Yours sincerely

Linah K Mohohlo
GOVERNOR

17938 Khama Crescent, Gaborone; Tel: (267) 360-6000; Cables: Botbank; Telex: 2448 BD/2405 BD
Website: www.bankofbotswana.bw

Board Members
as at December 31, 2005

L K Mohohlo
Governor and Chairman of the Board

G K Cunliffe
Board Member

S S G Tumelo
Board Member

B Moeletsi
Board Member

O A Motshidisi
Deputy Governor

C S Botlhole-Mmopi
Board Member

B Bolele
Board Member

B K Molosiwa
Board Member

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as at December 31, 2005

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Board Member

Contents – Part A

Statutory Report on the Operations and Financial Statements of the Bank in 2005

Contents – Part B

CHARTS AND TABLES

Abbreviations Used in the Report

ABCB	African Banking Corporation Botswana
AGOA	Africa Growth and Opportunity Act
AIDS	Acquired Immunodeficiency Syndrome
ASEA	African Stock Exchange Association
BAB	Bankers Association of Botswana
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BDF	Botswana Defence Force
BEAC	Business and Economic Advisory Council
BoB	Bank of Botswana
BoBCs	Bank of Botswana Certificates
BOCCIM	Botswana Confederation of Commerce Industry and Manpower
BRVM	Bourse Regionale des Valeurs Mobilieres
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
BSM	Botswana Share Market
BURS	Botswana Unified Revenue Service
CEDA	Citizen Entrepreneurial Development Agency
CPI	Consumer Price Index
CSO	Central Statistics Office
DCI	Domestic Company Index
DFIs	Development Finance Institutions
DPCF	Debt Participation Capital Funding
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FNBB	First National Bank Botswana Limited
GDP	Gross Domestic Product
HIV	Human Immunodeficiency Virus
HSBC	Hong Kong and Shangai Banking Corporation
ICT	Information and Communications Technology
IFC	International Finance Corporation

IFSC	International Financial Services Centre
IIP	International Investment Position
IMF	International Monetary Fund
IPOs	Initial Public Offerings
JSE	Johannesburg Stock Exchange
KBAL	Kingdom Bank Africa Limited
MFDP	Ministry of Finance and Development Planning
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
MTR	Mid-Term Review
NBFIs	Non-Bank Financial Institutions
NDB	National Development Bank
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NEMIC	National Employment, Manpower and Incomes Council
OTC	Over the Counter
OPEC	Organisation of Petroleum Exporting Countries
PDSF	Public Debt Service Fund
POPF	Public Officers Pension Fund
PPADB	Public Procurement and Asset Disposal Board
REER	Real Effective Exchange Rate
RSF	Revenue Stabilisation Fund
SACU	Southern African Customs Union
SADC	Southern African Development Community
SDR	Special Drawing Right
SIT	Sechaba Investment Trust
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax
VCB	Venture Capital Board

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Part A

Statutory Report on the Operations and Financial Statements of the Bank, 2005

Bank of Botswana

Heads of Department
as at December 31, 2005

R H Nlebesi
Banking & Currency Department

E T Rakhudu
Human Resources Department

O Mabusa
Banking Supervision Department

N A Mabe
Accounting & Planning Department

A M Motsomi
Research Department

J Ghanie
Technical Services Department

O Modisa
Payments & Settlement Department

STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK IN 2005

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 the promotion of 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 an efficient payments system and a sound banking sector

Functions of the Bank

1.2 As prescribed by the Bank of Botswana Act (CAP 55:01) 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) Monetary Policy Implementation is directed mainly at achieving the primary responsibility of the Bank, i.e., 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.

(c) Issuance of Currency (banknotes and coin) of high quality is an essential ingredient of an efficient payments system as it fosters confidence in the legal tender which, in turn, facilitates transactions and economic activity in general.

(d) Supervision of Banks and Other Financial Institutions is conducted in accordance with the Banking Act (CAP 46:02) and other relevant statutes. The purpose of prudential regulation and supervision is to ensure the safety, solvency and efficient functioning of the banking system and the overall financial sector.

(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 the 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 and Development Planning 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 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 by the Bank of Botswana Act. As at the end of 2005, seven members were in position, leaving 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. The Governor submits a report, after approval by the Board, on the operations and the audited financial statements of the Bank to the Minister of Finance and Development Planning within three months of the end of the Bank's financial year.[1]

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

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; it 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 2005, the Bank's eight Departments comprised Human Resources, Payments and Settlement, Financial Markets, Accounting and Planning, Banking and Currency, Technical Services, Research and Banking Supervision; 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, as appropriate.

The Bank has eight 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 the banking system's credit growth as an intermediate target.

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) 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, 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 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 selected national and international institutions. It is also a lender of last resort to the financial institutions licensed by the Bank.

Implementing the Banking Act and Regulations

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

1.16 Through ongoing 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 the institutions are managed in a prudent and safe manner. To this end, the Bank enforces prudential standards with respect to capital adequacy, liquidity, asset quality and corporate governance of the banks.

1.17 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 by the public, especially in the form of activities that involve unauthorised deposit taking and use of banking names.

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

1.18 Under the provisions of the Banking Act, the Bank has specific responsibilities relating to combating money laundering. Accordingly, banks are required to adhere to "know your customer" provisions 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.

1.19 The Bank is also responsible for the regulation and supervision of the International Financial Services Centre entities as well as the administration of the Collective Investment Undertakings Act (CAP56:09).

1.20 The Bank monitors commercial bank compliance with primary reserve requirements. 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 collaborates with private sector institutions, international organisations and the Government in introducing improvements to the safety and efficiency of the payments system.

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, 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). From the end of May 2005, a crawling band exchange rate mechanism was introduced and the rate of crawl is based on the differential between the Bank's inflation objective and forecast inflation for trading partner countries. 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 a stable real effective exchange rate and price competitiveness of domestically produced goods.

Managing Foreign Exchange Reserves

1.22 As Botswana's foreign exchange reserves have continued to grow, the Bank has sub-divided 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 within acceptable limits of risk, while the remainder comprises the Liquidity Portfolio, which is invested in money market instruments and short-term securities.

Foreign exchange reserves are managed to meet specific objectives

Advice on Economic Policy, Provision of Statistics and Public Education

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.

The Bank serves as advisor to Government

1.24 The Bank conducts annual briefings on economic trends based on the *Annual Report* and publishes macroeconomic statistics and the *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

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.

The Bank is the sole supplier of notes and coin

2. REPORT ON THE BANK'S OPERATIONS

Introduction

2.1 This section highlights key developments relating to the Bank's functions during 2005.

External Relations

The Bank continued to enjoy good relationships with regional and international organisations

2.2 In 2005, the Bank continued to enjoy good relationships with regional and international organisations. The Bank continued to take part in relevant conferences and seminars such as those of the SADC Committee of Central Bank Governors (CCBG), the Association of African Central Banks (AACB), the Bank for International Settlements (BIS), the International Monetary Fund (IMF) and the World Bank. The Bank benefited from assistance from the IMF through long-term advisors, short-term technical assistance and staff placements. As usual, the Bank held annual economic briefings for a range of stakeholders, including the Cabinet, Parliamentarians, media, senior government officials, representatives of the private and parastatal sectors and diplomats.

Management and Administration of the Bank

2.3 Pursuant to the strategic objective to attract and retain quality staff, the Bank has been recruiting new staff by continually advertising vacant entry-level positions as they occur. A number of staff members were sent on training during the period under review, for a variety of short and long-term training programmes.

2.4 The Bank completed the job evaluation exercise carried over from the 2004 Work Programme, the results of which were implemented in June 2005. In general, the exercise was a success and, except for a few job grade changes, it revealed a general consistency in job grades since the system was first adopted in 1994.

HIV/AIDS campaign continues in the work place

2.5 HIV/AIDS in the work place remains a major challenge for the Bank. This year the campaign focused on destigmatisation of HIV and creation of a tolerant and supportive work environment. The programmes seem to be having the desired impact as evidenced by the increased and more enthusiastic participation in campaign activities and the number of staff who are actively managing HIV-related ill health and an increase in the number of staff undergoing HIV testing.

The Bank produced a number of publications during the year

2.6 The Bank produced a number of publications during the year, including the 2004 Annual Report, the 2004 Banking Supervision Annual Report, the 2005 Monetary Policy Statement (MPS) and its Mid-Year Review, as well as the monthly Botswana Financial Statistics. The Bank also completed the production and printing of a Management Handbook for the Bank.

Public initiatives sustained

2.7 On public relations, the Bank maintained close relations with the media and undertook community service programmes through the Donations Advisory Group; financial and "in-kind" donations were made to a number of deserving charities and non-governmental organisations. As part of its Public Education programme, the Bank participated in the Botswana Confederation of Commerce, Industry and Manpower (BOCCIM), the Botswana Financial and Botswana International Trade Fairs, which are held annually, as well as in various career fairs. The Bank also facilitated schools visits, radio broadcasts and TV magazine programmes.

2.8 In its advisory role and collaboration with other institutions, the Bank continued to be represented in various external committees, viz., the National Employment, Manpower and Incomes Council (NEMIC), the Poverty Datum Line Reference

Group, the MFDP/BoB Working Group,[2] the Competition Policy Reference Group, the Statistics Producers Committee, the National Committee on Trade Policy and Negotiations, as well as the Business and Economic Advisory Council.

2.9 On internal audit matters, twenty-nine (29) scheduled audits and eight (8) special audits were carried out and the reports rated according to the significance of the findings. The audits provide a means to continuously assess internal controls and improve ways of communicating findings, while ensuring that the Departments achieve their objectives in the most efficient manner. Summaries of major findings and recommendations from the audits were reported to the Audit Committee of the Board in order to provide the members with insight into the internal control environment of the Bank.

Quarterly reviews of the Control Risk Self-Assessment Programme were carried out by Departments and Divisions; highlights of the findings and recommendations were reported to the Audit Committee. A Quality Assurance and Improvement Programme Review was undertaken by Deloitte and Touche during the year.

Monetary Policy Implementation

New exchange rate regime adopted in 2005, and restrictive monetary policy stance maintained

2.11 The Bank continued to undertake economic analysis to support policy formulation. In addition to the routine production of briefing notes and background papers on recent economic developments, the first part of the year saw completion of work on the crawling band exchange rate that was subsequently introduced in May 2005. As a result of these changes and the accompanying devaluation of the Pula, and in the context of increased external volatility, the effective monitoring of inflationary trends has been exceptionally challenging, while a more proactive monetary policy stance has been necessary. The Monetary Policy Committee (MPC) met six times in 2005 and adjustments to interest rates were made on three occasions: downwards by 0.25 percent in April, and upwards by the same magnitude in August and October. The Mid-Term Review of the 2005 Monetary Policy Statement resulted in a change in the inflation objective, from 3 - 6 percent to 4 – 7 percent, and the range for the intermediate target, commercial bank credit growth, was changed from 10 – 13 percent to 11 -–14 percent.

The Bank continued work on developing an inflation model for Botswana and improving monetary and balance of payments statistics

2.12 Progress has continued in developing an inflation model for Botswana with the support of the IMF-sponsored technical assistance from the Czech National Bank. As a result, the medium term forecasting model is at an advanced stage of development and, once completed, will be used as part of the MPC briefing process. The Bank hosted IMF technical assistance missions on the balance of payments, monetary statistics, and modelling and forecasting, as well as on implementation of the economic and financial database.

2.13 The Bank continued to use open market operations to mop up excess liquidity from the banking system and to influence short-term interest rates. During 2005 52 weekly auctions were conducted. The value of outstanding Bank of Botswana Certificates rose from P9.8 billion in December 2004 to P12.8 billion in December 2005. Repurchase agreements and reverse repurchase agreements were used to manage short-term fluctuations in liquidity.

2 This group comprises senior staff from the Ministry of Finance and Development Planning and the Bank of Botswana.

Reserve Management

2.14 The Investment Committee met regularly to review international financial, economic and political developments and translated these into investment strategy. The Committee upheld the key objectives of safety, liquidity and return.

Banking and Currency

New banking systems implemented

2.15 Major developments during 2005 included the implementation of the new banking system called Globus. The system replaced the Bankmaster system that was no longer producing the desired outputs needed by the Bank. Another major activity was the implementation of the Real Time Gross Settlement (RTGS) system.

2.16 To ensure compliance with the National Clearance and Settlement Systems Act, the operation of the Electronic Clearing House (ECH) was transferred to the Bankers Association of Botswana (BAB) and relocated from the Bank to Barclays House. This was successfully implemented on September 1, 2005.

2.17 Administration of the National Savings Certificates (NSCs) was transferred to the Botswana Savings Bank as at the end of March 2005.

Banking Supervision

2.18 The financial condition of banks was assessed through regular bilateral and trilateral meetings, off-site monitoring and on-site examinations, risk profiling and "early-warning" management reports. These revealed a generally satisfactory performance by banks. However, the Banking Supervision Department noted some instances of incorrect reporting from banks and qualified audit reports for the Botswana Savings Bank (BSB) for the financial years 2003, 2004 and 2005.

2.19 Full scope on-site examinations were carried out at African Banking Corporation Botswana (ABCB), Bank of Baroda (Baroda) and National Development Bank (NDB) during the year. Consumer compliance examinations were also conducted at BSB and the Botswana Building Society (BBS).

2.20 The Bank approved an application for a banking license by Capricorn Investments (Pty) Ltd to operate as Bank Gaborone.

2.21 The Bank assumed temporary management of Kingdom Bank Africa Limited (KBAL) with effect from June 22, 2005. After recapitalisation of KBAL, the Bank lifted the temporary management and handed the bank over to its management and owners on September 1, 2005.

2.22 Seven additional sub-funds of the Hong Kong Shanghai Banking Corporation (HSBC)- Capital Secured Growth Fund Plc were approved for marketing in Botswana, bringing the number of HSBC funds marketed domestically to 32 as at end of July 2005.

2.23 As at December 31, 2005, a total of 37 bureaux de change were licensed. On-site examinations were carried out on eight bureaux and no major violations were noted.

2.24 The closing balance of unclaimed abandoned funds was P4 268 952.38 as at December 31, 2005, made up of funds from First National Bank of Botswana

Limited (FNBB), Barclays Bank of Botswana Limited (Barclays) and Standard Chartered Bank Botswana Limited (Stanchart). The funds were advertised in the local newspapers during the last quarter of the year.

Technical Services

2.25 A number of the Bank's information technology systems were upgraded during the year to keep pace with the latest state of the art equipment. These included the reserve management system, HiPortfolio, and the Reuters Treasury Dealing System.

IT systems upgraded

Protective Services

2.26 The Bank has continued to cooperate with the financial institutions and related entities in preventing financial fraud and currency counterfeiting. Plans are afoot to put in place a central fraud database for use by all interested parties.

ANNUAL FINANCIAL STATEMENTS

2005

BANK OF BOTSWANA

BLANK PAGE 26

CONTENTS

The Annual Financial Statements set out on pages 28 to 49 were approved by the Board on March 21, 2006 and signed by:

Linah K Mohohlo	**Nozipho A Mabe**
Governor	**Director, Accounting and Planning Department**

Deloitte.

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Botswana

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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 29 to 49 for the year ended December 31, 2005. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Management, as well as evaluating the overall financial statement 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, 2005 and of the result of its operations, its changes in shareholder's funds, and cash flows for the year then ended, in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

Deloitte & Touche

Deloitte & Touche
Certified Public Accountants

GABORONE
March 21, 2006

Audit.Tax.Consulting.Financial Advisory.

Member of
Deloitte Touche Tohmatsu

BALANCE SHEET

December 31, 2005

	Notes	2005 P'000	2004 P'000 (Restated)
ASSETS			
Property and Equipment	1	127 668	130 244
Foreign Exchange Reserves			
Liquidity Portfolio	2.1	9 285 046	3 727 352
Pula Fund	2.2	24 867 274	20 013 213
International Monetary Fund (IMF)			
Reserve Tranche	3.1	58 201	134 084
Holdings of Special Drawing Rights	3.2	281 133	226 327
Administered Funds	3.4	118 747	99 219
Total Foreign Exchange Reserves		34 610 401	24 200 195
Government of Botswana Bonds	4	88 464	108 229
Advances to Banks	5	–	11 900
Other Assets	6	52 460	42 513
TOTAL ASSETS		34 878 993	24 493 081
LIABILITIES			
Notes and Coin in Circulation	7	935 263	910 858
Bank of Botswana Certificates	8	12 416 133	9 649 272
Deposits	9	1 596 622	1 684 555
Allocation of Special Drawing Rights (IMF)	3.3	34 595	28 584
Liabilities to Government (IMF Reserve Tranche)	10	58 201	134 084
Dividend to Government	11	426 169	97 025
Other Liabilities	12	34 553	26 370
Total Liabilities		15 501 536	12 530 748
SHAREHOLDER'S FUNDS			
Paid-up Capital	13	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		12 209 061	8 936 740
Currency Revaluation Reserve		3 688 770	129 893
Market Revaluation Reserve		1 854 626	1 270 700
General Reserve	14	1 600 000	1 600 000
Total Shareholder's Funds		19 377 457	11 962 333
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		34 878 993	24 493 081
FOREIGN EXCHANGE RESERVES IN US DOLLARS[1]		6 309 476	5 660 426
FOREIGN EXCHANGE RESERVES IN SDR[2]		4 405 904	3 700 210

		2005	2004
1. Pula/United States dollar		0.1823	0.2339
2. Pula/SDR		0.1273	0.1529

INCOME STATEMENT

Year ended December 31, 2005

	Notes	2005	2004 (Restated)
		P'000	P'000
INCOME			
Interest – Foreign exchange reserves		862 628	634 184
Interest – Debt Participation Capital Funding Limited Loan		–	19 989
Interest – Government of Botswana Bonds	24	9 774	10 996
Market gains on disposal of securities	15	1 219 054	439 742
Dividends		216 423	171 156
Realised currency revaluation gains	15/16	1 878 717	–
Unrealised currency revaluation gains	16	2 657 268	380 181
Unrealised market revaluation gains		7 570	–
Profit on domestic foreign exchange deals		175 197	4 625
Other income		11 472	9 263
		7 038 103	1 670 136
EXPENSES			
Realised currency revaluation losses	16	–	341 837
Interest	17	1 364 150	1 174 385
Administration costs		191 874	164 868
Depreciation		18 258	11 604
Unrealised market revaluation losses		–	8 844
		1 574 282	1 701 538
NET INCOME/(LOSS) FOR THE YEAR		5 463 821	(31 402)
TRANSFER TO CURRENCY REVALUATION RESERVE	16	(4 517 644)	(35 244)
NET INCOME/(LOSS) BEFORE TRANSFER (TO)/FROM GOVERNMENT INVESTMENT ACCOUNT		946 177	(66 646)
TRANSFERS (TO)/FROM GOVERNMENT INVESTMENT ACCOUNT		(205 008)	454 746
NET INCOME AVAILABLE FOR DISTRIBUTION		741 169	388 100
APPROPRIATIONS			
DISTRIBUTION TO GOVERNMENT		(741 169)	(388 100)
Dividend to Government from Pula Fund		(420 000)	(388 100)
Residual Net Income		(321 169)	–

CASH FLOW STATEMENT

Year ended December 31, 2005

	Notes	2005 P'000	2004 (Restated) P'000
OPERATING ACTIVITIES			
Cash generated by operations	19	3 551 487	871 845
INVESTING ACTIVITIES			
Net Investments		(5 182 854)	(81 584)
Loan to Debt Participation Capital Funding Limited		–	(800 000)
Loan Repayment by Debt Participation Capital Funding Limited		–	800 000
Proceeds from redemption of Government of Botswana Bonds (at cost)		19 189	–
Net interest received from Government bonds		147	–
Proceeds from disposal of property and equipment		587	404
Purchase of property and equipment	1	(15 699)	(16 107)
NET CASH USED IN INVESTING ACTIVITIES		(5 178 630)	(97 287)
FINANCING ACTIVITIES			
Dividend to Government	11	(412 025)	(479 825)
Government Investment/(Withdrawals)		2 014 763	(387 596)
NET CASH GENERATED FROM/(USED IN) FINANCING ACTIVITIES		1 602 738	(867 421)
NET INCREASE IN CURRENCY IN CIRCULATION		(24 405)	(92 863)
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(910 858)	(817 995)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(935 263)	(910 858)

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS

Year ended December 31, 2005

	Share Capital	Currency Revalua-tion Reserve	Market Revalua-tion Reserve	General Reserve
	P'000	P'000	P'000	P'000
Balance at January 1, 2004	25 000	145 163	923 159	1 600 000
Transfer to Income Statement of currency gains realised on repayment of loan by the IMF's Poverty Reduction Growth Facility (PRGF) Administered Fund	–	(17 229)	–	–
Transfer from Income Statement	–	35 244	–	–
Unrealised market gains for the year	–	–	427 730	–
Transfers to/(from) Government Investment Account:				
Unrealised market gains for the year	–	–	(80 189)	–
Unrealised currency gains for the year	–	(33 285)	–	–
Government withdrawals	–	–	–	–
Net (losses)/gains not recognised in the Income Statement for the year	–	(15 270)	347 541	–
Net loss for the year as previously stated	–	–	–	–
Prior year adjustment resulting from change in accounting policy	–	–	–	–
Net loss for the year as restated	–	–	–	–
Transfer to Currency Revaluation Reserve	–		–	–
Dividend to Government from Pula Fund	–	–	–	–
Transfers to the Income Statement for the year:				
Deficit of Government Pula Fund income over Pula Fund Dividend	–	–	–	–
To cover residual deficit	–	–	–	–
Balance at December 31, 2004	25 000	129 893	1 270 700	1 600 000
Transfer from Income Statement	–	4 517 644	–	–
Net unrealised market gains for the year	–	–	677 709	–
Transfers to Government Investment Account:				
Unrealised market gains for the year	–	–	(93 783)	–
Unrealised currency gains for the year	–	(958 767)	–	
Government investments	–	–	–	–
Net gains not recognised in the Income Statement for the year	–	3 558 877	583 926	–
Net income for the year	–	–	–	–
Transfer to Currency Revaluation Reserve	–	–	–	–
Dividend to Government from Pula Fund	–	–	–	–
Residual net income transferred to Government	–	–	–	–
Transfers to/(from) the Income Statement for the year:				
Excess of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
Balance at December 31, 2005	25 000	3 688 770	1 854 626	1 600 000

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

Government Investment Account P'000	Accumulated Profit P'000	Total P'000	
9 665 608	–	12 358 930	**Balance at January 1, 2004**
–	–	(17 229)	Transfer to Income Statement of currency gains realised on repayment of loan by the IMF's Poverty Reduction Growth Facility (PRGF) Administered Fund
–	–	35 244	Transfer from Income Statement
–	–	427 730	Unrealised market gains for the year
			Transfers to/(from) Government Investment Account:
80 189	–	–	Unrealised market gains for the year
33 285	–	–	Unrealised currency gains for the year
(387 596)	–	(387 596)	Government withdrawals
(274 122)	–	58 149	**Net (losses)/gains not recognised in the Income Statement for the year**
–	(404 711)	(404 711)	**Net loss for the year as previously stated**
–	373 309	373 309	Prior year adjustment resulting from change in accounting policy
–	(31 402)	(31 402)	**Net loss for the year as restated**
–	(35 244)	(35 244)	Transfer to Currency Revaluation Reserve
–	(388 100)	(388 100)	Dividend to Government from Pula Fund
			Transfers to the Income Statement for the year:
(94 210)	94 210	–	Deficit of Government Pula Fund income over Pula Fund Dividend
(360 536)	360 536	–	To cover residual deficit
8 936 740	–	11 962 333	**Balance at December 31, 2004**
–	–	4 517 644	Transfer from Income Statement
–	–	677 709	Net unrealised market gains for the year
			Transfers to Government Investment Account:
93 783	–	–	Unrealised market gains for the year
958 767	–	–	Unrealised currency gains for the year
2 014 763	–	2 014 763	Government investments
3 067 313	–	7 210 116	**Net gains not recognised in the Income Statement for the year**
–	5 463 821	5 463 821	Net income for the year
–	(4 517 644)	(4 517 644)	Transfer to Currency Revaluation Reserve
–	(420 000)	(420 000)	Dividend to Government from Pula Fund
–	(321 169)	(321 169)	Residual net income transferred to Government
			Transfers to/(from) the Income Statement for the year:
205 008	(205 008)	–	Excess of Government Pula Fund Income over Pula Fund Dividend
12 209 061	–	19 377 457	**Balance at December 31, 2005**

ACCOUNTING POLICIES

December 31, 2005

Basis of Presentation of Financial Statements

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

Change in Accounting Policy

International Accounting Standard No. 21 – "The Effects of Changes in Foreign Exchange Rates" requires that all realised and unrealised exchange gains and losses on monetary items be reported in the Income Statement. Prior to December 31, 2004, the Bank recognised unrealised exchange gains/losses relating to available-for-sale financial instruments directly in equity, as one of the alternatives allowed by IAS No. 39, "Financial Instruments Recognition and Measurement". Effective January 1, 2005, this alternative is no longer permitted by the Standard; hence all unrealised currency movements relating to monetary items are reported in the Income Statement. However, in line with the Bank's existing policy, these exchange gains/losses are not distributable and are, therefore, appropriated to the Currency Revaluation Reserve. Comparative figures for the year ended December 31, 2004 have been restated to effect this change retrospectively. The effect on the Income Statement and the Currency Revaluation Reserve as at December 31, 2004 as a result of the change in accounting policy referred to above is as follows:

	P'000
Income Statement:	
Increase in net unrealised currency gains	373 309
Transfer to Currency Revaluation Reserve	(373 309)
Net effect on Net Income Available for Distribution	–
Currency Revaluation Reserve:	
Decrease in unrealised currency gains for the year	(373 309)
Transfer from Income Statement	373 309
Net effect on Currency Revaluation Reserve	–

Financial Instruments

General

Financial instruments carried on the balance sheet include all assets and liabilities, including derivative instruments, but exclude property and equipment.

Short-term Investments (Liquidity Portfolio)

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

Securities invested in this portfolio are initially recognised at cost and are subsequently remeasured at market value based on bid prices. All related realised and unrealised gains and losses are taken to the Income Statement.

ACCOUNTING POLICIES (CONTINUED)

December 31, 2005

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments. All other purchases and sales are recognised as derivative forward transactions until settlement.

Long-term Investments (Pula Fund)

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

Unrealised revaluation gains and losses arising from changes in the market value of the instruments classified as available-for-sale are recognised in the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated market value or impairment adjustments are included in the Income Statement as gains or losses from investment securities.

All purchases and sales of investment securities in the fund are recognised at trade date, which is the date that the Bank commits to purchase or sell the investments. All other purchases and sales are recognised as derivative forward transactions until settlement.

Derivative Instruments

Derivative financial instruments are recognised in the balance sheet at cost (including transaction costs) and are subsequently remeasured at market value, based on bid prices for assets held or liabilities to be issued, and ask/offer prices for assets to be acquired or liabilities held. The treatment of market value movements in derivative instruments depends on whether they are designated as part of the Pula Fund or the Liquidity Portfolio.

FOREIGN CURRENCY ACTIVITIES

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

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

All monetary assets and liabilities denominated in foreign currencies are translated to Pula using the bid and offer rates of exchange, respectively, at the close of the financial year. All exchange gains/losses realised on disposal of financial instruments and unrealised exchange gains/losses are included in the Income Statement. However, all gains and losses relating to disposals whose proceeds are reinvested in foreign assets, and unrealised gains/losses are not distributable; they are appropriated to the Currency 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, based on offer prices, with movements in matured and unmatured discount recognised in the Income Statement.

ACCOUNTING POLICIES (Continued)

December 31, 2005

Government of Botswana Bonds

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

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

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

Secured Lending Facility

Under the Secured Lending Facility (SLF), the Bank provides emergency and intermittent funding to solvent financial institutions, intended to bridge overnight liquidity shortages. The advances are secured by Government of Botswana Bonds and Bank of Botswana Certificates (BoBCs), valued at market prices on the date of the transaction. The Bank has the right to call for additional collateral, should the value of the security decline during the tenure of the facility. Interest earned on the advances is credited to the Income Statement while advances outstanding as at the balance sheet date are recorded under the heading "Advances to Banks".

Repurchase and Reverse Repurchase Agreements

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

Securities purchased under agreement to resell (Repurchase Agreement) are recorded as funds receivable under the heading "Advances to Banks".

Only high quality, marketable and freely transferable paper with a minimum amount of risk is acceptable as security at the discretion of the Bank. Government and Government guaranteed securities of any maturity and other eligible paper with a remaining life of 184 days or less are also acceptable as security.

Securities sold under agreement to repurchase (Reverse Repurchase Agreement) are disclosed as Deposits.

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

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

Assets, Liabilities and Provisions Recognition

Assets

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

ACCOUNTING POLICIES (CONTINUED)

December 31, 2005

Contingent Assets

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

Liabilities and Provisions

The Bank recognises liabilities (including provisions) when:

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

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

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

Derecognition of Assets and Liabilities

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

INCOME AND EXPENSE RECOGNITION

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

OFFSETTING FINANCIAL INSTRUMENTS

The Bank offsets financial assets and liabilities and reports the net balance in the Balance Sheet where:

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

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

(iii) the maturity date for the financial asset and liability is the same; and

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

In view of the fact that the Bank values its foreign exchange investments on a portfolio basis, assets and liabilities within each portfolio have been set off.

GENERAL RESERVE

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

ACCOUNTING POLICIES (CONTINUED)

December 31, 2005

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.

MARKET REVALUATION RESERVE

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

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

PROPERTY AND EQUIPMENT AND DEPRECIATION

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

At each balance sheet date, the Bank reviews the carrying amounts of its tangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment.

Any impairment loss is recognised immediately in the Income Statement.

No depreciation is provided on land. All other property and equipment are depreciated on a straight line basis at the following annual rates, after determining the residual value of such assets:

		Percent
Buildings		2.50
Furniture, fixtures and equipment		20–50
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 (CAP 27:03). Contributions were made at the rate of 21.5 percent of pensionable emoluments up to November 30, 2005. On December 1, 2005 the rate was reduced to 20 percent of pensionable emoluments following the suspension of the Bank's 1.5 percent contribution to the Reserve Account, as it was determined that it was adequately funded. Of this, pensionable employees of the Bank continue to pay 4 percent. Other than the contributions made, the Bank has no commitments or obligations to this Fund.

ACCOUNTING POLICIES (CONTINUED)

December 31, 2005

FINANCE LEASES

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

RELATED PARTY TRANSACTIONS

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

December 31, 2005

1. PROPERTY AND EQUIPMENT

	Freehold Land P'000	Leasehold Land P'000	Buildings P'000	Capital Works in Progress P'000	Other Assets P'000	Total P'000
Cost or Valuation						
Balance at the beginning of the year	607	3 486	128 689	6 585	68 232	207 599
Additions	–	–	–	5 387	10 312	15 699
Disposals	–	–	–	–	(2 130)	(2 130)
Transfers	–	–	245	(1 100)	855	–
Balance at the end of the year	607	3 486	128 934	10 872	77 269	221 168
Accumulated Depreciation						
Balance at the beginning of the year	–	–	30 689	–	46 666	77 355
Charge for the year	–	–	3 231	–	15 027	18 258
Disposals	–	–	–	–	(2 113)	(2 113)
Balance at the end of the year	–	–	33 920	–	59 580	93 500
Net book value at December 31, 2005	607	3 486	95 014	10 872	17 689	127 668
Net book value at December 31, 2004	607	3 486	98 000	6 585	21 566	130 244

2. FOREIGN EXCHANGE RESERVES

2.1 Liquidity Portfolio

	2005 P'000	2004 P'000
Bonds	2 968 293	2 059 241
Amounts due from Pula Fund	457 956	417 235
Net Payables	(18 071)	–
Cash and Cash Equivalents	5 876 868	1 250 876
	9 285 046	3 727 352

2.2 Pula Fund

	2005 P'000	2004 P'000
Equities	8 012 907	8 445 392
Bonds	15 830 080	11 068 919
Amounts due to Liquidity Portfolio	(457 956)	(417 235)
Net Payables	(311 431)	(70 566)
Cash and Cash Equivalents	1 793 674	986 703
	24 867 274	20 013 213

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

	2005 P'000	2004 (Restated) P'000
Pula Fund Balance Sheet		
Capital Employed		
Government	11 637 399	8 892 951
Bank of Botswana	13 229 875	11 120 262
	24 867 274	20 013 213
Employment of Capital		
Investments	24 867 274	20 013 213
Investments expressed in US dollars ('000)	4 533 304	4 681 091
Investments expressed in SDR ('000)	3 165 604	3 060 020
Pula Fund Income Statement		
Income		
Interest and dividends	820 970	665 291
Realised market gains	1 196 195	446 027
Currency revaluation gains	3 782 846	15 442
Sundry income	17	19
	5 800 028	1 126 779
Expenses		
Administration charges	(75 030)	(60 211)
Net income for the year	5 724 998	1 066 568
Transfer to Currency Revaluation Reserve	(3 782 846)	(15 442)
Net income before transfer (to)/from Government Investment Account	1 942 152	1 051 126
Transfer (to)/from Government Investment Account	(205 008)	94 210
Net income available for distribution	1 737 144	1 145 336
Appropriations		
Dividend to Government	(420 000)	(388 100)
Bank of Botswana's share of net income	1 317 144	757 236

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

	2005 P'000	2004 P'000
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.		
Quota (SDR 63 000 000)	494 894	412 034
Less IMF Holdings of Pula	(436 693)	(277 950)
Reserve Position in IMF	58 201	134 084
The IMF Holdings of Pula are represented by a Non-Interest Bearing Note of P165 324 035 (2004 – P165 324 035) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in the current account held at the Bank (included in other deposits in Note 9).		
3.2 Holdings of Special Drawing Rights	281 133	226 327
The balance on the account represents the value of Special Drawing Rights allocated and purchased less utilisation to date.		
3.3 Allocation of Special Drawing Rights (IMF)	34 595	28 584
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.		
3.4 Administered Funds		
This relates to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust. The amount represents SDR 15 065 760 (and interest accrued thereon) lent on August 31, 2002, to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries Trust Fund, a fund administered in trust by the IMF.	118 747	99 219

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

	2005 P'000	2004 P'000
4. GOVERNMENT OF BOTSWANA BONDS		
(i) The Government Bond BW001 purchased on 26 May 2003 bearing interest at the rate of 10.75 percent, receivable semi-annually in arrears, matured on June 1, 2005.		
Market value	–	19 935
Interest accrued	–	179
	–	20 114
(ii) Government Bond BW002 purchased on 31 March 2003, maturing on 1 March 2008, bearing interest at the rate of 10.25 percent, receivable semi-annually in arrears:		
Market value	85 483	85 166
Interest accrued	2 981	2 949
	88 464	88 115
	88 464	108 229
5. ADVANCES TO BANKS		
Secured Lending Facility	–	11 900
6. OTHER ASSETS		
Staff Loans and Advances	44 850	37 743
Prepayments	3 312	1 059
Other	4 298	3 711
	52 460	42 513
7. NOTES AND COIN IN CIRCULATION		
Notes	875 526	854 062
Coin	59 737	56 796
	935 263	910 858

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.

	2005 P'000	2004 P'000
8. BANK OF BOTSWANA CERTIFICATES		
Face Value	12 496 680	9 755 220
Unmatured Discount	(80 547)	(105 948)
Market Value	12 416 133	9 649 272

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

	2005 P'000	2004 P'000
9. DEPOSITS		
Government	618 244	481 230
Bankers	452 541	350 977
Other	525 837	852 348
	1 596 622	1 684 555

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

At December 31, 2004, the Government balance included P2 043 479 of the Letlole National Savings Certificates scheme, which was launched by the Bank on behalf of the Government in 1999 as a means of encouraging savings. On March 31, 2005, the scheme was transferred to the Botswana Savings Bank.

	2005 P'000	2004 P'000
10. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)	58 201	134 084

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

	2005 P'000	2004 P'000
11. DIVIDEND TO GOVERNMENT		
Balance due at the beginning of the year	97 025	188 750
Dividend to Government from Pula Fund	420 000	388 100
Government share of residual net income	321 169	–
Paid during the year	(412 025)	(479 825)
Balance due at the end of the year	426 169	97 025

The final installment of the pre-set dividend of P105 000 000 and the residual net income of P321 168 777 unpaid at December 31, 2005 were provided for in accordance with Section 6 of the Bank of Botswana Act (CAP 55:01), which requires that all profits of the Bank be distributed to the shareholder, the Government.

	2005 P'000	2004 P'000
12. OTHER LIABILITIES		
Accounts payable	4 713	1 076
Other creditors and accruals	29 840	25 294
	34 553	26 370

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

	2005 P'000	2004 P'000
13. CAPITAL		
Authorised and paid-up capital	25 000	25 000
The capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act (CAP 55:01).		
14. 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.

15. REBALANCING OF FOREIGN EXCHANGE RESERVES

Market gains of P754 056 000 and currency revaluation gains of P601 850 000 included in the Income Statement were realised on reallocation of foreign exchange reserves between asset classes in November 2005.

16. CURRENCY REVALUATION GAINS/(LOSSES) RETAINED IN THE INCOME STATEMENT

	2005 P'000	2004 P'000
Total realised gains/(losses)	1 878 717	(341 837)
Total unrealised gains	2 657 268	380 181
Total currency revaluation gains taken to the Income Statement	4 535 985	38 344
Appropriated (to)/from Currency Revaluation Reserve:		
Realised and reinvested in foreign assets	(1 860 376)	344 937
Unrealised currency gains	(2 657 268)	(380 181)
Transferred to Currency Revaluation Reserve	(4 517 644)	(35 244)
Net currency revaluation gains retained in the Income Statement	18 341	3 100

17. INTEREST EXPENSE

	2005 P'000	2004 P'000
Bank of Botswana Certificates (BoBCs)	1 295 537	1 123 103
Debswana Tax Holding Account (Note 24)	42 804	38 703
Reverse Repurchase Agreements	25 759	12 359
National Savings Certificates	50	220
	1 364 150	1 174 385

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

	2005	2004 (Restated)
	P'000	P'000

18. CASH FLOW STATEMENT

This 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 7). However, it has the ability to create cash when needed.

19. CASH GENERATED BY OPERATIONS

	2005 P'000	2004 (Restated) P'000
Net Income/(loss) for the year	5 463 821	(31 402)
adjustments for:		
Unrealised exchange gains	(4 517 644)	(35 244)
Depreciation of property and equipment	18 258	11 604
(Profit)/Loss on disposal of property and equipment	(570)	500
Operating cash flows before movements in working capital	963 865	(54 542)
(Decrease)/Increase in Deposits – banks and other	(224 947)	452 052
Increase/(Decrease) in Deposits – Government	137 014	(367 273)
Increase in Bank of Botswana Certificates	2 766 861	909 926
Decrease/(Increase) in other assets	1 953	(497)
Decrease in other liabilities	(93 259)	(67 821)
Cash generated by operations	3 551 487	871 845

20. CAPITAL COMMITMENTS

	2005 P'000	2004 (Restated) P'000
Approved and contracted for	12 348	6 451
Approved but not contracted for	27 670	31 958
	40 018	38 409

These capital commitments will be funded from internal resources.

21. GOVERNMENT OF BOTSWANA BOND AGENCY

In accordance with Sections 45 and 46 of the Bank of Botswana Act (CAP 55:01), the Bank acts as agent of the Government for the issuance and management of the Government Bonds. An analysis of the bonds issued is provided below:

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

Government of Botswana Bonds issued as at December 31, 2005

Bond Detail	BW 002	BW 003	Total Since Inception P'000
Date of Issue	March 31 and December 1, 2003	May 6 and November 3, 2003	
Date of Maturity	March 1, 2008	October 31, 2015	
Interest Rate (per annum)	10.25 percent	10.25 percent	
Nominal Value (P'000)	850 000	900 000	1 750 000
Net Discount (P'000)	(21 029)	(32 571)	(53 600)
Net Proceeds (P'000)	828 971	867 429	1 696 400
Interest Paid (P'000)	199 875	210 125	410 000
Interest Accrued (P'000)	29 363	15 800	45 163

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

(ii) Interest is payable on all bonds on a semi-annual basis in arrears. Total cumulative interest payments of P571 250 000 (including that relating to redeemed Bond BW001) made to December 31, 2005 (2004 – P351 563 000) were funded from the Government's current account maintained with the Bank.

(iii) On June 1, 2005, Bond BW001, which was issued on May 26, 2003 at a net cost of P719 599 350, matured.

22. COMPARATIVES

Where necessary, comparative figures have been restated to conform with changes in presentation in the current year. The adjustments required as a result of the changes in accounting policies are reflected in the Income Statement, Accounting Policies and the Statement of Changes in Shareholder's Funds.

23. 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.

24. RELATED PARTY BALANCES AND TRANSACTIONS

Balances and Transactions with the Government

The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2005 were:

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)

December 31, 2005

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

(iii) being the Government agent in issuing of bonds.

The aggregate balances in Government accounts are disclosed in Notes 9 to 11.

No charge is made to the Government for provision of these services, except for commissions charged in domestic foreign exchange transactions, which are included in "Profit on domestic foreign exchange deals" in the Income Statement. This amounted to P38 893 560 (2004 – P1 026 841).

The Bank earned interest on its holding of the Government of Botswana Bonds of P9 774 000 (as described in Note 4). The Bank also realised market gains of P810 684 on the maturity of its holding of Government Bond BW001 on June 1, 2005. These have been included in "Other Income" in the Income Statement.

Other Related Party balances and transactions

Included in the Income Statement as interest expense are:

(i) Amounts paid to the following Government wholly owned or partly owned public sector organisations in respect of their investments in Bank of Botswana Certificates are as follows:

	2005 P'000	2004 P'000
Botswana Savings Bank	8 218	8 283
Debswana Diamond Company (Pty) Ltd	18 903	15 502
Motor Vehicle Accident Fund	19 540	13 512
Total	46 661	37 297

These are included in the Bank of Botswana Certificates interest expense of P1 295 537 (2004 – P1 123 103) in Note 17.

(ii) Debswana Diamond Company (Pty) Ltd, a company partly owned by the Government, holds a special "Debswana Tax Holding Account" at the Bank to facilitate payment of the company's tax obligations to the Government. Interest is payable on the daily account balance, at the rate of 60 basis points below the prevailing BoBCs three month rate. The interest expense paid in this regard is reflected in Note 17.

Purchases of P160 611 (2004 – P330 153) were made from Air Botswana, an institution wholly owned by the Government. These were charged to Administration Costs in the Income Statement.

(iii) Amounts due to related parties

Included in the balance of outstanding Bank of Botswana Certificates in Note 8 are the following

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2005

balances with Government owned or partly owned institutions.

	2005 P'000	2004 P'000
Botswana Savings Bank	69 557	56 195
Debswana Diamond Company (Pty) Ltd	59 919	30 137
Motor Vehicle Accident Fund	184 141	112 956
Total	313 617	199 288

Included in the balance of outstanding "Deposits – Other" in Note 9 are the following balances with Government owned or partly owned institutions.

	2005 P'000	2004 P'000
Botswana Savings Bank	7 296	1 927
Debswana Diamond Company (Pty) Ltd	159 831	587 181
Motor Vehicle Accident Fund	36	1
Total	167 163	589 109

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

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Part B

The Botswana Economy in 2005 and Theme Chapter

Bank of Botswana

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Chapter 1

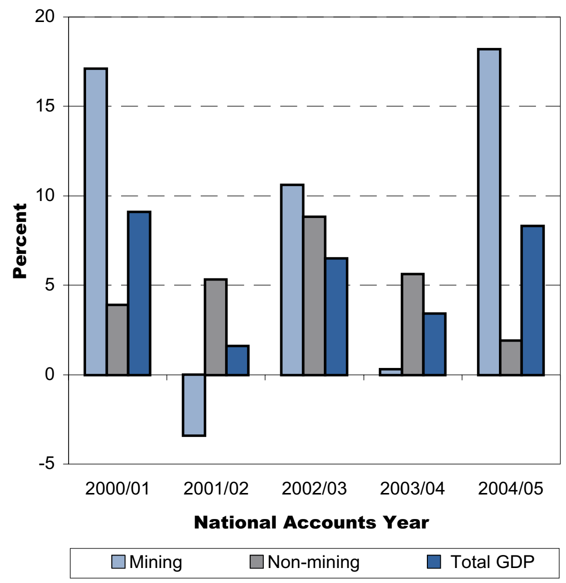
The Botswana Economy in 2005

1. Output, Employment and Prices

(a) National Income Accounts

1.1 The 2004/2005[1] provisional national accounts show an estimated 8.4 percent real growth in total Gross Domestic Product (GDP) (Chart 1.1). This is considerably higher than the growth of 3.4 percent in 2003/2004 that was revised downwards from an initial estimate of 5.7 percent.

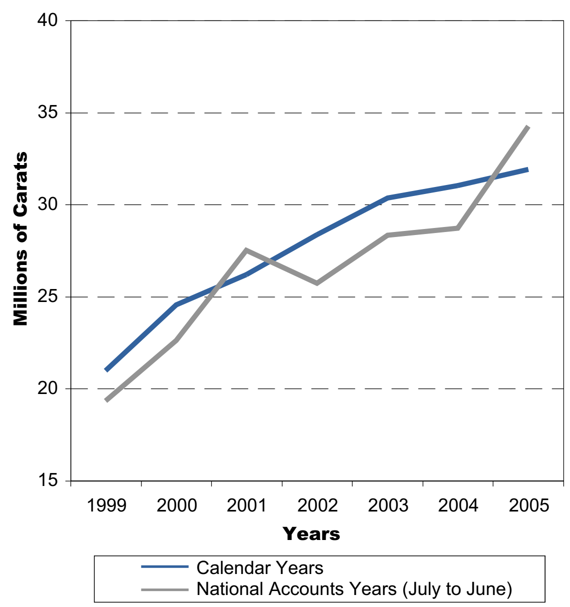
Chart 1.1: Growth in Real Gross Domestic Product



Source: Central Statistics Office.

1.2 The much higher GDP growth in 2004/05 was mainly due to the mining sector, which grew by 18.2 percent and accounted for 86.1 percent of total growth. The principal reason for the downward revision to GDP growth in 2003/04 was that the estimate for growth in mining output was revised downwards from 7 percent to 0.3 percent, reflecting the pattern of diamond production (which accounts for more than 90 percent of sectoral value added). As shown in Chart 1.2, output is generally smoother over calendar years than in national accounts years. The strong recovery in 2004/05 should, therefore, be seen in this context, as the calendar year is the relevant planning period for diamond producers.[2] Other sub-sectors of the mining industry also performed well as the copper and nickel producers responded to higher commodity prices with accelerated output; the new Mupane gold mine, which commenced operation in November 2004, also reached full production in 2005.[3]

Chart 1.2: Diamond Production



Source: Central Statistics Office.

1.3 Growth in the non-mining sector was much slower in 2004/2005 at 1.9 percent, a sharp decline from 5.5 percent in 2003/04, falling further to 1.3 percent when the general government sector is excluded. Furthermore, as has been the case in recent years, the net taxes component of GDP made a significant contribution to overall growth. In terms of sectoral value added (i.e., excluding

1. The national accounts year runs from July to June.

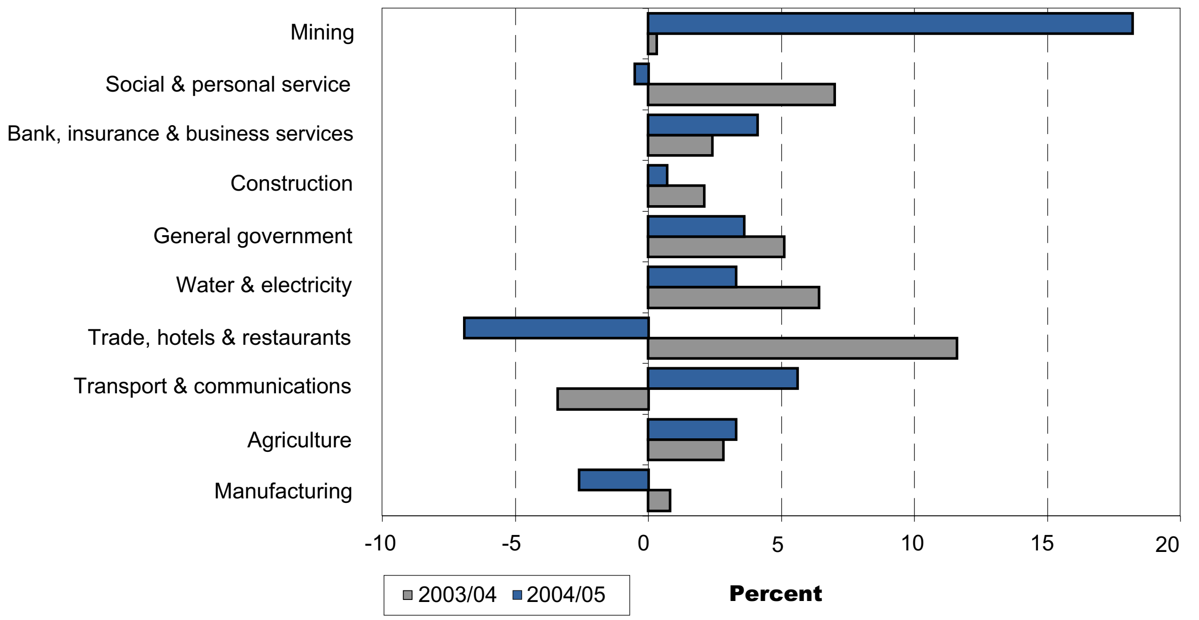
2. Diamond output was very low during the first half of 2004, accounting for the constant level of production in 2003/04. This shortfall was compensated for in the second half of 2004, while production was maintained at more normal levels in the first half of 2005, thus resulting in the very rapid growth in 2004/05.

3. It is estimated that gold production was 3 100 kg in 2005, compared to only 160 kg in 2004.

adjustment items such as indirect taxes, from GDP), growth excluding mining was only 0.9 percent, compared to 4.8 percent in the previous year. Without both mining and government, real value added declined by 0.2 percent, indicating stagnation, and possibly recession, in the non-mining private sector in 2004/05.

1.4 A more detailed breakdown of GDP by sector, as shown in Chart 1.3,[4] indicates that slower growth in the non-mining private sector was due to a steep decline of 6.6 percent in value added for the trade, hotels and restaurants sector, as well as a contraction of 2.6 percent and 0.5 percent in the manufacturing and social and personal services sectors, respectively.

Chart 1.3: Economic Growth by Sector



Source: Central Statistics Office.

1.5 The contraction in the trade sector is consistent with perceptions of depressed activity among retailers. Similarly, the decrease in growth for the construction sector from 2.1 percent in 2003/04 to 0.7 percent in 2004/05 reflects weakening investment and, in particular, slower growth in development expenditure by the Government, which traditionally provides impetus to construction. However, the reported decrease in manufacturing output (as well as the very small increase of 0.8 percent in the revised 2003/04 estimates) appears to be inconsistent with other data sources. In particular, while trade data indicate continued strong performance in the textiles sub-sector (Section 3, balance of payments, below), this does not appear to be fully reflected in the sub-sectoral estimates of GDP.

1.6 Value added increased for the rest of the sectors, most notably the transport and communications sector, which grew by 5.6 percent in 2004/05 mainly due to growth in road transport following a contraction of 3.4 percent in 2003/04. However, without accompanying growth in sectors that use transport extensively, including construction and trade, it is not clear how this increase would have occurred.

1.7 For the banks, insurance and business services sector, growth in value added accelerated from 2.4 percent in 2003/04 to 4.1 percent in 2004/05, while growth in water and electricity production declined from 6.4 percent to 3.3 percent over the same period, matching the slowdown in the rest of the economy

4. It should be noted that these are provisional estimates subject to revision.

and, possibly, reflecting the impact of water restrictions introduced in the Gaborone area in late 2004. Agricultural output also grew by 3.3 percent, albeit from a low base.

1.8 General government grew by 3.6 percent in 2004/05, down from 5.1 percent in 2003/04 and below the typical growth rate of 6–8 percent for recent years, reflecting the slower growth in government spending.[5]

1.9 Gross domestic expenditure grew marginally by 0.1 percent in real terms in 2004/05, following a 4.4 percent contraction in 2003/04. Within this, government final expenditure rose by 9.2 percent compared to a decline of 28 percent the previous year, while private consumption by households increased by 5.1 percent, a much slower rate than 9.3 percent in 2003/04. Gross fixed capital formation edged up slightly by 0.3 percent after falling by 8.1 percent in 2003/04 while the accumulation of inventories fell sharply by 15.7 percent against growth of 21.2 percent in 2003/04.[6] Both imports and exports recovered in 2004/05. In particular, exports rose substantially by 26.4 percent compared to a decrease of 12.3 percent in the previous year. Imports also increased rapidly by 8.8 percent in 2004/05, having fallen by 8.4 percent in the preceding year.

1.10 Overall, the expenditure estimates indicate stagnant domestic demand in 2004/05, which is broadly in line with wider business perceptions. However, the modest growth in some areas needs to be interpreted with caution since, at 11.1 percent, errors and omissions are a large component of total GDP and it is possible that domestic demand might have been underestimated.[7] It should also be noted that the GDP figures indicated above, except for the month of June, do not cover the period following the May 2005 devaluation of the Pula and, therefore, would not reflect the impact of the exchange rate adjustment.

(b) Economic Outlook

1.11 The economic outlook indicated in the Mid-Term Review (MTR) of NDP 9 suggests that GDP growth for the second half of the plan period (2006/07 – 2008/09) will average more than 6 percent per annum. Since the rapid growth of mining in 2004/05 was exceptional, it implies that for this annual rate of output expansion to be achieved, other sectors need to improve considerably.[8] The current weak performance in many sectors may itself lead to the necessary restructuring to improve business efficiency, while the expansionary government budget for 2006/07 (Section 2 below) has the potential to stimulate domestic demand.

1.12 Over 2005/06, for which the MTR estimates GDP growth of 4.2 percent and with growth in mining output of only 1.7 percent, consumer purchasing power was initially eroded by the impact of the devaluation. However, demand will be partially restored towards the end of the national accounts year following the 8 percent across-the-board civil service salary increase, and will gain momentum from July 2006 with the introduction of the various concessions for both direct and indirect taxes. At the same time, the ambitious development programme, which envisages P57 billion of major public and private sector projects in the next five years, is expected to stimulate strong economic growth.

(c) Employment

1.13 The estimated number of formal sector

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5. Revised figures for 2002/03 show sectoral growth of 14.2 percent which, however, reflects an anomaly arising from the way the introduction of the new Public Officers Pension Fund impacted on the measure of government output.

6. While apparently offsetting expansion in the remaining constituents of domestic spending, it should be noted that the ‘other inventories’ are calculated as a residual to help balance the expenditure and output accounts. The large size of this component (it is typically in the range of 10- 20 percent of total GDP) and sharp year-to-year movements could reflect accumulated errors and omissions from elsewhere.

7. The net errors and omissions arise from the different deflators used in the output and expenditure accounts to convert nominal to real GDP, and are additional to those already included in the calculations of inventories as a residual. For 2004/05, these errors and omissions are greater than the total growth of GDP estimated through the output measure, which is considered the more reliable estimate.

8. While growth in mining in 2004/05 is considered exceptional, the extent of current prospecting activity means that further positive developments can be expected. In 2005, the number of prospecting licences issued was 848, up by 22 percent compared to 2004.

employees rose by 2.8 percent (8 000 jobs) during the year ending in March 2005 to 299 000, thus continuing the sluggish growth of around 3 percent per annum since March 2001.[9] Although this remains slightly higher than the estimated rate of population growth of 2.4 percent, a large majority (7 700 or 96 percent) was due to increased employment by government while only 300 new jobs were created in the formal private and parastatal sector, an increase of just 0.2 percent. By comparison, in the previous year, the private and parastatal sector accounted for 44 percent of new jobs.

1.14 A significant loss of 4 400 jobs (15 percent) in the construction sector was the main source of stagnation in private sector employment, accounting for more than 70 percent of total job losses and broadly consistent with low output growth for this sector. There were also job losses (4.1 percent) in the transport and communications sector, although this appears to be inconsistent with the rapid growth estimated for sectoral output, and manufacturing for which employment declined by 1.1 percent. The other sectors in which there was a fall in employment are commercial agriculture (down by 0.8 percent) and education (down by 6.6 percent).

1.15 Among the sectors showing an increase in employment is the trade, hotels and restaurants sector (8.6 percent), which again contrasts with the estimated decline in output for this sector.[10] In mining, employment rose by 6.8 percent in line with buoyant activity in that sector. Jobs in the banks, insurance and business services sector expanded by 3.4 percent as output in the sector also increased.

9. The numbers reported here are taken from the biennial formal sector employment survey conducted by CSO. The definition of formal sector employment in Botswana excludes people working in businesses that are not formally registered and in small businesses with fewer than five employees as well as the number employed in the Botswana Defence Force (BDF). Thus, the data reported provide only a partial snapshot of the employment situation in Botswana.

10. While comparison between growth in jobs and output is legitimate, it must also be interpreted with caution as the two sets of statistics are not fully consistent in either timing or coverage, and possible changes in labour productivity must also be taken into account.

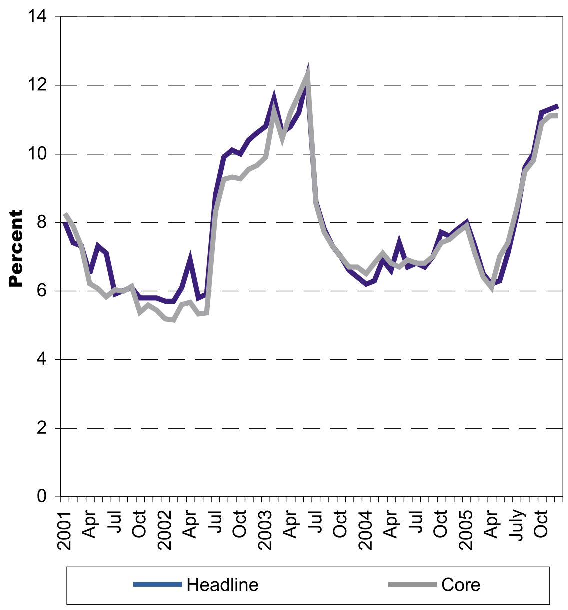
(d) Inflation

1.16 Global economic activity slowed moderately from 5.1 percent in 2004 to 4.3 percent in 2005. The subdued growth in output occurred against the backdrop of higher oil prices and pre-emptive tightening of monetary policy in some major economies. Inflation in the advanced economies edged up slightly from 2 percent in 2004 to 2.2 percent in 2005, mainly due to the continuing upward pressure on international oil prices, which rose for most of the year, reaching over USD52.5 per barrel in December 2005. In South Africa, inflation was generally on a downward trend in 2005, and remained within that country's 3–6 percent target on account of the substantial appreciation of the South African rand since the second half of 2002, low increases in food prices over an extended period of time and a progressive decline in inflation expectations, arising from apparent policy success in lowering inflation.

1.17 Domestic demand pressures in Botswana eased considerably in 2005 with modest growth in government expenditure and the year-on-year growth in credit to the private sector declining progressively and remaining below the range considered consistent with the inflation objective. Nevertheless, prospects for lower inflation in the short term were undermined by higher costs generated by the 12 percent devaluation of the Pula in May 2005 and substantial increases in some administered prices, particularly fuel and telecommunication tariffs.

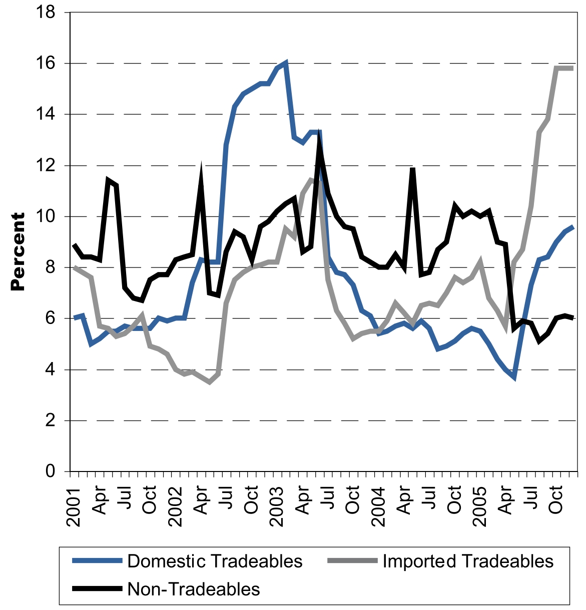
1.18 Inflation maintained a downward trend during the first half of 2005 until May, as the impact of the 7.5 percent devaluation in February 2004 fell out of the inflation calculation; however, it rose thereafter up to year-end (Chart 1.4). It is estimated that the 12 percent devaluation of May 2005 contributed 3–4 percentage points to inflation during 2005, through higher import prices in Pula terms. The stable South African inflation in 2005 helped mitigate the impact of the devaluation on domestic

CHART 1.4: BOTSWANA INFLATION



Source: Central Statistics Office and Bank of Botswana.

CHART 1.5: CPI INFLATION BY TRADEABILITY

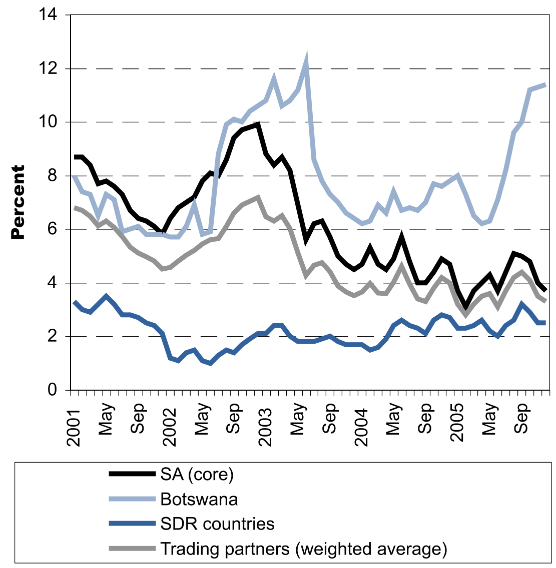


Source: Central Statistics Office.

prices. Excluding items with administered prices[11] and the effect of the devaluation, inflation is estimated to have been between 5 percent and 6 percent in 2005, thus falling within the 4–7 percent inflation objective set in the Mid-Term Review of the 2005 *Monetary Policy Statement* (MPS).

1.19 Core inflation, as measured by the 16 percent trimmed mean, continued to closely track headline inflation during 2005, reflecting the general absence of extreme price changes in most of the various categories of goods and services in the CPI basket.[12] Core inflation was 11.1 percent in December 2005 up from 7.4 percent in June 2005 and 7.7 percent in December 2004.

CHART 1.6: INTERNATIONAL INFLATION



Source: Central Statistics Office, Reuters and Bank of Botswana.

1.20 The annual rate of change in the cost of tradeables accelerated from 6.9 percent in December 2004 to 13.6 percent in December 2005, indicating the effects of the devaluation of the Pula in May 2005, which substantially increased the cost of imported tradeables, resulting in inflation for imported tradeables rising from 7.6 percent in December 2004 to 15.8 percent in December 2005. Similarly, inflation for domestic tradeables rose markedly

11. About 20 percent of the items in the consumer price index basket have prices that are administratively set by the Government and various parastatals outside the normal free market price determination. It is recognised, however, that these price adjustments are influenced to some degree by general price developments. The cost adjustments are justified as a way of catching up with market prices, a response to higher input costs and a move towards cost recovery, while fuel price adjustments are made in response to international oil price developments. However, these price changes are not directly influenced by monetary policy, hence it will not normally respond to them, except to the extent that they are expected to influence 'free' prices, especially through second-round effects. Administered price changes and the May 2005 devaluation are estimated to have added 2.9 percent and 3–4 percent to inflation in 2005, respectively.

12. The Bank's preferred measure of core inflation is based on an approach using the trimmed mean. This measure removes the most extreme price changes, regardless of their source. The core inflation rate is currently calculated by the Bank from data published by the Central Statistics Office.

from 5.6 percent in December 2004 to 9.6 percent in December 2005. For non-tradeables, the annual rate of price change fell from 10.2 percent in December 2004 to 6 percent in December 2005, suggesting a reduction in inflation due to underlying demand pressures and limited second-round effects arising from the devaluation and increases in the cost of fuel and other administered prices.

(e) Inflation Outlook

1.21 Global output growth is expected to be 4.3 percent in 2006, the same growth rate as in 2005, but weaker than the 5.1 percent output expansion in 2004. High oil prices, rising short-term interest rates in some major economies and the unusually disruptive hurricane season in the USA contributed to slow growth in 2005. Although oil prices still remain relatively high, the Organisation of Petroleum Exporting Countries (OPEC) has pledged to take measures necessary to secure oil market stability through the provision of adequate supplies. This is an accommodative stance which, if sustained, would dampen inflationary pressures emanating from high oil prices. Recently, however, there have been renewed concerns about supply disruptions in Nigeria and tensions in the Middle East, which caused a rise in oil prices.[13] Despite the high international oil prices, global inflation is generally under control due to tighter monetary policy in some of the major economies, market competition and improvements in productivity. However, average inflation in the SDR countries is forecast to rise from 2.5 percent in 2005 to 2.8 percent in 2006. South African inflation, which is the most important external influence on inflation in Botswana, is expected to be largely stable and to remain within the South African Reserve Bank's target range of 3–6 percent over the medium term.

1.22 Domestic demand, as reflected in growth rates of commercial bank credit and government expenditure, was subdued in 2005. In 2006, it is expected that domestic demand will increase due to higher disposable incomes arising from the 8 percent salary increase for civil servants, with possible economy-wide upward adjustments, as well as the net gain from personal tax adjustments, while government expenditure is also budgeted to increase significantly by 15 percent. Nevertheless, given that the increase in demand will be from a relatively low level, it is expected that the impact on inflation will be modest, particularly in the context of a relatively restrictive monetary policy.

2. Public Finance and the 2006 Budget Speech

2.1 The theme of the 2006 *Budget Speech* is "Building an Innovative Economy for the 21st Century" and it is intended to focus national efforts towards adopting best practices and devoting sufficient resources for research and development as well as productivity improvements through innovation. As indicated in the Budget Speech, the Government will support the realisation of this theme through improving the business environment to promote growth, including favourable conditions for foreign investment.

(a) Budgetary Performance – 2004/05 and 2005/06

(i) 2004/05 Final Budget Outturn

2.2 The final budget outturn for 2004/05[14] was a surplus of P574 million compared to a projected deficit of P1.43 billion in the revised estimates reported at the time of the 2005 *Budget Speech*. This large variation was mainly due to lower-than-budgeted expenditure which was P1.34 billion below the revised estimates and P757 million below the original budget. While some degree of underspending had been anticipated, it is noteworthy that this was largely

13. It is significant to note that refining capacity is also a major constraint limiting the supply of fuel despite the existing potential to increase production.

14. The Government financial year runs from April to March.

in the recurrent budget, which was below both the revised estimates and the original budget, by P860 million and P757 million, respectively. Development spending, which is usually the main source of overall underspending, was P420 million lower than the revised budget of P4.33 billion, but at P3.91 billion, it was above the original budget of P3.61 billion.

2.3 Total revenue and grants in 2004/05 was P17.96 billion and exceeded the revised budget by P662 million, due to mineral revenues that were P969 million higher than expected. The buoyancy in mineral revenues was largely due to the cumulative effect of three increases in prices for rough diamonds during the year, amounting to 19 percent in US dollar terms. However, it is noteworthy that most of the increase in mineral revenues was in the form of dividends and royalties, and came in the final quarter of the year. In contrast, mineral related taxes were slightly below budget.

2.4 Although the 2004/05 budget was in surplus, concern has been expressed by third party observers, notably Moody's Investors Service in their 2005 report, about the wide variation in the reported budget balance between the revised estimates and the actual outturn. This is important because, together with other data, reliable and timely information on trends in government revenue and expenditure are essential for effective policy formulation, including the necessary coordination of monetary and fiscal policies.[15]

(ii) The 2005/06 Revised Budget

2.5 While the original budget estimates for 2005/06 showed a modest surplus of P112 million, the revised estimates indicate a surplus of P1.58 billion. As with the previous year, buoyant mineral revenues continue to be the main contributor to this healthy financial position. Due to further price increases for rough diamonds, anticipated diamond sales in the final quarter of the fiscal year and favourable exchange rate movements in 2005, mineral revenues are expected to be P963 million higher than the original budget. Moreover, improved collection of fees and other charges is expected to boost this budget item by P355 million to P1.31 billion, while non-mineral income tax is projected to increase by P136 million to P2.69 billion.

2.6 The revised estimates of total expenditure for 2005/06 show a decrease of P331 million to P20.1 billion compared to the original budget estimate. The decline is accounted for by development expenditure that is expected to be P408 million lower than the original budget, due to capacity constraints in both the Government and the private sector.[16] The revised recurrent budget of P15.8 billion is virtually unchanged compared to the original budget. It has, however, not been indicated if the causes of the serious underspending in this category in 2004/05 have been resolved.

(b) 2006/07 Budget Proposals

2.7 The budget for 2006/07 was presented in the context of the Mid-Term Review (MTR) of National Development Plan 9 (NDP 9), which was approved by the National Assembly in December 2005. The MTR influenced the budget in two key respects as indicated below:

(i) The MTR adopted a *fiscal rule*, which seeks to limit annual government expenditure to 40 percent of GDP. This is to counter a possible upward drift in spending in response to budget surpluses, which are unlikely to be sustainable, while, at the same time, allowing for the budget to move into deficit in the face of a temporary slowdown in revenue collections. Maintaining revenues at 40 percent of GDP will require the development of alternative revenue sources and if this cannot be achieved

15. As well as technical problems that apparently delay the processing of the budget data, the practice under which the revised estimates are based on budgetary approvals rather than on likely spending patterns results in further difficulties in interpreting fiscal data.

16. In this regard, the explicit factoring into the revised budget estimates of provision for under-expenditure is a welcome development.

without raising existing tax rates, the ratio may need to be adjusted downwards. The rule also emphasises setting an overall limit to spending before considering spending plans of individual ministries and is intended to reduce the scope for supplementary budget requests, which in the past have proved difficult to control. Implementation of the rule can, however, be constrained by the practical problem that the most recent GDP data currently available both lag substantially behind the financial year for which a budget is being prepared and are subject to substantial revision. This may be dealt with through appropriate assumptions about likely rates of GDP growth, but it also means that it may take some time to assess if the rule has, in fact, been adhered to.

(ii) The MTR required a readjustment of the balance between the development and recurrent budgets so that by the end of NDP 9 (in 2008/09) development spending should have increased from 25 percent to 30 percent of total expenditure. The aim is to raise the levels of investment in the economy and enhance economic growth. However, for this strategy to be successful, the Government faces two major challenges. First, expansion of the development budget will serve little purpose if it is not accompanied by development of public infrastructure projects that provide a genuine return on the investment made. Second, in NDP 9, priority was given to the recurrent budget so that sufficient resources could be allocated to maintenance of existing infrastructure, which had not been well maintained. In reversing this in favour of additional investments, there is a major challenge of ensuring that the recurrent budget is properly managed to ensure that maintenance is not neglected.[17]

17. See NDP 9, 4.27 (p63).

(i) Budget Balance

2.8 The budget estimates for 2006/07 show an overall surplus of P922.5 million based on estimates for total revenue and grants of P24.14 billion and expenditure of P23.22 billion.[18] Both the revenue and expenditure estimates represent substantial increases over the revised estimates for 2005/06.

(ii) Revenue

2.9 The P11.39 billion budget for mineral revenues make up 47 percent of total budgeted revenue, but this item will contribute only P500 million of the total P2.45 billion increase in revenues. It is anticipated that most of the increase in revenue will come from a P1.80 billion increase in payment from the Southern African Customs Union (SACU) revenue pool, while there are also significant increases budgeted for non-mineral income tax, VAT and property income, the latter being mainly due to a larger payment from Bank of Botswana profits.

(iii) Expenditure

2.10 The total budget for expenditure and net lending shows an increase of 15.4 percent over the revised estimate for 2005/06. Based on the projections in the MTR for nominal GDP in 2006/07, this level of expenditure is largely in line with the new fiscal rule; and if the faster output growth in 2004/05 is taken into account, the ratio of spending to GDP falls below the 40 percent ceiling. However, envisaged spending growth of this magnitude inevitably raises concerns about implementation capacity in both the Government and private sectors. To help address this, the Public Procurement and Asset Disposal Board (PPADB) has increased the scope for ministries to carry out pre-contract preparation, introduced greater flexibility in tendering and raised the financial limits of the separate ministerial tender committees

18. This and other figures are based on the estimates shown in Table A8 of the *2006 Annual Economic Report*. This shows a somewhat lower budget balance than the *Financial Statements* that also accompanied the *Budget Speech*. The latter, which shows the overall surplus of P1.73 billion, was prepared at an earlier stage and did not include explicit provision for some expenditure items, notably the 2006 civil service pay award.

from P200 000 to P1 million. There will also be greater decentralisation of project implementation away from the Department of Building and Engineering Services.

while there are also large increases planned for economic services, where about 40 percent is due to increased provision for road construction and public services.

TABLE 1.1: GOVERNMENT BUDGET 2004/05 – 2006/07 (P MILLION)

	2004/05			2005/06		2006/07
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	**18 209**	**17 294**	**17 957**	**20 566**	**21 697**	**24 144**
Mineral revenue	8 070	7 713	8 682	9 926	10 889	11 389
Non-Mineral	10 139	9 581	9 275	10 640	10 808	12 755
Expenditure	**18 141**	**18 720**	**17 383**	**20 454**	**20 122**	**23 222**
Recurrent	14 571	14 625	13 765	15 720	15 796	17 234
Of which Personal Emoluments	4 776	4 776	5 129	–	5 436	5 998
Development	3 610	4 327	3 910	4 858	4 450	6 035
Net lending	–40	–232	–293	–124	–124	–47
Balance	**68**	**–1 426**	**574**	**112**	**1 575**	**923**

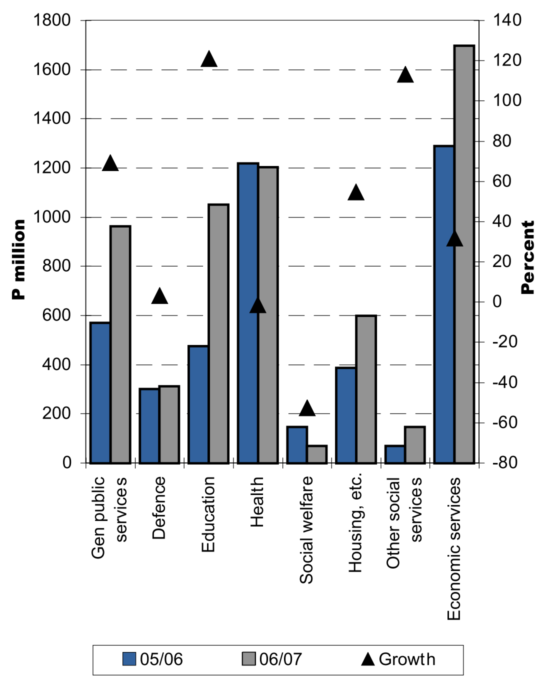
Source: MFDP, *Financial Statements (various years); 2006 Annual Economic Report.*

2.11 Within the overall expenditure growth rate, there is a marked difference in the recurrent and development budgets. The recurrent budget is set to grow at 9.1 percent in 2006/07 and by 5.5 percent before adjusting for the costs of the public sector pay award, thus indicating a fall in real terms. The development expenditure is, however, budgeted to grow substantially by 35.6 percent and is intended to stimulate private sector activity and overall economic performance.

2.12 The breakdown of development expenditure by various functional categories is indicated in Chart 1.7 and shows that most categories are budgeted to increase substantially; although growth in spending is significantly constrained for some categories. In particular, development spending on health and defence will be broadly unchanged, while that for social welfare programmes will decline due to a substantial reduction in funds budgeted for drought relief. The largest increase in both proportionate and absolute terms is in spending for education,[19]

2.13 It is reported in the 2006 *Budget Speech* that the 8 percent increase in civil service salaries was based on a formula contained in the MTR, which allows for cost of living adjustments to be a maximum of half the rate of inflation, with any further increase to be

CHART 1.7: DEVELOPMENT SPENDING BY ECONOMIC SECTOR (2005/06 – 2006/07)



Source: MFDP, *Financial Statements* 2006/07.

19. The figure includes P235 million for the Tertiary Education Fund which is not included in the *Financial Statements*, but is included in total spending reported in the *Budget Speech* and the *Annual Economic Report* (see footnote 2).

based on productivity improvements. Since the previous salary increase in 2004, the cost of living was reported to have increased by 15.6 percent, and provision was made in the budget for the 8 percent adjustment to be applied not just to civil servants but also more widely to related payments.[20] Strict application of the new formula should help prevent the erosion of gains in competitiveness following the May 2005 devaluation and implementation of the new exchange rate regime. While measuring productivity improvements in government is not easy, the new system provides a clear incentive for performance improvement in the civil service and should be consistent with an appropriately implemented performance-based reward system.

(c) Fiscal Legislation

2.14 In contrast to 2005, when no changes to tax policy were announced, the *Budget Speech* included various proposed amendments to both the Income Tax and VAT legislation, among others, with a view to simplifying the tax structure and improving compliance. The main proposals are highlighted below:

(i) Simplifying company tax so that the current 15 percent basic company tax and 10 percent additional tax are merged into a single rate and levied together, with withholding tax on dividends as a final charge.

(ii) An increase in the thresholds for personal income tax, which have been in place since 2001. To partially compensate for the subsequent erosion through inflation, the threshold at which people become liable for tax is to be raised from P25 000 per annum to P30 000, while the various tax bands will be widened so that the maximum tax rate of 25 percent becomes applicable for income above P120 000, up from P100 000. It is estimated that for someone earning P120 000 these adjustments will result in an increase in take home pay of about 3 percent.

(iii) To improve tax compliance, interest income in excess of P1 000 per quarter for Botswana residents earned on deposits at domestic banks and financial institutions, and holdings of BoBCs, bonds and securities will be subject to withholding tax of 10 percent.

(iv) Rules on taxation of disposal gains from trading in the domestic capital markets are to be clarified. This includes exemptions from such tax for trades in securities issued by government or related institutions, for shares released by listed companies for trading on the Botswana Stock Exchange, and for IFSC registered companies.

(v) Permissible activities (and associated tax exemptions) for IFSC companies are to be widened to include group holding and administration companies, business processing outsourcing and call centres, and mutual funds.

(vi) The Government remains committed to retaining VAT as a broad-based tax on consumption in order to reduce administrative complexities and maintain a low overall rate.[21] However, within this framework it has been decided to increase the range of goods and services that receive special treatment, through either exemption or zero rating. Zero rating was extended to a range of basic foodstuffs,[22] as well as some farming inputs. Exemption (which primarily reduces administrative costs to businesses) is to be extended to passenger transportation (except for tourists), donations, grants and the sale of condoms.

20. These included local authority workers, parastatals which rely on government funding, old age and war pensions, and allowances for destitutes, members of village development committees and home-based care volunteers.

21. As noted in the *Budget Speech*, the 10 percent VAT rate levied in Botswana compares favourably with elsewhere in the region where rates range from 14 percent to 17.5 percent.

22. Sorghum and maize meal were already zero rated. To this, have been added various grains and sugar.

(vii) A Tax Administration Bill will be drafted to consolidate the existing Income Tax, VAT and Botswana Unified Revenue Service (BURS) Acts into a single piece of legislation. This is with the aim of rationalising, strengthening and simplifying administrative procedures, as well as to strike a balance between the rights of BURS and of the taxpayers. Moreover, legislation will be revised to include tax incentives aimed at promoting youth employment.

(d) Policy Initiatives

2.15 In the context of an expansionary budget that includes rapid growth in development spending, and which is expected to total P21 billion during the remainder of NDP 9 (by way of contrast, the total development spending in the first half of the plan was less than P13 billion), several major projects that are not part of the government-funded development programme were also highlighted. These included the planned expansion of Morupule Power Station, development of an export power station at the Mmamabula coalfield and new investments by De Beers and Debswana. These projects are to be implemented over the next five years and represent expected investment of approximately P36 billion. In addition, other potential investments announced include tannery and ceramics projects being developed with support from the BDC. Moreover, early results from assessment of deposits of coal bed methane, as well as high level of prospecting activity more generally, signify potential increase in mining activity in the medium term (footnote 8).

2.16 It is recognised, however, that to succeed and effectively contribute to the country's development, these investments and projects should be supported by other growth promoting policies, including an effective combination of high return public investment, removing administrative barriers, maintenance of a competitive exchange rate and improvements in productivity. It is expected that a new strategy for attracting foreign investment will be finalised by the first half of 2006 and legislation on FDI will follow thereafter. Meanwhile, the Business and Economic Advisory Council (BEAC) that first met in October 2005 with a mandate to develop innovative ideas to further grow and diversify the economy is to finalise and present its recommendations by September 2006.

2.17 The *Budget Speech* further indicated the Government's continuing commitment to developing successful policies for alleviation of poverty, building on the effectiveness of current programmes which, combined with the substantial growth of the economy, have led to rapid reduction in rates of poverty. However, there is some concern that Batswana are reluctant to accept employment opportunities, especially in low-income job categories, preferring instead to rely on support from families and social safety nets. If this trend, which results in employers resorting to non-citizen labour even when the required skills are available locally, was to continue, it could undermine the viability of such safety nets and frustrate the ideal of 'a just and caring nation', which is a key pillar of *Vision 2016*.

2.18 Regarding the development of financial services, the Botswana Stock Exchange (BSE) Act will be replaced with new securities legislation. This is with a view to keeping up with continuing rapid innovation in the provision of financial services and to foster greater flexibility in trading, through broadening the range of instruments that can be traded on the BSE, the introduction of electronic trading and records storage, and streamlining governance procedures while, at the same time, introducing provisions to deter market manipulation and insider trading. More broadly, the Government intends to introduce legislation during 2006 to establish a non-bank financial institutions regulatory authority. This is mainly in response to the rapid growth of the domestic fund management industry, where total pension fund assets are now considerably larger than those of the commercial banks. Regulatory reforms are also envisaged in the areas of Information and Communications Technology (ICT) where legislation to consolidate regulation of all ICT sub-sectors (including postal services, telecommunications and broadcasting) is planned.

3. Exchange Rates, Balance of Payments and International Investment Position

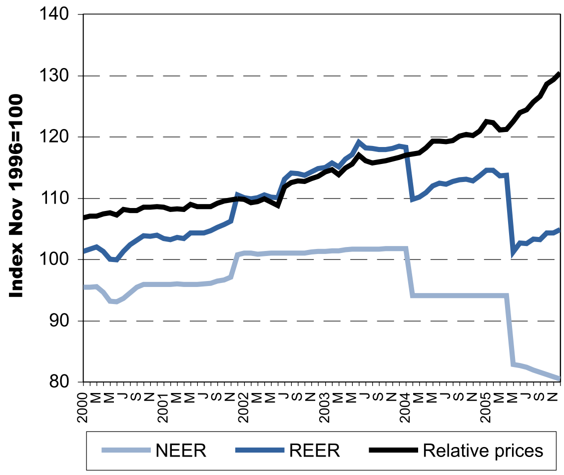
(a) Exchange Rates

3.1 The objective of Botswana's exchange rate policy is to maintain the country's competitiveness, as measured by the real effective exchange rate (REER) of the Pula. In the context of the new crawling band exchange rate regime, it is intended that this will be achieved through a continuous adjustment of the trade-weighted nominal exchange rate of the Pula at a rate equal to the differential between the Bank's inflation objective and forecast inflation for trading partner countries.

3.2 The nominal effective exchange rate (NEER) of the Pula which had been stable up to end-May 2005, following the 7.5 percent devaluation of February 2004, depreciated by 14.4 percent year-on-year to December 2005 due to the 12 percent devaluation of the Pula in May 2005 and the subsequent downward crawl (Chart 1.8). The Pula was devalued in order to correct for the misalignment of the currency, measured in terms of the extent of appreciation of the real effective exchange rate. The introduction of the crawling band exchange rate mechanism was intended to enable an automatic nominal adjustment of the Pula exchange rate to maintain REER stability and thus avoid the need for discrete devaluations as in the past. As inflation in Botswana was higher than in the trading partner countries in 2005, the nominal exchange rate peg crawled downwards during the year.

3.3 Bilaterally, the Pula depreciated by 17 percent against the SDR, but experienced a larger weakening of 22.3 percent against the US dollar, as the US currency strengthened against other currencies during the year. Against the rand, the Pula depreciated by 13 percent. The strength of the US dollar was mainly due to the Federal Reserve Bank's series of twelve gradual increases in US interest rates, from 1 percent in June 2004 to 4.25 percent in December 2005. On the other hand, the 10.7 percent depreciation of the rand against the US dollar was attributable to a combination of factors, including the effects of the October 2005 relaxation of exchange controls in South Africa and the depreciation of the euro (the currency of South Africa's main trading partner) against the US dollar (Table 1.2). In the seven months following the devaluation, the Pula appreciated by 2.5 percent against the SDR and depreciated by 5.5 percent against the rand, resulting in a 2.5 percent depreciation of the NEER.

Chart 1.8: Nominal and Real Effective Exchange Rates and Relative Prices



Source: Bank of Botswana.

3.4 Year-on-year to December 2005, the REER of the Pula depreciated by 7.7 percent (Chart 1.9) wholly due to the depreciation of the NEER. The relatively lower depreciation of the REER as compared to the NEER is due to the positive inflation differential between Botswana and its trading partner countries, which was not fully offset by the downward crawl. Notably, the impact of the positive inflation differential is also reflected in the 3.7 percent

TABLE 1.2: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES

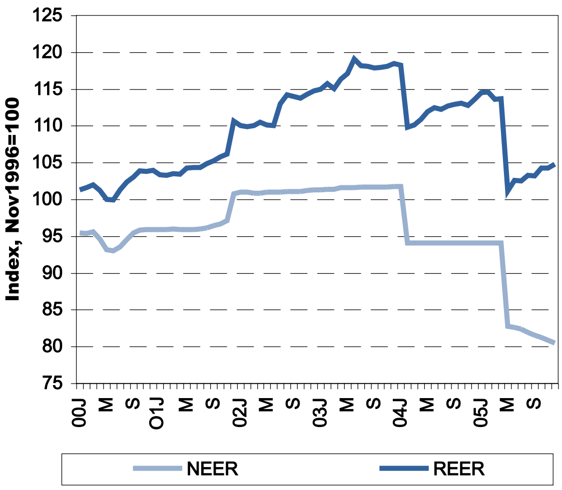
Nominal Exchange Rates (Foreign Currency per Pula)			
As at end of	**2004**	**2005**	**Percentage Change**
SA rand	1.3233	1.1511	–13.0
US dollar	0.2336	0.1814	–22.3
Pound Sterling	0.1211	0.1050	–13.3
Japanese yen	23.96	21.27	–11.2
SDR	0.1527	0.1267	–17.0
Euro	0.1714	0.1527	–10.9
Nominal Effective Exchange Rate (Index)	**94.1**	**80.5**	**–14.5**
Real Pula Exchange Rate Indices (November 1996=100)			
SA rand[1]	120.9	113.1	–6.5
SA rand[2]	109.2	102.1	–6.5
US dollar	126.8	106.1	–16.3
SDR	123.5	111.4	–9.8
Real Effective Exchange Rate (Core)	**113.6**	**104.8**	**–7.7**

1. Calculated using South African headline inflation.
2. Calculated using South African core inflation. Core inflation includes the prices of all items in the consumer price index, except mortgage interest costs and prices of various volatile food items.

Source: Bank of Botswana.

appreciation of the REER in the seven months to December 2005 following the devaluation of the Pula. It should, however, be recognised that the achievement of a stable REER should be assessed over the medium- to long-term, particularly in circumstances where the rise in inflation is due to correctional devaluation, which is expected to have a transitory impact on inflation. This underscores the fact that productivity improvements are key to achieving global competitiveness and would reduce the burden on monetary policy and the exchange rate, both of which can impact negatively on economic performance in the short-run.

CHART 1.9: REAL AND NOMINAL EFFECTIVE EXCHANGE RATES



Source: Bank of Botswana.

3.5 Bilaterally, the Pula depreciated in real terms against all major currencies, in line with the nominal depreciation of the Pula exchange rate in 2005. The Pula depreciated by 9.8 percent in real terms against the SDR (16.3 percent in real terms against the US dollar), and by 6.5 percent against the South African rand (using the South African core inflation measure).

(b) Overview of the Balance of Payments

3.6 The overall external balance for 2005, based on the changes in reserves during the year, is estimated at P7 036 million compared to a deficit of P272 million (revised from the previous estimate of a P575 million surplus) in 2004.[23] Total reserves increased by P10 410 million during 2005, of which P3 375 million

23 The calculation of the overall balance in 2004 and 2005 has been revised in line with recommendations made by the International Monetary Fund (IMF), that realised gains/losses should be added to Balance of Payments transactions. Revisions to earlier years will be made in due course.

was due to unrealised valuation adjustments.

(i) *Merchandise Trade*

3.7 The merchandise trade account registered a surplus of P9 147 million in 2005, a two-fold increase from 2004. Exports grew by 35.9 percent to P23 579 million, the main contributor being the diamond industry, where exports rose by 29.2 percent due to increased production and upward price adjustments (diamond prices in terms of the US dollar and Pula rose by an average of about 6 percent and 15 percent, respectively, during the year), as well as the impact of the May 2005 devaluation which resulted in higher Pula receipts. Similarly, exports of copper/nickel grew by 46 percent, while the newly opened Mupane gold mine also had an impact, with monthly exports rising rapidly to reach P219.1 million for the year and almost matching soda ash in importance. The combined effects of the Africa Growth and Opportunity Act (AGOA) concessions and the Pula devaluation have led to a substantial growth in textile exports as compared to 2004. Textile exports in 2005 were 99 percent higher than in 2004, although without the impact of the devaluation this growth would have been in the region of 80–85 percent.

Table 1.3: Balance of Payments: 2000–2005 (P million)

	2000	2001	2002*	2003*	2004*	2005#
Current Account	2 782	3 492	1 245	2 288	1 352	8 096
of which:						
Visible trade	4 603	4 149	4 477	4 441	3 904	9 147
Services	–1 136	–1 010	182	–46	–204	–42
Income	–1 792	–801	–4 418	–3 543	–4 817	–3 744
Net current transfers	1 108	1 153	1 368	1 436	2 469	2 736
Financial account	–1 030	–2 976	–1 375	–1 875	–1 556	–880
Capital account	194	34	4	111	149	161
Net errors and omissions	–58	474	462	272	–217	–341
Overall balance	1 941	1 023	336	797	–272	7 036

* Revised
\# Provisional
Source: Bank of Botswana.

3.8 Imports in 2005 were 7.4 percent higher than in 2004,[24] with the largest increase in fuel imports, which grew by 23.5 percent. This was partly offset by declines in imports of wood and paper products (7.2 percent) and vehicles and transport equipment (4.6 percent).

3.9 Some tentative indications of the impact of the devaluation are shown in Table 1.4, which compares the average level of imports for various commodity groups in 2005 for periods before and after the devaluation (i.e., January to May and June to December). The average Pula value of imports of food, beverages and tobacco grew by 20.4 percent between the two periods indicating that goods in this category are necessities (their demand is inelastic). Imports of fuel also grew substantially, by 62.5 percent, reflecting not only the devaluation but also rising international fuel prices. Other commodities indicate varying trends, but overall growth was only 4.4 percent, suggesting some cutbacks following the devaluation. Interestingly, imports of vehicles fell by value, although other reports have suggested that volumes increased. This could be explained by increased purchases of lower-value vehicles, including cheap imports from Asia.

24. Note that this growth rate incorporates an adjustment to allow for the less-than-full coverage in the 2005 figures indicated by CSO.

(ii) Current Account

3.10 A record surplus of P8 096 million is estimated for the current account, compared to P1 352 million in the revised estimates for 2004. This is mainly driven by the rapid growth in exports compared to the lower increase in imports.

TABLE 1.4: IMPORTS IN 2005 (P MILLION)

	Jan – May (Monthly Average)	June – Dec (Monthly Average)	Growth (percent)
Food, Beverages and Tobacco	169.5	204.0	20.4
Fuel	134.5	218.6	62.5
Chemicals and Rubber Products	151.7	173.3	14.2
Wood and Paper Products	152.2	85.3	–44.0
Footwear and Textiles	57.7	69.4	20.3
Metals and Metal Products	89.9	115.1	28.0
Machines and Electrical Equipment	213.0	234.3	10.0
Vehicles and Transport Equipment	208.8	146.1	–30.0
Other Goods	171.1	160.9	–6.01
Total Imports	**1 348.3**	**1 407.1**	**4.4**

Source: Central Statistics Office.

3.11 The income account registered a deficit of P3 744 million in 2005. For the 2005 estimates, some allowance has been made for retained earnings by large companies, which have led to large revisions over the past few years. The retained earnings are treated as outflows in the income account with a matching inflow treated as investment in the financial account. Earnings on reserves and dividends form the bulk of the credit side in the income account.

3.12 The services account recorded a deficit of P42 million in 2005 compared to a P204.0 million deficit in 2004. This seems to conform to the general pattern of a reduction in the deficit as local service industries develop, although there is a possibility of some error as part of this item continues to rely on commercial banks reporting[25] of foreign exchange transactions.

3.13 It is notable that the surpluses in the merchandise trade and current transfers accounts continue to remain stable, and help in mitigating the large income account deficits.

(iii) Capital and Financial Accounts

3.14 Although modest, the capital account continues to record surpluses. But there is an estimated net outflow of P880 million in the financial account, mainly driven by continued large outflows of portfolio investment assets. Direct investment into Botswana is estimated at P1 475 million, which is mostly the imputed counterpart to retained earnings, which are shown as outflows in the income account. While appropriately classified as new investment, these retained earnings do not represent additional financial flows into the country.

3.15 Using pension funds data for the period January to December 2005, a net outflow of P1 908.4 million was estimated for the portfolio investment and a P447 million net outflow with respect to "other investment".

(iv) Foreign Exchange Reserves

3.16 Foreign exchange reserves were P34.6 billion at the end of December 2005, P10.4 billion (43 percent) more than at the end of 2004 and equivalent to 22 months of imports of goods and services. Apart from favourable diamond prices, the growth in the domestic

25. Commercial banks submit monthly data on purchases and sales of foreign exchange. These should detail purpose of all the transactions. This was more feasible in the past, prior to the abolition of exchange controls. The quality of information has since deteriorated, as there is no requirement to produce any documents stating the purpose of transactions as required for balance of payments statistics. Ways to address this problem are currently being considered.

currency value of reserves was partly due to the depreciation of the Pula as a result of the May 2005 devaluation as well as realised gains arising from portfolio rebalancing. In US dollar and SDR terms, the reserves grew by 11.5 percent and 19.1 percent, respectively.

(c) International Investment Position and Foreign Investment

(i) International Investment Position (IIP)

3.17 Detailed data for the IIP, which records the stock of foreign financial assets and liabilities, were available up to 2004, while only major aggregates were estimated for 2005. While total foreign assets declined marginally by 0.13 percent in 2004 due to a decrease in direct investment assets, they are estimated to have increased substantially in 2005 mainly as a result of the substantial increase in reserve assets.

3.18 Portfolio investment abroad grew from P7 billion in 2003 to P9 billion in 2004, an increase of 27 percent, with 2005 estimates showing even higher growth, mainly associated with pension funds. Other investment abroad declined by 5 percent in 2004, especially due to a drop in the currency and deposits component. An increase in other investment abroad of P1 547 million is estimated for 2005. Total foreign liabilities also declined in 2004, with a decrease in the value of all the three components of direct investment, portfolio investment and other investment. The 2005 preliminary estimates show foreign liabilities as having increased by 32.3 percent, with the three components of direct investment, portfolio investment and other investment contributing positive growth rates.

(ii) Industry and Country Classification of Investment

3.19 Tables 1.5 and 1.6 show Botswana's stock of foreign liabilities at the end of 2004 classified, respectively, by industry and country. These figures are based on the 2004 Balance of Payments Survey conducted by the Bank. Mining continues to dominate total foreign direct investment, accounting for 59 percent, followed by the finance sector at 22 percent of the total. As in 2003, Europe continued to be the principal source of direct investment, accounting for 74 percent, with Luxemburg contributing most (80 percent) of that, thus reflecting the residence status of the major mining investor in Botswana.

3.20 By the end of 2004, the Government's external debt, classified under public administration in

Table 1.5: Levels of Foreign Investment in Botswana by Industry (P million as at December 31, 2004)

	Foreign Direct Investment			Other Investment		
Industry	**Equity**	**Non-Equity**	**Total**	**Equity**	**Non-Equity**	**Total**
Mining	2 477	17	2 494	0	144	144
Manufacturing	124	28	151	28	215	244
Finance	931	–	931	3	140	143
Retail and Wholesale	189	50	239	8	1 618	1 627
Electricity, Gas and Water	33	6	39	0	196	196
Real Estate and Business Services	93	0	93	2	89	91
Transport, Storage and Communications	50	84	134	0	25	25
Construction	11	17	28	0	12	12
Hospitality	52	5	57	0	1	1
Public Administration	0	0	0	0	1 989	1 989
Other	6	31	38	0	0	0
TOTAL	**3 967**	**238**	**4 204**	**41**	**4 429**	**4 470**

Source: Bank of Botswana.

TABLE 1.6: LEVELS OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY (P MILLION AS AT DECEMBER 31, 2004)

	Foreign Direct Investment			Other Investment		
Country	**Equity**	**Non-Equity**	**Total**	**Equity**	**Non-Equity**	**Total**
North and Central America	23	3	26	0	98	98
Of which						
United States	19	0	19	0	98	98
Europe	3 023	92	3 115	1	408	409
Of which						
United Kingdom	427	0	427	0	108	108
Netherlands	41	4	45	0	0	0
Luxembourg	2 500	0	2 500	0	66	66
Other Europe	55	88	143	1	234	235
Asia Pacific	26	1	27	1	498	499
Africa	851	125	976	11	1 687	1 698
Of which						
South Africa	806	72	878	8	556	564
Middle East	40	16	56	28	48	76
Other	3	2	5	0	1 691	1 691
Total	**3 967**	**239**	**4 205**	**41**	**4 430**	**4 471**

Source: Bank of Botswana.

Table 1.5, was the major component of other investment, accounting for 44.5 percent, followed by retail and wholesale trade, accounting for 36.4 percent. The share of 36.4 percent for other investment in the retail and wholesale trade sector represents significant growth from 3.5 percent in 2003. The increase in this category was due to increased trade credits, mostly for retailers specialising in food and beverages.

4. MONEY AND CAPITAL MARKETS

(a) Monetary Policy and Liquidity Management

4.1 The objective of the Bank's monetary policy is to achieve and maintain low and sustainable inflation that will, among others, enable the maintenance of international competitiveness of domestically produced goods and services. Through its Monetary Policy Statement (MPS), the Bank lowered its inflation objective from 4–7 percent in 2004 to 3–6 percent for 2005. The reduction of the objective range in 2005 was in response to the positive inflation outlook indicated by continuing restrained demand pressures and the impact of the February 2004 devaluation of the Pula falling out of the inflation calculation. In the circumstances, monetary policy was eased by a 25 basis point reduction in the Bank Rate in April 2005.

4.2 The inflation outlook, however, changed considerably as a result of the 12 percent devaluation of the Pula in May 2005, necessitating an upward revision of the inflation objective to 4–7 percent in the Mid-Term Review of the 2005 MPS to take account of the anticipated increase in inflation arising from the exchange rate depreciation. Although the change in the inflation objective was much smaller than the expected impact of the devaluation, it signalled a desire by the Bank to contain the extent of price increases arising from the exchange rate adjustment and the continuation of the decline in the yearly price increase for non-tradeables.

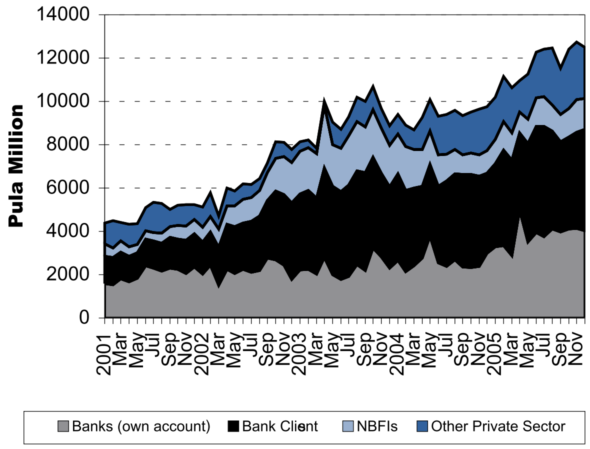
4.3 In addition to the devaluation of the Pula, the increase in some administered prices engendered a persistent rise in inflation during the second half of 2005. While inflation was close to the upper end of the objective range prior to the May devaluation, it rose sharply and remained above the revised objective in the second half of the year. However, domestic demand pressures were generally restrained during 2005, partly due to a modest rate of fiscal expansion and relatively restrictive monetary policy, which contributed to subdued growth of private sector credit. In particular, the growth rates for both government expenditure and credit to the private sector in 2005 were below the ranges considered to be compatible with the inflation objective. Globally, the significant rise in international oil prices in 2005 resulted in slower GDP growth and a modest increase in global inflation. Inflation was constrained by policy tightening in some of the major economies, increased market competition and productivity improvements.

4.4 Given the rise in domestic inflation, which was expected to remain above the Bank's objective in the short-term and in order to restrain the secondary effects of the devaluation and the rise in administered prices as well as inflation expectations, the Bank tightened monetary policy, increasing the Bank Rate by 25 basis points, each time, in August and October 2005. To ensure that short-term interest rates, specifically yields on Bank of Botswana Certificates (BoBCs) were consistent with its monetary policy stance, the Bank conducted open market operations to manage liquidity in the domestic banking system during the year. Consequently, the nominal three-month BoBC rate ranged between 11.25 percent and 12.37 percent in 2005. The yield for the 14-day BoBC, which was introduced in November 2004 in order to enhance liquidity absorption in the short-end of the domestic money market, fluctuated within a narrower range of 11.72 percent to 12.27 percent.[26] Yields were higher towards the end of the year, reflecting the cumulative 50 basis points increase in the Bank Rate in the second half of 2005.

4.5 Outstanding BoBCs increased by 28.1 percent during the year to P12 496.7 million in December 2005 compared to a 10 percent increase in 2004. Commercial banks' holdings of BoBCs increased by 35 percent in 2005 and amounted to 30.4 percent of total outstanding BoBCs at the end of the year. Within the non-bank private sector, holdings by commercial banks' clients rose by 26.4 percent during 2005 and constituted 37.6 percent of the total holdings of BoBCs outstanding at year-end, while the non-bank financial institutions increased holdings by 39.2 percent and held 11.3 percent of total outstanding BoBCs at the end of 2005. Meanwhile, BoBCs held by the other private sector entities grew by 15.5 percent over the twelve months to December 2005, resulting in a share of 18.9 percent.

4.6 The substantial increase in BoBCs, apart from being indicative of restrained borrowing, reflects the absence of alternative domestic short-term money market instruments, while external placement of funds is subject to exchange rate risk (currency mismatch between assets and liabilities). Moreover, the current level of interest rates in Botswana is more attractive. In this environment, the conduct of open market operations to absorb excess liquidity in order to support a relatively restrictive monetary policy becomes increasingly costly and complex. It is considered that the financial market as

Chart 1.10: Outstanding Bank of Botswana Certificates (BoBCs)



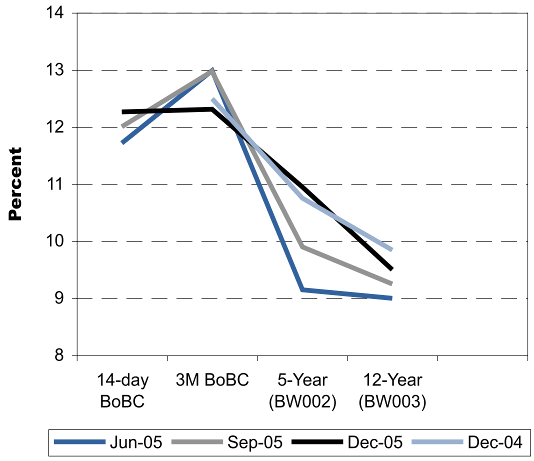
Source: Bank of Botswana.

26. The 14-day BoBC is auctioned weekly under the competitive multiple price auction format.

well as saver/investor sophistication has now developed to a level where it can sustain the development of alternative instruments in addition to deposits at financial institutions. Therefore, from December 31, 2005, the Bank of Botswana adopted a new framework for its open market operations whereby only commercial banks are eligible bidders at BoBC auctions. However, to allow a smooth transition, banks could submit bids on behalf of customers until the end of February 2006. With effect from March 2006, only the primary counterparties, that is, commercial banks, will be permitted to purchase and hold BoBCs. In a similar development (to limit the extent of commercial bank purchases of BoBCs and consistent with the prevailing monetary policy stance), the required reserve ratio against commercial banks' deposits was raised from 3.25 percent to 5 percent effective February 1, 2006.

4.7 The 2-year government bond with a par value of P750 million, which was issued in 2003, matured in June 2005 and was not replaced. As at the end of December 2005, the 5-year and 12-year Government bonds were outstanding with a total par value of P1.75 billion and yields of 10.95 and 9.5 percent, respectively. The value of secondary market trades in these bonds in 2005 amounted to P662 million, compared to P1 152 million during 2004. The yield curve continued to be downward sloping in 2005, partly reflecting higher demand for longer-term bonds and lower medium- to long-term inflation expectations (Chart 1.11).

CHART 1.11: YIELD TO MATURITY ON BOBCS AND GOVERNMENT BONDS



Source: Bank of Botswana.

(b) Interest Rates

4.8 Following the reduction in the Bank Rate from 14.25 percent to 14 percent in April 2005, commercial banks reduced their prime lending rates from 15.75 percent to 15.5 percent, while the average deposit rate fell from 9.1 percent in December 2004 to 8.8 percent in June 2005.[27] Thereafter, as the Bank Rate was raised by a cumulative 50 basis points in August and October 2005, the commercial banks responded by raising their prime lending rates by the same magnitude. The 88-day deposit rate increased from an average of 8.81 percent in July to 9.11 percent in August, but subsequently declined to 8.93 percent in December 2005. As a result of these movements in the short-term nominal interest rates, the spread between the lending rate and deposit rate increased from 6.62 percent in December 2004 to 7.1 percent in December 2005.

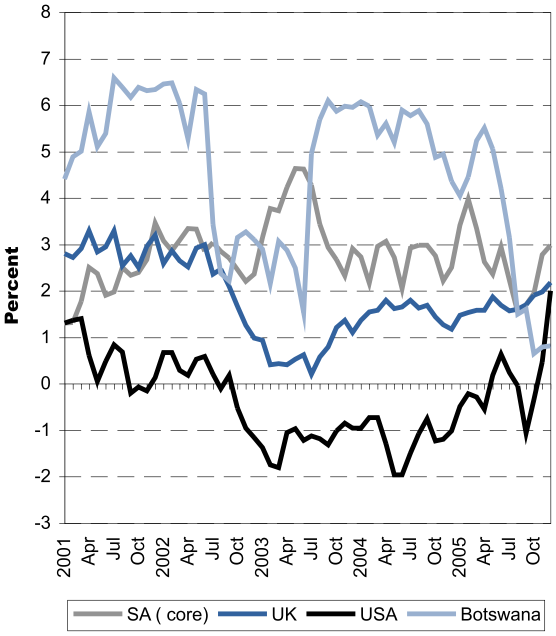
4.9 Money market real interest rates fell in 2005 due to the sharp increase in inflation. The real three-month BoBC rate ranged between 0.7 percent and 5.5 percent in 2005 and averaged 3.1 percent in the twelve months to December 2005, compared to a range of 4.4 percent to 6.1 percent in 2004. As at the end of December 2005, the real commercial bank prime lending rate was 4.1 percent, compared to 7.4 percent in December 2004.

(c) Banking System

4.10 The year-on-year growth in commercial bank credit declined sharply from 16.1 percent in December 2004 to 7.3 percent in December 2005, falling below the lower end of the 11–14 percent range that the Bank considered to be consistent with the revised inflation objective

27. The average deposit rate is the average interest rate paid on the 32–88 day deposits by commercial banks.

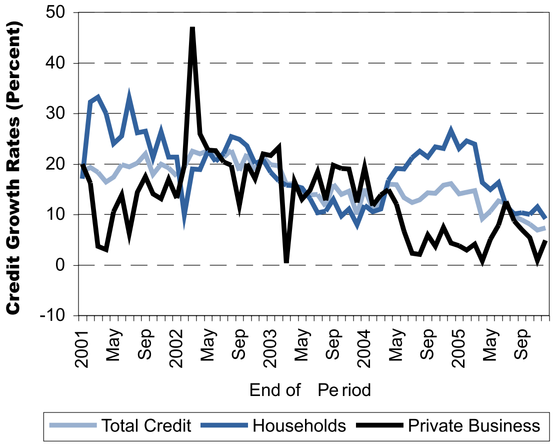
CHART 1.12: REAL INTEREST RATES – INTERNATIONAL



Source: Bank of Botswana.

for 2005. The deceleration in the annual credit growth rate was mainly due to the slower increase in borrowing by households which dropped from 26.6 percent in 2004 to 9.2 percent in December 2005 and was influenced by the relatively restrictive monetary policy and the absence of an increase in public service salaries during 2005. The annual increase in credit to private businesses was also low, albeit rising marginally from 4.3 percent in 2004 to 4.8 percent in 2005, and was similarly

CHART 1.13: ANNUAL GROWTH RATES OF CREDIT



Source: Bank of Botswana.

influenced by the restrictive monetary policy as well as the moderate growth in government expenditure.

(i) Monetary Aggregates

4.11 Year-on-year to December 2005, broad money supply (M4) grew by 14.8 percent, compared to a lower growth rate of 10.9 percent in 2004. The increase of 7.3 percent in private sector credit and a substantial rise of 40.8 percent in net foreign assets contributed to the accelerated growth in money supply during the year. By component, the rise in M4 was reflected in a 25.5 percent increase in the non-bank holdings of BoBCs and a 3.4 percent expansion in interest-bearing deposits (call, savings, notice and time deposits) in the year to December 2005, compared to a higher growth of 8.3 percent in the corresponding period in 2004. Demand deposits declined year-on-year by 20 percent in 2005 compared to a substantial annual increase of 54.6 percent during the same period in the previous year, while currency outside banks also contracted by 0.7 percent in 2005, compared to 19.5 percent in 2004. Foreign currency accounts (FCAs) deposits rose substantially by 108.5 percent in December 2005, partly due to the depreciation of the Pula against major international currencies, following the currency's devaluation in May 2005. This compares with the 7.3 percent decrease in the Pula value of FCAs deposits in 2004.

(ii) Bank of Botswana

4.12 Total assets/liabilities of the Bank of Botswana increased substantially by 42.4 percent to P34 879 million in the twelve months to December 2005, following a slight increase of 2 percent in 2004 and a sharp decrease of 20.3 percent in 2003. The increase in the balance sheet in 2005 was mainly attributable to the increase of 36.2 percent in Government deposits at the Bank of Botswana to P12 827 million, and currency revaluation gains arising from the depreciation of the Pula.

(iii) *Commercial Banks*

4.13 Total assets of commercial banks grew annually by 19.2 percent to P17 686 million at the end of December 2005, following a lower annual increase of 14.5 percent in 2004. Contributing to the increase in total assets were BoBCs and balances due from foreign banks, which rose by 62.8 percent and 85.8 percent, respectively, while growth in advances was much slower at 7.3 percent. This implies greater substitution in favour of BoBCs and foreign asset holdings from advances as demand for credit was restrained.

4.14 On the liabilities side, total private sector deposits at commercial banks increased by 14.2 percent year-on-year to December 2005, to P13 073 million, compared to a lower growth rate of 9.8 percent in 2004. In the same period, commercial banks' capital and reserves increased by 4.8 percent to P1 462 million in 2005 compared to 3.7 percent growth in 2004.

(iv) *Merchant Banks*

4.15 Total assets/liabilities of the only merchant bank, African Banking Corporation (Pty) Ltd, grew by 20 percent in the twelve months to December 2005, compared to a decrease of 31.1 percent over the year to December 2004. The decrease in assets in 2004 was due to Investec Bank merging with Stanbic Bank Botswana, Ltd. Most of the increase in assets in 2005 was due to a substantial rise of 114.7 percent in the bank's holdings of BoBCs compared to a decrease of 17.2 percent in BoBC holdings in 2004. Balances due from domestic banks contracted by 49.8 percent in the twelve months to December 2005, following a decline of 58.1 percent in 2004, from P60.2 million in December 2004 to P30.2 million in December 2005. In contrast, loans and advances decreased by 35.2 percent to P226.6 million in December 2005 from P350 million in December 2004. With respect to liabilities, total deposits, mostly held in notice and time accounts, increased by 34 percent, from P564 million in December 2004 to P755.6 million in December 2005.

(d) Non-Bank Financial Institutions

4.16 The total assets/liabilities of the Botswana Building Society (BBS) increased by 16.1 percent over the year to December 2005, compared to the larger increase of 44.2 percent observed in 2004. Loans and advances (which include mortgage loans) increased considerably, by 29 percent, to P726.1 million in December 2005. With respect to the National Development Bank (NDB), total assets increased by 29.7 percent in the twelve months to December 2005, compared to a smaller growth of 5.3 percent over the same period in 2004. The rise in assets was driven by a substantial increase in BoBCs of 568 percent. On the liabilities side, loans from abroad increased considerably by 157.7 percent during 2005. The Botswana Savings Bank's (BSB) assets increased by 6.2 percent in the year to December 2005, a lower growth rate than the 13.3 percent recorded in 2004. Loans and advances rose by 10.6 percent, compared to a higher increase of 15.5 percent in the previous year. Capital and reserves also grew by 9 percent, compared to 10.7 percent in 2004. For BDC, assets rose by 4.4 percent in the twelve months to December 2005 to a level of P1 569.9 million, compared to a considerable growth of 29.3 percent recorded for the twelve months period to December 2004. The growth in assets was due to a substantial increase of 22.3 percent in investment in related companies, while loans, advances and leasing dipped by 40 percent in the same period.

4.17 The domestic company share index of the Botswana Stock Exchange (BSE) showed a general upward trend from the beginning of the year and gained 670 points (23.2 percent), ending the year at 3 559 from 2 889 in December 2004. Market capitalisation rose by 23.4 percent to P13 418 million in the twelve months to December 2005, compared to lower growth of 15.2 percent the previous year. The foreign companies index rose at a much faster rate of 78 percent during 2005, from the 11.9 percent in 2004. Trading was subdued in 2005 with only 44.2 million shares valued at P239 million traded. This compares with a higher volume of 69.9 million shares in 2004, albeit with a lower value of P203 million.

4.18 The number of domestic companies listed on the BSE was unchanged at 19 between December 2004 and December 2005 while foreign companies increased from 7 in the previous year to 9 by the end of 2005. On the Venture Capital Board, the number of domestic companies fell to 2, with Turnstar listing on the main board, while an additional foreign company, AFCopper, was listed during the year, bringing the total number of companies on the board to 6. The 2-year, 5-year, and 12-year government bonds were listed in February 2005, although the 2-year bond subsequently matured in June 2005. Stanbic Bank Botswana Ltd and Peermont Global issued one unlisted bond each in 2005. The European Investment Bank also issued a Pula bond listed on the Luxembourg Exchange.

(e) Credit Ratings

4.19 Moody's Investors Service (Moody's) and Standard & Poor's (S & P) conducted annual assessments of Botswana's creditworthiness for credit rating in 2005. The sovereign credit ratings assigned Botswana by Moody's since 2001 were maintained, with A2 for long-term foreign currency debt, Prime-1 (P-1) for short-term foreign currency debt and A1 for domestic currency debt, as well as the stable outlook. S & P also affirmed Botswana's original sovereign credit rating at A/A-1 foreign currency and A+/A-1 local currency sovereign credit ratings. The rating agencies' ratings reflect the country's well-managed mineral-based economy and political and macroeconomic stability. However, the agencies expressed concern at the narrowness of the mineral-based economy and the HIV/AIDS pandemic, which generate fiscal pressures at a time when mineral revenues are expected to be reaching a plateau. They emphasised the need for accelerating economic reforms, particularly privatisation and improvement in the business environment, which they perceive as having progressed too slowly. In the medium term, the ratings could improve when reforms gain pace, thereby supporting economic diversification and Botswana's long-term fiscal strength. Conversely, the ratings would come under pressure if the necessary structural reforms were not speedily implemented, resulting in slower than projected growth, which could undermine the sustainability of the fiscal position.

(f) Other Financial Sector Developments

4.20 The International Financial Services Centre (IFSC) Certification Committee considered and approved five companies in 2005, bringing the number of certified companies operating under the IFSC to 29. This number excludes the 7 companies which were deregistered due to failure to start or continue operations.

4.21 During 2005, the Letlole National Savings Certificates registered an increase in sales. The outstanding value of purchases was P0.9 million as at end of December 2005, compared to P0.8 million in December 2004. On the other hand, redemptions for the year totalled P0.9 million, which reduced net savings to P0.04 million in 2005, compared to P0.1 million in 2004. Meanwhile, the Bank of Botswana stopped the operation of the scheme effective April 2005 and handed it over to the Botswana Savings Bank.

4.22 Following the National Clearance and Settlement Systems Act of 2003, which distinguishes between the Bank's settlement agent function and clearing services to banks, the clearing agent role that had hitherto been performed by the Bank of Botswana was transferred to the Bankers Association of Botswana effective September 2005. The Bank still participates in the clearing exercise along with the other clearing banks.

4.23 Financial institutions continue to take advantage of emerging technologies in innovating their operations and broadening the services available to customers, particularly the use of mobile phones to access and manage accounts and get detailed information on financial products.

BLANK PAGE 76

Chapter 2

The Role of Capital Markets in Economic Development – Botswana's Experience

1. Introduction

1.1 The seventh *National Development Plan* (NDP 7: 1991 – 1997), outlined, among others, a strategy for financial sector development, while the 1989 World Bank report entitled, *Botswana: Financial Policies for Diversified Growth*, provided background analysis for the strategy. Since then, the Bank has, in a number of *Annual Reports* (1993, 1999, 2001 and 2003), undertaken a review of the developments in the financial sector and progress made in the implementation of the strategy. However, broader reviews of the financial sector had more detail and analysis on the banking system, largely reflecting its faster development and improved availability of data compared to the capital market.

1.2 Nevertheless, capital markets have an important role to play in providing opportunities for wealth creation, overall economic development and growth by channelling resources to their most efficient use, enabling both savers and investors to reap the highest possible returns. Moreover, through the provision of long-term finance, capital markets complement short-term bank finance and their growth enhances the scope for funding diversification within financial systems or markets that are dominated by banking systems. Capital markets can also facilitate the financing of privatisation programmes, providing instruments for domestic savers and investors to acquire ownership of entities that are being privatised as well as facilitating the flow of international capital.

1.3 Significant progress has been made in Botswana's capital market resulting from the implementation of the financial sector development strategy, developments in the macroeconomic policy framework and the response to emerging needs of participants by the market. However, further growth and improvements in efficiency of the capital market are needed to support the national diversification objective, as well as to enable domestic savers and foreign investors to participate in the envisaged privatisation of parastatals as articulated in the country's *Privatisation Master Plan*, published in 2005. For domestic savers, this is important because of the limited long-term investment opportunities currently available in the bank-dominated local market, while potential participation of foreign capital in the privatisation programme will entail the transfer of globally competitive technology and skills, and provide opportunities for domestic companies to access the international market.

1.4 While the broad financial system can be a conduit for the transmission of macroeconomic policy to the real sector, there are particular linkages between policy formulation and capital market development, notably an increase in the number and extent of instruments that facilitate financial flows and the market determination of the cost of funds. The prevailing monetary and exchange rate regimes and the degree to which they are transparent can, for example, influence the determination of investment risks, evolution of financial instruments and the flow of capital. In addition, the fiscal position and the choice of financing instruments by the Government can influence the development of the capital market. On the other hand, the level of capital market development can support policy formulation and the fluidity and predictability of policy transmission to the real sector. The capital market can also be a useful source of information through its capacity to assess and predict the long-term outcome of policy initiatives, as reflected in the risk/return and maturity profiles of instruments, and the type and direction of capital flows.

1.5 To be effective and to conform to national priorities, standards of good governance and the macroeconomic policy framework, there is a need for effective regulation of the capital market. Such regulation should, among others, aim at ensuring soundness, stability, operational ease and efficiency of the capital market, as well as protection of investors through disclosure rules and sanctions for misrepresentation and fraudulent activities by capital market players. Therefore, legislative and regulatory initiatives and reforms need to be assessed on a regular basis in relation to their support for capital market development, investment growth, macroeconomic policy formulation, ease of financial flows and investor protection.

1.6 The objective of the theme topic is to examine the role and evolution of capital markets in economic development generally and in particular, in supporting economic growth in Botswana. To map out the evolution of capital markets in Botswana, the following section reviews the main elements of the country's financial sector development strategy and how it supports the development of capital markets. This is followed by an examination of the role of capital markets in economic development, their evolution and structure in Botswana, the need for a regulatory and supervisory framework, a comparison of capital market development in Botswana with what prevails in other countries and an examination of linkages between capital market development and macroeconomic management in the country. The conclusion addresses suggestions for further development of the capital market that can contribute to policy formulation and economic development.

2. Botswana's Financial Sector Development Strategy

2.1 The 1989 World Bank report entitled, *Botswana: Financial Sector Policies for Diversified Growth*, provided a significant impetus to the subsequent growth and development of the financial sector in Botswana, with a number of its recommendations formulated as strategies for stimulating the development of the sector in NDP 7. As a development framework, the strategy had a long-term focus, with inter-related elements requiring appropriate coordination and sequencing. The strategy was premised on the realisation that diversification of the economy would come mainly through growth of the private sector, and that the savings mobilisation and investment allocation functions performed by financial institutions and markets would facilitate entrepreneurship and diversified growth. Future development of the financial sector was, therefore, to be guided by the following three basic criteria:

(a) efficiency of the intermediation processes that transform financial savings into productive investments;

(b) soundness of the policies, institutions and practices that define the context within which financial activities are conducted; and

(c) adaptability of the financial system to changes in domestic and international circumstances.

The Role of Government in Financial Sector Development

2.2 Historically, the Government has played a significant role in the domestic financial sector given its relatively large revenue and expenditure compared to other sectoral flows, with budget surpluses being a major source of financial savings in the economy. Therefore, the activities of the Government and the Bank of Botswana in managing the financial affairs of the country and regulating the financial system had a strong influence on the level and character of financial activities in the economy. Moreover, several publicly-owned development finance institutions were established to channel credit to parastatals and private sector borrowers and to support public policy objectives. The Government was also engaged in significant lending to parastatals and local authorities out of the Public Debt

Service Fund (PDSF) and the Revenue Stabilisation Fund (RSF).[1] From the early 1980s up to the late 1990s, total lending out of these funds was higher than the combined lending of all the other financial institutions. The interest rate charged for this lending was also generally below that for commercial banks, which provided an implicit subsidy to users of utilities, parastatal services and borrowers from development finance institutions.

2.3 It was nevertheless envisaged that growth in government revenues would in future be slower, but without a corresponding reduction in growth in expenditure; hence, the role of government in loan financing would gradually decline and be curtailed. The parastatals, in particular, would then be required to rely on their own revenue and non-government financing from both domestic and external sources. To facilitate this, the Government would encourage the development of the private financial sector so that it would have the capability to serve the financial needs of parastatals and other domestic investors. The adjustment process would involve a review of policies for the management of the PDSF and RSF with a view to converting them into true investment funds, as originally intended, and gradually moving lending interest rates on those funds to levels that reflect both the national development priorities and market conditions. It was intended that this would foster the allocation of resources to their most productive use and support the development of market-oriented financial institutions in the private sector.

Operational Efficiency and Soundness of the Financial System

2.4 While earlier planning sought the desired modifications of banking practices and financial development through dialogue between the Government and the banks (NDP 6), this was subsequently judged to be less effective than the promotion of competition. Additional banks and other financial institutions have, therefore, been licensed from the late 1980s, adding to the three commercial banks and government-supported development finance institutions existing at the time. The smooth and efficient operation of the private sector financial institutions and markets was viewed as a necessary ingredient in the financial sector development in Botswana. Competition among commercial banks would ensure the improvement of access to a wider variety of services at competitive prices. This development was supported by a review of the Banking Act that included a widening of the definition of banking beyond the commercial banks and leasing companies to include merchant banks, discount houses and other forms of specialised institutions. It also included the formulation of enhanced supervisory practices for, among others, licensing, determination of capital adequacy and liquid assets, asset concentrations, relationship with bank auditors, reconstruction of distressed institutions and collaboration with other supervisors (Bank of Botswana *Annual Report*, 1995, p33). It was considered that growth of the financial system and a greater variety of institutions as well as a strengthening of public education and access to financial services, would enhance competition and ensure more efficient and transparent pricing for services. Enhanced supervisory services were, therefore, required to support government initiatives of establishing higher banking standards and more diversified services while maintaining the integrity of banking institutions and practices, and to ensure overall stability of a more competitive financial system.

Effectiveness of Development Finance Institutions (DFIs)

2.5 For the most part, the development finance institutions that were established at this time

1. The PDSF was created to meet future public debt obligations, and the RSF was established as a general revenue reserve to supplement recurrent revenue in future years if needed. Given the annual appropriations to these funds (that have occurred without reference to future debt obligations), they grew substantially, especially during the 1980s when the Government was recording periodic substantial budget surpluses. As they grew, their secondary function as a lender to parastatals and local authorities effectively became the primary operation.

served the intended development objectives reasonably well, although some institutions, notably the Botswana Cooperative Bank (BCB) and the National Development Bank (NDB), increasingly exhibited managerial and structural weaknesses. This required a comprehensive review of their mandates and rationalisation of operations. Significantly, it was considered imperative to more clearly define the distinction between their social welfare role and commercial objectives, with the former to be supported by explicit budgetary provisions and the latter to be run commercially. As stated in NDP 7, the cost of loanable funds for the DFIs, including those from the Government through the PDSF, were to be brought closer to market rates. Moreover, as a substantial amount of government funds was entrusted to the DFIs for on-lending, there was need for closer supervision of the quality of the loan portfolio. In particular, supervisory oversight was needed for early identification and action on non-performing loans and bad debts, for "restructuring of distressed debtor/creditor relationships and, where necessary, reform of individual DFIs on a case-by-case basis".[2] This recognised that defaulting to DFIs was an undesirable form of credit subsidisation and would result in the decapitalisation of the lending institutions, hence weakening their market position. Therefore, reforms involved significant restructuring of the development finance institutions and further development of the capital market. These reforms included, among others, the closure of the less efficient and bankrupt Botswana Cooperative Bank (BCB) and performance improvements at the National Development Bank (NDB), at a time when both institutions had been heavily burdened with non-performing loans. At the same time, the Botswana Development Corporation (BDC) would continue to promote the development of focused financial institutions for leasing, small and medium scale loans (Financial Services Company – also partly owned by NDB – ulc and Tswelelo), the establishment of the stock market and the setting up of institutions to promote the ownership of shares in the stock market (Stockbrokers Botswana (Pty) Limited, Sechaba Investment Trust and Kgolo Ya Sechaba).

Development of Domestic Money and Capital Markets

2.6 The development of well-functioning domestic money and capital markets was a central feature of the financial sector development strategy, with the Government "leading the way by adopting a realistic interest rate policy with respect to short-term financial instruments around which money market activities can be organised, and longer-term financing arrangements around which markets for debt and securities can be generated" (NDP 7, p149). Developing the capital markets in this way would link the financial activities conducted in the public and private sectors to common standards, and the determination and adjustment of interest rates would appropriately reflect economic and market fundamentals and developments. While government-supported programmes would continue to reflect development priorities, they were to be directed primarily towards ensuring availability of credit to targeted groups, rather than provision of subsidised interest rates to privileged borrowers (NDP 7, p149). As an element of the strategy, the Government was to encourage the establishment of venture capital enterprises and the development of the capacity of the stock exchange to serve as a vehicle for channelling savings into productive investments. This required promotional work to stimulate the supply and demand for debt and equity securities, including encouraging the larger domestic and foreign companies to list on the stock exchange, as well as privatisation of parastatals and government-financed companies. These initiatives were to be supported by an appropriate legal framework encompassing adequate accounting and reporting practices, as well as a taxation regime that did not unduly inhibit the development

2. *National Development Plan* (NDP) 7, p149.

of financial market activities. As indicated in Section 4 below, the tax regime would seek to promote greater financial market activity through measures such as tax concessions for listing on the stock exchange.

Domestic and External Asset/ Liability Management

2.7 The financial development strategy sought to improve the management of the Government's financial resources with the intention of "promoting economic development in the short-term and securing the country's long-term future" (NDP 7, p150). This envisaged the investment of the PDSF/RSF in a wider range of assets, both domestic and external, and not just development projects, while the growing foreign exchange reserves were to be managed actively and prudently within a framework of acceptable risk parameters. Another element of the strategy was the balancing of the external asset and liability positions where, in the context of the strong foreign exchange position, there would be a continuous assessment of possibilities for utilising the funds to pay outstanding external debt with a higher servicing cost than the return earned on foreign exchange reserves. Correspondingly, the terms for new external borrowing to finance investment projects would be compared to the earnings foregone in drawing down reserves.

The Role of Monetary Policy

2.8 The formulation of the financial strategy and initiatives on widening access to financial services, as well as encouraging more productive financing, was within an environment in which interest rates were low and mostly negative in real terms, thus indicative of the general excess liquidity situation prevailing in the economy. Interest rate policy was generally based on the desire to maintain a low cost of borrowing as it was felt that there was not enough lending to support production and development. The maintenance of low interest rates for borrowing was also intended to encourage acceptance of deposits by commercial banks who, at times, were unwilling to accept them, given the excess funds they were holding. The excess liquidity situation generally led to an increasing shift out of long-term interest bearing deposits into short-term deposits that also forced interest rates down. The resulting negative real interest rates discouraged financial savings and reduced the productivity threshold of projects and led to substantial growth in demand for credit, which generated inflationary pressures.

2.9 The conduct of monetary policy, in particular the sterilisation of excess funds, was also affected by the limited range of monetary instruments where traditional measures, such as open market operations and reserve requirements, were not readily available or effective in an environment of excess liquidity.[3] There was, therefore, a need, as articulated in NDP 7, to strengthen the capacity of monetary policy to mop up the excess liquidity and facilitate an upward movement in interest rates. To this end, the Bank of Botswana began to issue short-term financial instruments in 1990 (eventually in 1991 the Bank of Botswana Certificates (BoBCs)) in the domestic money market as a means to control the liquidity of the financial system. Correspondingly, the Government was to eventually raise interest rates on new PDSF and RSF loans in line with a revised policy objective of achieving positive real rates of interest. In the circumstances, by March 1991 short-term interest rates had increased two-fold over a 12-month period with prospects for a similar movement in longer-term rates on loans by the Botswana Building Society and the PDSF, which had fallen behind.

3. The absence of a need to borrow from the central bank by the commercial banks and the controls on interest rates meant that the standard approach of changing the Bank Rate would have little influence on the economy. Also, reserve requirements would not be effective in influencing lending behaviour when banks held excess reserves. Deposit and lending rates were, however, normally changed at the same time as changes in the Bank Rate in order to maintain an appropriate interest rate structure, i.e., a higher cost of borrowing from the central bank than the interest rate banks paid on deposits.

2.10 Overall, the change in the interest rate policy was motivated by the immediate need to forestall inflationary pressures as well as the longer-term objective of encouraging higher domestic savings. The strengthening of instruments of monetary policy employed by the Bank of Botswana meant that its central banking functions could be performed in a more effective and timely manner. Open market operations, based on issuance of short-term financial instruments at market-determined prices to commercial banks and others with influence on excess liquidity, would strengthen the Bank's linkage with the market and influence the availability of loanable funds, supporting the implementation of the price stability objective. These measures would improve a market-determined interest rate structure, enhance returns to savers and encourage financing of more productive investments. The measures would also complement those aimed at improving the efficiency, soundness and adaptability of the financial system.

2.11 Overall, the following outcomes were expected from the implementation of the financial sector development strategy during NDP 7:

(a) a greater emphasis on coordination of fiscal and monetary policies to provide a stable environment for strengthening institutional and market structures within which financial activities are conducted;

(b) optimal utilisation of the budget and foreign exchange reserves, and enhanced justification for credit and related subsidy programmes implemented by the DFIs;

(c) the private financial institutions were to be more effective and competitive in savings mobilisation and allocation of resources under an environment of increased scrutiny of their services by supervisory agencies and users of services;

(d) the financial environment was to be modified to require private and parastatal enterprises to manage their financial affairs in a more effective and sophisticated manner with reference to a wider range of alternatives, and with less scope for government subsidies and financial decisions based on terms and conditions established by competitive market forces. The parastatals, in particular, were to be weaned from excessive reliance on government financing; and

(e) there were expectations of enhanced opportunities for financial savings by households, given the range of instruments, while greater protection against the erosion of financial savings from inflation and the establishment of a more equitable balance between return to savers and cost of credit would better balance the choice between saving and consumption.

3. The Role of Capital Markets in Economic Development

Definition of Capital Market and its Relationship with the Financial Sector and the Broad Economy

3.1 The financial system involves intermediation and transfer of financial resources between savers and borrowers, creation of financial instruments, and determination of the cost of funds, which help to improve returns to savings and investment and enhance overall productivity. It comprises the following elements:

(a) savers and borrowers;

(b) institutions with differing specialties;

(c) a variety of financial instruments; and

(d) processes, standards and conventions.

3.2 Beyond the direct intermediation channel, financial institutions provide a wider variety of services, facilities and instruments through which borrowers can sell securities or change the form of financial instruments held to enable hedging and diversification as well as pooling of risk. There are also incidental benefits to the operations of the financial system, including facilitating the execution of transactions and resource allocation, reducing market imperfections and enhancing good corporate governance. Within the broad financial system, the capital market can be viewed as the collective activities of financial institutions that specialise in collecting funds, often in relatively small amounts and from diverse entities, and then channelling the funds in the form of relatively large amounts of longer-term capital to borrowers.[4] Therefore, it affords a diversified funding of projects and ventures for which good returns are only expected in the long-term.

3.3 The financial system can be categorised according to different maturities of financial instruments, which distinguishes between longer-dated instruments of the capital market and those of the money market (financial instruments of maturities of less than one year). The long-term instruments traded in the capital market include government, local authorities/municipal and corporate bonds as well as equity shares, both of which can be traded in a share/stock market or through over-the-counter (OTC) arrangements.[5]

3.4 Generally, the financial system has two levels of operation inherent in both the money and capital markets; these are the primary and secondary markets. The primary market refers to the original issuance of a financial instrument (debt or equity) by a public or private (existing or start-up) entity in need of funding. The secondary market involves trade in existing securities and fixed period instruments before maturity.[6]

3.5 A typical (and sufficiently developed) capital market consists of a variety of institutions and financial instruments under broadly two segments: securities and non-securities. The institutions in the non-securities segment include savings banks, mortgage banks, development banks, insurers and leasing companies; while the instruments include deposits, pension and other insurance funds, long-term loans, mortgages and leases. The players in the securities market include investment bankers, brokers and dealers, venture capitalists, stock exchanges, OTC markets and mutual funds. In this segment, the traded instruments include shares, bonds and their derivatives.

3.6 Typically, the main holders of financial instruments in the capital market and the major long-term lenders/investors are contractual savings institutions or institutional investors with long-term liabilities that are often holding funds on an agency basis. These mainly include insurance and pension funds and unit and investment trusts, with smaller amounts held by private corporations and individuals. Overall, the acquisition of these financial instruments is an important source of long-term funding for both public and private sector activities and projects.

3.7 Table 2.1 is an example of the primary assets and liabilities of financial intermediaries in a financial system which shows that the larger proportion of instruments held by capital market institutions (contractual savings institutions) are long term. For example, pension funds mobilise long-term funds and, in order to minimise financial gaps, investors normally seek a matching asset in the form of long-term investments in bonds, shares and property.

3.8 In their operations and interaction with the rest of the economy, capital markets play a critical role in economic development through their contribution to productivity and sustainable output growth. As a conduit for the transfer of investment funds that could be committed over the long term and since the rate of capital accumulation is a fundamental determinant of

4. It is recognised that some of the funds loaned in the capital market are created by the commercial banking system, and that other funds may be provided by foreign investors.

5. There are two ways of organising the secondary market. Exchanges are where buyers and sellers of securities meet in one location to conduct trades. In an over-the-counter market, dealers at different locations have an inventory of securities and stand ready to buy and sell securities "over the counter" to anyone willing to accept their prices. (see Mishkin and Eakins, 2006, *Financial Markets and Institutions*, p21).

6. In general, the singular reference to "the capital market" does not distinguish between the primary and secondary markets nor between markets for different instruments (such as shares, corporate and government bonds) while the plural reference to "capital markets" implies or recognises these distinctions.

Table 2.1: Primary Assets and Liabilities of Financial Intermediaries

Type of Intermediary	Primary Liabilities (Sources of Funds)	Primary Assets (Uses of Funds)
Depository institutions		
Commercial banks	Deposits	Business and consumer loans, mortgages, government bonds
Savings and loan associations	Deposits	Mortgages
Mutual savings banks	Deposits	Mortgages
Credit unions	Deposits	Consumer loans
Contractual savings institutions		
Life insurance companies	Insurance premiums	Bonds, mortgages
Fire and casualty insurance companies	Insurance premiums	Bonds
Pension funds, government retirement funds	Employer and employee pension contributions	Bonds, shares
Investment intermediaries		
Finance companies	Commercial paper, shares, bonds	Consumer and business loans
Mutual funds	Shares	Bonds, shares
Money market mutual funds	Shares	Money market instruments (certificates of deposit, treasury bills, etc.)

Source: Mishkin and Eakins (2006).

long-term growth, the existence of a capital market and its performance is potentially important for ensuring stability of corporate funding and investment; hence the long-term performance of an economy. Significantly, the capital market complements short-term finance, which is mainly provided by banks given their short-term liabilities, and largely used for operational/working capital purposes.[7]

3.9 Below is a highlight of some of the important and complementary activities of capital markets that aid financial flows and growth in productivity, as well as contribute to sustainable output growth. Their function, as it relates to the transfer of funds from surplus sectors to deficit sectors with investment opportunities, has been addressed above.

7. There are notable exceptions, however; in some banking systems (e.g., Germany, Japan and Hong Kong), banks predominantly issued long-term loans to businesses.

Other Important and Complementary Activities of Capital Markets

Redistribution and Spread of Risk

3.10 In the process of intermediation using securities, capital markets facilitate the redistribution of cash flow risk associated with investment in tangible assets, as well as risky investments with long gestation periods. A well-functioning and deep capital market makes the conversion into liquid assets easier and faster, thus mitigating the liquidity risk. From the perspective of lenders, a capital market, including an efficient and liquid secondary component, makes it relatively easy for investors to vary their exposure to risk by continually shifting across institutions and agents and holding a diversified portfolio of financial instruments. Borrowers and issuers of securities benefit from not being dependent on a single or limited number of lenders; therefore, they are exposed to less risk of withdrawal of funding. The existence of a developed and active secondary market ensures that a stable level of funding is maintained even when some investors withdraw their funding. Moreover, in the absence of stable long-term funding, the risk of maturity mismatches may bias the investment decisions of firms towards short-term projects, a situation that can undermine long-term economic growth prospects.

Price Determination

3.11 In well-functioning capital markets, where traders of securities compete in the context of a wide range of instruments available to savers and investors, the process of competitive trading and the interaction of buyers and sellers provides a mechanism for determining the prices of traded assets that are close to fundamental asset values. Such market-determined prices are informative in the sense that they give traders the right signals with respect to investment opportunities and risks; hence they can be considered an efficient basis for resource allocation. The process permits resources to be directed to economic agents who value them most and can put them to their most productive use, thereby increasing overall productivity in the broader economy. The overall benefit to the economy is that resources are channelled to their most efficient use, thus enabling savers and investors to generate optimal returns for any given degree of risk. These efficiency gains serve to optimise the economy's rate of growth.

Oversight and Appraisal of Management Performance

3.12 As another benefit to economic performance and development, a well-functioning capital market facilitates oversight and appraisal of management practices and performance of individual companies and, broadly, the corporate sector, thus reducing monitoring costs, especially for smaller investors. For example, the corporate bond market can appraise management performance by downgrading (discounting) the value of bonds of poorly managed enterprises. Similarly, the performance of a corporation's management is under constant monitoring by the stock market and its judgement reflected in the performance of the share price. Poorly performing entities tend to exit the market through, for example, a change of management, bankruptcy, restructuring, or through mergers and takeovers; and, apart from changes brought through the legal regulation, this can be instigated by shareholders.[8] Consequently, management tends to ensure satisfactory share price performance by focusing on continuous innovation and improvement in productivity to effectively compete in the market for products and resources, including capital funding and personnel. The macroeconomic outcome of healthy and sound businesses/producers is robust overall economic performance.[9] Typically, however, such monitoring and market discipline is only applicable in respect of large corporations whose shares and bonds are traded in stock exchanges or held privately by large and influential institutional investors/shareholders.[10]

3.13 The same scrutiny applies to borrowing by government, particularly given the desire to maintain a good sovereign credit rating in order to continue to attract funding. There is an incentive, therefore, for governments to maintain good governance, discipline and transparency with respect to macroeconomic policies and data dissemination.

Secondary Market and Liquidity

3.14 In the capital market, an efficient secondary market provides liquidity and opportunities to spread risk across portfolios and market participants. Efficient secondary markets

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8. In addition, the management may discover that they could more easily obtain funds from alternative sources (other than the stock market) if the company has a record of consistent sound performance.

9. See Bencivenga and Smith (1991), "Financial Intermediation and Endogenous Growth", Review of Economic Studies, 58: 195-209, which concludes that such arrangements in well-developed capital markets enhance corporate control and translate into higher levels of investment and rapid economic growth.

10. Institutional investors (e.g., insurance and pension funds) do not normally provide funding for small firms because they may find it uneconomical to monitor these firms, as they often do not have track records.

make it relatively easier for investors to reduce their exposure to risk by continually shifting positions to maintain an optimal diversified portfolio of stocks, bonds and other financial assets as circumstances change. Liquid markets help reduce information asymmetry (where only borrowers have information about the risk of borrowing and lenders do not), and this tends to result in transparency and lower transactions costs as search costs are eliminated. This facilitates informative price discovery and helps reduce the cost of borrowing and, potentially, increases the volume and quality of loans and investment.

Support for Economic Growth

3.15 Overall, there is consensus in economic literature that a properly functioning financial system plays a significant and positive role in enhancing long-run economic growth as well as in contributing to a stable economic environment. Theoretical analysis and empirical evidence point to a causal relationship between a number of financial development indicators and economic growth. For example, Levine and Zervos (1996)[11] indicate that there is a growing theoretical literature, which shows that stock markets render services that bolster economic growth by reducing the cost of savings mobilisation and easing trade in equities (stock market liquidity), and thus enhance investment in productive technologies. In addition, it has further been demonstrated that internationally integrated stock exchanges improve the allocation of resources through risk sharing and can boost economic growth.

3.16 While there are economic benefits to the development of capital markets, they are invariably supported and enhanced by an effective supervisory and regulatory framework. In this respect, there are several alternative legal and regulatory frameworks ranging from self-regulation to direct government supervision. However, there are, broadly, two types of overarching frameworks for financial regulation. The latter places the responsibility for implementation, monitoring and enforcement of standards on a legally constituted public body, while the former entails a voluntary approach and relies mainly on self-regulation. Direct supervision is the most common and is in place in the United States of America (USA) and most European countries, while in the United Kingdom, self-regulation predominated until the mid-1980s when the country moved closer towards direct public supervision, as domestic capital markets opened to international competition.[12]

3.17 As with other markets and specialised institutions or activities, the underlying reason behind the regulation of capital markets is to protect the less sophisticated market participants from potential exploitation, and generally protect a capital market's integrity, ensure its continued efficient operation and minimise the effect of poor operators or losses on the rest of the market and the economy. In particular, regulation is considered necessary to deal with 'systemic' failure or contagion effects, where failure of one institution or a special activity/operation can adversely impact on and even lead to a collapse of the whole system.

3.18 Overall, the main objectives of a regulatory framework are to develop a structure that:

(a) allows the market sufficient room to function properly, while preventing practices that take advantage of the less

11. Levine and Zervos (1996), "Stock Market Development and Long-Run Growth", the World Bank Economic Review. It should, however, be noted that the authors caution that despite the strong link between stock market development and economic growth indicated by the data, the results should not be considered as conclusive findings; instead the results should be interpreted as partial correlations that should prompt further research.

12. Self-regulation in the UK before 1986 involved each of the market participants formulating their own codes of conduct by which members of the 'club' were supposed to abide. For example, the London Stock Exchange devised its own rules relating to take-overs and mergers, without any statutory foundation. When the capital market was opened up to international competition, it was considered that a more extensive framework was necessary, reflecting that, in such an environment, a mechanism that relied on members of the club knowing each other and being willing to abide by the rules would be ineffective. Consequently, the Financial Services Act 1986 was adopted as a legal instrument for the framework used to regulate the carrying on of investment business and consolidated much of the existing legislation, covering issues such as insider dealing and take-overs.

sophisticated market participants, thereby potentially jeopardising the integrity of the market;

(b) facilitates transactions and transfers of value and ownership; and

(c) does not inhibit or prohibit potential innovations by market participants.

3.19 Financial institutions have a high degree of leverage where most of the funds lent or used to create/acquire other assets belong to outside investors/depositors, and not to the owners and management of the institutions. In order to profit from the leverage, the owners and managers have an incentive to engage in high-risk ventures. Hence it is important to introduce a type of control mechanism to guard against possible abuse or excessive assumption of risk. This is normally done through prudential supervision which is concerned with the quality of assets, adequacy of capital as a buffer against losses and the soundness of bank management.

3.20 In general, regulation of capital markets takes one or more of the following four forms: disclosure regulation, financial activity regulation, regulation of financial institutions and regulation of foreign participants. Disclosure rules require issuers of securities to avail financial information to existing and potential investors, given that the management would have more reliable information about the financial health and future prospects of the issuing company than the investors. Financial activity regulation has to do with rules about trading and the quality as well as professional responsibilities and/or integrity of traders in the financial market. Hence it is crucial that there are rules to prevent insider trading to regulate activities of corporate officers since they are in a better position to know about the firm's prospects than public investors. As indicated above, the regulation of financial institutions involves prudential supervision to ensure continuing stability of individual institutions and the market. Failure of any financial institution and market instability can disrupt economic activity and (monetary) policy implementation. Several countries also regulate participation by foreign firms in the domestic financial securities markets in order to limit or monitor ownership and control of local institutions, as well as the level of participation.

3.21 Apart from the benefits to capital market participants, there is a close relationship between financial sector development and macroeconomic policy formulation and implementation, particularly fiscal, monetary and exchange rate policies. If macroeconomic policies are properly set so as to attain macroeconomic stability, the country would potentially achieve robust economic growth, with low and stable inflation, as well as sustainable fiscal and balance of payments positions. This environment supports the development of capital markets. Investors are more willing to undertake long-term investment projects, which they could finance by issuing long-term debt when there is demand for those instruments, since savers would be willing to hold them.

3.22 Conversely, if macroeconomic policies generate high and volatile inflation, economic agents will tend to avoid holding long-term financial assets due to increased uncertainty of return. This is more likely to inhibit the development of capital markets. Furthermore, high and variable inflation contributes to macroeconomic instability, which discourages cross-border capital inflows that could be invested in the domestic capital market and the general economy. Greater demand for funding by governments due to unsustainable budget deficits can lead to a skewed flow of funds in the economy or crowding out of the private sector and a distortion of the interest rate structure, generally resulting in a higher cost of funds in the economy (for the private sector). Moreover, political instability can also add to economic uncertainty, hindering the flow of capital into the domestic economy. It is, therefore, important to have both macroeconomic and social (sector) policies that support the maintenance of not only macroeconomic stability, fiscal balance and steady economic growth, but political stability as well, which would normally provide a conducive environment for the development of capital markets.

3.23 Additional factors that can inhibit the development of a capital market include controls on interest rates and foreign exchange transactions and lack of competition. Interest rate controls may, for example, result in negative real interest rates, where deposit rates are below the rate of inflation, such that they discourage domestic savings. Consequently, the development of a capital market will be hindered, since funds will go into physical assets and/or abroad (capital flight), particularly in the absence of the exchange controls. Exchange controls force economic agents to invest all their resources in the local market, thus preventing international diversification of investment portfolios and hence market risk. Moreover, exchange controls discourage inflows of foreign capital, which could be invested in the domestic capital market.

3.24 Lack of competition in any of the capital market segments (the banking and the non-banking sectors) constrains capital market development. In particular, the strong oligopolistic feature of some banking markets (see Bank of Botswana *Annual Report 2003*) is inimical to competition, while the absence of effective inter-sectoral competition between the banking and non-banking sectors also hinders the development of the capital market. It is, therefore, important to encourage competition across the broad spectrum of institutions and players in the money and capital markets, including the various types of banks, as well as leasing and venture capital companies, through a supportive national policy and supervisory framework.

3.25 The development of a capital market can also be slow in situations where companies do not raise finance through the securities market, but rather rely on internal funds and bank finance. Some of the factors that influence firms' choices with respect to issuing securities and investors' decisions to invest in long-term market instruments include tax policy and investment incentives. A tax regime that is more favourable to interest earned on bank deposits than to returns from securities discriminates against capital market development, while poor investment incentives will limit the type and number of securities issued in the capital market. From the lenders' or financiers' perspective (demand side), additional factors that influence the holding of securities and, therefore, the development of capital market instruments include the degree of transparency, quality of information and liquidity of a secondary market.

3.26 The development of a capital market is, however, not an unmitigated benefit to the economy, and several possible detrimental effects of the market need to be recognised. In particular, literature suggests that increased risk sharing through internationally integrated stock markets can lower savings rates and lead to a slowing of economic growth. Others have argued that stock markets can hamper economic growth by facilitating corporate takeovers, which may be counter-productive, and by promoting changes in ownership and management that reduce welfare.[13] Also, the widening of the financial system through growth of the capital market increases the sources of financial market instability and spread of problematic financial contagion. In terms of policy formulation, the growth of domestic capital markets can, for example, result in a greater proportion of financial intermediation being carried out in capital markets, rather than through banks and other traditional intermediaries, as is the case in the USA and several Latin American countries, with important implications for monetary policy. If the banks' intermediary role diminishes, the conduct of monetary policy may be affected since the monetary policy transmission mechanism may change, and its

13. See, for example, Shleifer, A. and Summers, L. (1988): "Breach of Trust in Hostile Takeovers" in Alan Auerbach, Ed, *Corporate Takeovers and Consequences*.

impact become less certain, thus resulting in the conventional monetary policy approach of controlling inflation being less potent. Nevertheless, the problem of the uncertain impact of monetary policy could be mitigated by realigning the monetary policy framework to take into account the changed structure as well as market and institutional relationships.

4. THE EVOLUTION OF CAPITAL MARKETS IN BOTSWANA: AN OVERVIEW

4.1 Historically, the financial sector in Botswana has been dominated by the commercial banks, which have played a major role in contributing towards the development of the economy. However, the banks have been criticised for not providing enough financing options suitable for investors, especially new locally-owned businesses that may neither be able to provide adequate security for long-term loans, nor have access to other sources of funding (e.g., through external borrowing or support from parent companies). In the past, this gap has been partly filled by the Government, through state-owned development finance institutions (DFIs) and special government-funded schemes providing concessional finance to business, ranging from small enterprises to parastatal corporations.

4.2 This situation has changed in recent years with the rapid growth of private pension funds that, by 2005, had assets far in excess of those of the commercial banks.[14] This rapid mobilisation of additional savings suggests significant potential for further capital market development since, as emphasised earlier, such funds have a strong preference for longer-term investments, such as mortgages, bonds and shares. However, at present a large portion of these funds constitute excess liquidity, and this is reflective of the current general under-development of capital markets in Botswana.[15] The excess funds are absorbed by the Bank of Botswana through the issuance of short-term money market instruments (BoBCs) using open market operations.

Listing on the Stock Exchange

4.3 As in other countries, the capital markets in Botswana can be broadly classified into primary markets (for new issues of stocks and bonds) and secondary markets (where existing securities are traded). The structure of these markets can also be classified under market participants and market instruments.

4.4 The distinguishing feature of the capital markets in Botswana is their narrow base as typified by a few buyers and sellers. Participants in both the primary and secondary markets include domestic and foreign companies, commercial banks, corporates, parastatals and institutional investors (pension funds, insurance companies and mutual funds), the Bank of Botswana and Government, as well as the general public.

4.5 The principal capital market institution in Botswana is currently the Botswana Stock Exchange (BSE), where company shares and bonds are listed and traded. When the BSE was established in 1989 (originally as the Botswana Share Market (BSM)), it started with only five listed companies. By the end of 2005, a total of 28 companies and 21 bonds were listed. Chart 2.1 shows the breakdown of the listed securities by major category.

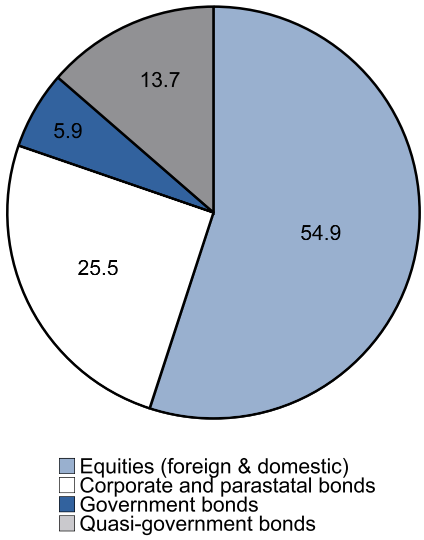
4.6 The listed companies on the BSE represent a wide range of economic sectors including manufacturing, wholesale/retail, banking, medical services, property, security services, mining, tourism and information technology. Recently, most new listings have been in the mining sector, a reflection of both high prevailing prices for minerals and the attractive investment climate for mining operations in Botswana.[16] Newer businesses, which

14. At the end of 2005, pension fund assets were P22 billion compared to nearly P18 billion for commercial banks.

15. The Bank has decided that non-banks will no longer be allowed to invest in Bank of Botswana Certificates (BoBCs) since the certificates had always been intended as a tool through which short-term interest rates are established.

16. According to the *Resource Stocks World Investment Risk Survey* for 2005, Botswana provided the most attractive destination for mining investment in the world. Given the high level of current interest in this sector, there is anticipation of some further listings by mining ventures.

CHART 2.1: BSE LISTED SECURITIES BY CATEGORY (PERCENT)



Source: Bank of Botswana.

cannot provide a track record of satisfactory operations, are able to list through the separate 'venture capital board' (VCB), which signals higher investment risk. Six companies, mainly in the mining sector, were listed on the VCB at the end of 2005 and, during the year, for the first time one company graduated to the 'main board' having established the required track record. Since 1997, the BSE has allowed dual listing with other stock exchanges and, at the end of 2005, nine foreign companies were listed in this manner, the largest being Anglo American Corporation.

4.7 In common with other stock exchanges, share prices are monitored through a variety of indices, the most widely watched being the Domestic Companies Index (DCI). The DCI tracks movements in share prices on the BSE using a weighted average of all domestic companies listed on the exchange. It is similar to famous indices on other exchanges such as the FTSE 100 in London or the Dow Jones Industrial Index in New York.

4.8 It is important to appreciate that the number and range of companies listed on the BSE should not be used as the only criterion for its effectiveness and importance in the Botswana economy. A standard measure that is widely used is the ratio of market capitalisation to gross domestic product (GDP). At the end of 2005, this ratio was approximately 25 percent in Botswana, up from 8 percent in 1995, and this growth indicates the growing relative influence of stock market activity in the country. However, the effective capitalisation is considerably less, as most of the listed companies allow only a proportion of their shares ('free-float') to be traded on the exchange, and this is a reflection of the original owners' desire to maintain control and their share of profits. Often this proportion is small. For example, the three largest companies traded on the exchange, all of which are commercial banks, have an average free-float of only 27 percent, while for the most recently listed domestic company the free-float is just five percent. There are exceptions to this pattern, including two companies where all shares are tradable through the exchange and, importantly, Sechaba Brewery Holdings (Sechaba) with a large free-float of 58 percent. Sechaba, in particular, was originally used as a vehicle to help the government-owned Botswana Development Corporation (BDC) to divest its holdings. If the DCI was calculated on the basis of the free-float, rather than market capitalisation, Sechaba would have the largest weight in the index.

4.9 Publicly available information on share ownership is, by its nature, less easy to come by.[17] However, it is apparent that large institutional shareholdings are dominant. For example, as of March 2005, ninety percent of Sechaba shares (including those outside the free-float) were controlled by only 25 shareholders. Of the largest ten shareholders, excluding the two original owners, all were institutional funds. Looking at the aggregate data for the share market as a whole, the total capitalisation of the domestic companies listed on the BSE was P13.4 billion at end-December 2005, or about 26 percent of GDP. The free-floating portion was just under P5 billion, of which the registered pension funds held about half.

17. While records of share ownership are maintained, there is less operational need of information on the background of individual shareholders.

4.10 This concentration of shares is not a new phenomenon. In 1992, it was estimated that the general public in Botswana held only eight percent of the shares in the BSM, with institutional investors using the share market as a means to diversify their portfolios away from property.[18] However, the general public have participated to a greater extent than is indicated by such figures, as the sales of shares, upon listing, have on several instances given preference in allocation to small investors (in terms of guaranteed quantities at the prescribed issue price), who have been able to profit by selling their shares at a premium to larger investors.

4.11 When the stock exchange commenced its operations, it only traded equities. The first bond listing was in 1997 when the BDC issued a bond with a nominal value of P50 million. By 2001, there were three other listed bonds, all by parastatals, which underscored the Government's resolve to eventually wean such entities from government funding.

4.12 Subsequently, the bond market has grown more rapidly, underpinned by government support through its own bond issues. In 2003, three government bonds were issued, with maturities of two, five and twelve years and a combined face value of P2.5 billion. The explicit aim was to support capital market development[19] by increasing the supply of longer-term debt instruments and establishing a risk-free yield curve against which the launch of bonds by other issuers could be benchmarked.[20] However, for technical reasons the bonds were not listed on the BSE until January 2005. In 2004, using a 'special purpose vehicle', the Government completed the securitisation of a large portion of the PDSF, resulting in a further seven bonds with a combined face value of P1 billion being listed. At the end of 2005, the nominal value of listed bonds on the BSE was P3.8 billion, or about 8 percent of GDP. Most of these were for fixed interest rates, but four were floating-rate instruments with interest rates set as a margin above either inflation (as measured by the Botswana CPI) or yields on BoBCs.

4.13 Over the same period, there was an upsurge in listings of private sector bonds, in particular by financial institutions. The significant interest of commercial banks in issuing bonds is noteworthy, reflecting two separate factors. First, the structure of some of the issues was in the form of preference shares[21] which, in turn, enabled the banks to count the proceeds as capital required for reserves, freeing up funds for other purposes, including cash payments to shareholders. Second, issuing longer-term bonds enables the banks to better match their liabilities with specific lending opportunities, and this illustrates that traditional banking activities can also benefit from more developed capital markets.

4.14 Until 1998, there was only one stockbroker whose role was to match buy and sell orders from clients and was also responsible for the overall management of the nascent share market. However, following the establishment of a fully independent stock exchange in 1995, and the continued gradual development of the market, two further brokerage firms were registered with the BSE between 1998 and 2000, thus providing some degree of competition. Brokers help with the flow of information that is essential to the efficient functioning of the market, providing updates and briefings on market development, including assessments of the performance of listed companies.

(d) Botswana Stock Exchange Transactions

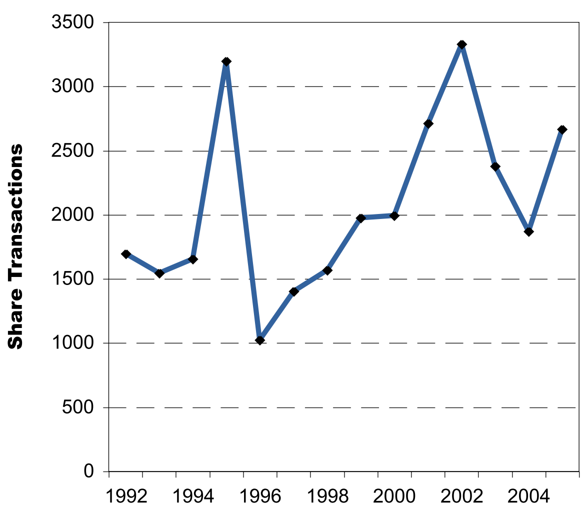
4.15 While the increased number of brokers is a sign of heightened market activity, a feature of the Botswana markets has

18. Bank of Botswana *Annual Report 1993*, p28.
19. The Government continues to have sufficient funds and does not need to resort to borrowing to fund its activities.
20. A yield curve plots yields against maturities. By issuing debt that is effectively risk free, government bonds indicate yields over a range of maturities making the benchmarking of other issues easier for both buyers and sellers.
21. This is subordinated debt; in the unlikely event that the issuer was to become insolvent, the debt would be converted into equity.

consistently been a lack of liquidity. This is measured as the value of shares traded in relation to total market capitalisation. The number of buyers and sellers is often very small in both the primary and secondary markets. The heavily restricted free float limits supply while, in turn, investors, especially with the growing importance of the fund management industry, are often unwilling to sell their shareholdings (i.e., they tend to buy and hold) since such a decision cannot be easily reversed in an illiquid market. High brokerage fees and a lack of skills in taking advantage of trading opportunities are also cited as obstacles to greater liquidity. The net result is that trades for very small quantities can take place at prices that can significantly affect aggregate market indicators such as the DCI; and if shares remain untraded for some time, the reference prices quoted by the exchange and used to calculate the share indices may have little relevance. As observed earlier, one consequence of illiquidity is that prices are less likely to be 'efficient', i.e., they may not reflect the underlying fundamental value of the assets in question. In turn, this has the effect of reinforcing the illiquidity as buyers and sellers will be less willing to trust the 'going' price as a reflection of the underlying value of a stock.

4.16 Chart 2.2 shows the total number of shares traded on the BSE each year since 1992. While there has been some general upward movement, especially since 2001, this was from a low base and only in the most active years has there been an average of more than ten trades per working day.[22] In addition, the amounts traded vary tremendously. During 2005, the weekly value of shares traded ranged from less than P0.5 million to over P61 million. The bond market is much less active and it is often characterised by long periods without trades.

Chart 2.2: Botswana Stock Exchange: Annual Transactions (Number of Trades)



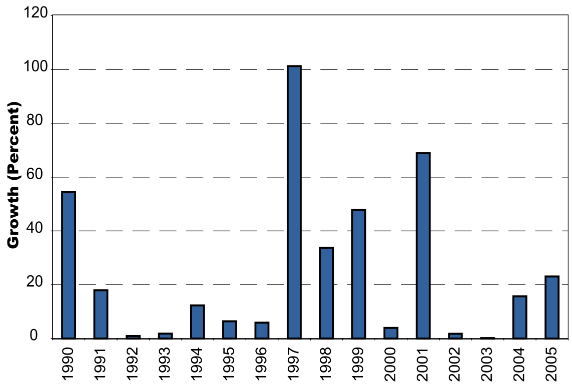
Source: Bank of Botswana, *Annual Reports*.

4.17 Another indicator of the performance and growth of the stock market is the change in DCI. The Botswana DCI was set at 100 at the time of commencement of operations in June 1989. By the end of 2005, the DCI had risen to above 3 500, representing an annual growth rate of approximately 25 percent. This is much higher than the rate of inflation which averaged 10 percent over the same period, and this indicates a substantial real growth in the average value of shares; it is also much faster than the rate of growth of nominal GDP, which was about 13 percent over the same period.

4.18 As shown in Chart 2.3 below, the growth of the DCI was in distinct phases; the initial period of low growth in the early 1990s, when the index generally increased by less than 10 percent per annum, followed by an acceleration in growth. With the exception of 1997, for which growth was exceptionally high at 101 percent, the annual average for the period 1990–2005 has been 25 percent. Within this latter period growth was far from uniform; for example, in 2003 the index was almost unchanged and at one point during the year had fallen by 11 percent. This long 'bull run' on the BSE is largely due to the impact of pension funds in the early 2000s, while the combination of increased demand and limited supply may have led to some of the BSE stocks becoming overvalued at some points over the period.

22. It is striking in Chart 2.2 that trading levels in 1995 were relatively high. This reflects the effect of the divesting by BDC of much of its stake in Sechaba, the brewery holding company. The sale was over-subscribed and small bids given preference, with many of these holders quickly selling their shares at a profit.

CHART 2.3: DOMESTIC COMPANY INDEX: ANNUAL GROWTH



Source: Bank of Botswana, *Annual Reports.*

4.19 The following points are worth noting in regard to the rapid growth in the DCI:

(a) the overall movement of the DCI is heavily influenced by the market valuations of the listed commercial banks, which currently make up approximately 60 percent of the index. Since inception of the DCI, both the assets and profitability of banks in Botswana have increased substantially;

(b) there is some indication that in the early years of the market's operations, share prices were undervalued, as they were held back by low liquidity, deliberate under-pricing of new issues, and the relative lack of sophistication among domestic investors. Subsequently, the growing involvement of international investors and increased demand helped in achieving a better market determined price level.[23]

(c) while the overall dividend yield has shown some decline since 2003, this was from historically high levels, and remains on a par with earlier years (Table 4.5 in the statistical section of the *Annual Report*). Moreover, the behaviour of individual share prices has generally reacted to the specific business circumstances of the companies involved, e.g., poor performance leads to a falling share price, and *vice versa.* In other words, investors' demand for shares has not been so great that they buy at any price regardless of the risks.

While these points may be valid in terms of the performance of the DCI, there is a possibility that some asset prices may have become over-valued. Excessive asset price inflation can result in asset price 'bubbles' that could, in turn, lead to financial instability.

4.20 Table 2.2 below shows (for 1995, 2000 and 2005) the assets of the commercial and merchant banks, several non-bank financial institutions and pension funds, together with the capitalisation of domestic companies listed on the BSE, and the outstanding volume of loans by banks and the Government; the outstanding amount of domestic bonds is also shown. These provide some indication of the growing importance of capital market activities in Botswana relative to the financial sector overall.[24] Growth in all categories has been rapid, with the exception of loans by the Government, which is indicative of the decision to wean parastatals off PDSF borrowing and the sale of much of the PDSF loan book in 2004.[25] Over the period of Table 2.2 below; the growth of Bank of Botswana assets has been robust at 10.1 percent per annum, although there was a decline from a peak of P41.3 billion in 2001. This reflects, in the main, the transfer of assets previously under the custody of the Bank of Botswana to the Public Officers Pension Fund (POPF).[26] As indicated earlier, the total assets of the pension funds now substantially exceed those of the banking sector having grown by an average

23. See Jefferis *et al.* (2001) 'International Stock Market Linkages in Southern Africa' *AERC Research Paper 105.*

24. While informative, these numbers should be viewed with care, and not as an aggregate measure of overall financial sector activity. There are elements of both double counting (e.g., the growing assets of the banks and NBFIs are also mirrored in the capitalisation of the BSE and the expanded bond market) and omissions due to data limitations (e.g., neither insurance nor micro-lending activities are included).

25. The lending by the Government would be much higher if the activities of the Citizen Entrepreneurial Development Agency (CEDA) were included. However, this is not yet included in regular surveys of financial sector activity. As of March 2004, disbursed lending by CEDA stood at P613 million.

26. As at end of September 2005, funds in the Public Officers Pension Fund amounted to over P16 billion.

of 31.7 percent since 2001 and are almost equivalent to the assets of banks and DFIs combined. The funds raised on the domestic bond market have risen from zero in the mid-1990s to almost 50 percent of total bank lending.

Table 2.2: Botswana Financial Sector – 1995 to 2005 (Year end, P million)

	1995	2001	2005	Growth (Percent p.a.)
Assets/Liabilities				
Commercial & merchant banks	3 151	12 067	18 567	19.4
Bank of Botswana	13 369	41 341	34 879	10.1
DFIs[1]	1 309	2 410	4 466	13.1
BSE[2]	1 120	8 909	13 418	28.2
Pension funds	n/a	7 427[3]	22 329	31.7[6]
Borrowing				
Commercial & merchant bank loans	1 779	5 735	9 306	18.0
Government loans[4]	2 445	1 987	1 262	–6.4
Bonds[5]	0	180	4 525	124[6]

1. Botswana Savings Bank, Botswana Building Society, National Development Bank, Botswana Development Corporation and the Motor Vehicle Accident Fund.
2. Capitalisation of domestic listed companies.
3. September 2002.
4. Mainly the PDSF, but also the RSF and Development Fund. As of end-March in the reference year.
5. Includes unlisted bonds.
6. Growth rate covers period 2001–2005 only.

Source: Bank of Botswana, *Botswana Financial Statistics* and *Annual Reports (various issues).*

Government Support for Capital Market Development

4.21 It is important to examine the supporting institutional arrangements and, in particular, areas where the Government or its agents have been active in directly stimulating the development of the capital market. This support of capital market development should be seen in the context of the NDP 7 financial sector development strategy, where the leading role envisaged for the Government was articulated.

4.22 The origins of the BSE predate the financial sector development strategy, arising from the efforts of the BDC to establish a vehicle for divesting its interests in selected companies in a way that could encourage investment in equities by members of the public. Prior to setting up a share market, the BDC had established Sechaba Investment Trust (SIT), which held investments in a variety of BDC companies. Shares in SIT were offered to the public from 1984, and the value of the Trust's investments grew rapidly from P24 million in 1984 to P156 million in 1990.[27] However, trade was limited by lack of a secondary market, and its focus on BDC companies further restricted investor choice (the investment portfolio of SIT was heavily concentrated in the beverage industry). At the same time, the emergence of private sector pension and insurance businesses created an institutional demand for equities. By June 1989, the time was opportune for the establishment of the BSM, thus providing a platform of a secondary market for the five listed stocks; in turn this led to more direct involvement by the Government in the development and regulation of the market.

4.23 Tax incentives were provided for those companies that listed on the BSM as a promotional measure to encourage listing. These included an exemption from capital gains tax on sales of publicly quoted shares and lower income tax for listed companies with at least 25 percent of their shares held by non-controlling interests. The fact that some of the larger listed companies chose to make available the minimum 25 percent to gain the income tax concession is a clear indication that this was an important consideration in opting to list.

4.24 From the Government's point of view,

27. The history of SIT prior to setting up the BSM is instructive as it shows how limited capital market development can be encouraged without additional resources required to establish a fully fledged stock market. Similarly, in 2001 the Lesotho Government established the Lesotho Unit Trust to allow its remaining shareholdings in privatised enterprises to be sold to the public. This came after the option of establishing a stock market had been explicitly rejected as being too costly.

providing limited incentives in the form of tax incentives was a worthwhile initiative to help launch the BSM, especially since the listing of major companies, such as commercial banks, was desirable to help establish the new market's credibility. At the same time, it represented a clear cost to the Government in the form of lost tax revenue. For instance, in 1992, it was estimated that the concession on corporate income tax cost the Government about P4 million,[28] which was, at the time, equivalent to about one percent of total receipts of non-mineral income tax.

4.25 There are regular suggestions that further tax concessions are needed to stimulate further development; however, these suggestions should be considered with caution. Although continued capital market development may contribute to the economy's development, there is no obvious reason to give it preference over other sources of diversification which could, in many instances, make a similar or better case for concessions.[29] This is particularly so as the Government continues to meet a substantial part of the costs of running the BSE after it became a separate legal entity in November 1995, following the passage of the Botswana Stock Exchange Act the previous year.[30]

4.26 In early 2001, Botswana was awarded investment grade sovereign ratings by two of the world's leading credit rating agencies, Moody's Investors Service and Standard and Poor's.[31] The decision to acquire ratings had been announced in the 2000 Budget Speech and was explicitly aimed at improving the links between the domestic economy and capital markets, both domestic and international. Given that the Government itself had no need to borrow at that time or in the immediate future, the costs of such an exercise represented an investment in economic development more widely. Such ratings provide internationally accepted credentials for economic and financial performance. It was felt that, following the removal of exchange controls in 1999, Botswana was well placed to make itself more known by the international market. Sovereign credit ratings do not only take account of the track record and financial position of a government, they also consider the performance of the private sector and the prevailing political and social conditions. A good rating provides a positive signal to potential investors and helps to lower the costs of international borrowing.[32]

4.27 The ratings given to Botswana reflect a strong external position of the country, coupled with development policies that have successfully balanced the provision of social services with prudent fiscal and monetary management over the years. The investment grade ratings have been successfully maintained every year following the annual reviews, and the discipline of regular reviews should also help to ensure that the prudent management of the economy is maintained. Both rating agencies have commented in their reviews, most recently in 2005, on increasing concerns that Botswana has yet to achieve the "hoped-for" success in diversifying the economy away from dependency on diamond mining. There is also concern about the slow implementation of some policies, including the privatisation policy, and that the monitoring of the government budget could be improved to reduce the sometimes large discrepancies between initial estimates and final figures. The task of maintaining the ratings is an important challenge because if, for any reason, the ratings were to come under pressure this would signal a decline in confidence in the economy.

28. Bank of Botswana *Annual Report 1993,* p28.

29. Moreover, if the development of financial markets becomes too dependent on incentives and concessions, then the primary function of allocating resources to their most productive use could be undermined.

30. Between 1989 and 1995, the listing rules, members' rules and all general requirements used in the market were developed in cooperation with the Zimbabwe Stock Exchange.

31. Ratings are not graded according to common standards, but by scales devised by individual rating agencies. The classification 'investment' or 'A grade' means that any borrowing by (or backed by) the Botswana Government would be accorded low risk.

32. In relation to this point, there have been periodic suggestions that the Botswana Government should issue an international bond to establish its presence on the international capital market.

4.28 As with acquiring a sovereign credit rating, the decision to issue Pula-denominated bonds on the domestic market was not based on any pressing financial need on the part of the Government. Even though it had entered a period where budget deficits were recurring, these could still be easily financed from accumulated savings without recourse to additional borrowing. Thus, the net interest payments[33] and other costs associated with the bond issues should be seen as the cost of this further investment in capital market development. There is no doubt that the government bonds played an important role of providing a home for some of the assets in the rapidly growing pension funds, particularly the POPF which was established just prior to the launch of the bonds. In the circumstances of the prevailing relatively high interest rates, investors preferred to invest locally and did not take advantage of the dispensation of the Registrar of Pensions to invest up to 70 percent of their portfolios in offshore markets.

4.29 Table 2.3 below shows the breakdown by holder of government bonds as of mid-2004. The main participants in the market are the primary dealers (four of the five commercial banks), domestic investors, foreign investors and, to a lesser extent, the Bank of Botswana, which maintains a register of transactions and took up small holdings in some of the bonds to help promote liquidity in the market. Since the primary dealers were not members of the BSE, the bonds could not be listed on the exchange until a new category membership was established, which was not achieved until the end of 2004. However, interim arrangements were made to report on market conditions and the practical impact seems to have been minimal as the bonds had the desired effect of establishing a yield curve and encouraging possible further bond issuance.

4.30 While the bonds were primarily intended for the domestic market, there was no restriction on foreign holdings. Indeed, there is a strong case for encouraging such holdings as developing an international market for domestic currency bonds is a way of developing wider confidence in the market.[34] The bond with the shortest maturity (BW001) proved particularly attractive to foreign investors, thus reflecting the inverted yield curve with lower returns on the bonds with longer maturities due to relatively high demand from domestic institutional investors. In this context, the timing of the devaluation of the Pula at the end of May 2005 was problematic as it came just before the

Table 2.3: Holdings of Government Bonds[1]: end year 2004-2005 (P million – Percent in brackets)

	2004				2005		
	BW001	BW002	BW003	Total	BW002	BW003	Total
Primary Dealers	131.9	174.4	13.6	327.1	78.6	13.5	92.1
	(18.5)	(20.5)	(1.5)	(13.1)	(9.2)	(1.2)	(5.3)
Customers	591.0	589.4	886.4	2 066.8	685.2	886.4	1 571.6
	(78.8)	(69.4)	(98.5)	(82.7)	(80.6)	(98.5)	(89.8)
Of which:							
Foreign	107.8	101.5	23.0	232.3	0.0	0.0	0.0
	(14.4)	(11.90)	(2.6)	(9.3)	(0.0)	(0.0)	(0.0)
Bank of Botswana	20.0	86.3	0.0	106.3	86.3	0.0	86.3
	(2.7)	(10.2)	(0.0)	(4.3)	(10.2)	(0.0)	(4.9)
Total	750	850	900	2 500	850	900	1 750

1. The coupon (percent) and maturity of the three bonds are: BW001: 10.75/2005; BW002: 10.25/2008 and BW003: 10.25/2015.

Source: Bank of Botswana.

33. The net interest cost was lower than the gross interest paid on the bonds, as the borrowing had a counterpart in the retained foreign exchange reserves on which some return was earned.

34. The term 'original sin' has come into widespread use in financial and economic analysis to describe situations where the issuing of long-term domestic currency debt faces chronic difficulties, reflecting an underlying lack of confidence in the currency.

maturity of the two-year bond. The adverse impact on confidence was clearly apparent among market participants and, since the devaluation, foreign holdings of the remaining two bonds have been negligible. There was also concern that the Government's decision not to replace the matured bond could send a signal that its interest in supporting capital market development was waning. Among proposals, there have been suggestions that the Government could make clearer its intentions regarding future bond issuance (particularly when the remaining bonds mature) in order to maintain momentum and that consideration could be given to developing other segments of the market. In this regard, one possibility could be to initiate a programme for issuing short-term treasury bills, which would lessen the strain on monetary operations in mopping up excess liquidity from the banking system and would serve as an alternative short-term investment instrument now that BoBCs are no longer available to non-bank customers.

4.31 Of the new bonds issued in 2004, seven were by Debt Participation Capital Funding (DPCF), a special purpose vehicle set up in order to securitise the commercial portion of the Public Debt Service Fund (PDSF) loan book. This is consistent with the NDP 7 financial sector development strategy of reducing dependence of parastatals on government loans as a way of enhancing further financial sector development. As indicated in Section 2, among other initiatives, interest rates were increased, borrowing procedures were tightened and the Government introduced further debt/equity swaps. By 2003, the total PDSF loan portfolio was P1.5 billion, compared to P2.2 billion in 1994. In the 2002 Budget Speech, it was announced that no new loans would be made from the PDSF, as the Fund would return to its original purpose of financing government debt service payments.

4.32 The Government announced that the existing loan book would be sold to private financial institutions which, in turn, would convert the loans into marketable securities to be listed and sold through the BSE. Initially it was envisaged that this would be done through an international competitive tender to secure the best market price. In the event, however, securitisation of the loans was done through the DPCF under an arrangement where the Government received the proceeds of the bond sales less the costs of issuing and listing the bonds, together with start-up capital for the company. Not all the loan book was sold; approximately P500 million of PDSF loans remained with the Government. These were mainly the non-commercial portion of the portfolio, mostly loans to local councils. The latter loans were not considered viable for securitisation, thus reflecting the current financial position of the local authorities. This will need to be taken into account when considering suggestions that the capital markets could be further developed by issuing local authority bonds. The PDSF loans that were securitised were backed by government guarantees not only for repayment, but also as a way of committing to re-borrow and make an equivalent set of payments to DPCF in the event that a loan was repaid early. DPCF was also indemnified against changes in the tax regime. Thus, although the bonds were not directly guaranteed by the Government, they were effectively a risk free investment.

4.33 The seven fixed-interest rate bonds (with a total face value of P1 billion and closely matching the face value of the portion of the PDSF loan book that had been sold to DPCF) had maturities of three to 21 (twenty-one) years, with the structure determined by the repayment profile of the loan book. Overall, the issue was over-subscribed, but this was due mainly to demand for the longer maturity bonds, which was reflective of the limited supply of such investment instruments in the country. Some of the shorter maturity bonds were under-subscribed, even when sold at less than par value, and the balance of these issues was subsequently placed directly (not through a bidding process) with investors at the price determined by the auction. Conversely, the longer-dated bonds were sold at a premium and this resulted in the inversion of the yield curve (compared to the coupon rates which, except for the shortest maturity bond, had the traditional upward sloping curve).

4.34 A strong case can be made that the Government's strategy to encourage the development of the bond market was successful as evidenced by the larger number of non-government (or quasi-government) bonds that have subsequently been listed; and the initiative was widely welcomed by market participants. There continues to be an absence of significant secondary market trading, but this may be reflective of the costs associated with such trading. These costs include listing fees, and it is notable that three bonds have been issued but not listed, thus avoiding the additional payments to the BSE, including the only issues by businesses that are neither financial institutions nor parastatals.[35]

4.35 There are, however, arrangements being put in place to encourage more active trading and, in this regard, the BSE has indicated that it will seek government assistance in reviewing the relevant legislation and in establishing a Central Securities Depository as a prerequisite for the greater automation of the trading system. Recognising the need to come into line with international best practice regarding regulatory issues, the Government has indicated its intention to repeal the BSE Act and replace it with a Securities Act. The new legislation should facilitate the trading of all types of bonds on the exchange, modernise trading through the introduction of electronic trading, streamline governance and update capital requirements for stock exchange members while, at the same time, introducing effective provisions to deter market manipulation and insider trading.

TABLE 2.4: ISSUE OF DPCF BONDS – JUNE 2004

	Issue (P million)	Maturity	Coupon (Percent)	Successful bids	Stop out price	Effective yield (Percent)
DPCF001	170	2007	10.34	160	95.4	12.23
DPCF002	195	2010	10.17	81	97.5	10.75
DPCF003	225	2013	10.31	153	97.4	10.76
DPCF004	220	2016	10.45	220	99.4	10.54
DPCF005	100	2019	10.60	100	100.5	10.53
DPCF006	55	2022	10.75	55	102.0	10.50
DPCF007	35	2025	10.90	35	102.9	10.55

Source: Stockbrokers Botswana.

4.36 The introduction of the defined contribution pension scheme for public officers had a major impact on the capital market. This development saw a total of P4.9 billion being transferred from government deposits at the Bank of Botswana to the POPF in 2001. As of September 2005, the scheme covered over 75 000 members and, with assets having risen to more than P16 billion, it accounted for over 70 percent of total pension funds in Botswana. On the downside, the growth of the POPF has led to a significant increase in excess liquidity in the domestic financial system, with the total stock of BoBCs increasing by more than 200 percent since the end of 2000.[36] This is against the background of the relatively tight stance of monetary policy which is attractive to domestic investors.

4.37 There is no doubt that the Government has

35. The three unlisted bonds are those issued by First National Bank of Botswana, Kgalagadi Breweries Ltd and Peermont Global.

36. While the fund managers' direct holding of BoBCs may not be very large (in June 2005, total holdings of domestic non-government bonds and BoBCs was only P2 billion), the large cash/near-cash holdings (P3 billion) will have a substantial counterpart in BoBCs held by the commercial banks.

effectively and successfully privatised the management of public service pensions, without the long consultative processes that have accompanied privatisation processes. What is of critical importance now is the establishment of a regulatory and supervisory framework for this rapidly growing industry of fund management. Hence legislation for the regulation and supervision of non-bank financial institutions, and establishment of a capital market, are at an advanced stage.

4.38 While not formally part of the domestic financial sector, it is relevant to highlight the importance of the country's efforts to establish a centre for the provision of international financial services. The level of success achieved by the International Financial Services Centre (IFSC) could also impact on perceptions about the status of domestic financial market development; similarly, increasingly vibrant domestic markets could help attract more internationally oriented businesses.

4.39 The IFSC formally commenced operations in early 2000. Initially it operated as part of the BDC before being established as a separate corporate entity in 2003, so that it could be more visible for promotional purposes. The IFSC's establishment was meant to position Botswana as a hub for cross-border financial services and a regional gateway for capital and investment flows. This has been backed by the country's good political and economic credentials, which are buttressed by the independent assessment of third party observers such as the International Monetary Fund (IMF) and the sovereign credit rating agencies. The abolition of exchange controls, a preferential tax regime for the IFSC (15 percent corporate income tax rate guaranteed until 2020), exemption from domestic capital gains and withholding taxes and access to the country's network of double taxation treaties have further supported the operations of companies that have established a presence in the IFSC. The designated regulatory authorities for the IFSC are the Bank of Botswana and the Registrar of Insurance, and operations can be approved in a wide variety of areas such as foreign currency banking, finance, insurance and securities trading, investment advice, custodial functions, financial administration and development and supply of computer software in related areas. Some of the companies operating in the IFSC are listed on the BSE.

4.40 The initial problems pertaining to employment of skilled labour have been resolved by exempting IFSC-registered companies from normal work permit application procedures. In relation to this, while it is not suggested that the same exemptions should be extended to domestic financial companies, it should be recognised that their requirements in terms of skilled labour may not differ much from those of the IFSC. Nevertheless, the IFSC has developed only slowly; for instance, as of March 2005, the total number of companies accredited to the IFSC was 31. While these employed about 300 people with an investment of about P78.4 million,[37] many of the registered companies had still to commence operations. This mixed progress suggests that highly rated macroeconomic credentials will not by themselves be sufficient in attracting foreign investment. One particular concern has been the high cost of telecommunications, with analysts having warned that the IFSC is unlikely to realise its potential unless this constraint is removed. Given its intention to move away from purely financial services to outsourcing of more general office services (including call centres), this becomes even more urgent.

5. COMPARISON WITH OTHER DEVELOPING CAPITAL MARKETS

5.1 It is relevant that Botswana's experience in the development of its capital market is compared with that of other emerging economies.

37. IFSC News Letter, Issue No. 3, Volume 3, December 2005.

Stock Exchanges

5.2 The two largest stock markets in Africa are in South Africa and Egypt; they were established in the late nineteenth century, while those in Kenya, Morocco, Nigeria and Zimbabwe were established in 1954, 1929, 1960 and 1945, respectively. However, the most rapid development has been since the early 1990s when the number increased from ten to eighteen, almost all of which are members of the African Stock Exchanges Association (ASEA). This accelerated growth reflected increased commitment to market-oriented economic policies and to the importance of capital market development in Africa. The new exchanges have generally been established with government support, often as part of a wider strategy of financial sector reform. This is in striking comparison to older exchanges that have typically emerged as private sector initiatives, with governments becoming involved at a later stage in matters of regulation and supervision. Subsequent market activity has typically been fuelled by a combination of privatisation, issuance of government debt, encouraging the listing of subsidiaries of large international companies, and the development of a domestic fund management industry. The establishment and development of the BSE followed this trend.

5.3 Despite heightened activity, African stock exchanges have been described as 'frontier' markets. This refers to low levels of capitalisation and liquidity as well as concerns about insufficient availability of information, antiquated trading systems and below par corporate governance.

5.4 In terms of size, African stock markets are relatively small. For instance, the Johannesburg Securities Exchange (JSE) accounts for about three-quarters of the combined capitalisation of the eighteen existing markets and, in 2001, Africa accounted for only 0.7 percent of world capitalisation and 7.6 percent of the capitalisation of all emerging markets. Therefore, it should not be surprising that African stock markets face an uphill struggle in attracting the attention of international investors, although this is not an impossible task for those that make effective use of modern technology and have a credible claim for operating according to international norms.

5.5 Table 2.5 shows a range of standard comparative statistics of listed domestic companies for a selection of stock exchanges in Africa and other emerging markets. In Africa, the large size and structure of the South African and Egyptian stock exchanges stand out in all measures except when compared to other emerging markets.

5.6 The size of the Egyptian stock market is, to a large extent, a function of the size of the national economy, as the ratio of capitalisation to GDP is similar to that of several other smaller exchanges; but the exchange has, by far, many more listed companies, albeit dominated by small businesses. In contrast, market capitalisation of the JSE exceeds national output but the number of listed companies is less than those of the Egypt Stock Exchange. Listed companies in Botswana are relatively large in terms of GDP compared to any of the other listed exchanges, including the JSE.[38]

5.7 It can be concluded from this that, given the small size of most, if not all, African stock markets, they tend to play a marginal role in the development of their respective economies. As a result, many exchanges continue to depend on public funding and, in some cases, tax concessions. In explaining this continued support, some analysts have stressed the importance of symbolism in promoting stock exchange development: that establishing a stock exchange can be a cost-effective way of making a highly visible commitment to economic modernisation (see Moss, 2004).[39] It has been further pointed out

38. In 2002, the average capitalisation of companies on the Botswana Stock Exchange as a proportion of GDP was 1.5 percent. This is higher than in the other countries listed in Table 2.5 (South Africa's figure is only 0.29 percent). This is all the more remarkable, given the proportion of mining GDP for which there are no listed domestic companies.

39. 'Irrational Exuberance or Financial Foresight? The political logic of stock markets in Africa', in *African Emerging Markets Contemporary Issues Vol 2*, African Capital Markets Forum.

TABLE 2.5: COMPARATIVE STATISTICS – SELECTED STOCK EXCHANGES IN AFRICA AND OTHER EMERGING COUNTRIES

	Market Capitalisation (MCPT; USD million)	MCPT (Share of Africa Total; percent)[1]	MCPT/GDP (Percent)	Listed Companies (Number)	Annual Trade (Percent of MCPT)
Africa					
Botswana	1 717	0.7	29.4	19	3.6
Egypt	26 245	10.7	31.2	1 151	28.1
Ghana	382	0.2		24	2.9
Kenya	1 676	0.7	13.4	50	2.1
Mauritius	1 324	0.5	27.2	40	4.5
Morocco	8 319	3.4	21.3	56	11.1
Namibia	201	0.1	6.5	13	N/A
South Africa	182 616	74.6	140.8	472	42.1
Other Emerging Markets					
Brazil	140 818	NA	27.7	510	52.1
Malaysia	157 917	NA	179.5	723	66.8
Poland	21 273	NA	11.6	174	51.9
Thailand	43 010	NA	37.3	415	71.9
Turkey	46 001	NA	31.6	273	150.5

1. Data for Africa are for 2002 and 2001 for other emerging markets.

Source: African Stock Markets Handbook (UNDP, 2003); Emerging Stock Markets Handbook.

that the establishment of stock exchanges has generally not been the main plank of donor-sponsored economic reform programmes, which could be ascribed to the so called symbolism.

5.8 The reasons advanced for the persistence of illiquidity in African markets (as indicated by the ratio of trade to market capitalisation in Table 2.5) have focused on the efficiency of market institutions and the sophistication of participants. Other problems relate to settlement procedures, high trading fees, insufficient regulation and unsound corporate governance (e.g., accounting, disclosure, minority shareholders rights, etc.). These problems contribute to relatively high costs of trading which ultimately lead to price distortions and moral hazard. In addition, the small number of listings on most exchanges reflects unwillingness to list among small and medium scale companies, where the owners who may lack relevant experience could fear loss of control of their businesses. Needless to say, these and other related problems can be redressed by the establishment of modern regulatory and supervisory structures and the development of requisite skills to effectively take charge of the infrastructure.

5.9 While the origin of the BSE is closely associated with the BDC's divestment programme, privatisation has not yet played a role in terms of increasing the supply of tradeable corporate shares.[40] This is in contrast to the Lusaka Stock Exchange, which was established in 1994 with technical assistance from the International Finance Corporation (IFC) and the World Bank and has been pivotal to the success of the privatisation programme in Zambia. Similarly, privatisation provided the initial boost for stock market development in the Baltic States in the mid-1990s.

5.10 It is generally expected that, when the privatisation programme in Botswana finally starts to gain momentum, Initial Public

40. As has already been mentioned, the *demand* for shares has been boosted by the effective privatisation of the Government pension fund, while the supply of bonds was substantially enhanced by the securitisation of a large part of the PDSF loan book.

Offerings (IPOs) and listing on the BSE will form a central component and lend support for further market development. Privatisation is expected to give local share markets a major boost, while associated stock exchange listings should help underpin the success of privatisation. Nonetheless, the experience in Zambia (where concerns about the financial viability of some parastatals meant that, in some cases, the IPOs were substantially under-subscribed, thus leaving a large portion of shares in government hands) indicates that this cannot be taken for granted in every case.

5.11 In 1998, the stock exchange in Abidjan was converted to the 'Bourse Regionale des Valeurs Mobilieres' (BRVM) to serve the eight countries in the West African franc zone. So far, this is the only regional market in Africa, although the ASEA has long-term plans to consolidate the various national exchanges into regional hubs. This consolidation is important as it enables the exchanges to benefit from scale economies and increased liquidity. However, there are indications that the case of the BRVM may be exceptional, as Abidjan hosted the only existing exchange in the zone and was the obvious commercial centre in the zone. It is unfortunate that similar consolidation plans in the Central African franc zone have stalled, in large part because there are no existing exchanges and there is no agreement among the six nations on the location of its headquarters. In other regions, the economic impetus for increased integration and cooperation to take advantage of scale economies could similarly be held back by concerns that the role of existing national exchanges will be diminished.

5.12 The experiences of other stock markets in developing countries, especially in Africa, are illuminating. Botswana's efforts at development in this area are not unique, but at the same time, it is clear that country-specific circumstances play a major role. In this regard, Botswana would seem to be well placed in two important respects. First, there is a relatively strong base of good economic and corporate governance. Second, there is a relatively good supply of funds for investment and management by market practitioners. At the same time, there is the constraint of low market liquidity. This appears to be pervasive among smaller markets, and is one reason why their contribution to national economic development has often been marginal. It is to be hoped that the expected developments in the Botswana economy, including the rolling out of the privatisation programme and development of major projects (especially in the mining sector) which will require major private sector funding, should provide the necessary stimulus to move the market to the next tier of activity.

Bond Markets

5.13 An important policy consideration for the prevention or mitigation of financial crises in emerging markets has focused on the development of local bond markets. Well functioning local bond markets can absorb the effect of lack of access to international capital markets or credit from the banking sector by providing an alternative source of finance. At a microeconomic level, bond markets can provide a diverse menu of instruments that can be used to address currency and maturity mismatches in emerging markets.

5.14 Bond markets in emerging economies have grown considerably in the past few years, mainly as a result of financial crises in the late 1990s and a deliberate implementation of policy prescriptions to foster their development. In response to the crises, several emerging market countries have embarked on efforts to develop local bond markets which, in some cases, are increasingly providing an alternative funding source. Not only does this provide an important fallback position in the event the local banking system experiences problems or when access to international capital markets is curtailed or denied, but it may also be a more appropriate form of funding by way of providing longer-term financing in local currency. Furthermore, another factor which provided impetus to the growth of emerging bond markets is the progressive elimination of barriers to cross-border investment which, in turn, led to the demand for local instruments by global fixed income investors.

5.15 Structurally, emerging country bond markets are largely similar to those in the mature or developed markets in that respective governments account for 50 percent or more of the bonds issued, while the remainder are issued by domestic corporations, international companies and financial institutions. There are, however, some significant regional variations. For instance, the Latin American markets are dominated by domestic government bonds (55 percent) and international bonds (32 percent), while the largest share of corporate bonds (17 percent) are in Asian markets. In the remainder of the emerging markets, government bonds account for 73 percent of total issues.

5.16 According to the International Monetary Fund, the need to recapitalise banking systems and to finance expansionary fiscal policies have driven the growth of local bond markets in Asia. In Latin America, the fast growth of institutional investors and the substantial refinancing requirements of the corporate sector against the background of a tough external environment were the major factors providing the momentum for the growth of local bond markets.

Government Bond Markets

5.17 In several emerging market countries, the development of government bond markets has outpaced that of corporate bond markets. The risk associated with this type of trend is that it could result in the over issuance of government debt which can crowd out the corporate sector.

5.18 As mentioned earlier, the rapid growth of government bond issues in the emerging world was due to the need to finance fiscal deficits. Botswana's direct use of government debt, which was not driven by need to borrow, is unusual. There are cases where governments in other countries adopted deliberate policy strategies to develop bond markets in the absence of fiscal necessity. Chile, Hong Kong and Singapore have endeavoured to develop their domestic bond markets without the need to finance budget deficits. For these governments, which also run regular fiscal surpluses, developing local bond markets entail costs, particularly when there are limited high return investment opportunities for the funds mobilised. However, this cost may be justified on the basis "that public-good aspects of bond markets justify some degree of official involvement in their development – in particular those related to market infrastructure".[41] This way of developing local bond markets may provide encouragement to the Botswana authorities.

5.19 Elsewhere in Africa, some countries, e.g., Kenya and Ghana, have been able to effectively tap into local bond markets to improve the management (and cost) of government debt. In Latvia, the government issued more bonds than needed, relative to its fiscal needs, in order to promote the local bond market and long-term financing in domestic currency. However, this was not so successful in stimulating market development, and it is likely that this was due to the fact that demand had been over-estimated. The experience of Chile, where pension reform was introduced in the early 1980s, also points to the importance of institutional investors in the development of financial markets in the context of developing economies.

5.20 It has been argued that "…a well functioning market for government debt can serve as a platform for the development of private sector debt markets and provide key information about market expectations"[42] (Schipke et al., 2004, p9). In this regard, there are a number of policy initiatives aimed at developing government bond markets and these include

41. IMF, *Emerging Local Securities and Derivatives Markets*, 2004.

42. Schipke, A. *et al* (2004) 'Capital Markets and Financial Intermediation in the Baltics'. *IMF Occasional Paper 228.*

improving market infrastructure, developing a domestic investor base, establishment of benchmark issues and yield curves, increasing the depth of the market and transparency through pre-announced and regular issuance programmes. On the improvement of market infrastructure, some countries (e.g., Hong Kong) improved their clearing and settlement systems and established links with international clearing houses such as Euroclear and Clearstream, while others created a system of primary dealership. In Asia, bond market issues have, in the recent past, surpassed the growth of banking sector liabilities, thus indicating an expansion and widening of the investor base. Long-term investors such as insurance companies have sought to raise the duration of their assets by investing heavily in longer maturity government bonds. In addition, pension system reform and capital market reforms can also contribute to the development of a local investor base, as well as increasing the depth and stability of the local bond market.

Corporate Bond Markets

5.21 Experience from other countries suggests that a well-developed government bond market tends to be a catalyst for the development of a corporate bond market. It is also generally the case that, while corporate bond financing is becoming more important, bank credit still constitutes the main source of finance to the corporate sector in the developed and emerging markets; although corporate bond financing is becoming an important source in comparative terms. According to IMF estimates, among the developed countries, the USA has the biggest corporate bond market accounting for 22 percent of GDP, followed by Japan at 16 percent and the Euro Area countries at 10 percent. The latter lower figure reflects greater reliance on bank financing in the major European economies other than the United Kingdom. Corporate bond markets are generally small in emerging markets. Notwithstanding this, Malaysia and Korea rank among the biggest emerging bond markets in the world with 38 percent and 21 percent of GDP, respectively. In Latin America, Chile has the largest quantity of corporate bonds issued at 11 percent of GDP.

5.22 The growth of corporate bond issuance intensified in the middle of the 1990s in the emerging markets due to a number of factors. These included the quest for alternative funding in order to address currency and maturity mismatches, reduced dependence on bank lending as well as cyclical and structural factors. The financing requirements of the corporate sectors following the financial crises in Asia and Mexico were important in driving the growth of these markets. With corporates in the aforementioned areas undergoing restructuring through the substitution of costly international debt with domestic funding, this provided the additional growth impetus. In addition to the foregoing factors, the authorities in these countries also implemented a series of important measures specifically to develop corporate bond markets. Some of these measures included liberalising market eligibility standards, allowing issuance of unsecured bonds, improving bond market infrastructure that enhanced trading, clearing and settlement systems, as well as strengthening the regulatory environment. The majority of these countries had already established benchmark yield curves through government bond issues raising funds for financial restructuring, undertaking infrastructure projects and mopping excess liquidity resulting from the accumulation of foreign exchange reserves.

5.23 To understand the factors that underpin the growth of corporate bond markets, it is important to investigate what has driven the demand and supply of corporate bonds in the emerging markets. According to the International Monetary Fund's regular world economic and financial surveys, the fast growth of funds under the management of local institutional investors is one of the important factors explaining the rapid growth of domestic corporate bond markets in Latin

America and, to a degree, in the emerging markets in Asia. The growth in assets under management is attributed to pension reforms, and the growing attraction of mutual funds. The main source of demand for corporate bonds in Asia has been the insurance industry, while in Latin America, this has been attributed to the growth in assets under management. The other important general trend observed in these markets is that the purchase of local corporate bonds by foreign investors is low compared to government bonds and equities, thus reflecting, *inter alia*, narrow spreads and the lack of hedging instruments. For instance, in Korea the extent of foreign investment in equity markets amounts to 40 percent, while the extent of participation in corporate and government bonds is minimal. On the supply side, banking distress, which can result in the collapse of bank lending or a rise in the cost of bank credit, may encourage corporate bond issues. In Russia, corporate bond issues more than doubled to 2.8 percent of GDP between 2000 and 2004, which was the result of "large financing needs of the corporate sector and the inability of the banking system to recover from the crisis of 1998–99".[43]

5.24 Apart from demand and supply factors, banks and other financial intermediaries have played a significant role in developing corporate bond markets, although there have been cases where they have been somewhat unwilling to lend support. For instance, it has been argued that the dominance of banks in some European countries and Japan retarded the development of bond markets until the late 1980s. The banks in these circumstances tend to opt for maintaining their lending ties with corporates, instead of offering alternative instruments like corporate bonds. The banks do this by restricting access to funds, or through supporting the promulgation of regulations that raise the cost of issuance and underwriting of bonds. While banks and other financial intermediaries have in a number of countries issued and purchased bonds, their primary role is the provision of underwriting to corporates as well as facilitating the proper functioning of secondary markets. The situation has, however, changed in the last two decades with experience from Canada and the European Union indicating that the banks and bond markets can, through the role of investment banks, support and complement each other.

5.25 Various studies have identified a number of institutional characteristics that are necessary for a proper functioning of corporate bond markets or, indeed, for the local bond market in emerging markets in general. Macroeconomic stability is one important necessary condition for the development of these markets. The second important prerequisite is the need to develop a substantial and diversified institutional investor base, such as pension funds, insurance companies and mutual funds. On the supply side, it is necessary to have an expanding and diverse group of issuers of the "size and credit quality" that can attract institutional investors, in order to attain sustainable growth of these markets. It is in this respect that Botswana is currently lagging behind. The authorities should put in place a regulatory framework that protects investors, promotes the integrity of the market and manages systemic risks. As already noted, this need has been recognised by the Botswana Government by advancing the speed of enacting the relevant enabling legislation.

6. CAPITAL MARKET DEVELOPMENT AND MACROECONOMIC MANAGEMENT

6.1 For Botswana, it is important to review the impact of the policies designed to develop the capital markets, while it is also useful to indicate how the state of capital markets has affected policy formulation.

6.2 As noted above, macroeconomic, industrial and financial sector policies can have an impact on the development of capital markets, while the latter's state of development can influence policy efficacy and support industrial

43. IMF, Global Financial Stability Report, 2005.

development. In general, when investors have confidence in government policies they are more willing to hold securities in the capital markets issued by both the government and private sector companies. As a result, funds are generated for promising investment opportunities and channelled through the capital markets, potentially aiding long-term sustainable output growth. Macroeconomic stability, which is accompanied by policy transparency, tends to attract investors, as they will have confidence in the economy, given the predictability of policy changes. Moreover, policy changes backed by a credible, transparent and predictable policy framework are better able to influence demand conditions and the mobilisation of investment finance, both locally and internationally.

6.3 Conversely, the absence of sound economic management, as characterised by chronic budget deficits and excessive money supply growth, tends to lead to inflationary pressures, uncertainty and a possible crowding out of the private sector, which is not conducive to private investment and sustainable development. When inflation is high and volatile, investors tend to avoid holding long-term financial assets due to increased uncertainty of return and, as a result, the development of longer-term financial instruments and a vibrant capital market tends to be inhibited. Chronic budget deficits generally require financing by the private sector through, among others, treasury bill and bond issues, or direct borrowing from the financial sector or the central bank. This tends to starve the private sector of funds, while the process of money creation that results from central bank financing can be inflationary. There is also an incentive to limit the cost of borrowing to the government through control of interest rates, which might distort the interest rate structure and the "true" cost of funds, as well as productive investment in the economy. The combination of high inflation and artificially low interest rates translates into negative real interest rates, which tend to hinder the development of capital markets, as potential investors would prefer to hold physical assets or foreign assets where there are positive real returns.

6.4 A well-functioning capital market can also contribute to minimising both macroeconomic and financial risks of policy making. In general, the formulation and implementation of monetary, exchange rate and fiscal policies involves the use of some types of financial instruments; and the related operations affect the availability and cost of funds in both the money and capital markets, which influences investment decisions. In the circumstances, and as indicated in Section 3, a well-functioning capital market allows for a more deterministic, transparent and predictable transmission process and limits the need for direct intervention.

6.5 As indicated in Section 2, Botswana's policy decision to support the development of the financial sector and the evolution of the monetary policy framework had a significant influence on the growth of both the money and capital markets. Among others, the notable developments include the Government's reduced role in the financial sector, changes in credit and interest rate policies, abolition of exchange controls and variation in implementing exchange rate policy.

6.6 While the Government remains a significant influence in the financial system through its relatively large deposits at the Bank of Botswana and funding of parastatals, albeit at a reduced level, its reduced role is increasingly supportive of the capital market development.[44] Indeed, the Government's decision to wean parastatals from dependence on government financing provided an investment vehicle for some of the excess liquidity in the banking system, while contributing to capital market development. Another notable development was the sale of the PDSF loan book, which increased private sector participation in the

44. The absence of a borrowing need by the Government can also be considered a significant influence on the capacity to develop the capital market.

capital market. The Government also made a significant contribution to the growth of the capital market through the issuance in 2003 of bonds, which not only provided an investment vehicle for funds, but also established medium- and long-term points on the yield curve as a benchmark for private sector bond issues. Moreover, the country's relatively good sovereign ratings by Standard and Poor's and Moody's Investors Service have helped to promote foreign participation in the domestic market as there is easy access to information on the state of the economy.

6.7 Another important element of the financial sector strategy, as outlined in Section 2, was the change in the monetary policy framework and its implementation. In line with the strategy, the determination of interest rates has since moved from direct controls, which was premised on the desire to keep the cost of credit low in order to stimulate business investment. In the current framework, monetary policy focuses on price stability and determination of interest rates by banks results in generally positive real interest rates, which tend to encourage the holding of financial instruments and, therefore, are supportive of capital market development. In turn, a more developed capital market aids policy transmission and the level and direction of yields through a spectrum of maturities.

6.8 Capital flows and, broadly, capital market development can also be influenced by a country's exchange rate policy. For Botswana, in the context of a fixed exchange rate peg to a basket of currencies, the exchange rate had been perceived as stable and predictable, while supported by a level of foreign exchange reserves that made the Pula convertible. Overall, the exchange rate policy is not considered to have been an impediment to capital market development. The more flexible and transparent crawling band regime introduced at the end of May 2005 offers enhanced predictability and can be responsive to capital flows induced by interest rate movements. In turn, the increased importance of capital flows engendered by the development of the capital market affords greater scope for the transmission of changes in monetary policy to the exchange rate.

6.9 The exchange controls that were in place until 1999, the remaining restrictions on holding of BoBCs by foreigners and prudential limits for offshore investment do not appear to have had much impact on capital flows. However, the removal of exchange controls was beneficial in reducing the resource costs of compliance and the negative perception of the country by investors, while opening up opportunities for outward investment and portfolio diversification by domestic companies and individuals, potentially reducing excess liquidity in the banking system.

6.10 Overall, given the relatively less developed domestic market, the combination of monetary and exchange rate policies appears to have not had much impact on capital flows vis-à-vis the rest of the world. However, the prevalence of excess liquidity, which can be viewed effectively as inward capital flow,[45] in the context of limited capital market instruments, has been a significant influence on the conduct of monetary policy and the level of interest rates. In order to conduct monetary policy, the Bank of Botswana influences the amount of loanable funds in the banking system and ensures that the interest cost of funds reflects the desired impact on demand conditions consistent with the price stability objective. This is done by mopping up excess liquidity from the banking system through open market operations, with the resulting yield indicative of tightness or otherwise of liquidity conditions.

6.11 The development and growth of the capital market should reduce the amount of excess funds in the banking system as investment opportunities open up, thus reducing the cost of conducting monetary policy. It is notable that, while the establishment of the POPF and the switch from the defined benefit to

45. The main counterpart of excess liquidity are financial inflows resulting from persistent large balance of payments surpluses.

the defined contribution scheme contributed to the development of the capital market, limited investment opportunities meant that the resulting liquidity raised the cost and complexity of conducting monetary policy, as a substantial amount of the funds was invested in BoBCs (see Section 4). The recent Bank of Botswana decision to curtail participation of non-bank institutions in open market operations (through BoBCs) should lead to the development of alternative investment instruments.

6.12 Indeed, increased competition in the financial sector, which was one of the envisaged outcomes of the NDP 7 financial sector development strategy, has resulted in the use of the capital market to raise funds and restructure the capitalisation of the banks. The issuance of bonds by the Government in 2003 and the disposal of the PDSF loan book in 2004 through the sale of bonds by DPCF are also judged to have affected the availability of institutional wholesale and long-term deposits. As indicated in Section 4, the banks have also been issuing comparable long-term instruments in the form of subordinated debt, which also counts towards meeting capital adequacy requirements. The long-term funding enables the banks to increase their long-term assets in the form of mortgage portfolios.

6.13 It can be concluded that, broadly, Botswana's investment policies, as reflected in and complemented by the industrial development policy, tax policy, open current and capital accounts and conducive macroeconomic policies, are supportive of capital market development. It is expected that implementation of the Privatisation Policy that was adopted in 2000 and followed by the publication of the Privatisation Masterplan in 2005 will significantly stimulate growth of the capital market as changes are made to the ownership and funding of parastatals and as new instruments and facilitating agencies/institutions are created. The expected growth of the capital market should be accompanied by related benefits. This includes the possible mitigation of excess liquidity in the banking system, as opportunities for investing the funds are availed, thus reducing the cost of conducting monetary policy as well as easing monetary operations and the determination of the interest rate structure. Moreover, related to productivity and growth, changes in funding, ownership and management might be beneficial if, as intended, they engender improved operational and management processes as well as technology and skills transfer. Possible competition arising from privatisation and enforced through the recently approved competition policy and appropriate sectoral regulatory bodies is expected to generate improvements in product and service delivery, and these should contribute to innovation and increases in productivity.

7. Conclusion

7.1 In addressing the theme topic, this chapter has pointed to the potential importance of capital markets in aiding economic development and the progress made in developing the capital market in Botswana through implementation of the financial sector development strategy, as articulated in NDP 7. Indeed, capital markets support development by providing investors with a range of options beyond those offered by traditional forms of financial intermediation through the banking sector. Share markets allow investors to more easily trade in ownership of enterprises, while bonds provide greater scope for risk management, which is particularly important for longer-term investments.

7.2 Outside the limited range of activities where governments may appropriately assume a leading role, the weight of evidence suggests strongly that a centrally planned allocation of resources cannot respond effectively to the varied needs of the entire economy, and that resource allocation for private sector development is much better handled through markets. The conclusion that well-run capital markets can support the allocation of resources to their most productive uses is, therefore, relevant to both developed and developing economies. Capital markets in developed countries have a long history that dates back to the beginning of their modern economic development. For Botswana and, as indicated in Section 2, the financial sector development strategy recognised a need to reduce the role of government in resource allocation and create an environment in which private and parastatal enterprises can develop a wide range of financial instruments to enhance opportunities for financial savings and provision of longer-term finance.

7.3 Some of the notable changes in the policy environment that have supported the deepening of the financial sector and widening of financial instruments include changes to the licensing policy for banks which facilitated a more competitive banking sector, a change in the implementation of the monetary policy framework to more effectively influence the market determination of short-term interest rates, aiding a more efficient pricing of instruments, government support in developing the bond market, improving the performance of the development finance institutions, supporting the development of infrastructure and institutions, an accommodating tax policy as well as updating and introducing appropriate legislation for the capital market.

7.4 As indicated in Section 4, the establishment of the stock market and a supportive tax policy has facilitated share ownership and a growing number of companies in various sectors listing on the stock exchange. In addition, several private enterprises have issued bonds, some of which are listed on the stock exchange, to fund their long-term investments. For banks in particular, the competition for wholesale funds has led them to issue long-term debt instruments, which can also count towards meeting capital adequacy requirements. It is also considered that over time there will be benefits from the issue of benchmark government bonds in 2003, in terms of further development of the market.

7.5 With regard to reducing the role of government in the financial sector, there has been significant progress in weaning parastatals from excessive reliance on government financing, as indicated by the sale of the PDSF loan book to the private sector. Moreover, prior to this, interest rates on borrowing from the PDSF had progressively been moved towards market interest rates while parastatals had started sourcing funds from the private market through issuance of bonds. In particular, the success of the development finance institutions in sourcing private funds has been aided by the performance improvements initially indicated in the financial sector development strategy. Overall, as envisaged in NDP 7, there is now a wider range of instruments to accommodate diversified financial saving with positive real rates of return and this is supporting the funding needs of both private institutions and parastatals. For parastatals and the development finance institutions in particular, the provision of funds at market determined interest rates could potentially lead to improvements in efficiency.

7.6 While this Chapter has established the potential benefits of capital market development, it is also apparent that experience differs widely across countries reflecting specific circumstances, including different historical influences. Among the advanced economies, capital markets play a greater role in the USA and the UK compared to the other European countries and Japan. As indicated in Section 5, for the emerging market economies, including Botswana, the increasing importance and fast growth in the capital markets has, among others, been variously driven by the transition to market-oriented policies, privatisation, growth in the fund management industry, the establishment of subsidiaries of international companies and issuance of bonds to reduce reliance on commercial bank finance. Moreover, the development of the capital market is supported by governments and is in the context of broad financial sector reform. Nevertheless, for developing countries and particularly in Africa, capital markets remain very small in relation to the advanced economies and, compared to the situation in the developed economies, limited in terms of their support for economic growth. In particular, the relatively low activity in capital markets in the developing countries is due to low levels of capitalisation and liquidity, insufficient information and "archaic" as well as costly trading and settlement processes.

7.7 The support of government implies that there are costs in developing the capital market. The experience of Botswana reflects a deliberate decision to invest public resources to support the development of bond and share markets, as well as related initiatives such as support for the establishment of the IFSC. This has generally been beneficial, notably the response to the issuance of government bonds. In addition to the costs of supporting market development, the two other major concerns for public policy are regulation and the impact of capital market development on broad parameters of macroeconomic policy formulation. Effective regulation needs the creation of an overarching supervisory structure. It would not be sufficient to simply extend the supervisory regime that is currently applied to banks to the financial sector more broadly. The range of players in capital markets is wider, implying a greater role for a business environment that emphasises general principles of corporate governance, rather than concentrating purely on sector specific regulations. At the same time, regulation should not significantly raise transaction costs or stifle innovation. While capital market supervision in Botswana still lags behind, this is being addressed through advanced proposals for a capital market supervisory authority.

7.8 The review has discussed, in Section 6, some ways in which the design of policy may need to be adjusted as capital markets develop. A framework for macroeconomic policy that encourages economic growth and development can stimulate capital market development which, in turn, may require adjustment to the existing policy framework. For example, to the extent that capital market development implies less reliance on the banking sector, this will mean a correspondingly reduced role for banks in the transmission of monetary policy requiring an adjustment of the monitoring framework. Similarly, active capital markets encourage more cross-boarder capital flows with consequences for the exchange rate and balance of payments, which require careful monitoring and the ability to make timely policy responses. The conduct of fiscal policy in the context of developing capital markets in Botswana should also be considered carefully, especially in terms of options for the financing of government spending. The experience so far demonstrates an appetite among investors for borrowing by government at both the long and short ends of the market. If carefully linked to financially attractive programmes of public investment, the issue of treasury notes and bonds could provide an alternative to the continued running down of government cash balances during times when revenues fall short of planned expenditures.