BANK OF BOTSWANA

ANNUAL REPORT

2007


BANK OF BOTSWANA
BANKA YA BOTSWANA

Board Members

as at December 31, 2007

L K Mohohlo
Governor and Chairman

G K Cunliffe

S S G Tumelo

D K U Corea

B Moeletsi

C S Botlhole-Mmopi

H Siphambe

B B Bolele

B K Molosiwa

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H Siphambe

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Boxes, Charts, Figures and Tables

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Abbreviations Used in The Report

AIDS	Acquired Immuno-Deficiency Syndrome
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BDF	Botswana Defence Force
BES	Business Expectations Survey
BFS	Botswana Financial Statistics
BoBC	Bank of Botswana Certificate
BSE	Botswana Stock Exchange
BSR	Budget Sustainability Ratio
BTC	Botswana Telecommunications Corporation
BURS	Botswana Unified Revenue Service
CIU	Collective Investment Undertaking
CPI	Consumer Price Index
CPIX	Consumer Price Index Excluding Mortgage Interest Rates
CSO	Central Statistics Office
DCI	Domestic Company Index
DFI	Development Finance Institution
DTCB	Diamond Trading Company Botswana
ECB	European Central Bank
FCA	Foreign Currency Account
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Programme
FSI	Financial Sector Indicator
GDP	Gross Domestic Product
GNP	Gross National Product
HIV	Human Immunodeficiency Virus
IFC	International Finance Corporation
IFS	International Financial Statistics
IFSC	International Financial Services Centre
IIP	International Investment Position
IMF	International Monetary Fund
IRB	Internal Ratings-Based
LFS	Labour Force Survey
MDG	Millennium Development Goal
MFDP	Ministry of Finance and Development Planning
MPS	Monetary Policy Statement
MTEF	Medium-Term Expenditure Framework
MTR	Mid-Term Review

NAV	Net Asset Value
NBFI	Non-Bank Financial Institution
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NMGDP	Non-Mining Gross Domestic Product
PDSF	Public Debt Service Fund
REER	Real Effective Exchange Rate
RMA	Rand Monetary Area
RSF	Revenue Stabilisation Fund
SA	South Africa
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
SBI	Sustainable Budget Index
SDDS	Special Data Dissemination Standards
SDR	Special Drawing Right
SSA	Sub-Saharan Africa
UK	United Kingdom
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax
VCB	Venture Capital Board

Part A

Statutory Report on the Operations and Financial Statements of the Bank, 2007

Bank of Botswana

Deputy Governors
as at December 31, 2007

O A Motshidisi

M D Pelaelo

Heads of Department
as at December 31, 2007

N A Mabe
Accounting & Planning

A M Motsomi
Research

R H Nlebesi
Banking & Currency

O Mabusa
Banking Supervision

J Ghanie
Technical Services

P Gundersen
Financial Markets (Acting)

E T Rakhudu
Human Resources

O Modisa
Payments & Settlement

2007 STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK

THE GOVERNOR'S FOREWORD

In carrying out its mandate in 2007, the Bank of Botswana faced both external and domestic challenges. Externally, what began as problems in the 'sub-prime' segment of the housing market in the United States of America quickly had a contagion effect in the global financial market with consequences for liquidity, exchange rate movements, oil prices and the performance of the world economy. In the event, by year-end, the US dollar had plummeted against major international currencies, while prices of primary commodities, including oil, rose sharply giving rise to significant inflationary pressures in some of Botswana's trading partner countries. Domestically, the rising international commodity prices added to the demand driven inflationary pressures, resulted in a reversal of the downward trend in inflation that occurred during the first half of the year.

It is in this context that the 2007 Annual Report theme topic, "Botswana's Framework for Macroeconomic and Financial Stability in Supporting Sustainable Economic Growth", points to the importance for coordination of monetary, fiscal and exchange rate policies to avoid disruption to the stability of the financial sector which ultimately affects economic performance at national level and, in the case of major economies, global growth.

While the country felt the effects of the rising food and oil prices, there was little immediate fallout from the onset of the credit crunch, although risks remain going forward. Overall, if the looming threat of a recession in the industrial economies is not averted, the international environment is likely to impact adversely on reserves management rates of return.

In fulfilling the key mandate of maintaining monetary stability, the Bank largely succeeded in containing inflation in the first half of 2007, notwithstanding episodes of supply shocks and persistent high growth rates of credit. The Bank also fostered safety, soundness and stability of an expanding financial sector, enhanced the security and efficiency of the payments system, and prudently managed the country's foreign exchange reserves. The latter resulted in a satisfactory financial performance, despite the challenges posed by turbulence in international financial markets due to the US sub-prime mortgage lending crisis.

Inflation progressively declined towards the end of 2006 and was within the 4–7 percent desired range in the early part of 2007. This downward inflation trend and the positive inflation prospects at the time encouraged the Bank to reduce the Bank Rate by half a percent to 14.5 percent in June 2007. It was considered that the rapid credit growth and higher government spending that continued throughout the year would not add impetus to inflation given the perceived economic slowdown. However, a rise in international oil prices, which increased to over USD 99 per barrel in November, together with increases in administered prices and other costs, reversed the downward trend in inflation during the second half of 2007. As a result, by year-end, inflation had risen to 8.1 percent.

In support of the general thrust of monetary policy, absorption of excess liquidity, that arose from the higher balance of payments surplus and government spending, resulted in an increase of 18.6 percent in outstanding Bank of Botswana Certificates (BoBCs). In addition, the Bank regularly announced monetary policy decisions, even when there was no policy change, and highlighted the near-term inflation outlook. The regular communication with stakeholders was intended to anchor expectations of low inflation. The Bank conducted

inflation forecasting in the medium-term and reviewed other indicators of inflationary pressures; the half-yearly Business Expectations Survey and the two measures of core inflation were published, the latter by the Central Statistics Office (CSO).

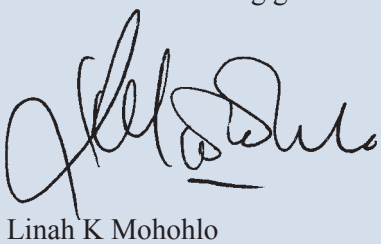
The financial services industry expanded through new entries, additions to the branch network, installation of new point-of-sale terminals and Automated Teller Machines (ATMs), as well as diversification of products, which together increased public access to banking services. Expectations are that the sector will continue to attract new entrants as new mining activity and diamond beneficiation projects get underway. Overall, the banking sector remained stable and profitable. An Act of Parliament was passed to establish a Non-Bank Financial Institutions Regulatory Authority (NBFIRA) and this should fill a vacuum that had existed in the regulation and supervision of non-bank financial institutions; the NBFIRA will also contribute to the overall stability of the financial sector.

The efficiency of the payments system was improved further through automation of processes and the implementation of the Real Time Gross Settlement (RTGS) as well as upgrading of the SWIFT system. These technological improvements should quicken the transmission of monetary policy signals in the economy which, in part, depends on the robustness, efficiency and resilience of the payments and settlement infrastructure.

During the year, the Bank interacted with international stakeholders, especially the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and the World Bank, and participated in the activities of other relevant bodies. Other events that strengthened international relations included the hosting of a seminar on "Trends in Central Bank Governance" for central banks in the Southern African Development Community (SADC), the visit of the Deputy Managing Director of the IMF, Mr. Takatoshi Kato, and his participation in the discussions of the Concluding Statement of the Article IV Consultation Mission. Mr Kato also took part in the presentation of the findings of the IMF/World Bank Financial Sector Assessment Programme (FSAP) mission.

The Bank's other activities, as reflected in the three-year rolling Medium-Term Strategic Plan, included active and functionally targeted capacity building initiatives of short-term and long-term duration.

Despite the challenges posed by both domestic demand pressures and international economic developments, the Bank discharged its functions relatively well in 2007, the credit for which is rightly due to the support extended by the Board, the Executive Committee and all staff of the Bank. Going forward, the Bank will continue to explore ways and means of enhancing overall productivity and ensuring continued adherence to sound central banking governance and efficient delivery in discharging its mandate.



Linah K Mohohlo

GOVERNOR

STATUTORY REPORT ON THE OPERATIONS OF THE BANK IN 2007

THE BANK'S ORGANISATION AND MANAGEMENT

The Bank was established by the Bank of Botswana Act (Cap 55:01), and falls under the purview of the Minister of Finance and Development Planning who presents the Annual Report on the Bank's operations and financial performance to Parliament. The Bank also submits to the Minister the Annual Statutory Banking Supervision Report required by the Banking Act, 1995.

The governing structures comprise the Board, the Executive Committee, eight Departments and three Divisions. Except for the Internal Audit Division, which reports directly to the Governor, all other Departments and Divisions report to the Governor through the two Deputy Governors.

The Board

The nine-member Board is chaired by the Governor in an ex-officio capacity; the Permanent Secretary of the Ministry of Finance and Development Planning also sits on the Board as an ex-officio member. The other seven members are appointed by the Minister of Finance and Development Planning. Out of these seven members, a maximum of two public officers are eligible to serve on the Board under the law.

Under the Bank of Botswana Act and the Bank's Bye-Laws, overall responsibility for policy oversight and monitoring of operations of the Bank is vested in the Board. Accordingly, the Board formulates, adopts and enforces appropriate policies, management and administrative systems, including internal controls, in order to ensure that the Bank is efficiently managed and its principal objectives are achieved. The Board, therefore, directs the Bank's strategic planning, determines the broad operational framework, approves the annual budget, monitors the Bank's financial as well as operational performance and reviews both management and external auditors' reports.

The Audit Committee of the Board is chaired by a non-executive Board member. Its main responsibility is to ensure that the Bank's accounting policies as well as practices conform to International Financial Reporting Standards (IFRS), and internal controls are adequate for the operations of the Bank.

The Governor

As the Chief Executive Officer of the Bank, the Governor ensures prompt and efficient implementation of Board decisions and guidelines. In the conduct of the Bank's administration and policy implementation, the Governor is supported by the Executive Committee and represents the Bank in its relations with the Government and other domestic as well as international stakeholders. In this regard, the Governor is the country's representative on the Board of the IMF. Among other responsibilities, the Governor is required to submit the Bank's Annual Report 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. She also submits to the Minister, by June 30 each year, the Bank's Annual Banking Supervision Report.

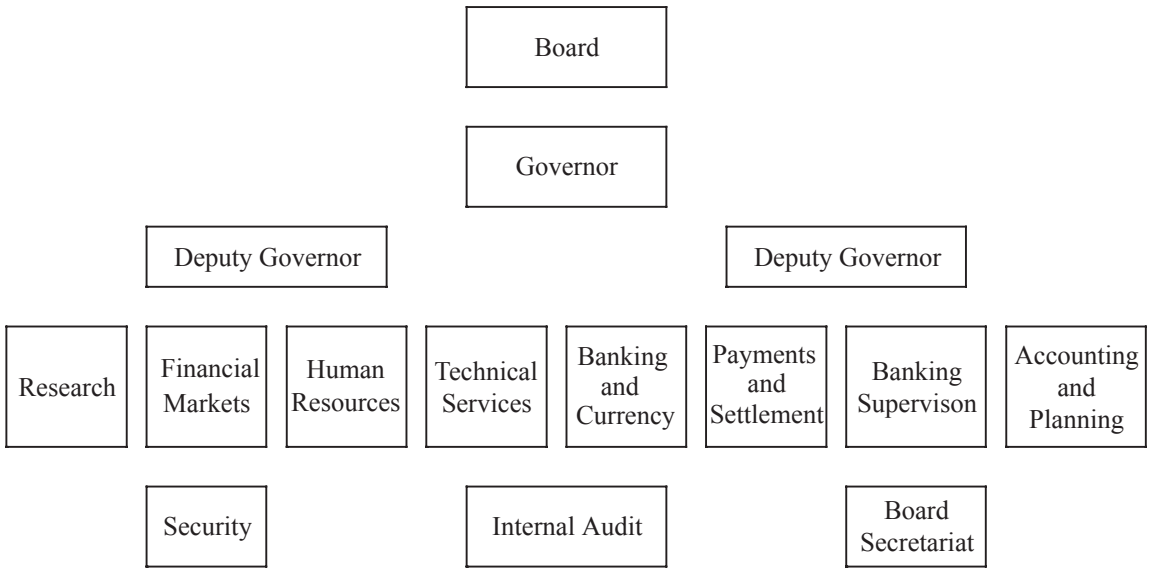
The Executive Committee

The Executive Committee is chaired by the Governor and comprises Deputy Governors and Heads of Department; senior advisors may be co-opted members. The Committee reviews the implementation of the Bank's policies and the execution of the work programmes of the Departments and Divisions. Departmental/Division yearly work programmes are designed to achieve the goals of the Bank's medium-term and long-term strategic plans. In general, the Committee advises the Governor on the day-to-day affairs of the Bank. The other committees which are chaired by various members of the Senior Management team include the following: Monetary Policy Committee, Investment Committee, Open Market Operations Committee, Regulatory Policy Committee, Strategic Planning Forum, Accounts Committee, Tender Committee, Training Committee, Security Committee, Physical Planning Committee and the Joint Negotiating Committee (Central Bank Union and management negotiating forum).

Departments and Divisions

The Bank's detailed activities relating to the overall implementation of the Board's policies and decisions in the fulfillment of the Bank's mandate are undertaken by Departments and Divisions. As at the end of 2007, the Bank's eight Departments were Accounting and Planning, Banking and Currency, Banking Supervision, Financial Markets, Human Resources, Payments and Settlement, Research, and Technical Services; the three Divisions were the Board Secretariat, Internal Audit and Security.

CHART 1: ORGANISATIONAL STRUCTURE AS AT DECEMBER 2007



THE BANK'S OBJECTIVES AND MISSION

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

- to promote and maintain monetary stability, which primarily requires the maintenance of low, predictable and sustainable level of inflation;
- to ensure that the overall financial system is safe and sound;
- to foster and maintain an efficient payments system;
- to monitor the wider external and domestic economic and financial environment in order to appropriately respond to any threats to the solvency of the banking sector; and
- in so far as it would not be inconsistent with primary objectives, the Bank also promotes an orderly and balanced economic growth for the country.

In support of the above objectives and mission, the Bank carries out several activities, especially the formulation and conduct of monetary policy with a view to maintaining a low, stable and predictable level of inflation; conducting open market operations in order to influence monetary conditions; regulating and supervising banks; providing banking services to the Government, commercial banks and selected public institutions; regulating and overseeing of the payments system; and providing technical advice to Government on economic and financial matters. Although these core functions are carried out by different Departments, they are inter-related as well as mutually re-enforcing and, together with the support of its corporate systems, they create the necessary synergies for the Bank to fulfill its mandate.

The Bank's conduct of the main responsibilities and the supportive corporate activities in 2007 are described below.

THE BANK'S MAIN FUNCTIONS AND OTHER CORPORATE ACTIVITIES IN 2007

Monetary Stability and Related Functions

The Bank formulated and implemented monetary policy relatively well during the year, and ensured that the banking and payments systems functioned properly and were stable.

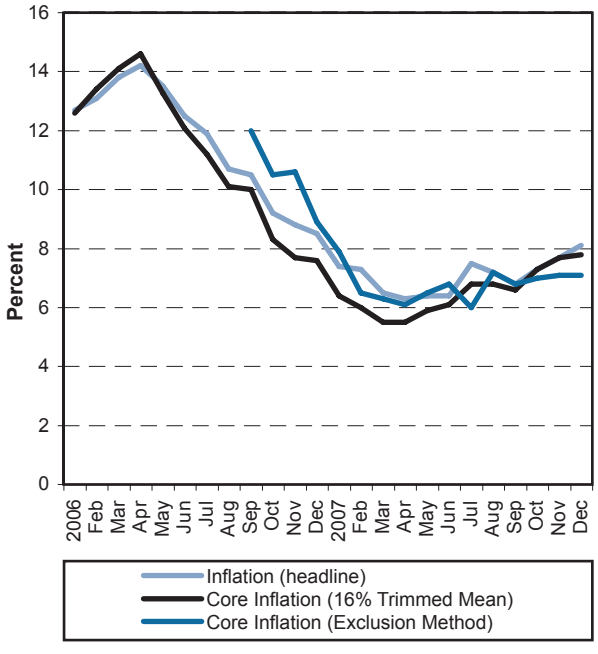
CHART 2: MISSION, OBJECTIVES AND STRATEGIES

Monetary Policy

As a critical part of monetary stability, the objective of the Bank's monetary policy is to achieve a low, sustainable and predictable level of inflation over the medium-term by influencing interest rates and liquidity in the banking system which eventually have an impact on aggregate spending and inflation.

The Monetary Policy Statement (MPS) set an annual inflation objective of 4–7 percent for 2007, and this was reaffirmed in the mid-year review which updated the inflation outlook for the year. Following the regular meetings, the Monetary Policy Committee (MPC) published statements announcing monetary policy decisions and assessments on the near-term inflation outlook, with a view to anchoring inflation expectations. The work of the MPC benefited from inflation forecasting in both the near-term and medium-term, and from analyses of other indicators of economic and financial trends that would have a bearing on the inflation prospects.

CHART 3: INFLATION INDICATORS, 2006 – 2007

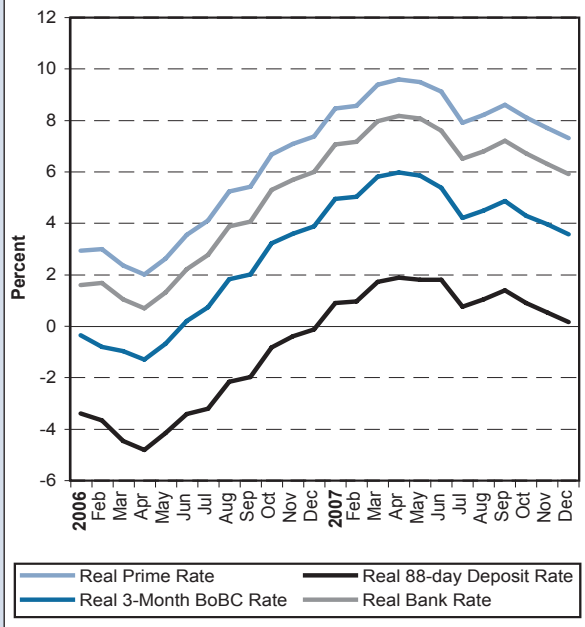


Source: Central Statistics Office

In view of the favourable inflation outlook in the first half of the year, the Bank Rate was reduced in June by 50 basis points to 14.5 percent, and market interest rates were adjusted by the same magnitude. Up to June 2007, inflation was broadly within the desired annual 4–7 percent objective, despite an acceleration of the rate of growth of credit and government spending. However, the downward trend in inflation reversed in July 2007 mainly due to the increase in international oil prices and the consequent cost increases of imported foodstuff and petroleum products. By year-end inflation had reached 8.1 percent.

As inflation rose, real lending rates and Bank of Botswana Certificates (BoBCs) yields declined by year-end. The Bank continued to sterilise banking system excess liquidity by conducting open market operations, viz., weekly auctions of BoBCs. By the end of 2007, outstanding amount of BoBCs amounted to P16.6 billion, compared to P14.0 billion at the end of the previous year.

Chart 4: Selected Key Real Interest Rates

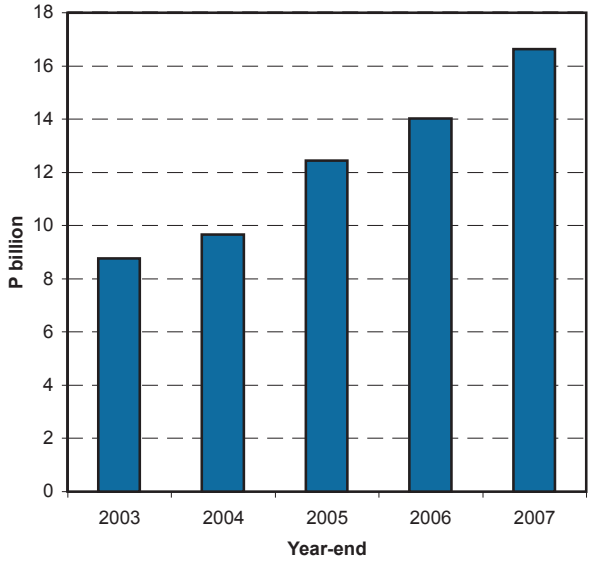


Source: Bank of Botswana

Exchange Rate Policy

The Bank continued to implement the country's exchange rate policy on behalf of the Government, the objective of which is to ensure stability of the real effective exchange rate (REER). The policy contributes to the competitiveness of non-traditional exports and other tradeable goods and services and is part of the economic diversification strategy; it also has the potential to stimulate the growth of the domestic industry. In 2007, the REER depreciated marginally by 1.4 percent due to the downward crawl of the nominal effective exchange rate (NEER) given the lower differential between actual domestic inflation and average inflation in trading partner countries. Although the Pula's bilateral nominal and real bilateral exchange rate movements were mixed, the local currency generally depreciated against the currencies of major trading partner countries. The challenge was in maintaining a balance between the need to meet the inflation objective and the competitiveness of the exchange rate through the implementation of the crawling band exchange rate mechanism.

Chart 5: Bank of Botswana Certificates (December 2003 – 2007)



Source: Bank of Botswana

Banking Supervision and Other Regulatory Activities

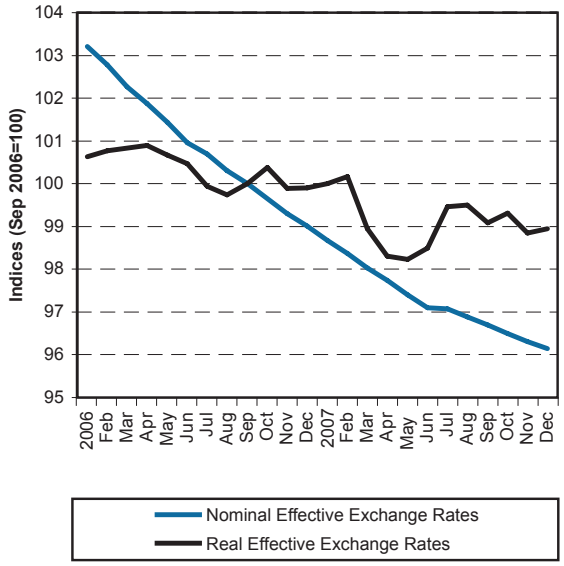
Generally, the banking system was sound, well managed and profitable during 2007. Compliance with supervisory, prudential and corporate governance requirements was monitored through on-site and off-site examinations combined with regular meetings of interested parties.

With the licensing of Capital Bank Limited in 2007, the number of commercial banks in Botswana increased to eight, while Collective Investment Undertakings (CIUs) had an addition of one to bring the number of funds

to thirteen. Similarly, the number of institutions in the International Financial Services Centre (IFSC) increased by two to nineteen. There was a net addition of five bureaux de change, thus bringing their total number to forty-seven. Overall, financial sector physical infrastructure and access to banking services increased, as more diversified products and services were offered.

The Non-Bank Financial Institutions Regulatory Authority (NBFIRA) was established by an Act of Parliament in March 2007. When it is operational, NBFIRA will complement banking regulation and supervision, and fill the gap which has been a source of market concern. It is expected to contribute to the stability and soundness of the financial sector. Consultations with banks on the implementation of the Basel II[1] Capital Adequacy framework commenced during the year; when implemented, the new framework and the necessary arrangements will enhance the stability of the banking system going forward.

CHART 6: NOMINAL AND REAL EFFECTIVE EXCHANGE RATES (2006 – 2007) (INDICES: SEPTEMBER 2006=100)



Source: Bank of Botswana

TABLE 1: BANKING SYSTEM SOUNDNESS AND PRUDENTIAL STANDARDS (2006 – 2007[2])

	Prudential[3] Standard (Percent)	Range of Prudential Standards for Banks (Percent)	
		2006	2007
Capital Adequacy	≥ 15	15.6 – 35.5	15.2 – 36.9
Liquid Asset Ratio	≥ 10	53.5 – 67.8	22.0 – 63.0
Profitability (Return on Assets)	Positive	1.2 – 4.8	0.6 – 4.6
Profitability (Return on Equity)	Positive	17.5 – 78.7	6.2 – 66.0
Asset Quality (Non-Performing Loans/Total Loans)	≤ 2.5	2.8 – 22.2	2.2 – 27.1
Intermediation Ratio (Advances/Deposits)	≥ 50	32.9 – 51.3	32.3 – 81.2

Sources: Bank of Botswana and Commercial Banks

Central Banking Services and Payments System

The Bank is also the sole issuer of Pula banknotes and thebe coin as legal tender, a medium of exchange, a unit of account and a store of value. In addition, the Bank maintains accounts of Government, commercial banks and other selected institutions.

The efficiency of banking operations and the functioning of the payments system was further improved

1. Basel II is the Revised Framework for International Convergence of Capital Measurement and Capital Standards prepared by the Basel Committee on Banking Supervision. It is known as Basel II because it follows an earlier version, the 1988 Capital Accord. The Basel Committee on Banking Supervision comprises banking supervisory authorities from central banks of major industrial countries. The Committee has a permanent secretariat based at the Bank for International Settlements in Basel, Switzerland.
2. Based on unaudited commercial banks' accounts.
3. Statutory or prudential requirements set by the Bank of Botswana or minimum trigger for active monitoring and surveillance.

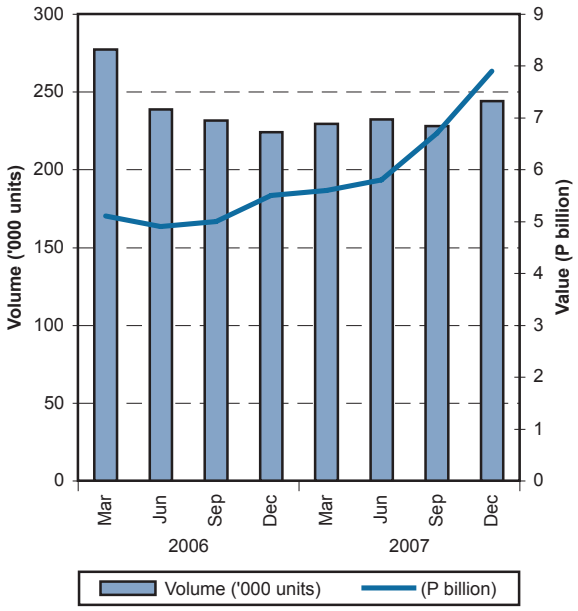
TABLE 2: CURRENCY IN CIRCULATION, AS AT END DECEMBER (2006 – 2007)

Banknotes (Number in millions)				Coin (Number in millions)			
	2006	2007	2006-2007 (Percentage Change)		2006	2007	2006-2007 (Percentage Change)
P100	7.9	9.8	24.1	**P5**	3.8	4.8	26.3
P50	2.5	3.2	28.0	**P2**	6.5	8.1	24.6
P20	3.3	5.8	75.8	**P1**	13.0	13.3	2.3
P10	3.0	3.1	3.3	**P0.50**	11.7	13.3	13.7
				P0.25	18.5	19.1	3.2
				P0.10	45.5	50.6	11.2
				P0.05	94.5	99.2	5.0

Source: Bank of Botswana

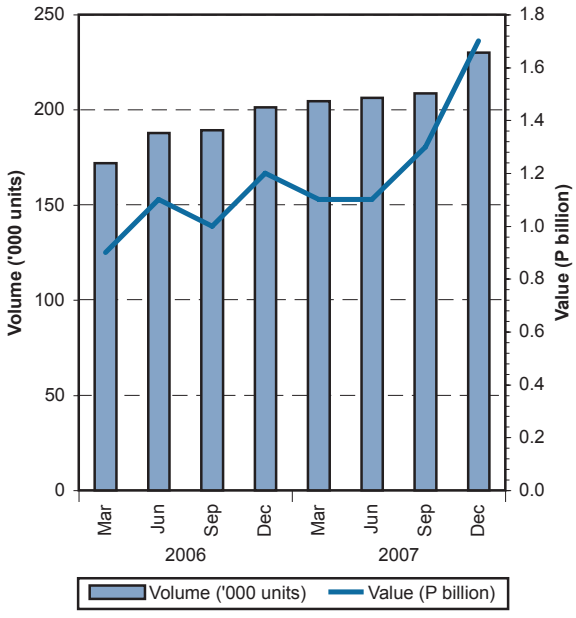
during the year. Banking operations, fund transfers and settlement transactions were inter-linked through interfacing the core banking system, Globus, with RTGS, SWIFT and the Electronic Clearing House (ECH). These developments further enhanced the Bank's ability to contain and mitigate systemic risks, as well as providing real time information for banking system liquidity management. As shown in Charts 7 and 8, the clearance and settlement of inter-bank transactions that were handled through the ECH and RTGS increased in value in 2007.

CHART 7: ELECTRONIC CLEARING HOUSE: CHEQUE PROCESSING (2006 – 2007)



Source: Electronic Clearing House

CHART 8: ELECTRONIC CLEARING HOUSE: ELECTRONIC TRANSFERS (2006 – 2007)

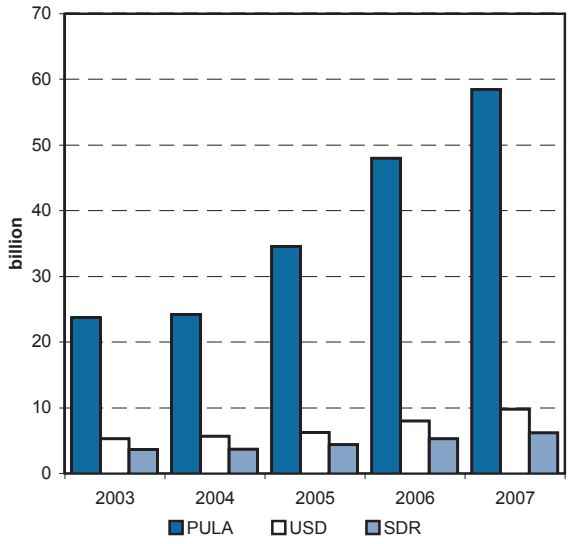


Source: Electronic Clearing House

Reserves Management

The foreign exchange reserves rose by 22.5 percent year-on-year to USD 9.8 billion at the end of 2007 due to the buoyant balance of payments situation. The increase of reserves in Pula terms also reflected the effect of the depreciation of the Pula against major international currencies. Despite the direct payments of foreign currency of Debswana's tax, royalties and other obligations to the Government into the Bank's accounts overseas, commercial banks' net sales of foreign exchange to the Bank still contributed to banking system excess liquidity during the year. Some efficiency measures were undertaken in the management of foreign exchange reserves relating

CHART 9: FOREIGN EXCHANGE RESERVES (END DEC. 2003 – 2007)



Source: Bank of Botswana

to, *inter alia*, clearing and settlement, correspondent banking relationships, real time portfolio valuation and performance measurement.

The Investment Committee met regularly to review developments in international financial markets and made relevant adjustments to the investment portfolios in line with the investment guidelines. Consistent with past practice, relations with external fund managers and other service providers were reviewed through regular meetings and consultations on matters of mutual concern.

RELATIONS WITH GOVERNMENT AND OTHER STAKEHOLDERS

Publications and Public Education

As legally required, the Bank's 2006 Annual Report and Banking Supervision Report were submitted to the Minister of Finance and Development Planning by March 31 and June 30, 2007, respectively. The monthly Botswana Financial Statistics bulletin and Monetary Policy Statement were also published. Economic briefings were conducted for a number of stakeholders immediately following the publication of the 2006 Annual Report, viz., Cabinet, media, diplomats, chief executive officers of public corporations, banks and other private sector institutions, and senior government officials. Public relations and outreach activities were also undertaken.

Advisory Functions

So far as Bank's advisory role and inter-agency collaboration activities are concerned, the Bank participated in a number of Task Forces including the Ministry of Finance and Development Planning/Bank of Botswana (MFDP/BoB) Working Group; Taxation Review Committee, Statistics Producers Committee, National Committee on Trade Policy and Negotiations; and the National Development Plan (NDP) 10 Reference Group. The Bank was also a member of the National Employment, Manpower and Incomes Council.

EXTERNAL RELATIONS

Regional Central Bank Cooperation

Within the Africa region, the Bank attended meetings and conferences of the Southern African Development Community (SADC) Committee of Central Bank Governors and the Association of African Central Banks (AACB) and hosted a two-day seminar on "Trends in Central Bank Governance" for SADC central bank governors during February 5–6, 2007.

International Financial and Other Institutions

The Bank coordinated the annual reviews by credit rating agencies, Moody's Investor Service and Standard and Poor's, both of which reaffirmed their respective high ratings of Botswana. For example, Standard & Poor's assigned the country A/A-1 rating for foreign currency sovereign credit rating and A+/A-1 rating for local currency rating. The International Monetary Fund (IMF) continued to provide the Bank with technical assistance including advisory missions on the Financial Sector Assessment Programme (FSAP) which was jointly carried out with the World Bank. The IMF also provided advisory assistance on the requirements for acceding to the Special Data Dissemination System (SDDS) and the implementation of General Data Dissemination Standards (GDDS).

Administration and Other Corporate Activities

The Bank achieved most of the planned activities and objectives outlined in the Medium-term Strategic Plan, 2007 – 2009 and the 2007 Work Programme, while ensuring adherence to good corporate governance in a secure and cordial work environment for all members of staff.

Staff Affairs and General Administration

The Staff Establishment increased by 2.3 percent to 580 mainly due to a restructuring of one of the departments, and there was a reduction of vacancies by seven to thirty-four during the year. Consistent with past practice, the Bank was engaged in an active training programme and sponsored many staff to a variety of relevant short-term and long-term study programmes.

The adverse effects of the HIV/AIDS pandemic on the Bank continued to be addressed through the "HIV/AIDS in the Workplace" programme.

As required under the Internal Audit Charter, a report on the major findings of the Internal Audit Division work for 2007 was submitted to the Audit Committee. The findings of the audit work were supplemented by a proactive identification of potential risk areas by Departments/Divisions, which also put in place appropriate risk mitigation measures and strategies.

Physical and Information Technology Projects

The Bank's operational efficiency benefited from improvements in physical infrastructure and adoption of new information technology (IT) systems during the year, such as the integrated human resources/payroll system.

Several modifications were made to the Globus core banking system to improve performance and stability.

Other information technology projects included the successful completion of the first phase of the migration to SWIFTNet Phase 2, and the duplication of the high business impact information and communication technology systems at the Disaster Recovery Planning Site. With the adoption of the IT Governance (COBIT) and Quality Assurance frameworks, all IT processes are defined, documented, evaluated, monitored and operated in accordance with international best practice.

Security Services

The Bank continued to make discernible progress in ensuring security in and around the Bank's premises. Among the main activities of 2007, and in collaboration with interested parties, a new initiative was undertaken to develop and implement strategies to mitigate the impact of white-collar crime in the banking sector. The programme is coordinated by the Financial Institutions Security Managers Forum, within which the Fraud Risk Sub-committee met regularly to discuss and recommend measures against fraud. The Bank also undertook a sensitisation initiative to help law enforcement agencies in identifying counterfeit currency.

ANNUAL FINANCIAL STATEMENTS

2007

BANK OF BOTSWANA

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STATEMENT OF RESPONSIBILITY OF THE BOARD AND APPROVAL OF FINANCIAL STATEMENTS

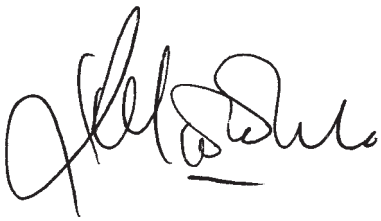
The members of the Board are responsible for the preparation of the annual financial statements in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (Cap 55:01).

The auditors are responsible to give an independent opinion on the fairness of the annual financial statements based on their audit of the affairs of the Bank in accordance with International Standards on Auditing.

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

The members of the Board are satisfied that Management introduced and maintained adequate internal controls to ensure that dependable records exist for the preparation of the annual financial statements, to safeguard the assets of the Bank and to ensure they are duly authorised.

Against this background, the members of the Board accept responsibility for the annual financial statements and the information on pages 29 to 61 which were approved on March 28, 2008 and are signed on its behalf by:



Linah K Mohohlo

Governor

Nozipho A Mabe

Director, Accounting and Planning Department

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INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the annual financial statements of Bank of Botswana, set out on pages 29 to 61, which comprise the balance sheet as at December 31, 2007, the income statement, cash flow statement and statement of changes in shareholder's funds for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Board Members' Responsibility for the Financial Statements

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

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Bank of Botswana as of December 31, 2007, and of its financial performance, statement of changes in shareholder's funds and its cash flows for the year ended in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

Deloitte & Touche

Deloitte & Touche
Certified Public Accountants

March 28, 2008
GABORONE

BALANCE SHEET

December 31, 2007

	Notes	2007 P'000	2006 P'000
ASSETS			
Property and Equipment	1	143 070	144 734
Foreign Exchange Reserves			
Liquidity Portfolio	2.1	18 389 216	10 592 440
Pula Fund	2.2	39 722 003	36 854 514
International Monetary Fund (IMF)			
Reserve Tranche	3.1	41 832	56 370
Holdings of Special Drawing Rights	3.2	365 366	335 396
Administered Funds	3.4	–	136 919
Total Foreign Exchange Reserves		58 518 417	47 975 639
Government of Botswana Bonds	4	89 045	88 355
Other Assets	5	93 485	73 753
TOTAL ASSETS		58 844 017	48 282 481
LIABILITIES			
Notes and Coin in Circulation	6	1 360 906	1 069 719
Bank of Botswana Certificates	7	16 616 216	14 002 691
Deposits	8	2 383 694	2 135 112
Allocation of IMF Special Drawing Rights	3.3	41 594	39 736
Liabilities to Government (IMF Reserve Tranche)	9	41 832	56 370
Dividend to Government	10	226 500	137 500
Other Liabilities	11	61 676	56 656
Total Liabilities		20 732 418	17 497 784
SHAREHOLDER'S FUNDS			
Paid-up Capital	14	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		26 983 118	20 467 583
Currency Revaluation Reserve		7 532 007	6 610 393
Market Revaluation Reserve		1 971 474	2 081 721
General Reserve	15	1 600 000	1 600 000
Total Shareholder's Funds		38 111 599	30 784 697
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		58 844 017	48 282 481
FOREIGN EXCHANGE RESERVES IN US DOLLARS[1] (000)		9 790 131	7 992 741
FOREIGN EXCHANGE RESERVES IN SDR[2] (000)		6 191 249	5 315 701
[1] Pula/United States dollar		0.1673	0.1666
[2] Pula/SDR		0.1058	0.1108

INCOME STATEMENT

Year ended December 31, 2007

	Notes	2007 P'000	2006 P'000
INCOME			
Interest – Foreign exchange reserves	16	2 105 953	1 468 041
Dividends – Foreign exchange reserves	17	235 545	195 867
Interest – Government of Botswana Bonds		8 829	8 846
Net market gains on disposal of securities	18	670 143	374 539
Net realised currency gains	19	1 690 973	2 172 447
Net unrealised currency gains	20	36 788	1 803 125
Net unrealised market gains	21	47 580	–
Net profit on domestic foreign exchange deals		306 376	246 269
Other income		19 709	16 241
		5 121 896	6 285 375
EXPENSES			
Interest expense	22	1 901 234	1 680 767
Administration costs		223 639	208 454
Depreciation expense/(net write-back)	1	12 604	(2 088)
Net unrealised market losses	23	–	13 373
		2 137 477	1 900 506
NET INCOME FOR THE YEAR		2 984 419	4 384 869
TRANSFER TO CURRENCY REVALUATION RESERVE	24	(1 721 539)	(3 973 017)
NET INCOME BEFORE TRANSFER (TO)/FROM GOVERNMENT INVESTMENT ACCOUNT		1 262 880	411 852
TRANSFERS (TO)/FROM GOVERNMENT INVESTMENT ACCOUNT		(356 880)	138 148
NET INCOME AVAILABLE FOR DISTRIBUTION		906 000	550 000
APPROPRIATIONS			
Dividend to Government from Pula Fund		(906 000)	(550 000)

CASH FLOW STATEMENT

Year ended December 31, 2007

	Notes	2007 P'000	2006 P'000
OPERATING ACTIVITIES			
Cash generated by operations	27	4 114 063	2 526 738
INVESTING ACTIVITIES			
Net investments		(9 151 931)	(8 083 083)
Interest received from Government of Botswana Bonds		8 846	8 846
Proceeds from disposal of property and equipment		227	84
Purchase of property and equipment	1	(11 180)	(15 024)
NET CASH USED IN INVESTING ACTIVITIES		(9 154 038)	(8 089 177)
FINANCING ACTIVITIES			
Dividend to Government	10	(817 000)	(838 669)
Government Investments		5 565 788	6 266 652
NET CASH GENERATED FROM FINANCING ACTIVITIES		4 748 788	5 427 983
NET INCREASE IN CURRENCY IN CIRCULATION		(291 187)	(134 456)
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(1 069 719)	(935 263)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(1 360 906)	(1 069 719)

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS
Year ended December 31, 2007

	Paid up Capital P'000	Currency Revaluation Reserve P'000	Market Revaluation Reserve P'000	General Reserve P'000
Balance at January 1, 2006	25 000	3 688 770	1 854 626	1 600 000
Transfer from Income Statement	–	3 973 017	–	–
Net unrealised currency gains for the year on non-monetary "available-for-sale" financial instruments	–	741 078	–	–
Net unrealised market gains for the year on "available-for-sale" financial instruments	–	–	564 641	–
Transfers to Government Investment Account:				
Net unrealised market gains for the year	–	–	(337 546)	–
Net unrealised currency gains for the year	–	(1 792 472)	–	–
Government investments	–	–	–	–
Net gains not recognised in the Income Statement for the year	–	2 921 623	227 095	–
Net income for the year	–	–	–	–
Transfer to Currency Revaluation Reserve	–	–	–	–
Dividend to Government from Pula Fund	–	–	–	–
Transfers to/(from) the Income Statement for the year:	–	–	–	–
Excess of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
Balance at December 31, 2006	25 000	6 610 393	2 081 721	1 600 000
Transfer from Income Statement	–	1 721 539	–	–
Net unrealised currency losses on non-monetary "available-for-sale" financial instruments	–	(26 412)	–	–
Net unrealised market losses for the year on "available-for-sale" financial instruments	–	–	(290 893)	–
Transfers to Government Investment Account:				
Net unrealised market losses for the year	–	–	180 646	–
Net unrealised currency gains for the year	–	(773 513)	–	–
Government investments	–	–	–	–
Net gains not recognised in the Income Statement for the year	–	921 614	(110 247)	–
Net income for the year	–	–	–	–
Transfer to Currency Revaluation Reserve	–	–	–	–
Dividend to Government from Pula Fund	–	–	–	–
Transfers to/(from) the Income Statement for the year:				
Excess of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
To cover residual deficit	–	–	–	–
Balance at December 31, 2007	25 000	7 532 007	1 971 474	1 600 000

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

Government Investment Account P'000	Accumulated Profit P'000	Total P'000	
12 209 061	–	19 377 457	**Balance at January 1, 2006**
–	–	3 973 017	Transfer from Income Statement
–	–	741 078	Net unrealised currency gains for the year on non-monetary "available-for-sale" financial instruments
–	–	564 641	Net unrealised market gains for the year on "available-for-sale" financial instruments
			Transfers to Government Investment Account:
337 546	–	–	Net unrealised market gains for the year
1 792 472	–	–	Net unrealised currency gains for the year
6 266 652	–	6 266 652	Government investments
8 396 670	–	11 545 388	**Net gains not recognised in the Income Statement for the year**
–	4 384 869	4 384 869	**Net income for the year**
–	(3 973 017)	(3 973 017)	Transfer to Currency Revaluation Reserve
–	(550 000)	(550 000)	Dividend to Government from Pula Fund
128 970	(128 970)	–	Transfers to/(from) the Income Statement for the year:
(267 118)	267 118	–	Excess of Government Pula Fund Income over Pula Fund Dividend
20 467 583	–	30 784 697	**Balance at December 31, 2006**
–	–	1 721 539	Transfer from Income Statement
–	–	(26 412)	Net unrealised currency losses on non-monetary "available-for-sale" financial instruments
–	–	(290 893)	Net unrealised market losses for the year on "available-for-sale" financial instruments
			Transfers to Government Investment Account:
(180 646)	–	–	Net unrealised market losses for the year
773 513	–	–	Net unrealised currency gains for the year
5 565 788	–	5 565 788	Government investments
6 158 655	–	6 970 022	**Net gains not recognised in the Income Statement for the year**
–	2 984 419	2 984 419	Net income for the year
–	(1 721 539)	(1 721 539)	Transfer to Currency Revaluation Reserve
–	(906 000)	(906 000)	Dividend to Government from Pula Fund
413 831	(413 831)	–	Transfers to/(from) the Income Statement for the year: Excess of Government Pula Fund Income over Pula Fund Dividend
(56 951)	56 951	–	To cover residual deficit
26 983 118	–	38 111 599	**Balance at December 31, 2007**

ACCOUNTING POLICIES

December 31, 2007

BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

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

ADOPTION OF NEW AND REVISED STANDARDS

The Bank has adopted all the new and revised Standards and Interpretations issued by the International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRIC) that are relevant to its operations and effective for annual reporting periods beginning on January 1, 2007. The Bank has adopted the principles of IFRS 7: Financial Instruments Disclosures in the current year under review. The primary objective of the Standard is to require entities to disclose in their financial statements, the significance of financial instruments in as far as their financial performance and position is concerned, and the nature and extent of risks arising from financial instruments that an entity is exposed to and the processes by which these risks are managed. In addition, the Bank has disclosed information regarding its objectives, policies and processes for managing capital as required by amendments to IAS 1: Presentation of Financial Statements.

At the date of authorisation of these financial statements, the Bank considered the amended version of IAS 1: Presentation of Financial Statements, which was issued in 2007 and is effective for annual periods beginning on or after January 1, 2009. The adoption of the revised standard will expand the required disclosures in the financial statements. There are no other standards and interpretations which are in issue but not yet effective which are relevant to the Bank's financial statements.

FINANCIAL INSTRUMENTS

General

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

Financial Assets

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

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

Short-term Investments (Liquidity Portfolio)

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

ACCOUNTING POLICIES

December 31, 2007

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

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

Long-term Investments (Pula Fund)

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

All realised market and currency gains/losses are taken to the Income Statement. Unrealised currency gains/losses on monetary items are recognised in the Income Statement and those on non-monetary items are reported in the Statement of Changes in Shareholder's Funds. In line with the Bank's policy, exchange gains/losses for this fund are not distributable and are, therefore, appropriated to the Currency Revaluation Reserve.

Unrealised revaluation gains and losses arising from changes in the market value of the instruments classified as "available-for-sale" are 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 portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

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.

Derivative Financial Instruments

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

Derivative financial instruments are initially recognised at cost (including transaction costs) and are subsequently

ACCOUNTING POLICIES (CONTINUED)

December 31, 2007

remeasured at market value, based on bid prices for assets held or liabilities to be issued, and ask/offer prices for assets to be acquired or liabilities held. The resulting gain or loss is recognised in the Income Statement.

Impairment of Financial Assets

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

Financial Liabilities

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

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 short term interest rates. BoBCs are issued at a discount to counterparties. They are classified as "other financial liabilities".

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

Other Financial Liabilities

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

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

SECURED LENDING FACILITY

Under the Secured Lending Facility (SLF), the Bank provides emergency and intermittent funding to solvent financial institutions, intended to bridge overnight liquidity shortages. The advances are secured by Government of Botswana Bonds and Bank of Botswana Certificates (BoBCs), valued at market prices on the date of the transaction. 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".

ACCOUNTING POLICIES (CONTINUED)

December 31, 2007

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 (Reverse Repurchase Agreement) are recorded as funds receivable under the heading "Advances to Banks", except for where the securities are BoBCs. In such instances, the advances are netted off against outstanding BoBCs liabilities.

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

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

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

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.

FOREIGN CURRENCIES

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

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

All 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 arising on translation of monetary items 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 arising on monetary financial instruments are not considered distributable in terms of Bank policy; they are appropriated to the Currency Revaluation Reserve. All unrealised exchange gains/losses on translation of non-monetary "available-for-sale" assets are reported in the Statement of Changes in Shareholder's Funds, until the financial assets are derecognised, at which time the cumulative gains/losses previously recognised in Shareholder's Funds are recognised in the Income Statement.

ASSETS, LIABILITIES AND RECOGNITION OF PROVISIONS

Assets

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

Contingent Assets

The Bank discloses a contingent asset arising from past events where it is probable that economic benefits will

ACCOUNTING POLICIES (CONTINUED)

December 31, 2007

flow from it, but this will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events outside the control of the Bank.

Liabilities and Provisions

The Bank recognises liabilities (including provisions) when:

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

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

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

Derecognition of Assets and Liabilities

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

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:

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

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

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

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

GENERAL RESERVE

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

CURRENCY REVALUATION RESERVE

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

ACCOUNTING POLICIES (CONTINUED)

December 31, 2007

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

MARKET REVALUATION RESERVE

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

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

PROPERTY AND EQUIPMENT

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

Land and buildings are valued on a fair value basis every two years, and the recoverable (revalued) amounts disclosed by way of a Note to the Financial Statements, providing that revalued amounts are in excess of the carrying amounts. Where the carrying amounts are more than the revalued amounts, an impairment loss is recognised in the Income Statement.

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

Any impairment loss is recognised immediately in the Income Statement.

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

Depreciation

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

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

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

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

RETIREMENT BENEFITS

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

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.

SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

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

Useful Lives of Property and Equipment

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

December 31, 2007

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 – 2007						
Balance at the beginning of the year	607	3 486	137 702	3 651	89 032	234 478
Additions	–	–	–	6 010	5 170	11 180
Disposals	–	–	–	–	(2 664)	(2 664)
Transfers	–	173	3 019	(3 844)	652	–
Balance at year-end	607	3 659	140 721	5 817	92 190	242 994
Accumulated Depreciation						
Balance at the beginning of the year	–	–	37 204	–	52 540	89 744
Charge for the year	–	–	3 479	–	9 125	12 604
Disposals	–	–	–	–	(2 424)	(2 424)
Balance at year-end	–	–	40 683	–	59 241	99 924
Net book value at December 31, 2007	607	3 659	100 038	5 817	32 949	143 070
Cost – 2006						
Balance at the beginning of the year	607	3 486	128 934	10 872	77 269	221 168
Additions	–	–	–	3 374	11 650	15 024
Disposals	–	–	–	–	(1 723)	(1 723)
Transfers	–	–	8 768	(10 595)	1 827	–
Adjustments	–	–	–	–	9	9
Balance at year-end	607	3 486	137 702	3 651	89 032	234 478
Accumulated Depreciation						
Balance at the beginning of the year	–	–	33 920	–	59 580	93 500
Charge for the year	–	–	3 284	–	7 125	10 409
Revision of economic lives and residual values	–	–	–	–	(12 497)	(12 497)
Disposals	–	–	–	–	(1 677)	(1 677)
Adjustments	–	–	–	–	9	9
Balance at year-end	–	–	37 204	–	52 540	89 744
Net book value at December 31, 2006	607	3 486	100 498	3 651	36 492	144 734

Revaluation of Properties

Freehold and leasehold land and buildings were valued by an independent professional property valuer in December 2006 at an open market value of P152 000 000. The next valuation will take place during the 2008 financial year.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

		2007 P'000	2006 P'000
2.	**FOREIGN EXCHANGE RESERVES**		
2.1	**Liquidity Portfolio**		
	Bonds – held for trading	2 825 919	3 111 888
	Amounts Due from Pula Fund	946 093	585 460
	Cash and Cash Equivalents	14 617 204	6 895 092
		18 389 216	10 592 440
2.2	**Pula Fund**		
	Equities – available-for-sale	11 148 040	10 528 490
	Bonds – available-for-sale	25 387 681	22 627 106
	Derivative Financial Instruments – assets (Note 13)	12 396	9 619
	Amounts Due to Liquidity Portfolio	(946 093)	(585 460)
	Derivative Financial Instruments – liabilities (Note 13)	(7 358)	(11 303)
	Cash and Cash Equivalents	4 127 337	4 286 062
		39 722 003	36 854 514
	Pula Fund Balance Sheet		
	Capital Employed		
	Government	26 483 118	19 967 583
	Bank of Botswana	13 238 885	16 886 931
		39 722 003	36 854 514
	Employment of Capital		
	Investments	39 722 003	36 854 514
	Investments expressed in US dollars ('000)	6 645 491	6 139 962
	Investments expressed in SDR ('000)	4 202 588	4 083 480

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

Pula Fund Income Statement	2007 P'000	2006 P'000
Income		
Interest and dividends	1 474 435	1 052 882
Realised market gains	661 864	377 759
Realised currency revaluation gains	1 365 980	979 851
Unrealised currency revaluation gains	90 732	1 516 763
Sundry income	25	113
	3 593 036	3 927 368
Expenses		
Administration charges	(83 307)	(70 592)
Net income for the year	3 509 729	3 856 776
Transfer to Currency Revaluation Reserve	(1 456 712)	(2 496 614)
Net income before transfer(to)/from Government Investment Account	2 053 017	1 360 162
Transfer (to)/from Government Investment Account	(356 880)	138 148
Net income available for distribution	1 696 137	1 498 310
Appropriations		
Dividend to Government	(906 000)	(550 000)
Bank of Botswana's share of net income	790 137	948 310

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 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)	595 463	568 592
Less IMF Holdings of Pula	(553 631)	(512 222)
Reserve Position in IMF	41 832	56 370
The IMF Holdings of Pula represented by the Non-Interest Bearing Note of P165 324 000 (2006 – P165 324 000) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in the current account held at the Bank (included in other deposits in Note 8).		
3.2 Holdings of Special Drawing Rights		
The balance on the account represents the value of Special Drawing Rights (SDR) allocated and purchased less utilisation on date.	365 366	335 396
3.3 Allocation of Special Drawing Rights (IMF)		
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.	41 594	39 736
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. This matured on August 31, 2007.	–	136 919

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 P'000
4. GOVERNMENT OF BOTSWANA BONDS		
Government Bond BW002 purchased on 31 March 2003, maturing on March 1, 2008, bearing interest at the rate of 10.25 percent, receivable semi-annually in arrears:		
Market value	86 080	85 374
Interest accrued	2 965	2 981
	89 045	88 355
5. OTHER ASSETS		
Staff loans and advances	62 626	56 972
Prepayments	1 552	1 510
Other	29 307	15 271
	93 485	73 753
6. NOTES AND COIN IN CIRCULATION		
Notes	1 285 932	1 005 157
Coin	74 974	64 562
	1 360 906	1 069 719
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.		
7. BANK OF BOTSWANA CERTIFICATES		
Face Value	16 878 820	14 302 570
Unmatured Discount	(262 604)	(299 879)
Carrying Amount	16 616 216	14 002 691
Bank of Botswana Certificates are issued at various short-term maturity dates and discount rates. Netted off against the carrying amount is P403.6 million of BoBCs, which were repurchased from counterparties as at December 31, 2007 (2006: P316.2 million).		

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 P'000
8. DEPOSITS		
Government	708 631	663 068
Bankers	1 066 563	1 039 244
Other	608 500	432 800
	2 383 694	2 135 112

These represent current accounts of Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free, except for the Debswana Tax Holding Account (see Note 33).

9. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)	41 832	56 370

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

10. DIVIDEND TO GOVERNMENT

Balance due at the beginning of the year	137 500	426 169
Dividend to Government from Pula Fund	906 000	550 000
Paid during the year	(817 000)	(838 669)
Balance due at the end of the year	226 500	137 500

The final instalment of the pre-set dividend of P226 500 000 unpaid at December 31, 2007 was 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.

11. OTHER LIABILITIES

Accounts payable	1 547	12 304
Other creditors and accruals	60 129	44 352
	61 676	56 656

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 P'000
12. CATEGORIES OF FINANCIAL INSTRUMENTS		
Financial Assets		
Held for trading		
Bonds	2 825 919	3 111 888
Derivative Financial Instruments	12 396	9 619
Available-for-sale		
Bonds	25 387 681	22 627 106
Equities	11 148 040	10 528 490
Government Bonds	89 045	88 355
Loans and Receivables		
IMF Reserves	407 198	528 685
Staff loans and advances	62 626	56 972
Cash and cash equivalents	18 744 541	11 181 154
Total Financial Assets	58 677 446	48 132 269
The above is disclosed in the balance sheet as follows:		
Total Foreign Exchange Reserves	58 518 417	47 975 639
Add: Derivative Financial Instruments (liabilities)	7 358	11 303
Government of Botswana Bonds	89 045	88 355
Other assets – staff loans and advances (Note 5)	62 626	56 972
Total	58 677 446	48 132 269
Financial Liabilities		
Held for trading		
Derivative Financial Instruments	7 358	11 303
Other Financial Liabilities – at Amortised Cost		
Bank of Botswana Certificates	16 616 216	14 002 691
Allocation of SDR (IMF)	41 594	39 736
Liabilities to Government (IMF)	41 832	56 370
Deposits	2 383 694	2 135 112
Dividend to Government	226 500	137 500
Other liabilities	61 676	56 656
Total Financial Liabilities	19 378 870	16 439 368

Fair Values

The fair value of all financial assets and liabilities are substantially identical to the carrying amounts reflected in the balance sheet.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

13. DERIVATIVE FINANCIAL INSTRUMENTS

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

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

		Assets 2007 (P'000)	Liabilities 2007 (P'000)	Notional Amount 2007 (P'000)	Assets 2006 (P'000)	Liabilities 2006 (P'000)	Notional Amount 2006 (P'000)
Fixed Income Futures	–Buy	–	(7 358)	1 238 633	–	(11 303)	676 810
	–Sell	6 591	–	(388 633)	6 148	–	(178 550)
Fixed Income Options	–Buy	–	–	–	113	–	160
	–Sell	290	–	(646)	–	–	–
Currency Futures	–Buy	2 768	–	292 552	3 232	–	133 337
	–Sell	14	–	(70 833)	–	–	–
Currency Options	–Buy	2 699	–	12 912	126	–	676
	–Sell	34	–	(42)	–	–	–
Total		12 396	(7 358)	1 083 943	9 619	(11 303)	632 433

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

Futures

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

Options

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 P'000
14. PAID-UP CAPITAL		
Authorised and Paid-up Capital		
The capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act (CAP 55:01). The Bank is not subject to any externally imposed capital requirements. Therefore, capital is not actively managed. Management considers the Paid-up Capital and the General Reserve to be capital.	25 000	25 000
15. GENERAL RESERVE		
In the opinion of the Board, the General Reserve, taken together with other reserves which the Bank maintains, is sufficient to ensure the sustainability of future operations of the Bank.	1 600 000	1 600 000
16. INTEREST – FOREIGN EXCHANGE RESERVES		
Liquidity Portfolio		
Cash and cash equivalents	692 438	455 375
Bonds – held for trading	158 684	140 386
IMF Reserves – loans and receivables	15 916	15 151
Pula Fund		
Cash and cash equivalents	189 682	64 963
Bonds – available-for-sale	1 049 233	792 166
Total	2 105 953	1 468 041
17. DIVIDENDS – FOREIGN EXCHANGE RESERVES		
Pula Fund		
Equities – available-for-sale	235 545	195 867
18. NET MARKET GAINS/(LOSSES) ON DISPOSAL OF SECURITIES		
Liquidity Portfolio		
Bonds – held for trading	8 279	(3 220)
Pula Fund		
Derivative instruments – held for trading	52 682	(1 556)
Bonds – available-for-sale	(51 137)	(39 626)
Equities – available-for-sale	660 319	418 941
Total	670 143	374 539

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 P'000
19. NET REALISED CURRENCY GAINS/(LOSSES)		
Liquidity Portfolio		
Cash and cash equivalents	350 321	899 248
Bonds – held for trading	(32 064)	293 348
IMF – loans and receivables	6 734	–
Pula Fund		
Derivative instruments – held for trading	32 570	38 112
Cash and cash equivalents	165 110	77 902
Bonds – available-for-sale	877 519	633 176
Equities – available-for-sale	290 783	230 661
Total	1 690 973	2 172 447
20. NET UNREALISED CURRENCY GAINS/(LOSSES)		
Liquidity Portfolio		
Cash and cash equivalents	5 697	84 361
Bonds – held for trading	(88 473)	147 163
IMF reserves – loans and receivables	14 104	54 838
Pula Fund		
Cash and cash equivalents	35 761	(42 383)
Bonds – available-for-sale	72 761	1 558 002
Derivative instruments – held for trading	(3 062)	1 144
Total	36 788	1 803 125
21. NET UNREALISED MARKET GAINS		
Liquidity Portfolio		
Bonds – held for trading	39 775	–
Pula Fund		
Derivative instruments – held for trading	7 805	–
Total	47 580	–
22. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	1 838 783	1 589 259
Debswana Tax Holding Account (Note 33)	43 426	53 267
Reverse Repurchase Agreements	19 025	38 241
	1 901 234	1 680 767

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 P'000
23. NET UNREALISED MARKET LOSSES		
Liquidity Portfolio		
Bonds – held for trading	–	(10 999)
Pula Fund		
Derivative instruments – held for trading	–	(2 374)
Total	–	(13 373)
24. NET CURRENCY REVALUATION GAINS RECOGNISED IN THE INCOME STATEMENT		
Total net realised gains (Note 19)	1 690 973	2 172 447
Total net unrealised gains (Note 20)	36 788	1 803 125
Total net currency revaluation gains taken to the Income Statement	1 727 761	3 975 572
Appropriated to Currency Revaluation Reserve:		
Net realised and reinvested in foreign assets	(1 684 751)	(2 169 892)
Net unrealised currency gains	(36 788)	(1 803 125)
Transferred to Currency Revaluation Reserve	(1 721 539)	(3 973 017)
Net currency revaluation gains retained in the Income Statement	6 222	2 555

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

The Bank's contribution to the Bank of Botswana Defined Contribution Staff Pension Fund for the year ended December 31, 2007 is P10 265 000 (2006: P9 142 000).

26. CASH FLOW STATEMENT

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

	2007 P'000	2006 P'000
27. CASH GENERATED BY OPERATIONS		
Net income for the year	2 984 419	4 384 869
adjusted for:		
Net realised and unrealised exchange gains	(1 721 539)	(3 973 017)
Depreciation expense/(net write-back)	12 604	(2 088)
Loss/(Profit) on disposal of property and equipment	13	(38)
Interest – Government of Botswana Bonds	(8 829)	(8 846)
Operating cash flows before movements in working capital	1 266 668	400 880
Increase in Deposits – banks and other	203 019	493 666
Increase in Deposits – Government	45 563	44 824
Increase in Bank of Botswana Certificates	2 613 525	1 586 558
Increase in other assets	(19 732)	(21 293)
Increase in other liabilities	5 020	22 103
Cash generated by operations	4 114 063	2 526 738
28. CAPITAL COMMITMENTS		
Approved and contracted for	14 427	2 638
Approved, but not contracted for	35 866	39 021
	50 293	41 659

These capital commitments will be funded from internal resources.

29. COLLATERAL

There were no open positions under the Secured Lending Facility at the year-end, hence no "Advances to Banks" and corresponding collateral held by the Bank at the balance sheet date.

30. GOVERNMENT OF BOTSWANA BOND AGENCY

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

Government of Botswana Bonds issued as at December 31, 2007

Bond Detail	BW 002	BW 003	
Date of Issue	March 31 and December 1, 2003	May 6 and November 3, 2003	Total P'000
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 to date (P'000)	374 125	394 625	768 750
Interest Accrued (P'000)	29 201	15 713	44 914

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

30. GOVERNMENT OF BOTSWANA BOND AGENCY (continued)

(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 interest payments of P768 750 000 made to December 31, 2007 (2006 – P589 375 000) were funded from the Government's current account maintained with the Bank.

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS

Risk is inherent in the Bank's management of financial instruments which are comprised primarily of foreign exchange reserves, which are held in various financial instruments. This risk is managed through a process of ongoing identification, measurement and monitoring that is subject to an extensive framework of risk limits and other controls. The process of risk management is critical to the Bank's ongoing operations, with the day to day management of the financial instruments being conducted by the Financial Markets Department. A key element in the risk management of the foreign exchange reserves is safety, defined as the preservation of purchasing power of the foreign exchange reserves. To this end, the Bank has continued to pursue a conservative and diversified investment strategy, with an SDR weighted currency allocation as the benchmark. The Bank's objectives, policies and procedures for managing the risk exposures and the method used to measure the risks have remained consistent with the prior year and there has been no significant change in the risk profile as compared to the previous year.

Risk Management Governance Structure

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

(i) Board

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

(ii) Investment Committee

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

(iii) Financial Markets Department

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

(iv) Segregation of Duties

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (cont'd)

Tranching of Foreign Exchange Reserves – Liquidity Portfolio and Pula Fund

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

Pula Fund

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

Liquidity Portfolio

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

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

Types of Risk Exposure

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

(i) Currency Risk

The foreign exchange reserves are invested in currencies that are freely convertible, less susceptible to frequent and sharp exchange rate fluctuations and are used in well developed financial markets. The Bank's policy is to invest only in currencies with high ratings assigned by Moody's Investor Services and Standard and Poor's. Through a diversified currency allocation relative to an SDR weighted benchmark, the Bank ensures that the purchasing power of the foreign exchange reserves is preserved. In terms of the Investment Guidelines, a maximum deviation from the neutral level (using the SDR weights as a benchmark) for USD and EUR of 10 percentage points is permitted, while a deviation of up to 5 percentage points on all other currencies is permitted. At the end of 2007, the Bank's total exposure to SDR and related currencies was P56 billion (2006: P46.7 billion).

(ii) Interest Rate Risk

Interest rate risk is the possible loss in the value of a fixed income asset resulting from an unexpected and adverse movement in interest rates and a consequent change in price. Interest rate risk is measured by modified duration, which measures the sensitivity of the price of a bond to changes in interest

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (cont'd)

rates expressed in years. The Bank benchmarks the interest rate risk for the Pula Fund (fixed income assets) to reflect the long-term nature of the portfolio with emphasis on higher return. The higher interest rate risk is generally compensated by higher returns expected from longer maturity bonds. The modified duration benchmark will vary over time, as changing market conditions and index weights impact the global modified duration of the index. At the end of 2007, the average modified duration of the fixed income portion of the Pula Fund was 5.7 years (2006: 5.4 years). As the Liquidity Portfolio gives priority to liquidity over return, given the constant need to provide foreign exchange to finance transaction payments, from the Bank's perspective, this portfolio is exposed to minimum interest rate risk. At the end of 2007, the Liquidity Portfolio's average modified duration was 1.5 years (2006 : 1.2 years).

(iii) Equity Price Risk

Equity price risk is the risk that the value of equities decrease as a result of changes in the level of equity indices and diminution of value of individual stocks. The geographic allocation of equity exposure follows generally the market capitalisation among the major markets. The investment guidelines stipulate the holding levels of equities. Holdings of more than 5 percent in one company are not permitted. A reasonable spread among the industry sectors is maintained in the portfolio. There are no investments in private placements or unquoted stocks. At the end of 2007, the equity portion of the Pula Fund was P11.1 billion (2006: P10.5 billion).

Market Risk Sensitivity Analysis

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

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

December 31, 2007

Risk Variable	Adverse Market Change				Beneficial Market Change		
		Scenario	Effect on income statement (P'000)	Effect on equity (P' 000)	Scenario	Effect on income statement (P '000)	Effect on equity (P' 000)
Interest Rate Risk		Increase in yields by 50 basis points	(20 450)	(719 361)	Decrease in yields by 50 basis points	20 450	719 361
Currency Risk	SDR currencies	Strengthening of the Pula by 1%	(448 205)	(111 480)	Weakening of the Pula by 1%	448 205	111 480
	South African rand	Strengthening of the Pula by 1%	(25 499)	–	Weakening of the Pula by 1%	25 499	–
Equity Risk	Global Equities	Decline in global equity prices by 5%	–	(557 402)	Increase in global equity prices by 5%	–	557 402

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (cont'd)

December 31, 2006

Risk Variable	Adverse market change				Beneficial market change		
		Scenario	Effect on income statement (P '000)	Effect on equity (P '000)	Scenario	Effect on income statement (P '000)	Effect on equity (P '000)
Interest Rate Risk		Increase in yields by 50 basis points	(18 940)	(612 356)	Decrease in yields by 50 basis points	18 940	612 356
Currency Risk	SDR currencies	Strengthening of the Pula by 1%	(361 535)	(105 285)	Weakening of the Pula by 1%	361 535	105 285
	South African rand	Strengthening of the Pula by 1%	(12 937)	–	Weakening of the Pula by 1%	12 937	–
Equity Risk	Global Equities	Decline in global equity prices by 5%	–	(526 425)	Increase in global equity prices by 5%	–	526 425

The market risk estimates as presented in the Table above are based on sensitivities to the individual risk factors. The correlation between the risk variables is not reflected in the effects on the income statement and equity.

(iv) Credit risk

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

During the year under review, none of the institutions where the Bank's investments are held were downgraded by the rating agencies. Consistent with the Investment Guidelines, the Bank withdraws the invested funds if there has been a downgrade of any institution.

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

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

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

Exposure to Credit Risk

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (cont'd)

		2007 (P'000)	2006 (P'000)
Foreign Exchange Reserves	Notes		
Liquidity Portfolio			
Bonds – held for trading	2.1	2 825 919	3 111 888
Cash and cash equivalents		15 563 297	7 480 552
Pula Fund			
Bonds – available-for-sale	2.2	25 387 681	22 627 106
Derivative financial instruments – held for trading		12 396	9 619
Cash and cash equivalents		3 181 244	3 700 602
International Monetary Fund-loans and receivables			
Reserve tranche	3.1	41 832	56 370
Holdings or Special Drawing Rights	3.2	365 366	335 396
Administered funds	3.4	-	136 919
Government of Botswana Bonds – available-for-sale	4	89 045	88 355
Other Assets – staff loans and advances – loans and receivables	5	62 626	56 972
Total		47 529 406	37 603 779
Analysis of Credit Exposure			
Measured at fair value			
Bonds		28 213 600	25 738 994
Derivatives		12 396	9 619
Government of Botswana Bonds		89 045	88 355
Measured at amortised cost			
IMF reserves		407 198	528 685
Staff advances		62 626	56 972
Other		18 744 541	11 181 154
Total		47 529 406	37 603 779

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

The Tables below reflect the credit exposure based on the fair value of the assets with counterparties as at December 31, 2007.

Credit Exposure on Bonds

Moodys/S&P Rating	Government (P'000)	Corporate (P'000)	Other (P'000)	Total 2007 (P'000)	Total 2006 (P'000)
Aaa/AAA	17 330 633	4 464 949	122 167	21 917 749	19 455 009
Aa1/AA+	509 603	197 786	193 932	901 321	621 335
Aa2/AA	1 826 940	274 346	24 409	2 125 695	1 838 684
Other	1 799 683	94 401	1 374 751	3 268 835	3 823 966
Total	21 466 859	5 031 482	1 715 259	28 213 600	25 738 994

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (cont'd)

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

Fitch/IBCA Rating	2007 (P'000)	2006 (P'000)
A1	14 210 089	5 339 140
A2	562 337	593 290
A/B1	1 974 737	3 425 652
A/B2	61 151	199 806
B1	1 815 362	1 621 775
B2	119 825	1 416
Other	1 040	75
Total	18 744 541	11 181 154

(v) Instrument Risk

Sovereign Bonds

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

Corporate Bonds

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

(vi) Liquidity Risk

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

Financial Liabilities at Undiscounted Cash Flows

The Table below summarises the maturity profile of the Bank's financial liabilities as at December 31, 2007 based on contractual undiscounted repayments obligations.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (cont'd)

December 31, 2007

	Less than 3 months (P'000)	3–12 months (P'000)	1–5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	13 968 280	2 910 540	–	–	16 878 820
Deposits	2 383 694	–	–	–	2 383 694
Allocation of SDR-IMF	–	–	–	41 594	41 594
Liabilities to Government-IMF	–	–	–	41 832	41 832
Dividend to Government	226 500	–	–	–	226 500
Other Liabilities	61 676	–	–	–	61 676
Total	16 640 151	2 910 540	–	83 426	19 634 116

December 31, 2006

	Less than 3 months (P'000)	3–12 months (P'000)	1–5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	12 230 130	2 072 440	–	–	14 302 570
Deposits	2 135 112	–	–	–	2 135 112
Allocation of SDR-IMF	–	–	–	39 736	39 736
Liabilities to Government-IMF	–	–	–	56 370	56 370
Dividend to Government	137 500	–	–	–	137 500
Other Liabilities	56 656	–	–	–	56 656
Total	14 559 398	2 072 440	–	96 106	16 727 944

Other Risks

(vii) External Fund Managers

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

(viii) Custody

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

(ix) Operational Risk

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

32. COMPARATIVES

Where necessary, comparative figures have been restated to conform with changes in presentation in the current year arising from the adoption of IFRS 7.

33. 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, 2007, were:

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

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

(iii) being the Government agent for government bonds.

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

No charge is made to the Government for provision of these services, except for commissions charged in domestic foreign exchange transactions, which are included in "Profit on domestic foreign exchange deals" in the Income Statement. This amounted to P201 124 000 (2006 – P96 831 000).

The Bank earned interest on its holding of the Government of Botswana Bonds (as described in Note 4) of P8 829 000 (2006 – P8 846 000).

Other Related Party Balances and Transactions

(i) Non-commercial banks are no longer allowed to trade in Bank of Botswana Certificates effective March 1, 2006; hence, as at December 31, 2007, there were no interest payments made to Government owned or partly owned institutions in respect of their investments in Bank of Botswana certificates. The amounts as at December 31, 2006 provided below were interest payments made before the policy was effected.

	2007	2006
	P'000	P'000
Botswana Savings Bank	–	1 846
Debswana Diamond Company (Proprietary) Limited	–	461
Motor Vehicle Accident Fund	–	669
Total	–	2 976

(ii) Debswana Diamond Company (Proprietary) Limited, 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 22.

(iii) Purchases of air tickets amounting to P410 000 (2006 – P300 000) were made from Air Botswana, an institution wholly owned by the Government. These were charged to Administration costs in the Income Statement.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
December 31, 2007

33. RELATED PARTY BALANCES AND TRANSACTIONS (continued)

(iv) Amounts due to related parties.

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

	2007	2006
	P'000	P'000
Botswana Development Corporation	6	6
Botswana Postal Services	–	168
Botswana Savings Bank	2 117	2 593
Debswana Diamond Company (Proprietary) Limited	18 223	12 874
Total	20 346	15 641

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

(v) Remuneration of Key Management Personnel

Key management personnel comprise the Governor, Board Members, Deputy Governors and Heads of Department. Gross emoluments of the key management personnel are:

	2007	2006
	P'000	P'000
Non-Executive Board members	104	51
Executive Management		
Short term benefits	5 601	4 648
Post-employment benefits	381	350
Other long-term employee benefits	609	556
	6 695	5 605

Of the Staff Loans and Advances per Note 5, P2 912 000 (2006 – P3 048 000) are attributable to Executive Management.

Part B

The Botswana Economy in 2007 and Theme Chapter

Bank of Botswana

CHAPTER 1

THE BOTSWANA ECONOMY IN 2007

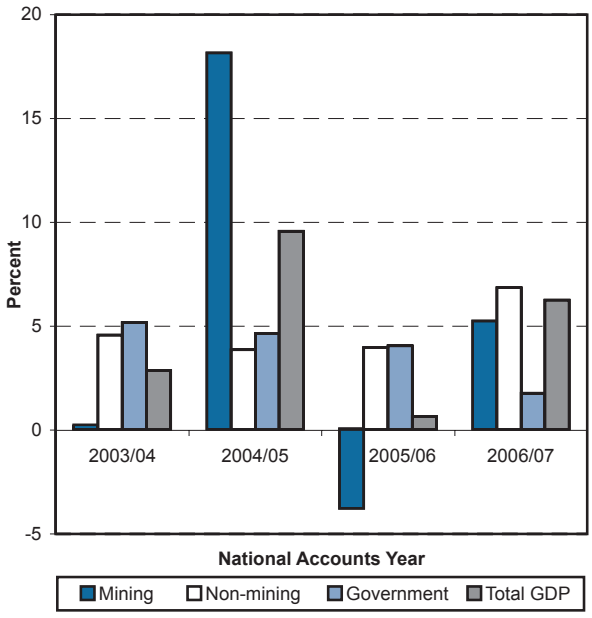
1. OUTPUT, EMPLOYMENT AND PRICES

(a) National Income Accounts

Overview

1.1 Provisional national accounts estimates for 2006/07[1] indicate that the economy gained momentum, with real gross domestic product (GDP) growing at 6.2 percent, up from marginal growth of only 0.6 percent for 2005/06. Despite the modest upward revision to the estimate for 2005/06,[2] average GDP growth in the first half of National Development Plan 9 (NDP 9) was 4.3 percent and below the 4.7 percent anticipated in the Plan's Mid-Term Review (MTR). Therefore, economic performance in the second half of the plan period will need to remain buoyant if the envisaged growth objectives are to be realised. As highlighted

CHART 1.1: REAL GDP GROWTH DURING NDP 9



Source: Bank of Botswana.

TABLE 1.1: GDP GROWTH BY MAJOR ECONOMIC SECTOR, 2003/04 – 2006/07[1]

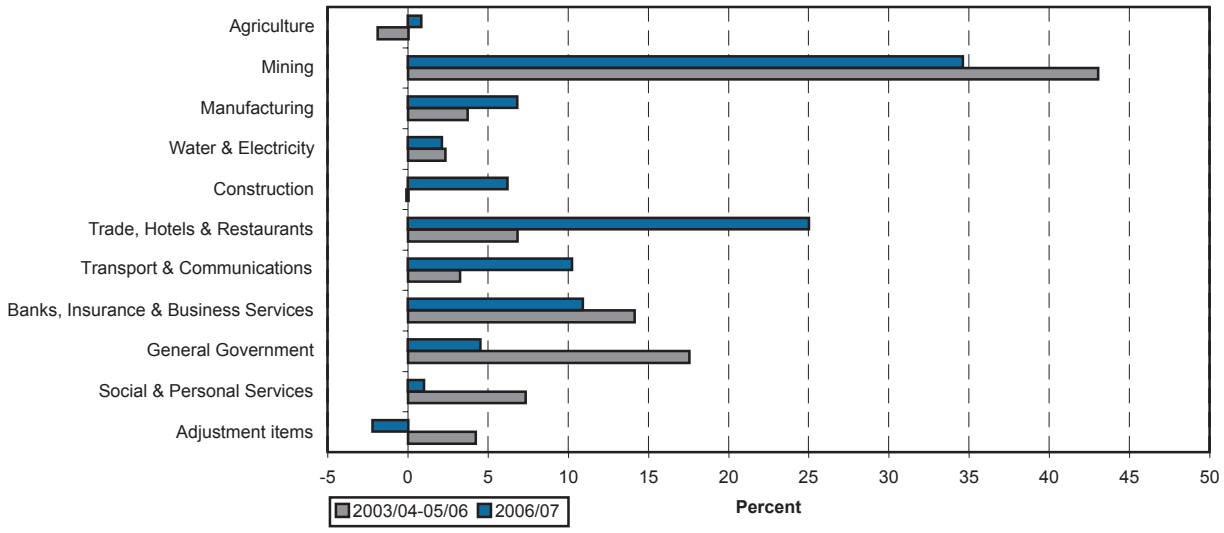
	2006/07 (prelim)	2005/06 (revised)	2005/06 (prelim)	Average, first half of NDP 9 (2003/04-05/06)
Agriculture	2.9	–3.6	–3.6	–3.9
Mining	5.2	–3.8	–4.4	4.9
Manufacturing	12.0	5.3	–3.3	4.6
Water & electricity	5.9	3.6	3.6	4.5
Construction	8.7	–3.3	–3.3	–0.1
Trade, etc.	16.3	6.3	5.9	3.1
Transport & communications	20.3	18.2	18.2	4.7
Banks, insurance & business services	6.6	11.2	1.7	6.1
General government	1.7	4.0	4.0	4.6
Social & personal services	1.6	7.5	7.8	8.3
Total GDP	6.2	0.6	–0.8	4.3
Excluding mining	6.8	3.9	1.8	4.1
Excluding mining & government	8.8	3.9	0.9	3.9

1. As the Table indicates, there continue to be substantial revisions made to national accounts data, especially the preliminary estimates (see also footnote 2 above). Therefore, both the rate and composition of GDP growth in 2006/07 may be subject to further changes as more information on the economy is collected.

Source: Central Statistics Office.

1. The national accounts year runs from July to June.
2. In 2005/06, GDP was initially estimated to have contracted by 0.8 percent. As indicated in Table 1.1, the upward revision to 0.6 percent was due mainly to large changes in the estimates for *manufacturing* and *banks, insurance and business services*.

CHART 1.2: CONTRIBUTION TO GDP GROWTH 2003/04 – 2006/07



Source: Central Statistics Office.

in the 2008 Budget Speech, growth averaging 6.8 percent per annum over the next decade is needed to achieve the targets for GDP set out in *Vision 2016*. The prospects for such rapid and sustained growth are considered further below.

1.2 The recovery of both the mining and non-mining sectors boosted the overall performance of the economy in 2006/07. The *mining* sector, which is the largest contributor to GDP (42 percent in 2006/07 in current prices[3]), reversed the decline of 3.8 percent in 2005/06 to grow by 5.2 percent in 2006/07. This performance was, however, surpassed by growth of the non-mining sector, which grew by 6.8 percent. This was the fastest annual increase since the beginning of NDP 9, and compares to average growth in non-mining GDP during the first half of NDP 9 of 4.1 percent. Moreover, for the first time in NDP 9, in 2006/07 non-mining growth was not boosted by more rapid expansion in output from the government sector. Growth in *general government* in 2006/07 was only 1.7 percent compared to an annual average of 4.6 percent over the previous three years, while growth excluding both mining and government was 8.8 percent.

1.3 Chart 1.2, which compares the sources of GDP growth in 2006/07 with the first half of NDP 9, indicates the extent to which mining influences the performance of the entire economy. Overall, output growth generally moves in tandem with developments in the mining sector, which is a major component of total GDP; and within mining, diamond production constitutes most of sectoral GDP. In 2006/07, despite significantly more rapid growth in several other sectors, *mining* made the largest contribution to overall growth, at 34.6 percent. However, this falls below the contribution for the first half of NDP 9 of 43 percent, and this is a possible indication of progress in diversifying the economy. Reflecting both its rapid growth and significant size in the economy, *trade, hotels and restaurants* contributed 25 percent of total GDP growth in 2006/07. In contrast, despite being the most rapidly growing sector, *transport and communications* contributed only 10.2 percent to overall output, mainly because of its small size.[4] The other notable development is the diminished contribution of growth in *general government* in 2006/07 compared to the first half of NDP 9.

3. Detailed estimates of sectoral contributions to total GDP are presented in Tables 1.3 and 1.4 of the Statistical Section.

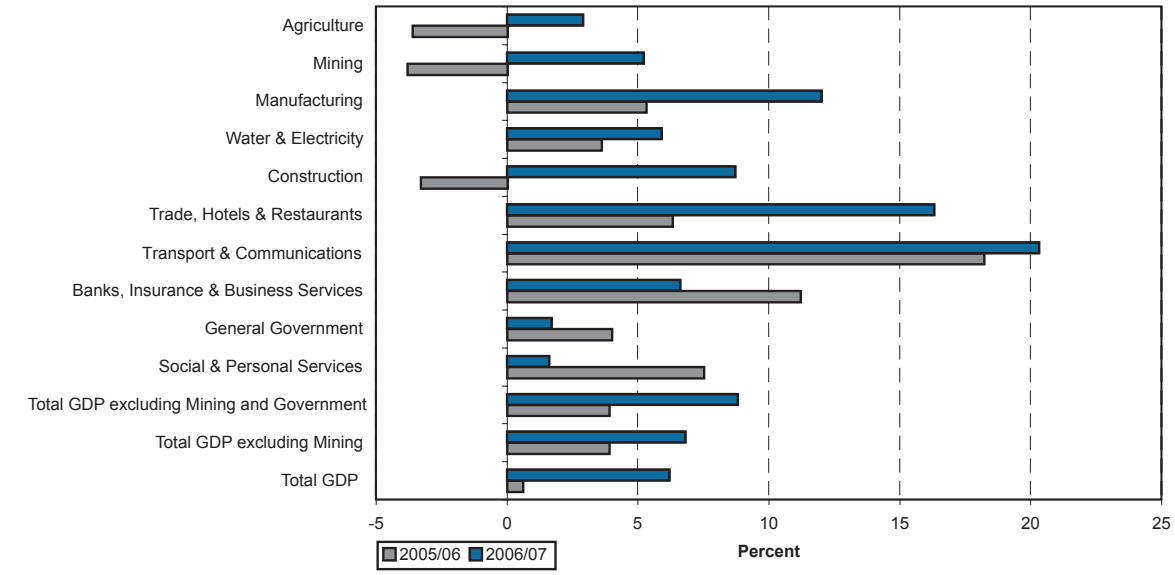
4. In nominal terms, *trade, hotels and restaurants* made up 10.5 percent of GDP compared to 3.5 percent for *transport and communications*.

Performance by Economic Sector

1.4 As is evident from Chart 1.3, all sectors expanded in 2006/07 (in contrast, three sectors experienced negative growth in 2005/06) and only *banks, insurance and business services*, *general government* and *social and personal services* recorded lower growth rates than in the previous year.

1.6 The faster expansion in mining output was mainly due to a resumption of growth in diamond production, which increased by 5.2 percent compared to a contraction of 4.3 percent the year before. While copper/nickel output grew by 128 percent in nominal terms, this was due to buoyant commodity prices, as the volume produced contracted

CHART 1.3: ECONOMIC GROWTH BY SECTOR



Source: Central Statistics Office.

1.5 Although agricultural output recovered from a decline of 3.6 percent in 2005/06 to grow by 2.9 percent in 2006/07, the contribution of agriculture to total GDP dropped slightly from 1.7 percent to 1.6 percent in 2006/07. With drought conditions resulting in low crop yields and the total area under cultivation falling by over 50 percent, the main contributor to growth was the livestock sub-sector. While the contribution of agriculture to GDP has remained below 2 percent since 2004/05, it is possible that the current estimates do not account for all relevant activities, particularly at a time when the objective is for the sector to diversify away from traditional farming.[5]

by 7 percent. Output of 'other mining' was boosted by the inclusion of gold, where output from the Mupane mine rose by 14 percent in 2007.

1.7 *Manufacturing* output increased by 12 percent in 2006/07, following a revised growth estimate of 5.3 percent for 2005/06. However, the sector's overall share of GDP remains low at 3.5 percent. The strong performance was driven by rapid growth of 16.4 percent in *other manufacturing*. This is now the largest single sub-component of the overall sector, suggesting a need for some more detailed breakdown. *Beverages* also grew strongly by 13.6 percent. There is, however, a continuing difficulty in reconciling the GDP estimates for *textiles* with data from other sources.[6]

5. There is also an issue of classification where, following international guidelines, some activities that may appear agricultural in nature, such as abattoirs, are classified as manufacturing.

1.8 The *construction* sector recovered from a 3.3 percent contraction to grow by 8.7 percent in 2006/07. This is consistent with the gradual acceleration of government expenditure over the same period. In addition, construction growth reflects growing optimism in prospects for the domestic economy as reported in the Bank of Botswana's biannual Business Expectations Survey (BES).

1.9 Performance across the service sectors was also generally strong, with the exception of *general government* and *social and personal services* which grew by 1.7 percent and 1.6 percent, respectively.[7] Growth in *trade, hotels and restaurants* and *transport and communications* was particularly rapid at 16.3 percent and 20.3 percent, respectively. Recovery in the *trade* sub-sector, where growth increased from 1.3 percent in 2005/06 to 15.5 percent, reflects the general expansion of commercial activity throughout the economy. At 6.6 percent, growth in *banks, insurance and business services*, while down from 11.6 percent the previous year, remained healthy and reflected robust performance across a range of financial and business services.

GDP by Expenditure

1.10 Following a marginal contraction of 0.6 percent in 2005/06, real gross domestic expenditure grew by 2.7 percent in 2006/07, with faster expansion across most major categories of expenditure. In particular, household consumption and gross fixed capital formation grew by 8.3 percent and 10.1 percent, respectively. In contrast, consumption by government rose only marginally by 0.4 percent. To some extent, the slower growth of domestic expenditure compared to overall GDP expansion reflects the importance of the external sector in influencing economic activity. In 2006/07, net exports grew by 28.5 percent in real terms. However, the large errors and omissions item in the estimates, which is equivalent to 6.5 percent of GDP, suggests that some components of expenditure have been underestimated. One possibility is the estimate for construction-related capital formation, where the reported decline of 8.8 percent appears at odds with the rapid growth in the output of the construction sector.

(b) Domestic Economic Outlook

1.11 Although expansion of the economy continues to be lower than the rates required to meet the growth objectives of NDP 9 and *Vision 2016*, growth in 2006/07 indicates generally positive prospects for the economy in the medium term. However, these will only be realised if several potential constraints, such as availability of electricity and diversion of resources to infrastructure projects in South Africa, in preparation for the 2010 World Cup, can be overcome.

1.12 Renewed growth in 2006/07, led by the non-mining private sector, is consistent with the view that recent reforms, including the stabilisation of the real effective exchange rate (REER) at a more competitive level, are starting to have a positive effect. The other reforms are those aimed at removing administrative bottlenecks that impede business (including improving the efficiency of the public sector).[8]

1.13 In the short term, the economy will also receive several sector-specific stimuli. These include the momentum arising from the diamond and other minerals beneficiation initiatives[9] as the new Diamond Trading Company Botswana (DTCB) comes into full operation, together

6. While the national accounts suggest that this sub-sector declined by 14.3 percent in 2006/07, trade data for the same period indicate that textiles exports rose (in nominal terms) by 58.5 percent.

7. Slow growth in the government sector is inconsistent with accelerating government expenditure. The main component of government GDP is wages and salaries.

8. See 2008 Budget Speech.

9. In order to support downstream minerals developments, Parliament has recently approved tax agreements with the promoters of both the Mmamabula coal-fired export power station and the Botswana Metal Refinery being constructed near Francistown.

with accelerated government spending at the end of NDP 9. Recent assessments of the potential to further develop tourism in Botswana have also been positive.

1.14 The downside risks to domestic economic performance include the prospect of a significant slowdown in the world economy, following the onset of the 'sub-prime crisis' in the second half of 2007. However, the prospect of a recession in the United States is to a large extent counterbalanced by continuing growth in major emerging economies, such as India and China, which are increasingly important markets for minerals (diamonds included). For Botswana, the downside risks to performance of the mining sector reinforce the need to promote other sources of growth.

1.15 Meanwhile, the rapid acceleration in government spending during 2007/08 (Section 2 below) has provided an immediate stimulus to domestic demand, notably in the construction industry, which may feed through to the wider economy. The biannual BES has confirmed increased optimism in the local business community. However, there could be supply-side constraints to a rapid expansion in demand.

1.16 Notably, the temporary disruption caused by power cuts in early 2008 signalled the potential for the emerging regional electricity shortages to undermine growth prospects.[10] In the short term, this problem is expected to intensify as the supply of electricity is largely fixed at a time when energy-intensive mining developments will commence and increase operations. For growth to be maintained, this needs to be countered by effective measures to encourage power conservation. These should involve price-based incentives (both penal rates and, if appropriate, subsidies) to encourage conservation and efficiency, which are more likely to sustain production compared to an arbitrary and disruptive programme of load shedding.

1.17 The accelerated programme to develop additional public infrastructure, including construction of roads and dams and airport redevelopment, is being undertaken in the context of rapidly growing regional demand for construction and related services. If associated bottlenecks, including the supply of skilled labour and materials, should tighten, careful prioritisation of project implementation may be necessary. Demand by the Government for construction should also accommodate the requirement to maintain existing public infrastructure, and avoid crowding out investment by the private sector. From the perspective of the private sector, mining development may also be impeded by rising costs and shortages of both skilled labour and equipment.

(c) Employment

1.18 Estimates for March 2007 indicate that formal sector employment[11] increased by 7 087 or 2.4 percent compared to the previous year. This compares with a loss of 3 800 jobs (1.3 percent) recorded for the year ending March 2006, and with average annual growth in formal employment of only 1.5 percent in the first half of NDP 9.

1.19 While the apparent increase in the pace of formal sector job creation is welcome, there are some difficulties in reconciling some of the data for employment and GDP. For example, the employment estimates indicate growth in non-government employment has slowed, while the GDP data for the equivalent period show accelerating growth. The breakdown of employment by sector suggests some further anomalies.[12] In addition to such possible discrepancies, comparisons between employment data must be interpreted with

10. The power cuts were due to a combination of shortages in supply by Eskom, the South African power utility, combined with technical problems that hampered access to alternative supply from Mozambique.

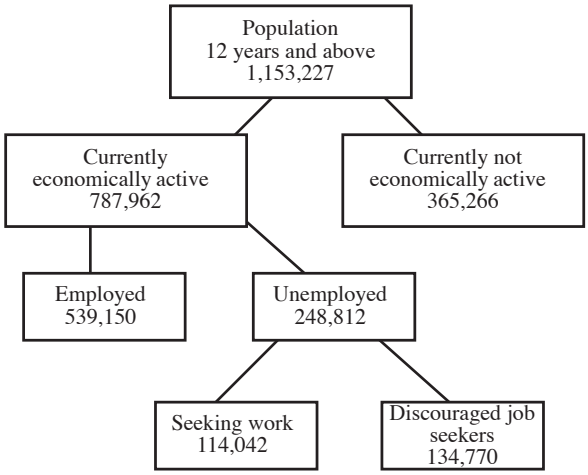
11. The formal sector is defined to include businesses with more than five employees.

12. For instance, contraction of employment by 12.5 percent and 5.1 percent in *construction* and *transport and communications*, respectively, is hard to reconcile with rapid GDP growth in those sectors.

caution due to differences in timing, coverage and the influence of other factors, including changes in labour productivity.

1.20 The draft final report of the 2005/06 Labour Force Survey (LFS) was released by the CSO for public discussion in November 2007 and the key results are shown in Figure 1.1. The survey largely confirms the preliminary results reported earlier,[13] including the decrease in the national unemployment rate to 17.5 percent. This compares with 21.5 percent in the 1995/96 LFS and 19.5 percent in the 2001 population census. The unemployment rate for females, at 19.7 percent, is noticeably higher than for males, at 15.3 percent. Two-thirds of the unemployed were in urban areas, a reflection of the greater scope among rural dwellers to undertake subsistence activities.

FIGURE 1.1: 2005/06 LABOUR FORCE SURVEY – SOME KEY RESULTS



Labour force participation rate[1]	68.3
Unemployment[2]	17.5
Discouraged workers[3]	17.1
Unemployment including discouraged workers[3]	31.6
Underemployment[4]	4.6

Notes:
1. Proportion of the working age (over 12) population.
2 Proportion of the economically active population excluding discouraged workers.
3. Proportion of the economically active population.
4. Proportion of the employed population.

Source: Central Statistics Office.

1.21 It is also evident that unemployment is most heavily concentrated among young people, with the highest unemployment rate of 34.9 percent in the 20-24 age cohort. However, despite concern about rising unemployment among graduates from tertiary education, there continues to be a clear correlation between unemployment and lack of education and/or training. The survey indicated that unemployment for people with no training was 69.5 percent, followed by those with certificates at 16.6 percent, while, among those with diplomas and degrees, it was 7.7 percent and 5.5 percent, respectively.

1.22 The LFS also indicates that only 4.6 percent of those employed were reported to be *underemployed* (i.e., working less than full time while available for full time employment). Of these, 90 percent were outside cities and towns, with more than one third of the total working in traditional agriculture.

1.23 A more significant issue than underemployment appears to be that of the so-called 'discouraged workers', i.e., those who are available but not actively looking for work. By international convention these are not generally included when calculating the unemployment rate. But as a proportion of the labour force, this category increased from 16.7 percent in 1995/96 to 17.1 percent in 2005/06, and their inclusion would raise the national unemployment rate to 31.6 percent. However, the case for their inclusion is not clear cut, especially since there are diverse reasons, other than being genuinely 'discouraged', for being included in this group. Of the total in this category, less than half (47.5 percent) indicated that they were not looking for work because they believed no jobs were available. Other reasons included

13. Bank of Botswana *Annual Report 2006*, p59. The LFS provides much useful information on the make-up of the contemporary Botswana labour force. However, its results need to be interpreted with caution. This is especially since, in some areas, the data are difficult to reconcile with other relevant data sources, including the biannual surveys of formal sector employment and the decennial population and housing censuses.

being too occupied with household duties (29.7 percent) or caring for the sick (2.5 percent), as well as those who were awaiting the results of job applications (6.5 percent) or, even, preparing to start work (2.5 percent). As with the underemployed, most discouraged workers lived in rural areas, an indication that, although overall unemployment rates may be lower, there are greater obstacles confronting rural dwellers in seeking jobs.

1.24 The LFS also highlights the importance of the informal sector in the economy. According to the survey, 20 percent of employment in 2005/06 was in informal activities, up from 11 percent in 1995/96. This points to the importance of the informal sector for job creation and reducing unemployment; it also suggests that other data, notably GDP estimates, would benefit from improved information on the scope of informal activities.

(d) Inflation

1.25 Global economic growth is estimated to have slowed slightly from 5 percent in 2006 to 4.9 percent in 2007.[14] The slower growth occurred against the background of significantly higher energy prices and restrictive monetary policy in the major economies that prevailed prior to a reduction in interest rates towards the end of the year to counter the risks of economic recession. Mainly reflecting a rise in international oil prices, which peaked at USD99 per barrel in November before declining moderately towards the end of the year, inflation in advanced economies rose from 2 percent in 2006 to 2.4 percent in 2007. In South Africa, the target measure of inflation, CPIX,[15] rose from 5 percent in December 2006 to 8.6 percent in December 2007, breaching that country's target range of 3–6 percent.[16] The rise in CPIX reflected increases in food and fuel prices, as well as higher costs for housing services.

1.26 Domestic demand conditions in Botswana in 2007 were not supportive of low inflation. For the whole year, the annual growth of commercial bank credit to the private sector was significantly above the upper limit of the range of 11–14 percent, which was considered at the time to be consistent with the Bank's annual inflation objective of 4–7 percent. Demand pressures also rose due to faster expansion in government expenditure, which increased more rapidly than had been forecast in the budget for 2007/08.

1.27 Headline inflation fell from 8.5 percent in December 2006 to 8.1 percent in December 2007, remaining above the upper end of the annual inflation objective range of 4–7 percent. However, as it had fallen earlier in 2007, inflation was on average lower at 7.1 percent (compared to 11.6 percent in 2006) and was within the objective range for five of the twelve months. The major sources of upward pressures on inflation in the latter half of 2007 were increases in administered prices, particularly the cost of fuel, as well as food prices. Rising world prices for staple foods together with drought conditions prevailing for most of the year in the Southern African region influenced the faster increase in the cost of food domestically. Fuel prices were adjusted downwards in March 2007, but were subsequently increased in May, July and December, following renewed upward pressure on international oil prices. There were also significant increases in fees for public health services and domestic telephone tariffs charged by the Botswana Telecommunications Corporation. At the same time, overall inflation was moderated by stable and falling prices in some categories, including clothing and footwear, communications and items which benefited from the declining cost of new technology.

14. Figures and projections for global GDP growth and inflation are based on the *World Economic Outlook Update, January 2008* published by the IMF.

15. CPIX refers to the consumer price index excluding mortgage interest rates.

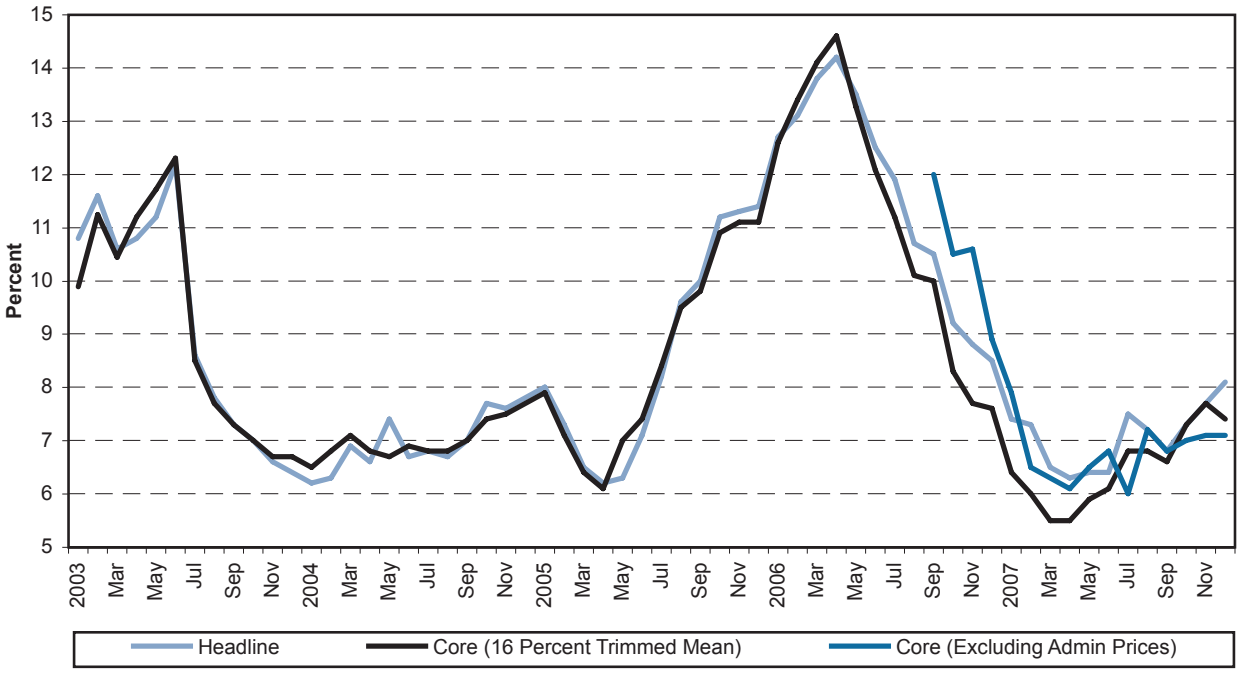
16. The CPIX breached the upper end of the target range in April 2007, for the first time since August 2003, and has stayed above it since.

1.28 In June 2007, the CSO commenced publication of two measures of core inflation, alongside headline inflation. The measures are the 16 percent trimmed mean and the CPI excluding administered prices. The 16 percent trimmed-mean method excludes goods and services that record price changes which are extreme compared to the median.[17] The core inflation measure, which excludes administered prices, removes items for which price changes are not necessarily in response to prevailing market forces, and the volatility inherent in prices that are only adjusted periodically.[18]

1.29 Along with the decline in overall CPI inflation, core inflation, excluding administered price items, fell during the year from 8.9 percent in December 2006 to 7.1 percent in December 2007. However, the trimmed mean measure of core inflation rose from 7.6 percent in December 2006 to 7.8 percent in December 2007.

1.30 The annual rate of change in the cost of tradeable goods and services rose significantly from 8 percent in December 2006 to 10.3 percent in December 2007, mostly reflecting the increase in prices of food items due to drought conditions in the region as well as rising fuel prices. Inflation for imported tradeables rose from 7 percent at the end of 2006 to 7.7 percent in December 2007 as inflation in South Africa (Botswana's major trading partner) had breached the upper end of its inflation target since April. Domestic tradeables inflation increased more rapidly over the same period, from 10.3 percent to 15.2 percent, thus reflecting the inclusion in this category of staple food items that were affected by drought. In contrast, non-tradeables decreased sharply from 9.5 percent in December 2006 to 3.4 percent at the end of 2007.

CHART 1.4: BOTSWANA HEADLINE AND CORE (16 PERCENT TRIMMED MEAN AND EXCLUDING ADMINISTERED PRICES) INFLATION

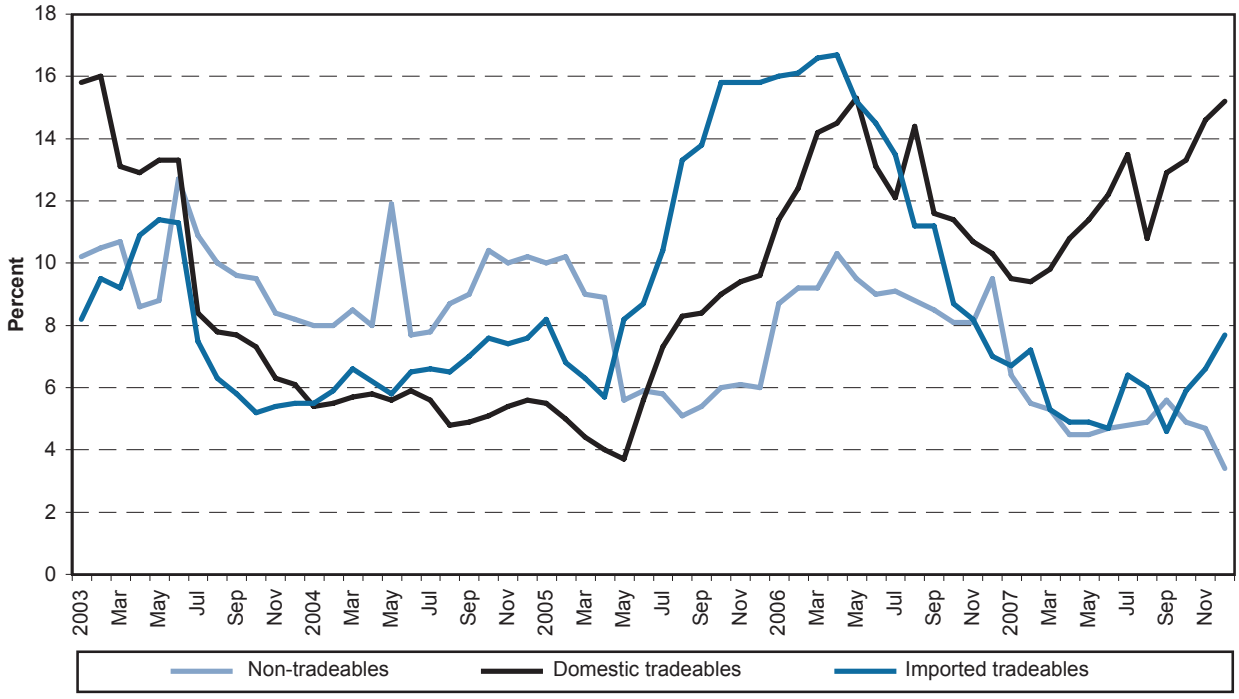


Source: Central Statistics Office and Bank of Botswana.

17. Each month, 8 percent (by weight) of the items comprising the CPI are excluded from both ends of an ordered series of the percentage price changes of the items.

18. Administered price items constitute 10.9 percent of the CPI basket.

CHART 1.5: INFLATION FOR TRADEABLES AND NON-TRADEABLES



Source: Central Statistics Office.

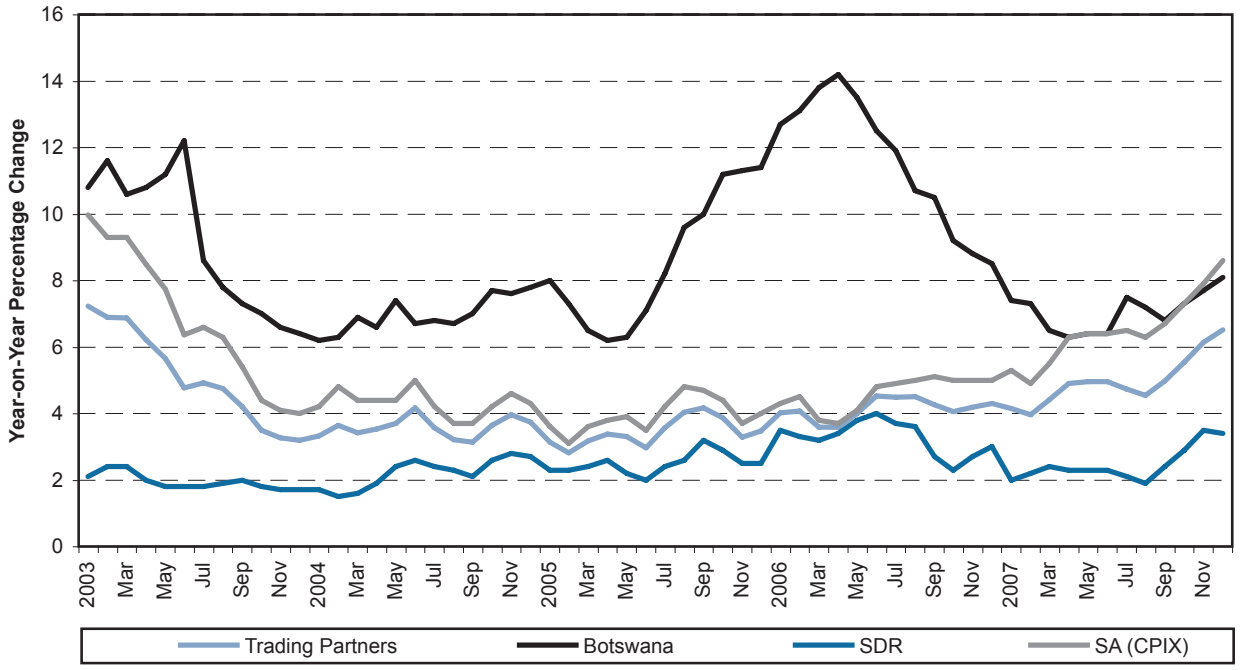
(e) Inflation Outlook

1.31 Global economic activity is expected to weaken in 2008, with forecast annual GDP expansion revised downward to 4.1 percent, compared to 4.9 percent in 2007. The lower growth is due to expected weaker performance across the advanced economies, especially in the USA, where there has been a sharp contraction in the housing market. However, it is expected that buoyant activity in the emerging market economies, especially China and India, will help maintain strong growth overall. Notwithstanding the robust output growth, global inflationary pressures are expected to be restrained by competitiveness in the goods market and productivity gains. However, although inflation expectations have continued to be well-managed, there are some upside risks due to the recent monetary policy loosening in some developed economies to counter the risks of slower growth. There are also risks of inflationary pressures due to capacity constraints in emerging markets. Although world inflation rose to 4.2 percent in 2007 from 3.5 percent in 2006, mainly reflecting the record increase in international oil prices, global inflation is forecast to decelerate to 3.4 percent in 2008. For the countries that make up the SDR (the euro zone, Japan, United Kingdom and USA), average inflation is forecast to fall to 2.1 percent in 2008 from 2.5 percent in the previous year. South African inflation is projected to remain above the upper end of the target range of 3–6 percent for most of 2008, but to fall within the target range by the final quarter of 2008, while it is expected to be around 5.6 percent by year-end, compared to the average of 6.9 percent in 2007. However, a large scheduled increase in electricity prices will contribute to upward pressures on inflation,[19] while the potential for a further increase in food and fuel prices will add further to the upside risks.

1.32 In Botswana, credit growth maintained an upward trend during 2007, remaining significantly above the upper end of the Bank

19. The National Electricity Regulator in South Africa has granted the state-owned power utility corporation, Eskom, permission to increase electricity tariffs by 14.2 percent in 2008 and 2009 in order to help meet the costs of constructing new power stations, upgrading the existing infrastructure and help curb growth in electricity consumption.

CHART 1.6: INFLATION IN BOTSWANA AND TRADING PARTNERS (JANUARY 2003 – DECEMBER 2007)



Source: Central Statistics Office and Bank of Botswana.

of Botswana's target range of 11–14 percent throughout the year. Credit growth peaked in November at 27.8 percent before easing to 24.4 percent in December. If the current high levels of credit growth are maintained, together with expansion in government spending that continues to be faster than budgeted, domestic demand pressures will accelerate, thus contributing negatively to the domestic inflation outlook. It is likely that higher electricity prices in South Africa, from where Botswana imports most of its energy requirements, will also feed to domestic inflation.

2. PUBLIC FINANCE AND THE 2008 BUDGET SPEECH

2.1 The 2008 Budget Speech covered the 2008/09 financial year, which is the last year of NDP 9. With NDP 10 scheduled to commence in April 2009, it was appropriate that the theme chosen for the speech was 'Accelerating the Achievement of *Vision 2016* through NDP 10'. This is especially since the projected achievement of the ambitious objectives of both *Vision 2016* and the Millennium Development Goals (MDGs) fall within the NDP 10 plan period. It was indicated in the Budget Speech that renewed private sector growth pointed to the success of various recent policy initiatives, including the introduction of the new crawling band exchange rate mechanism in 2005. However, it was also noted that further administrative reforms on the part of Government to ease the regulatory burden and delays in the provision of services were necessary to sustain robust economic performance.

(a) Budgetary Performance – 2006/07 and 2007/08

(i) 2006/07 Final Budget Outturn

2.2 The final budget outcome for 2006/07 was a surplus of P7.7 billion, which far exceeded the surplus of P4.4 billion in the revised budget announced in the 2007 Budget Speech. The substantial surplus resulted from a combination of two factors: first, the continued underspending of both the recurrent and development budgets resulting in P2.7 billion of unspent funds; and, second, total

revenues exceeding the budget by more than P600 million.

2.3 Total expenditure and net lending of P19.7 billion in 2006/07 represented underspending of P2.7 billion (13.5 percent), compared to the revised budget estimate of P22.4 billion. At P16 billion, actual recurrent expenditure was 5.7 percent, or P905 million, less than the P16.9 billion estimated in the revised budget. In comparison, development expenditure of P4.1 billion was 28 percent lower than the revised budget estimate of P5.6 billion.

2.4 Total receipts were P27.4 billion, up 2.2 percent on the revised estimate of P26.8 billion. Mineral revenue was P1.7 billion above budget due to a 6 percent increase in diamond sales, and there were also slightly higher receipts from the Bank of Botswana (P19 million) and Value Added Tax (VAT – P57 million). However, these were offset by shortfalls in other revenue categories; most notably, the rescheduling of a windfall payment from the Southern African Customs Union (SACU) meant that this category was P751 million below budget. In addition, slower than expected growth in non-mineral income tax led to a shortfall of P243 million.

(ii) 2007/08 Revised Budget

2.5 The original budget estimates for 2007/08 anticipated a surplus of P738 million.[20] This remained virtually unchanged in the revised budget at P787 million. Total revenues and grants in both the original and revised budgets amount to P27.2 billion, while the revised estimate for total expenditure and net lending, at P26.4 billion, shared a marginal fall of P50 million. Development expenditure was revised upwards by P464 million to P7.7 billion in light of improvements in project implementation. However, despite additional resources allocated to accommodate the new Ministry of Youth, Sports and Culture, recurrent spending was P513 million lower overall.

2.6 The MTR of NDP 9 had set a target of 27 percent of total expenditure for development spending in 2007/08. This was surpassed in the revised budget where the share rose to 29.3 percent. However, in the previous year,

TABLE 1.2: GOVERNMENT BUDGET 2006/07 - 2008/09 (P MILLION)

	2006/07			2007/08		2008/09
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	**24 144**	**26 797**	**27 397**	**27 179**	**27 178**	**29 889**
Mineral	11 045	11 374	13 114	10 890	10 890	10 558
Non-mineral	11 222	15 423	14 283	16 289	16 288	19 331
Expenditure	**23 222**	**22 409**	**19 737**	**26 441**[1]	**26 391**	**30 220**
Recurrent	17 234	16 861	15 954	19 245	18 732	21 836
of which Personal Emoluments	5 998	5 556	5 801	7 086	6 689	7 910
Development	6 035	5 595	4 055	7 257	7 720	8 500
Net lending	-47	-47	-271	-61	-61	-116
Balance	**922**	**4 388**	**7 660**	**738**	**787**	**-331**

1. The expenditure budget shown for 2007/08 includes a provision for the 6 percent increase in government salaries. This was not shown in the documents which accompanied the 2007 Budget Speech, but was subsequently included with the Budget Speech on the Government website (www.gov.bw).

Source: Government of Botswana.

20. This includes the costs of the 6 percent salary increase that was not included in the original budget estimates (see note 1, Table 1.2).

although the budgeted development spending was 25 percent of total expenditure, the final outturn was only 20.5 percent. The shortfall in the share of development budget was due to inadequate capacity to implement projects which, despite recent improvements, still remains a potential constraint on spending.

(b) 2008/09 Budget Proposals

(i) Budget Balance

2.7 The budget for 2008/09 is in broad balance and projecting a modest deficit of P331 million. This is based on total revenue and grants estimated at P29.9 billion and set against total expenditure and net-lending of P30.2 billion. However, the expenditure estimate did not include any provision for adjustments to public service salaries (see below).

(ii) Revenue

2.8 The estimate for total revenue and grants in 2008/09 is 10 percent higher than the revised budget for 2007/08. Although continuing as the principal source of government revenue, mineral receipts comprise 35.3 percent of the total, compared to an average of 39 percent in the first half of NDP 9. This decline is due to the combined effects of a 3 percent decrease in total mineral revenues arising from lower forecast profits for Debswana in 2008 together with continued growth in other revenue sources.

2.9 The second largest source of revenue is payments from SACU, which is expected to increase by 10.5 percent to P8.2 billion. SACU revenues have grown at an average annual rate of 38.1 percent over the past four years and now comprise 27.4 percent of the revenue budget compared to only 13.9 percent at the start of NDP 9. This reflects the combined effect of an increase in imports into the SACU region and the impact of the new revenue sharing formula introduced in 2004/05. Non-mineral income tax is expected to grow by 39.6 percent to P5 billion, while collections of VAT are budgeted to increase by 13.1 percent to P2.9 billion. As a result, the share of non-mineral taxes in total revenue is 26.9 percent.[21] This compares to 23.4 percent in the first half of NDP 9 and, in the context of rapidly rising overall revenues, is an important indicator of success in diversification away from dependence on mineral revenues.

2.10 Payments to government from the Bank of Botswana have been set at P1.3 billion for 2008/09, the largest amount since the method for calculating this revenue item was changed in 1997/98. The amount, which is the minimum payable,[22] was based on an assumption of a 4.75 percent SDR-denominated rate of return on the Pula Fund.

(iii) Expenditure

2.11 The 2008/09 budget for expenditure and net lending amounts to P30.2 billion and it is 14.5 percent higher than the revised budget for 2007/08. Growth in recurrent expenditure excluding the costs of the salary adjustment for public servants is set at 16.5 percent while budgeted growth in development spending is 10.1 percent.

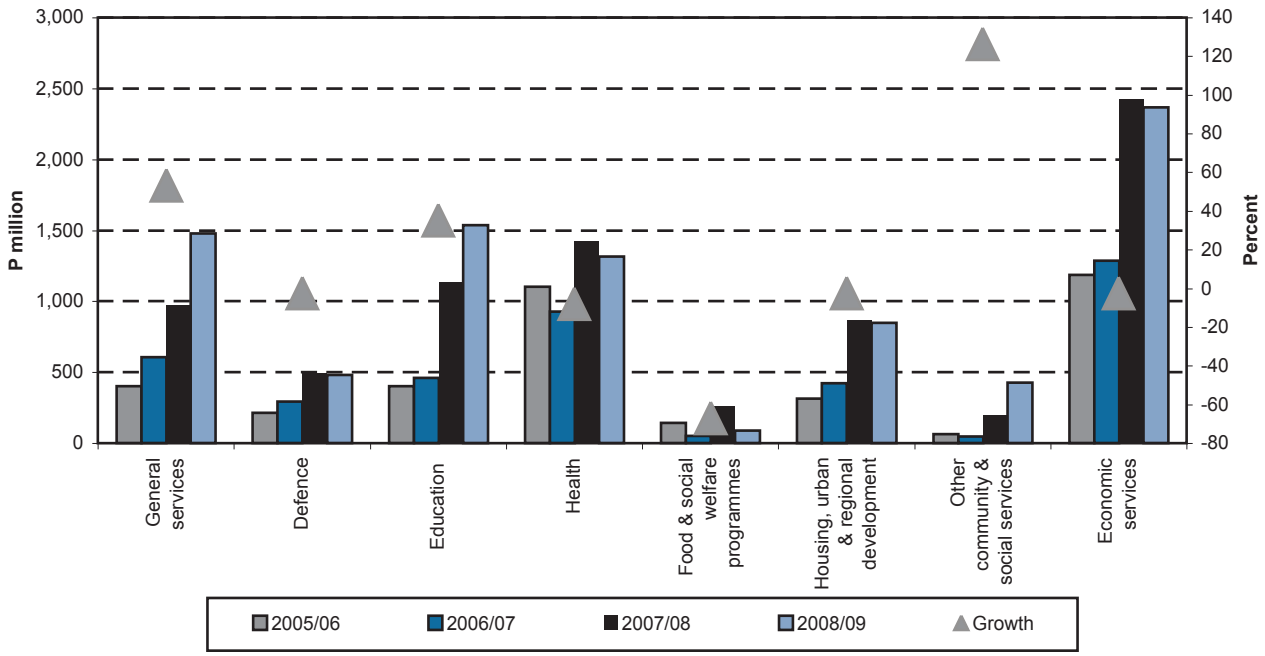
2.12 Within the recurrent estimates, which make up 72.3 percent of total expenditure, 93.3 percent is for ministerial allocations, while the remainder is for statutory expenditure items, the largest of which is the P774 million government contribution to the Public Officers Pension Fund. The ministry of education accounts for 26.8 percent of the total ministerial budget of P20.6 billion, followed by the ministry of local government with 17.4 percent.[23]

21. As well as income tax and VAT, non-mineral domestic taxes also include assorted minor taxes (on property and motor vehicles, for example) and licence fees.

22. If the return on investments is higher than expected, then the payment can increase. This happened in 2006/07 when the Bank of Botswana paid an additional P19 million on top of the originally agreed payment of P550 million.

23. However, about two thirds of the allocation to local government is for revenue support grants to local authorities.

CHART 1.7: DEVELOPMENT SPENDING BY ECONOMIC SECTOR (2005/06-2008/09)



Source: Government of Botswana.

2.13 The government budget is being supported by an increase in the manpower establishment for central government, by an average of 4.4 percent during NDP 9, compared to the original target of 1.9 percent.[24] This growth had been allowed on the basis that key projects and programmes, including the accelerated expansion of health and education services, both of which are labour intensive, had either underestimated manpower requirements, or had not been originally included in NDP 9.

2.14 The development budget for 2008/09 of P8.5 billion, of which 6.8 percent is expected to be financed through donor funding (loan and grants), accommodates all projects planned for NDP 9 for which ministries have made submissions. However, it was noted that, in order to expedite implementation, ministries would have the flexibility to reassign funds from slow- to fast-spending projects, and that those that remain would be carried over to NDP 10.

2.15 A detailed breakdown of the development budget by economic sector[25] is shown in Chart 1.7. The allocation of P2.4 billion for economic services represents the largest share of 27.8 percent and is for funding large infrastructure investments, including airport redevelopment and the extension of electricity and water supplies. The second largest share (P1.5 billion or 18 percent) is for education, of which almost half is to fund the fast-tracking of four new senior secondary schools.

(iv) Public Service Salaries

2.16 The Government announced an across-the-board salary increase of 15 percent, which followed a review of remuneration levels and salary structure by two distinct commissions for the civil service and the political leadership. The overall cost of the package, which is also expected to cover workers in local government and government funded agencies and parastatals, is projected at P1.7 billion, or approximately 2 percent of

24. Excluding the Botswana Defence Force (BDF).

25. Sectoral allocations do not necessarily match those of individual ministries. In particular, responsibilities for implementing both health and education programmes are shared by more than one ministry.

the Government's forecast GDP for 2008/09. Given that the Government had stated that funding of the salary increment would not be done at the expense of cutbacks on other spending programmes, the budget deficit would be about P2 billion. Even before taking into account the likelihood of underspending elsewhere in the budget, this is comfortably within the upper limit of P2.5 billion that is consistent with the fiscal rule that limits total expenditure to 40 percent of GDP, as well as being in line with keeping the deficit to less than 3 percent of GDP.

(c) Fiscal Legislation

2.17 For the second year in succession, there were no new tax-related proposals. The only outstanding issue is the proposed Tax Administration Bill, the draft of which should be finalised by mid-year. The aim is to harmonise and simplify procedures under various tax laws to enhance the efficiency of the Botswana Unified Revenue Service (BURS).

2.18 However, the Government has indicated that the tax regime would be extensively reviewed in the next financial year in order to enhance the investment climate and improve the competitiveness of the economy. It was stressed that any reforms would be introduced gradually to ensure that, while they improve the investment climate, they do not lead to any significant revenue loss that would constrict the Government's financial resources, especially at a time when the likely stagnation of mineral revenues requires greater reliance on other revenue sources.

(d) Other Policy Announcements in the 2008 Budget Speech

2.19 To support the development of capital markets the Government has, since March 2008, started a regular programme of issuance of bonds and treasury bills with maturities ranging from 6 months to 12 years.[26] The programme, which is intended to support capital market development, is expected to also contribute to a reduction in the overall costs of implementing monetary policy and facilitate financing of major infrastructure projects planned for NDP 10.[27]

2.20 The Government has established an investment trust fund, Privatisation Asset Holdings. This government owned fund will warehouse shares and other assets from privatised entities and should help allay fears that there will be limited opportunities for citizens to benefit from privatisation. The Government's shares in the Botswana Building Society have already been transferred to the fund. It was further announced that the International Finance Corporation (IFC) has been appointed as the transaction advisor for the impending privatisation of the Botswana Telecommunications Corporation (BTC), while a strategy to privatise the National Development Bank (NDB) was in progress.

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 through a stable real effective exchange rate (REER). The crawling band exchange rate mechanism introduced in May 2005 is the means towards achieving REER stability and competitiveness through a continuous adjustment of the Pula at a rate equal to the differential between the Bank of Botswana's inflation objective and forecast inflation of trading partner countries. For the

26. The programme commenced in early March with the auction of treasury bills and bonds amounting to P1.3 billion and included a replacement of the P850 million five-year bond that had matured.

27. The Government had previously indicated that the proceeds from rolling over the five-year bond would go to the Tertiary Education Development Fund.

whole of 2007, nominal effective exchange rate (NEER) of the Pula depreciated by 2.9 percent.

TABLE 1.3: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES:
NOMINAL EXCHANGE RATES (FOREIGN CURRENCY PER PULA)

As at end of	2006	2007	Percentage Change
SA rand	1.1565	1.1318	–2.1
US dollar	0.1658	0.1665	0.4
Pound sterling	0.0844	0.0833	–1.3
Japanese yen	19.71	18.63	–5.5
SDR	0.1102	0.1053	–4.4
Euro	0.1259	0.1129	–10.3
NEER[1]	99.0	96.1	–2.9
Real Pula Exchange Rate Indices (September 2006 = 100)			
SA rand[2]	97.4	95.7	–1.8
SA rand[3]	96.2	93.4	–2.9
US dollar	107.1	111.8	4.3
Pound Sterling	100.5	103.1	2.6
Japanese yen	107.4	109.1	1.5
Euro	102.5	96.4	–5.9
SDR	104.7	104.6	0.0
REER (Core) [1,2]	99.9	98.9	–1.0

1. Index, September 2006 = 100.
2. Calculated using South African core inflation, which excludes mortgage interest costs and prices of various volatile food items.
3. Calculated using South African headline inflation.

Source: Bank of Botswana.

3.2 Bilaterally, the Pula depreciated in nominal terms against most of the major international currencies during 2007. Against the SDR constituent currencies, the Pula depreciated by 10.3 percent, 5.5 percent and 1.3 percent against the euro, the Japanese yen and the British pound, respectively, while appreciating marginally (0.4 percent) against the US dollar. Overall, the nominal depreciation of the Pula against the SDR was 4.4 percent. Against the South African rand, the Pula depreciated by 2.1 percent, which is a reflection of a strengthening of the rand against the US dollar. The rand appreciated by 2.6 percent against the dollar during 2007 underpinned by an increase in the price of gold, which peaked at USD843 per ounce due to broad dollar weakness. The increase in interest rates by the South African Reserve Bank (SARB) at a time when the US Federal Reserve was cutting rates in an effort to forestall the threat of economic recession also contributed to the appreciation of the rand.[28]

3.3 During 2007, the REER remained broadly constant, depreciating by only 1 percent. However, bilateral movements in real exchange rates were varied. The Pula appreciated in real terms against the major international currencies, reflecting higher inflation in Botswana. This was with the exception of the euro, where the nominal depreciation had been large enough to offset the inflation differential between Botswana and the euro area. The real depreciation against the rand was similar to the movement in the nominal exchange rate, thus reflecting the convergence of inflation rates in Botswana and South Africa.

3.4. The stability of the REER, which has been maintained since 2006, indicates that the crawling band mechanism continues to work well, and is supportive of the competitiveness of the domestic industry. However, a higher level of productivity, rather than a reliance solely on adjustment of monetary and exchange rate policies, is the key to sustaining international competitiveness.

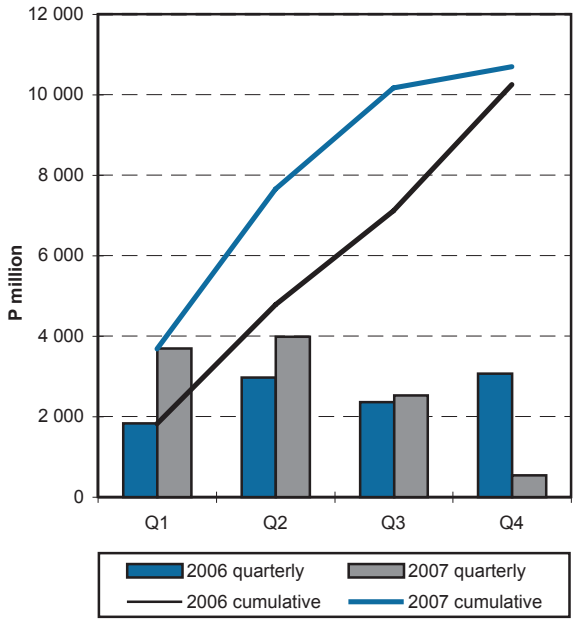
(b) Overview of the Balance of Payments

3.5 Measured by changes in the level of foreign exchange reserves, the overall external balance for 2007 was P10.7 billion,[29] an increase of P438 million (4.3 percent) compared to P10.3

28. By November 2007, the SARB's key repo rate had reached 11 percent from 9 percent early in the year. In contrast, in the US, the benchmark federal funds rate fell from 5.25 percent in July to 4 percent at year-end.
29. The overall balance is equal to the change in total official reserves adjusted for unrealised market and currency revaluation gains/losses.

billion in 2006. Chart 1.8 shows the quarterly breakdown of the overall surplus for 2006 and 2007.[30] It is notable that most of the surplus was accumulated in the first half of 2007. In particular, the surplus in the fourth quarter was substantially lower than in the same period in 2006 due to lower growth of exports.

CHART 1.8: QUARTERLY BALANCE OF PAYMENTS – 2006-2007



Source: Bank of Botswana.

(i) Current Account

3.6 The current account is the sum of the balance of trade in goods and services, the income account and current transfers. This shows an estimated surplus of P12.1 billion in 2007, compared to P11.3 billion in the revised estimates for 2006 (an increase of 7 percent). This was mainly accounted for by the merchandise trade surplus which amounted to P10 billion or 80.5 percent of the current account surplus. However, this was lower than in 2006 as imports of goods grew much faster than exports as diamond sales slowed; in turn, the increase in the overall current account surplus was due to growth in net current transfers. Despite narrowing slightly, the income account deficit remained high, while the deficit on the services account continued to increase.

Merchandise Trade

3.7 Total exports in 2007 are estimated at P30.8 billion, which is an increase of 16.9 percent over the revised estimate for 2006 of P26.4 billion.[31] Mining exports continued to perform strongly, driven by rising copper-nickel exports, which increased by 44.5 percent. Production volumes of copper-nickel remained similar to those of 2006,[32] with favourable price effects explaining the increase in value. The international prices of both copper and nickel continued to increase, averaging 326 US cents per pound (up from 305 cents per pound in 2006) and 1 769 cents per pound (up from 1 100 cents per pound), respectively, in 2007. Disaggregated export data also show the growing importance of copper/nickel ore and concentrates, which in 2007 made up 20.2 percent of total primary copper exports compared to 9 percent in 2006.[33] This is in addition to the traditional exports of matte. Diamond exports increased by 3.9 percent, from P19.7 billion in 2006 to P20.5 billion, as higher prices were offset by slightly lower production. Gold exports also benefited from record prices, which averaged USD697.4 per ounce in 2007 compared to USD604 per ounce in 2006, but foreign sales of soda ash slowed in 2007 compared to a strong performance in 2006.

30. The Bank of Botswana has recently started publishing regular estimates of quarterly balance of payments statistics. This commenced in the February edition of the Botswana Financial Statistics (BFS) and the estimates are also included in the statistical section of this report (Table 6.3). The production of quarterly estimates also resulted in some further revisions to the annual estimates for 2004 and 2005.

31. The data on exports used for compiling the balance of payments may differ from that published in the trade statistics published by the CSO. This is because different data sources are used to collect data on major exports, which can result in some discrepancies.

32. Production volumes were held back due to the temporary shutdown for maintenance of the smelter at the Selebi-Phikwe mine.

33. This was previously included along with the 'other exports' category. Ore differs from matte as it is unprocessed.

TABLE 1.4: BALANCE OF PAYMENTS: 2003 – 2007 (P MILLION)

	2003	2004	2005*	2006*	2007#
Current Account	2 288	1 641	7 972	11 319	12 114
Of which:					
Merchandise trade	4 441	3 904	8 982	11 115	9 955
Services	–46	–237	–154	–372	–810
Income	–3 543	–4 496	–4 293	–4 509	–4 017
Net current transfers	1 436	2 469	3 437	5 086	6 986
Capital account	111	149	349	142	493
Financial account	–1 875	–1 556	–774	–1 030	–1 398
Net errors and omissions	272	–558	–507	–174	–516
Overall balance	797	–324	7 036	10 256	10 694

* Revised

\# Preliminary

Source: Bank of Botswana.

TABLE 1.5: MERCHANDISE IMPORTS 2006 - 2007 (C.I.F.)[1]

	2006		2007		
	P million	Share in Total (percent)	P million	Share in Total (percent)	Annual Percentage Change
Total imports, o.w.	17 902		24 510		36.9
Food, beverages & tobacco	2 488	13.9	3 242	13.2	30.3
Fuel	3 083	17.2	3 859	15.7	25.2
Machinery & electrical equipment	2 966	16.7	4 607	18.8	53.8
Vehicles & transport equipment	1 738	9.7	2 802	11.4	61.2

1. The total imports used in this table are higher than the P20.9 billion shown in paragraph 3.10. This is because, for balance of payments purposes, imports are calculated free on board (f.o.b.) with the costs of carriage, insurance and freight (c.i.f.) being classified as imports of services.

Source: Central Statistics Office.

3.8 After several years of stagnation, the rapid growth in beef exports that commenced in mid-2006 continued in 2007 with a total export value of P592 million compared to P363 million the previous year (63.1 percent increase).[34] This reflected both an increased number of cattle being slaughtered, following an increase in producer prices in 2006, and the exchange rate effects resulting from a gradual depreciation of the Pula against European currencies.

3.9 After stagnating in 2006, exports of textiles grew substantially by 138.4 percent in 2007, from P917 million in the previous year to P2.19 billion. The other non-traditional exports were also buoyant in 2007 and included iron and steel products (by 15.6 percent), machinery and electric equipment (60.4 percent), plastic and plastic products (39.1 percent). Meanwhile, the 'other goods' category, which includes such varied products as pasta, chewing gum, biscuits and veterinary vaccines, grew by an estimated 11.3 percent to P650 million. The composition of this category continues to be revised as rapidly-growing items (e.g. copper/nickel ore) are allocated to other categories.

3.10 Total imports in 2007 are estimated at P20.9 billion, a 36.8 percent increase from P15.3 billion in 2006. This increase is accounted for by significantly higher foreign purchases of food, beverages and tobacco, fuel, machinery

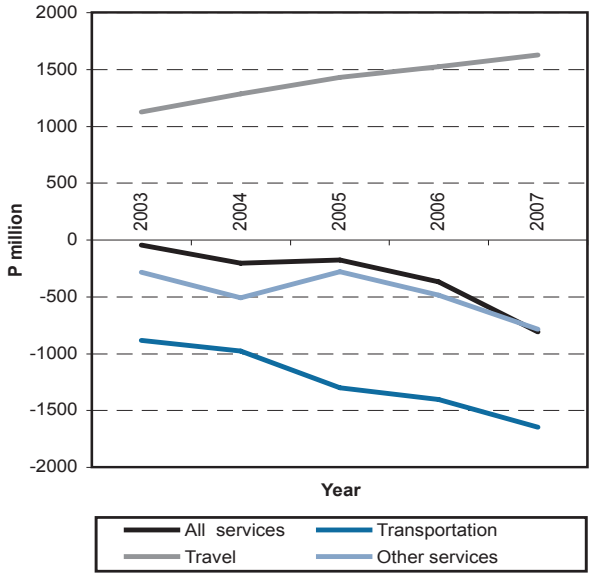
34. The Botswana Meat Commission has a monopoly on beef exports from Botswana.

and electrical equipment, as well as vehicles and transport equipment. In particular, imports of machinery and electrical equipment and vehicles and transport equipment rose very rapidly, by 53.8 percent and 61.2 percent, respectively, reflecting renewed growth in the economy and associated increase in investment spending. However, fuel imports grew by a lower annual rate of 25.2 percent in 2007, down from 39.1 percent in 2006. Meanwhile, imports of food, beverages and tobacco increased by 30.3 percent in 2007 compared to 10.9 percent in 2006, reflecting rising food prices. During the year, rough diamonds became a significant import and accounted for 3.1 percent of total imports in 2007. This reflects the commencement of operations by additional cutting and polishing factories prior to coming into effect of the new arrangement under which they will source supply directly from DTCB.

Trade in Services

3.11 The services account covers payments for transportation, travel and other service-related transactions between residents and non-residents. In 2007, this account is estimated to have recorded a deficit of P810 million, compared to the revised estimate for the 2006 deficit of P372 million. The growing deficit and the revision for 2006 from an initial estimate of a modest surplus, is largely attributed to higher transport usage, freight in particular, associated with the growth in imports of goods, as well as the increase in imports of 'other services'.[35] For 2006, an initial estimate of P536 million for other service imports was revised to P1.4 billion. This rose further to P2.1 billion in 2007, an increase of 55.2 percent. Both the revisions and the subsequent growth can be traced in large part to activity in the mining sector, reflecting imports of services to support mineral prospecting and mine development. In contrast there was a modest increase in the surplus on the travel account, which grew by 6.9 percent to P1.6 billion due to rising travel-related spending by non-residents in Botswana. Chart 1.9 shows the trend in the main components of the services account from 2003 to 2007.

CHART 1.9: BALANCE OF TRADE IN SERVICES (2003 – 2007)



Source: Bank of Botswana.

Income Account

3.12 The income account registered a deficit of P4 billion in 2007 compared to the revised estimate of P4.5 billion in 2006. The credit side of this account is mainly the earnings from the foreign exchange reserves and international investments by pension funds. The debit components consist of dividends and profits of foreign companies operating in Botswana, and include both actual remittances and retained earnings. Retained earnings, which have contributed to substantially higher income debits in recent years are matched by an equivalent imputed inflow, representing an inward investment, in the financial account.

35. This category covers a whole range of services, including communication, insurance, legal services, property rental, mining, business services, etc. It should be noted that there is a significant margin for error in the data for this item which relies on monthly data on purchases and sales of foreign exchange submitted by the commercial banks. These should detail the purpose of all the transactions. However, since the abolition of exchange controls the quality of information has deteriorated, as there is no longer a legal requirement for supporting documentation regarding the purpose of transactions.

Current transfers

3.13 In 2007, the surplus on current transfers was P7 billion, representing 58 percent of the overall current account surplus. This item has grown rapidly in recent years; it reflects the buoyancy of net receipts from the Southern African Customs Union (SACU), which were P5.7 billion in surplus. Government transfers (withholding tax in particular) and net private transfers (mainly remittances from Batswana living abroad) of P528 million also contributed to the surplus in this account.

(ii) Capital and Financial Accounts

3.14 The capital account mainly comprises capital grants to government and the transfer of migrants' assets. The surplus on this account rose significantly from P142 million in 2006 to P493 million in 2007, due to the increased inflows of capital grants.

3.15 The financial account which comprises direct investment, portfolio investment and 'other' investment shows an estimated net outflow of P1.4 billion compared to P1 billion in 2006. The main source of the financial account deficit continued to be the outflow of portfolio investment assets estimated at P2.6 billion and the P1.5 billion net outflows in 'other investments', mainly from commercial banks. The net inflow of direct investment is estimated at P2.7 billion in 2007 (6.9 percent increase over the revised estimate for 2006) and mostly reflecting retained earnings.[36]

(iii) Foreign Exchange Reserves

3.16 Official foreign exchange reserves were P58.5 billion at the end of 2007, P10.7 billion (22.4 percent) more than at the end of 2006 and equivalent to 26 months of imports of goods and services. The decline in import cover from 30 months at the end of 2006 was due to the rapid growth of imports during the year.[37] In SDR terms, the increase was lower at 16.5 percent and reflected the depreciation of the Pula during 2007 against most international currencies. In US dollar terms, the growth of reserves was slightly faster at 22.5 percent.

(c) Balance of Payment Outlook

3.17 In the medium term the current account surplus is expected to narrow. Although merchandise exports will continue to increase, both from mineral and non-mineral products, imports are expected to grow at a much faster rate. This reflects rapid growth in capital imports required for major infrastructure and mining-related investments. These will also increase the deficit on transport services. In contrast, the surplus on travel services will benefit from increased tourism activity in Botswana, especially in the build up to the soccer World Cup to be held in South Africa in 2010. Also in support of major investments, imports of other services are likely to increase, although this is likely to be offset to some extent by development of internal capacity. Net current transfers will remain in overall surplus due to receipts from SACU, although growth in these payments is expected to be less rapid than in recent years.

3.18 Narrowing current account surpluses are expected to be countered by increased surpluses on the capital and financial accounts. These are expected due to inflows arising from inflows of portfolio and direct investment, as well as other investment in the form of loans to finance private sector developments in the mining and tourism sectors. The overall balance of payments is thus expected to remain in surplus.

36. Investment by foreign companies financed by borrowing from abroad (except in the case where borrowing is from a related company) does not count as direct investment, but as 'other investment'. The total capital cost of a foreign-financed project is, therefore, often a poor guide to the extent of FDI in the country.

37. In 2006 the average monthly value of imports of goods and services was P1.68 billion. In 2007 this rose to P2.24 billion, an increase of 33.6 percent.

(d) International Investment Position (IIP) and Foreign Investment

3.19 Detailed data for the IIP, which records the stock of foreign financial assets and liabilities, are available up to 2006. With regard to 2007, only major aggregates have been estimated, using information based on financial flows during the year.

(i) International Investment Position in 2007

3.20 Based on the 2007 preliminary estimates, Botswana's foreign assets increased from P76.2 billion at the end of 2006 to P90.5 billion as at December 2007 and were mostly constituted by reserve assets (64.6 percent), which grew by 22.2 percent to P58.5 billion. Portfolio investment increased at a lower rate of 13.9 percent from P18.8 billion to P21.4 billion, while direct investment abroad by Botswana grew by 6.8 percent to P4.9 billion, and 'other investment' rose by 18.3 percent to P5.7 billion.

3.21 Total foreign liabilities at the end of 2007 were P18.7 billion, which is an increase of P2.9 billion from P15.8 billion in 2006. Of this increase, 44 percent was due to inward direct investment.

(ii) Investment in Botswana in 2006 by Industry and Country

3.22 Tables 1.6 and 1.7 show Botswana's stock of foreign liabilities at the end of 2006 classified by industry and country, respectively.[38] This indicates that, as at the end of the survey period, foreign direct investment into the finance sector industry was slightly higher than in the mining sector, due mainly to investment in the insurance industry.[39] Europe continued to dominate (45.8 percent) as the main source of direct investment. Luxemburg makes up 84.5 percent of Europe's total investment in Botswana and reflects the residence status of major mining investors in the country.

3.23 In 2006, Africa became the dominant source of 'other investment' at P3 589 million, followed by Europe at a slightly lower level of P3 559 million. South Africa made up the bulk of Africa's investment in Botswana at 69.4 percent, while Germany was the main source of European investment in this category due to a loan extended to the mining industry in 2005. The 'other investments' were dominated by the finance sector at 38.5 percent; followed by the mining sector with 30.5 percent. The Government's external debt which is classified under public administration registered 22 percent.

4. MONEY AND CAPITAL MARKETS

(a) Monetary Policy and Liquidity Management

4.1 Monetary policy aims to contribute to macroeconomic stability through achieving low, predictable and stable inflation. This should foster stability of the REER, and thereby contribute towards international competitiveness of domestically produced goods and services. In 2007, the Bank of Botswana maintained the annual inflation objective of 4–7 percent and the medium-term objective of 3–6 percent. The medium-term inflation objective was introduced in 2006 in recognition of the fact that the monetary policy transmission process from changes in interest rates to annual price changes takes a long time. The medium-term inflation objective is, therefore, intended to anchor inflation expectations beyond the short term and affords the Bank sufficient time to direct policy actions to the sources of inflation that are directly under the influence of monetary policy.

4.2 This approach to monetary policy formulation has been reinforced by the announcement in the 2008 Monetary Policy Statement that

38. These figures are based on the 2006 Balance of Payments Survey conducted by the Bank of Botswana. Note that the figures refer to aggregate stocks of investment at the end of the year rather than new investment during the year.

39. However, while this appears to be a reversal of the previous dominance of mining, the data need to be treated with caution and may be subject to revision. In particular, the survey coverage and response rates need further improvement to fully pick up recent trends.

TABLE 1.6: STOCK OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY, END OF 2006 (P MILLION)

	Direct Investment			Other Investment		
Industry	**Equity**	**Non-Equity**	**Total**	**Equity**	**Non-Equity**	**Total**
Mining	3 134	0	3 134	0	2 967	2 967
Manufacturing	61	28	88	0	149	149
Finance	3 295	0	3 295	4	3 744	3 748
Retail and Wholesale	44	94	138	0	212	212
Electricity, Gas and Water	0	0	0	0	287	287
Real Estate and Business Services	41	0	41	0	90	90
Transport, Storage and Communication	34	53	87	0	78	78
Construction	5	3	8	0	24	24
Hospitality	19	1	20	0	2	2
Public Administration	0	0	0	0	2 143	2 143
Other	0	23	23	0	41	41
Total	**6 633**	**202**	**6 835**	**4**	**9 737**	**9 741**

Source: Bank of Botswana.

TABLE 1.7: STOCK OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY, END OF 2006 (P MILLION)

	Direct Investment			Other Investment		
Country	**Equity**	**Non-Equity**	**Total**	**Equity**	**Non-Equity**	**Total**
North and Central America	**420**	**759**	**1 179**	**0**	**103**	**103**
of which:						
United States	416	0	416	0	103	103
Europe	**3 060**	**73**	**3 133**	**0**	**3 559**	**3 559**
of which:						
United Kingdom	352	19	371	0	764	764
Netherlands	51	1	52	0	0	0
Luxemburg	2643	0	2 646	0	20	20
Germany	0	0	0	0	0	0
Other Europe	13	54	67	0	2 775	2 775
Asia Pacific	**41**	**19**	**60**	**0**	**457**	**457**
Africa	**2 283**	**145**	**2 428**	**4**	**3 585**	**3 589**
of which						
South Africa	2 035	143	2178	4	2 487	2 491
Middle East	**33**	**0**	**33**	**0**	**153**	**153**
Other	**2**	**1**	**3**	**0**	**1 881**	**1 881**
Total	**5 839**	**997**	**6 835**	**4**	**9 737**	**9 741**

Source: Bank of Botswana.

the Bank will, henceforth, focus only on the medium-term horizon for policy formulation, based on an assessment of the monetary policy transmission path to price changes. Moreover, improvements in policy analysis have enabled the Bank to use a more inclusive inflation forecast as an intermediate target that informs a systematic response to deviations from the inflation objective. This is in place of the annual growth in credit to the private sector, which is affected by other influences unrelated to changes in monetary policy while it is also one among

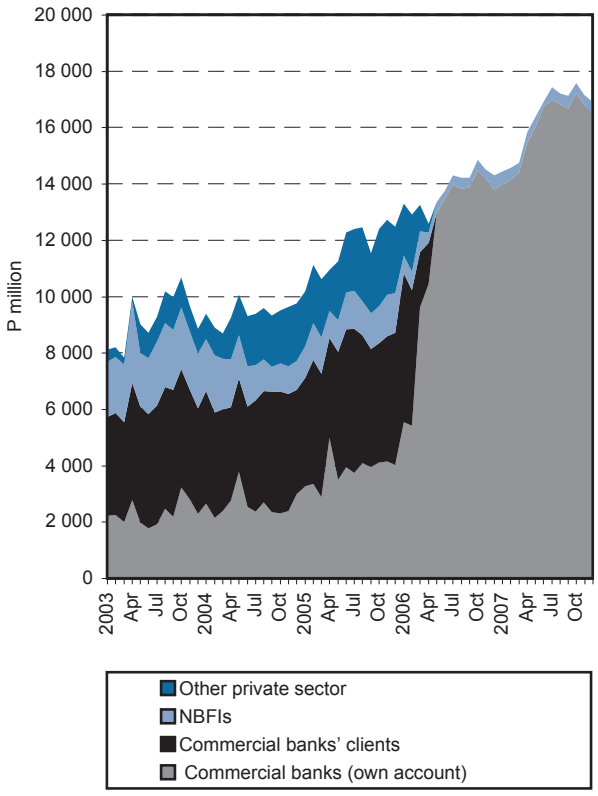
several influences on price developments. The inflation forecast, on the other hand, is more comprehensive as it is based on an assessment of prospective developments with respect to a broad range of factors.

4.3 Inflation maintained a downward trend in the first half of 2007 and was within the 2007 annual objective range for four consecutive months to June as the impact of earlier administered price increases dissipated.[40] In consideration of the positive inflation outlook, the Bank Rate was reduced by 50 basis points to 14.5 percent in June 2007. With the exception of September when inflation fell to 6.8 percent, it was above the inflation objective in the latter half of the year due mainly to the increase in food and fuel prices.

4.4 The Bank conducted open market operations to manage excess liquidity in the domestic banking system to ensure that short-term interest rates, particularly yields on Bank of Botswana Certificates (BoBCs), were consistent with the relatively restrictive monetary policy stance.[41] Consequently, the nominal 3-month BoBC rate ranged between 11.90 percent and 12.72 percent in 2007, while the 14-day BoBC rate[42] fluctuated within a range of 11.96 – 12.74 percent, with the highest yield occurring in January 2007.[43] The one-year BoBC that was re-introduced in March 2006 was discontinued in November 2007 due to weak demand; there was also a need to streamline monetary policy instruments and operations.

4.5 The total outstanding market value of BoBCs increased by 18 percent between end-2006 and end-2007 to P16.9 billion, compared to 14.5 percent a year earlier. Commercial banks held 97.8 percent of total outstanding BoBCs at the end of the year while the remainder was held by a merchant bank. [44]

CHART 1.10: OUTSTANDING BANK OF BOTSWANA CERTIFICATES (BoBCs)



Source: Bank of Botswana.

(b) Interest Rates

4.6 Following the 50 basis points decrease in the Bank Rate to 14.5 percent in June 2007, commercial banks lowered their prime lending rates by the same magnitude to 16 percent. Deposit rates were also reduced, but to a lesser extent, with the average rate on commercial banks' 88-day deposits falling from 8.38 percent in December 2006 to 8.28 percent as at end-2007.

4.7 There were larger movements in real money market interest rates during 2007 that reflected variability in inflation over the course of the year. The real 3-month BoBC rate averaged

40. Prices of meat products increased sharply in early 2006 following the 40 percent increase in cattle producer prices and the re-introduction of fees in government secondary schools; this contributed 1.1 percentage points to inflation.

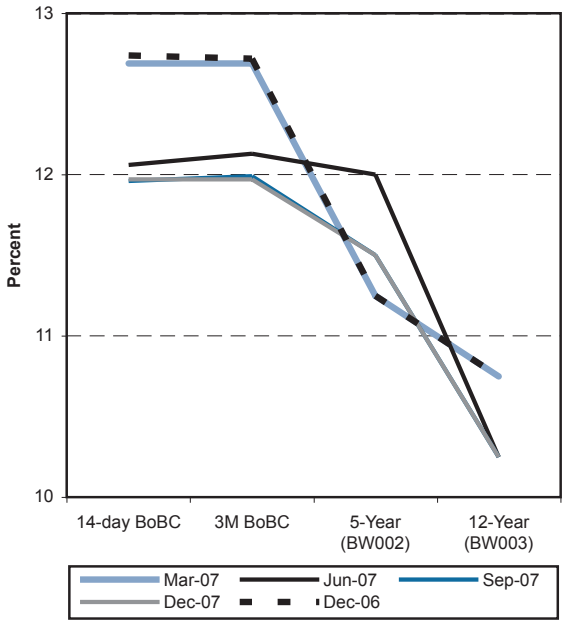
41. In response to the Bank Rate cut by 50 basis points in June, the 14-day and 3-month BoBC rates fell by the same magnitude.

42. The 14-day BoBC was introduced in November 2004 to enhance liquidity absorption at the short-end of the domestic money market.

43. The 14-day and 3-month BoBC rates are weighted averages of the winning bids at the auctions.

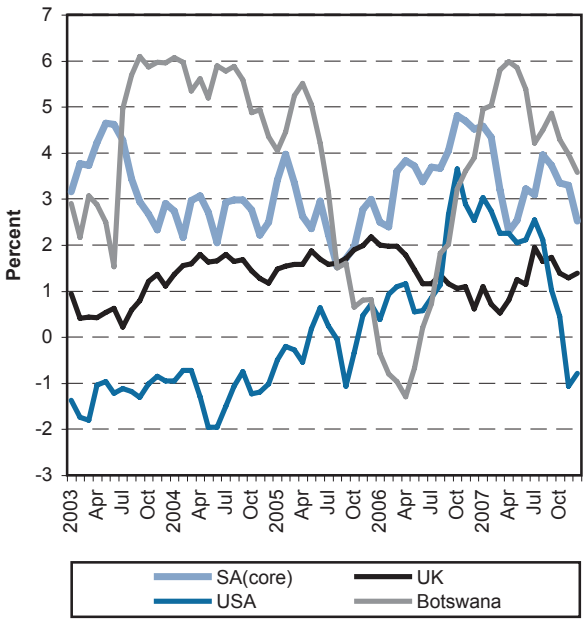
44. Merchant banks are allowed to hold BoBCs; there is currently one merchant bank operating in Botswana.

CHART 1.11: YIELD TO MATURITY ON BoBCs AND GOVERNMENT BONDS



Source: Bank of Botswana.

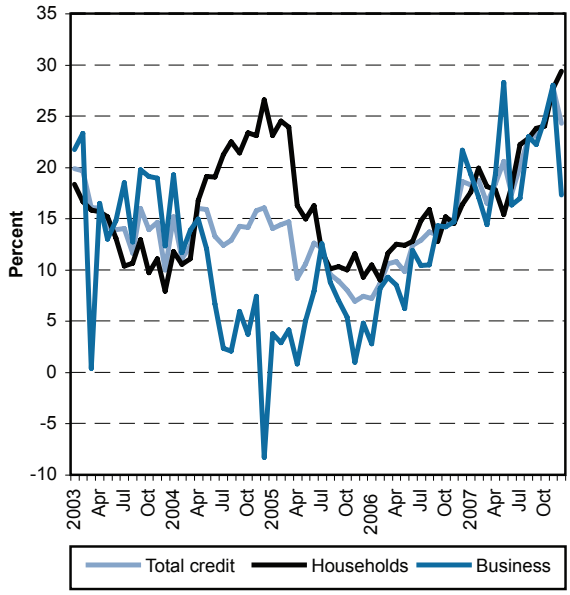
CHART 1.12: REAL INTEREST RATES – INTERNATIONAL COMPARISONS



Source: Bank of Botswana.

4.9 percent within a range of 3.6 – 6 percent, compared to an average of 1 percent and a range of -1.3-3.9 percent in 2006 (Chart 1.12). Real lending rates were relatively stable as the real commercial bank prime lending rate eased from 7.4 percent in December 2006 to 7.1 percent at the end of 2007.

CHART 1.13: COMMERCIAL BANK CREDIT GROWTH



Source: Bank of Botswana.

(c) Banking System

(i) Domestic Credit

4.8 The year-on-year growth in commercial bank credit rose significantly from 18.8 percent in December 2006 to 24.3 percent in December 2007 and was, throughout the year, above the 11-14 percent range that the Bank considered consistent with the inflation objective for 2007. The faster increase in the rate of growth of credit was due to expansion in lending to households, which rose from 16.7 percent in December 2006 to 29.4 percent in December 2007. The increase was explained by, *inter alia*, increased marketing of loan products and expansion of customer base (e.g., through easing of the minimum income threshold for accessing banking products) and geographical reach by commercial banks. In contrast the annual increase in lending to the business sector declined from 21.8 percent to 17.3 percent in the same period. This partly reflected repayment of advances by several large companies in December 2007. In addition, a large increase in business credit in December 2006 fell out of the calculation of annual credit growth. As a result of faster growth, the share of household credit in total private commercial bank credit increased from

57.5 percent to 59.9 percent.

(ii) Monetary Aggregates

4.9 Money supply (M2)[45] grew at an annual rate of 31.2 percent in December 2007 compared to 9 percent in 2006. The increase was due to a 23.7 percent and 24.4 percent growth in net foreign assets and credit to private and parastatal sectors, respectively, while the 31.1 percent increase in government deposits at the Bank of Botswana was contractionary. Non-transferable deposits grew by 34.2 percent. Meanwhile, foreign currency deposits increased by 90.8 percent in Pula terms and accounted for more than a quarter of the total volume of deposits in the banking system. The increase in foreign currency deposits was concentrated in deposits with maturities of three months and may represent an alternative short-term investment. Foreign exchange deposits also mitigate the impact of any adverse movements in the external value of the local currency, particularly in the context of a downward crawl of the Pula exchange rate.

(iii) Bank of Botswana

4.10 Total assets/liabilities of the Bank of Botswana grew by 24.6 percent to P60.2 billion as at the end of 2007 from P48.3 billion in December 2006. The expansion of the balance sheet in 2007 was largely a result of growth in government deposits at the Bank, which rose by 35.3 percent to P28.3 million and the increase in BoBCs. On the asset side, this was matched by growth in the foreign exchange reserves (Section 3 above).

45. At the beginning of 2006, the monetary survey conducted by the Bank of Botswana was expanded into a depository corporations' survey, which covers the Bank of Botswana, commercial banks and other deposit-taking institutions. The use of M4 was discontinued since foreign currency accounts (FCAs) are included in other aggregates. Since holdings of BoBCs are restricted to banks, and are a liability of the Bank of Botswana, M3 is currently equivalent to M2. Holdings of government treasury bills, which were introduced in March 2008, will be a part of M3.

(iv) Commercial and Merchant Banks

4.11 In 2007, total assets and liabilities of commercial banks grew by 24.1 percent to P36.3 billion, compared to a much larger expansion of 64.8 percent in 2006. The growth in total assets was due to a 372.5 percent and 48.1 percent growth in balances at the Bank of Botswana and balances due from domestic banks, respectively. In terms of funding, total bank deposits increased by 31.8 percent to P30.5 billion in December 2007, the largest proportion of which (38.6 percent) was held in call deposits.

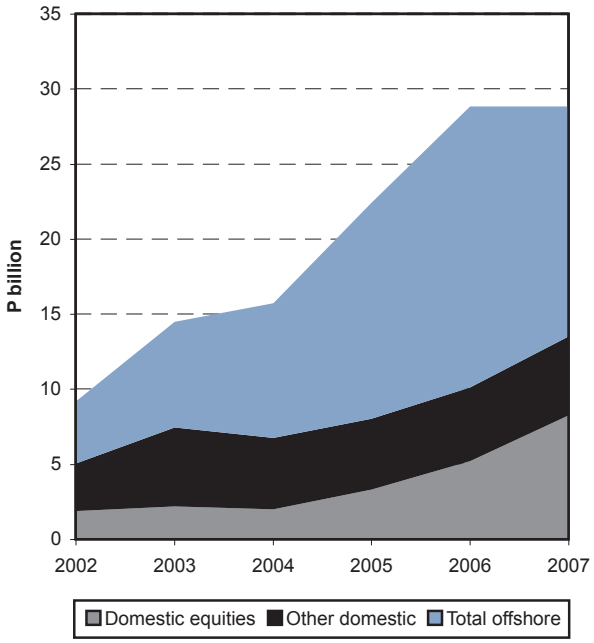
4.12 In 2007, total assets/liabilities of the one merchant bank operating in Botswana, African Banking Corporation of Botswana (ABC), increased by 9.1 percent, compared to 24.9 percent in 2006. Loans and advances of ABC grew by 51.3 percent in 2007 compared to a growth of 45.9 percent in 2006, while deposits increased by 22.5 percent to P941 million.

(d) Non-Bank Financial Institutions

4.13 The total assets/liabilities of the Botswana Building Society (BBS) increased by 15.5 percent in 2007, compared to 33.3 percent in 2006. Loans and advances, the major proportion of which is mortgage loans, rose by 16.5 percent to P1.1 billion. At the same time, cash and deposits at other banks also rose by 14.5 percent. In the case of the Botswana Development Corporation (BDC), assets/liabilities increased by 5.4 percent in 2007 to reach P1.8 billion, which is a slower growth rate than the 6.6 percent in 2006. The slower growth rate in overall assets was due to a contraction of 12.2 percent in loans, advances and leasing. Total assets/liabilities of the National Development Bank (NDB) rose by 10.9 percent in 2007 compared to the growth of 3.1 percent in 2006. The annual increase in lending by the NDB eased to 6.1 percent compared to 29.2 percent a year earlier. The balance sheet of the Botswana Savings Bank (BSB) grew by 32.5 percent in 2007 compared to 12.7 percent the previous year, with 40.6 percent

growth in savings deposit matched by 57.8 percent increase in liquid assets.

CHART 1.14: BOTSWANA PENSION FUND ASSETS (2002–2007)



Source: Ministry of Finance and Development Planning.

4.14 The Domestic Companies Index (DCI) of the Botswana Stock Exchange (BSE) rose by 36 percent in 2007, gaining 2 231.2 points to end the year at 8 426.8. This followed a growth of 74.1 percent in 2006. At the end of August, the DCI had gained 59.3 percent, but declined in the last four months of the year, mainly due to a decrease in commercial banks' share prices, which constitute the bulk of the DCI. Trading was active, with 124 million shares valued at P825 million traded during the year, compared to 87 million shares valued at P415 million traded in 2006. The foreign companies index also rose by 23.8 percent in 2007.

4.15 During 2007, pension fund assets grew by 18.2 percent from P29 billion at the end of 2006 to P34.3 billion. The strongest growth of 20.2 percent was in holdings of equities, the domestic component of which rose by 30.6 percent, while the level of offshore investment increased by only 12.4 percent and amounted to 61 percent of the total investment by the Botswana Public Officers Pension Fund.

4.16 Market capitalisation of domestic companies on the BSE grew by 37.5 percent to P32.7 billion, with the slightly faster increase than the DCI reflecting the increase in the number of domestic listed companies, from 19 in 2006 to 20. One company de-listed while two joined the Exchange. The number of foreign companies listed on the BSE decreased from 12 to 11. Of the listed companies, seven were on the Venture Capital Board (VCB), and the decrease from eight the previous year was due to one of the companies being included on the main board. All the VCB-listed companies were foreign mining-related operations

4.17 As of December 2007, the total par value of the two outstanding government bonds was P1.75 billion, with original maturities of 5 years and 12 years and yields at auction of 11.5 percent and 10.25 percent, respectively. In the 2007 Budget Speech, it was announced that the 5-year bond (BW002; par value P850 million) would be rolled over upon maturity in 2008 to support capital market development, with the resultant funds earmarked for the Tertiary Education Development Fund. At the end of 2007, foreign investors held only P1 million of BW002, which was unchanged from April 2006. There continued to be very limited secondary market bond trading, although trading in the 23 non-government bonds listed on the BSE increased by 23 percent to P104 million in 2007. The lack of secondary market liquidity indicates continuing unmet demand for longer-dated securities. This should be addressed by the Government's planned programme of bond issuance to be implemented in 2008.

(e) Credit Rating

4.18 For the seventh consecutive year, the international rating agencies, Moody's Investors Service (Moody's) and Standard and Poor's (S & P), reaffirmed the country's investment grade ratings. This is a reflection of Botswana's continued strong financial position, a well-managed and growing economy and political stability. In addition,

Moody's upgraded the foreign currency outlook from 'stable' to 'positive'. The upgrade reflects both the continued strengthening of the country's financial position and improved prospects for economic diversification away from diamond mining. Moody's indicated that, on the basis of these trends, an upgrade of the rating for foreign currency debt to match the domestic currency rating could be considered in 12–18 months. The agencies were positive about the boost the economy would get from the development of the downstream diamond industry and the broadening of minerals being exploited. They noted, however, that structural reforms needed to broaden the role of the private sector in the economy were critical to the overall economic growth and reduction of unemployment. The ratings continue to be constrained by the country's socio-economic challenges, which include the undiversified economy that heavily relies on mining as a source of additional growth and government revenue, fiscal pressures associated with large investment needs, and the cost of mitigating the HIV/AIDS pandemic.

(f) Other Financial Sector Developments

4.19 The Bank, as the regulator of the IFSC entities, issued two companies with Exemption Certificates in 2007, bringing the total number of IFSC companies granted regulatory approval to 19. This number excludes Enterprise Banking Group (EBG), which deregistered during the year and voluntarily surrendered its banking licence in accordance with section 11(2) of the Banking Act (CAP. 46:04), following a change in its business investment strategy.

4.20 In December 2007, Capital Bank was issued with a banking licence, which brought the total number of licensed banks to eight. The newly licensed bank is expected to commence operation within 12 months from the date of obtaining a licence as required by the Banking Act. Capital Bank Limited is a majority-owned subsidiary of First Merchant Bank Limited, a registered commercial bank in Malawi.

4.21 The total number of licensed bureaux de change in operation increased from 42 in December 2006 to 47 in December 2007. Eight bureaux de change were licensed in 2007, compared to six in the previous year, while three voluntarily closed down and surrendered their licences. An examination of five bureaux de change showed general compliance with the Bank of Botswana (bureaux de change) regulations.

4.22 In an effort to enhance customer service and satisfy varied customer financial needs, commercial banks introduced and/or expanded a broad range of products targeting different classes of customers during 2007. The products include expansion of credit card services, increase in credit facilities, expansion of cell phone banking and bank assurance through acquisition of shareholding in life assurance companies. Other initiatives to attract customers included expansion of geographical spread of banking facilities and lowering of the income threshold for accessing services.

CHAPTER 2

BOTSWANA'S FRAMEWORK FOR MACROECONOMIC AND FINANCIAL STABILITY IN SUPPORT OF SUSTAINABLE ECONOMIC GROWTH

1. INTRODUCTION

1.1 In the 40 years following independence, Botswana has managed to achieve robust economic growth which transformed the country from being one of the least developed countries to middle-income status. It is one of the top performing economies in Africa, with a per capita GDP of over USD4 500 and the highest sovereign rating (investment grade) by Moody's Investor Services and Standard and Poor's. Although this achievement was largely due to the exploitation of the country's large deposits of diamonds, sound macroeconomic policies, political stability and good governance also contributed to sustained good performance.

1.2 The concept of macroeconomic stability is multi-dimensional and includes budget balance, price stability, and external balance. Macroeconomic stability is, therefore, cast in terms of a fiscal stance that is consistent with fiscal solvency, a monetary policy stance that is consistent with low and stable inflation, and an exchange rate regime that avoids excessive volatility in the real exchange rate and sustains external balance. Across the world, policies for achieving macroeconomic stability have evolved over time in response to changes in economic structure, development imperatives, international relationships and policy transmission processes.

1.3 It is, therefore, instructive to discuss the evolution of the relevant policies in Botswana and how they have contributed to macroeconomic stability, support for economic growth and compare them to international benchmarks. Moreover, there have been recent pronouncements and changes in Botswana with respect to the implementation of fiscal policy (fiscal rules), the monetary policy framework (statement of inflation objective) and the exchange rate regime (crawling band mechanism) intended to support a stable macroeconomic environment that is conducive to sustained and diversified output growth.

1.4 Globally, after the financial crises of the 1990s, it was found necessary to add financial stability to the conventional elements of macroeconomic stability. In particular, the International Monetary Fund (IMF) redefined its mandate to include surveillance of financial sector policies in addition to fiscal, monetary and exchange rate performance. It is recognised that a stable financial system is better at mobilising savings and allocating funds to productive undertakings, in sustaining the efficacy of macroeconomic policies and in enhancing economic performance. The effects of the crises in financial systems that occurred in some countries (notably in East Asia, Russia and Latin America in the late 1990s) have demonstrated the close link between financial stability and the health of the real economy. These linkages and the need for appropriate country-specific, as well as global, infrastructure to deal with disruptions are also illustrated by developments surrounding the 2007 financial crises engendered by sub-prime lending in the USA.

1.5 Within the financial sector, commercial banks play a crucial role and their soundness is critical for overall financial stability. In particular, in many developing countries, including Botswana, where capital markets are less developed, banks dominate financial intermediation and play a prominent role in evaluating and monitoring credit risks and returns on investment projects. Banks are also the main conduit for transmitting monetary policy to the real sector. Therefore, instability

of the banking sector has greater potential to cause systemic crises than difficulties elsewhere in the financial sector. Ensuring financial stability through effective supervision of the banking system is, therefore, essential in sustaining macroeconomic stability and durable economic growth. Nevertheless, financial stability goes beyond the banking system and encompasses other elements of financial intermediation, while the supervisory processes for managing stability of the broad financial sector have evolved over time.

1.6 Broadly, the theme topic examines the role of policy formulation in Botswana in fostering macroeconomic and financial stability. Section 2, therefore, defines macroeconomic stability and outlines its role in ensuring sustainable growth and improvement in living standards. This is followed by detailed description of monetary, fiscal, exchange rate and financial sector policies and their role in supporting economic growth and development in Sections 3 to 6. In concluding, Section 7 makes an evaluation of policy performance over time and identifies the future areas of policy focus.

2. DEFINITION AND IMPORTANCE OF MACROECONOMIC AND FINANCIAL STABILITY

2.1 Macroeconomic stability defines a state of appropriate balance between aggregate demand for goods and services and aggregate supply; and it is typically characterised by sustainable growth, as well as price, fiscal, exchange rate and financial stability. While there are no exact statistical measures for these elements of stability, approximations are generally made in terms of a range of levels and variability, as well as appropriate institutional arrangements and policies. Moreover, it is often clear that certain levels and extremes of volatility constitute instability. The following discussion highlights key parameters for the constituent elements of macroeconomic stability.

Price Stability

2.2 Price stability is broadly defined as low and sustainable inflation that displays minimal variability. It would normally be a low, positive rate of inflation, but not zero inflation. While various policies and institutional arrangements contribute to price stability, it is mainly achieved through monetary policy (Section 3 below). As the control of inflation is associated with the impact of monetary policy on demand, and consequently supply, it is likely to result in some effect on output growth, especially in the short-run. The price stability objective can, therefore, be pursued alongside an output stabilisation goal.[1] In recent times, the primary objective of monetary policy in most countries is price stability, with consideration of output stabilisation subject to the maintenance of a sustainable low inflation. The notable exception among the major economies is the USA, which has a dual mandate of pursuing maximum sustainable employment and price stability.

2.3 High and volatile inflation is costly and detrimental to efficient economic activity and output growth. In particular, it inhibits growth by eroding savings, discouraging investment and inducing flight of capital abroad and into inflation hedges such as real estate and precious metals to the detriment of other, possibly more productive, investments. High inflation also aggravates income inequality as poorer people and/or those with fixed incomes (such as pensioners) cannot protect their income from erosion due to a rapid increase in prices.[2]

2.4 On the other hand, zero and negative inflation (deflation, where the general price level falls continuously) would also have a negative impact on economic performance

1. While there are theoretical as well as process/transmission intricacies, there is a view that policy tightening (an increase in interest rates) slows output growth, while stimulating output by easing interest rates potentially generates inflationary pressures. To maintain trend levels of GDP growth while achieving price stability, policy is formulated with some view about the trend level of output expansion that is consistent with the price stability objective.

and growth. With very low inflation, there is limited scope to stimulate economic activity during a recession through a reduction in real interest rates, as the rate of interest cannot be negative in nominal terms. Deflation is undesirable because it raises real interest rates and real wages, resulting in higher costs to businesses which impacts negatively on investment and employment, and ultimately output growth.

2.5 It is notable that inflation targeting countries define their targets in terms of low but positive inflation (typically around 2 percent) for the more advanced countries, and in the form of a range of up to 10 percent for the middle-income developing economies.[3] The inflation target, whether specified as a point or range, represents price stability. Where a range is specified, it is in recognition of possible variability of inflation within the bounds of the range. The specified inflation target is also considered to be consistent with sustainable long-term trend growth of the economy.

2.6 Similarly, the macroeconomic convergence criteria for member countries in regional groupings, such as the European Community and the Southern African Development Community (SADC) include price stability as a contribution to regional macroeconomic stability. Table 2.1 illustrates definitions of price stability (inflation targets and objectives) and levels of annual price changes that are considered consistent with long-run trend growth for selected countries. In general, inflation targeting obtains where the authorities define a numerical value for price stability, which the central bank is mandated to achieve; while for an inflation objective, a numerical value for price stability is defined to anchor inflation expectations, there is no institutional mandate for the specified level.

TABLE 2.1: SELECTED COUNTRY INFLATION TARGETS/OBJECTIVES

Country	Inflation Measure	Target (percent per annum)	Objective (percent per annum)
Developed Countries			
UK	Core	2 (+/-1)	
Canada	Headline	2 (+/-1)	
Sweden	Headline	2 (+/-1)	
New Zealand	Core	1 – 3	
Euro Zone	Headline		≤ 2[1]
USA			[…]
Sub-Saharan Africa			
Botswana	Headline		3 – 6
South Africa	Core	3 – 6	
Ghana	Core	0 – 10	
Nigeria	Headline		[…]
Mauritius	Headline		[…]
Zambia			[…]
Emerging Market Economies			
India			[…]
China			[…]
Brazil	Headline	4.5 (+/-2)	
Chile	Headline	2 – 4	
Israel	Headline	1 – 3	
Mexico		3 (+/-1)	
Philippines	Headline	5 – 6	
Thailand	Core	0 – 3.5	
Czech Republic	Headline	3 (+/-1)	
Hungary	Headline	3.5 (+/-1)	
Poland	Headline	2.5 (+/-1)	

Notes:

1. The objective of the European Central Bank is to aim for inflation below, but close to 2 percent.
2. […] denotes that while there is an inflation objective it is not assigned any numerical value. The numerical values are the most recently specified ranges.

Source: Epstein, G., (2006), "Too Much, Too Soon: IMF Conditionality and Inflation Targeting", University of Massachusetts; various central banks' websites.

2.7 In several countries, the measure of price stability is core inflation, computed to smooth out fluctuations and is deemed to reflect underlying price trends that can be affected

2. Empirical studies have found that, on average, over the past four decades countries with higher inflation generally experience volatile inflation. Furthermore, output growth fluctuates more rapidly in countries with high and volatile inflation. Moreover, in some countries with fixed exchange rate systems, higher inflation than in the anchor country leads to overvaluation of the real exchange rate, loss of international competitiveness and balance of payments crises.

3. Inflation targets are specified to be consistent with non-inflationary (defined not as zero, but as a positive inflation target or objective) output growth; theoretically, the natural rate of growth that is consistent with utilisation of all the factor inputs in the economy.

by monetary policy.[4] Hence, targeting this measure helps to avoid large adjustments to the policy instrument and volatility in real activity, which can result from focusing on the more volatile headline inflation. However, a single focus on core inflation has an inherent challenge in that inflation expectations continue to be based on the widely known headline measure. Furthermore, exclusion of volatile prices may be undesirable as they may provide useful information about future trends that is not reflected in prices that change more gradually; hence measures of core inflation entail the possibility of ignoring early signals of prospective inflation developments. For this reason, policy makers use the alternative measures of inflation as complementary sources of information on price developments, which can help articulate the basis for the policy stance adopted.

Fiscal Stability

2.8 The role of fiscal policy in supporting macroeconomic stability should be considered from two distinct perspectives. Fundamentally, fiscal stability broadly implies the sound management of the government budget with public expenditure adjusted in line with sustainable revenue sources, and where borrowing does not degenerate into a structural problem that, ultimately, may threaten a government's solvency. At the same time, fiscal policy impinges on the other objectives of economic growth, price stability and sustainable external balance. The demands of these two dimensions of fiscal policy may, at times, send conflicting signals as, for example, when the use of short-term countercyclical fiscal measures to stimulate the economy risks the long-term soundness of public finances. In addition, active use of fiscal policy can, if not timed and targeted correctly, aggravate rather than correct instability in the broader economy.

2.9 Prudent fiscal policy helps ensure sustainability of public expenditure levels and debt service ratio and, therefore, less disruption to the economic growth path. Therefore, to underpin stability these policies are commonly formulated within a framework of fiscal rules, providing benchmarks for periodic reviews. Among the guides to fiscal sustainability are those relating to the size, relative to the overall economy, of the budget deficit, government debt and expenditure. Surrounding these rules is the institutional set-up relating to transparency and policy coordination. There may also be rules to limit the extent of borrowing from the central bank, as the monetisation of government deficits has a direct bearing on price stability. Table 2.2 shows examples of 'convergence criteria' for regional groupings which provide indicative values for both the budget deficit/GDP and debt/GDP ratios.

TABLE 2.2: FISCAL STABILITY MEASURES/CRITERIA

	Deficit/GDP (percent)	Debt/GDP (percent)
European Union	3	60
Southern African Development Community	1 – 5[1]	60
African Monetary Cooperation Programme	3	…
West African Economic and Monetary Union	…	70
Gulf Cooperation Council	3	60

1. 5 percent by 2008; 3 percent by 2012 and 1 percent by 2018.

Source: IMF various online reports from www.imf.org.

2.10 A budget deficit, which occurs when government expenditure exceeds revenues, is the common outcome of fiscal operations, while surpluses are an exception and generally more prevalent among mineral-rich economies. It is important to note that a consistent budget deficit is not inherently unsustainable. As long as the real rate of

4. The most common core inflation measures exclude component price series that are deemed likely to display perverse behaviour (e.g., interest rate components) or to be prone to exceptional or non-representative price changes (e.g., seasonal food, administered price and energy components).

growth of the economy exceeds the prevailing level of real interest rates, then the economy should have the capacity to meet future obligations arising from increasing levels of debt.[5] Such stability is enhanced if borrowing, especially for the long term, is focussed on the financing of developmental projects that promote growth. Specific challenges relating to deficit spending and accumulation of debt include:

(a) the risk of an unanticipated loss of government revenue due, for example, to an economic downturn that limits tax collections;

(b) fully anticipating the future recurrent costs (operation and maintenance) of capital expenditure projects; and

(c) the risk that additional government spending may 'crowd out' private sector activity. This can occur, for example, through cost increases (e.g., higher wages and interest rates) arising from the appropriation of productive resources by the public sector, which discourage private sector investment.

2.11 While such negative outcomes are typically associated with deficit situations, it is also possible for governments that are in surplus to exert fiscal dominance with similar adverse effects. Hence the adoption in some cases of additional fiscal rules relating to levels of public expenditure relative to output. Governments may aim to maintain a balanced budget which is indicative of fiscal discipline and is more conducive to price stability. This is especially the case for the recurrent budget where, other than to smooth short-term cyclical fluctuations, borrowing is not usually desirable. However, because of such fluctuations, it is often difficult in practice to maintain a commitment to balanced budgets.

2.12 Furthermore, the overall budget balance can be misleading as an indicator of both fiscal sustainability and the stabilising stance of fiscal policy within the overall economy. Regarding the former, this can occur when the temporary nature of revenue flows, typically from non-renewable mineral resources, is not taken properly into account. Such revenues reflect the sale of assets (a transformation of stock) where the relevant measure of income is not the value of the sale, but the flow of receipts that can be maintained without reducing the asset value. It is, therefore, advisable for mineral-rich countries to consider adopting rules or guidelines relating to spending that explicitly link the use of such revenues to productive investments in physical infrastructure, human capital or financial assets. Moreover, it is common for any surpluses to be invested in specialised funds within the pool of foreign exchange reserves or a separate sovereign wealth fund (SWF). Examples of the investment-related rules in the context of Botswana are discussed in Section 4.

External Stability

2.13 In general, external stability defines the capability of the economy to meet its international financial commitments, with minimum disruptions to trade and financial flows due to rapid and unpredictable movements of the exchange rate.[6] Measures used to assess external stability include levels and fluctuations with respect to the exchange rate, foreign exchange reserves, as well as the level of foreign debt and the balance of payments relative to output (GDP). The exchange rate, in particular, influences the economy's performance in trade, as well as inward and outward financial flows, while its stability is measured in terms of volatility. Exchange rate volatility is normally measured

5. There is also the additional requirement that government revenues should match the structure of the debt, especially in terms of the capacity to service debt denominated in foreign currency.

6. It should be noted, on the other hand, that volatility or large changes in the exchange rate may be due to macroeconomic instability.

against a reference currency or basket of currencies. Potential exchange rate volatility can, in turn, be deduced from susceptibility to influences such as changes in commodity prices, market sentiment, or governance and the policy framework.

2.14 Movements in the exchange rate can also have a significant influence on internal balance, particularly relating to the rate of price changes. However, as well as engendering an increase in import prices, a devaluation or depreciation makes the country's exports relatively less expensive for foreigners, while foreign products become relatively more expensive; both of these developments can benefit local producers. Domestic currency depreciation or devaluation can also have a positive impact on the balance of payments as the possible increase (or faster growth) in exports and the reduction (or slower rate of growth) in imports improves the current account balance. It is apparent, therefore, that a revaluation or appreciation of the local currency is less advantageous to domestic producers, except to the extent that it results in a lower rate of price increase for imported inputs. Thus, it is often the case that a revaluation is instituted to mitigate imported inflation. The alternative exchange rate regimes, discussed in Section 5 below, allow for different policy options to achieve the stabilisation and development goals.

2.15 External balance also signifies a condition in which the country's current account is not too far in either surplus or deficit and is deemed sustainable. The current account is one of the components of the balance of payments (the others being the capital and financial accounts) and records a country's trade in goods and services, as well as flows of income and current transfers, with the rest of the world. A surplus in the current account indicates that an economy is a net creditor to the rest of the world, i.e., it is a net saver.[7] A current account deficit, on the other hand, denotes the converse. While there can be some negativity associated with a persistent deficit, it is sustainable to the extent that an economy achieves robust growth and also to the extent that it does not induce exchange rate instability. For example, Australia has had current account deficits from 1991 to 2007, but at the same time maintained robust economic growth. Similarly, the recent buoyant economic activity in the USA was largely supported by the capacity to absorb resources from the rest of the world as well as the willingness of the rest of the world to supply these resources.[8]

2.16 Terms of trade, defined as the ratio of export prices to import prices, is another measure of external stability. The terms of trade improve when a country's exports become more valuable in the international market and worsen when imports become more expensive relative to exports. For example, for countries like Botswana and where fuel accounts for a large share of the import bill, an increase in oil prices results in worsening terms of trade, if there is no similar increase in export prices. In the circumstances, stability can be achieved by a diversified production base and an export sector that facilitates switching consumption to domestic production.

2.17 Foreign debt relative to output is another indicator of external stability, showing the extent to which an economy relies on external funding for local projects or to service its fiscal deficit. A higher and increasing debt/GDP ratio would, for example, indicate potential for the debt to be unsustainable and a prospective source of macroeconomic instability.

2.18 Foreign exchange reserves represent the country's financial assets held in foreign currencies, typically reserve currencies such as the US dollar, euro, pound sterling and yen,

7. The maintenance of a current account surplus (investing abroad) could reflect a limited capacity to productively utilise resources in the domestic economy.

8. Since the balance of payments records inter-country trade and financial flows, a surplus in one country would be equivalent to the deficit in the trading partner country. Therefore, the logical outcome globally is that some countries would record deficits while others record surpluses.

and are available to service foreign liabilities, including current debt payments. As financial assets, the reserves are a stock of wealth; they also facilitate the determination of the value of a domestic currency and its adjustment and/or stabilisation as necessary. The level of foreign exchange reserves can, therefore, change as the authorities intervene in the foreign exchange market to maintain a given level of the exchange rate or reduce its volatility.

2.19 In particular, in a fixed exchange rate regime, it is the quantity of reserves that adjusts to changes in the relative demand for foreign currency vis-à-vis domestic currency. A faster increase in imports and/or capital outflow relative to exports and capital inflow would result in depletion of reserves and vice versa. In contrast, in a flexible exchange rate regime, it is the value of the exchange rate that responds to changes in the relative demand for domestic and foreign currency. The domestic currency would, therefore, appreciate in the context of faster growth in exports and inward capital flows.

2.20 Being an important indicator of a country's ability to pay for imports, service foreign debt and defend the value of its currency, foreign exchange reserves are often measured in terms of months of import cover. A higher level of months of import cover represents enhanced external stability. Generally, three months of import cover is considered the norm for a well diversified economy.

Financial Stability

2.21 Financial stability is similarly an important element of economic performance contributing to development and welfare improvement. It encompasses the ability of the financial system to continually allocate economic resources for productive purposes, including production and trade to sustain wealth accumulation, growth and social prosperity. Thus, the financial system's intermediation role, comprising the assessment, price allocation and management of financial risks should be maintained even in the context of internal imbalances and exogenous shocks or imbalances. Figures 2.1 and 2.2 (overleaf) illustrate a framework for maintaining financial stability.

2.22 Within finance, currency (notes and coins) serves as a means of payment, unit of account and store of value. In particular, the means of payment is unique as it provides for finality of payment. However, the store of value function (purchasing power) is vulnerable to decline over time, while the distribution of notes and coins does not match the transaction, investment and store of wealth/saving needs of economic agents at any specific point in time. These needs are facilitated by broader finance, encompassing *institutions*, *markets* and *payments and settlement infrastructure* where there are risks of default, loss of value and system failure.

2.23 In turn, each of the three elements of the financial sector, namely *institutions*, *markets* and *infrastructure,* can be a source of instability. In recent times financial stability has assumed increased significance, in particular because:[9]

(a) the financial system has expanded faster than the real economy;

(b) the process of financial deepening has been accompanied by the changing composition of the financial system, with an increasing share of non-monetary assets;

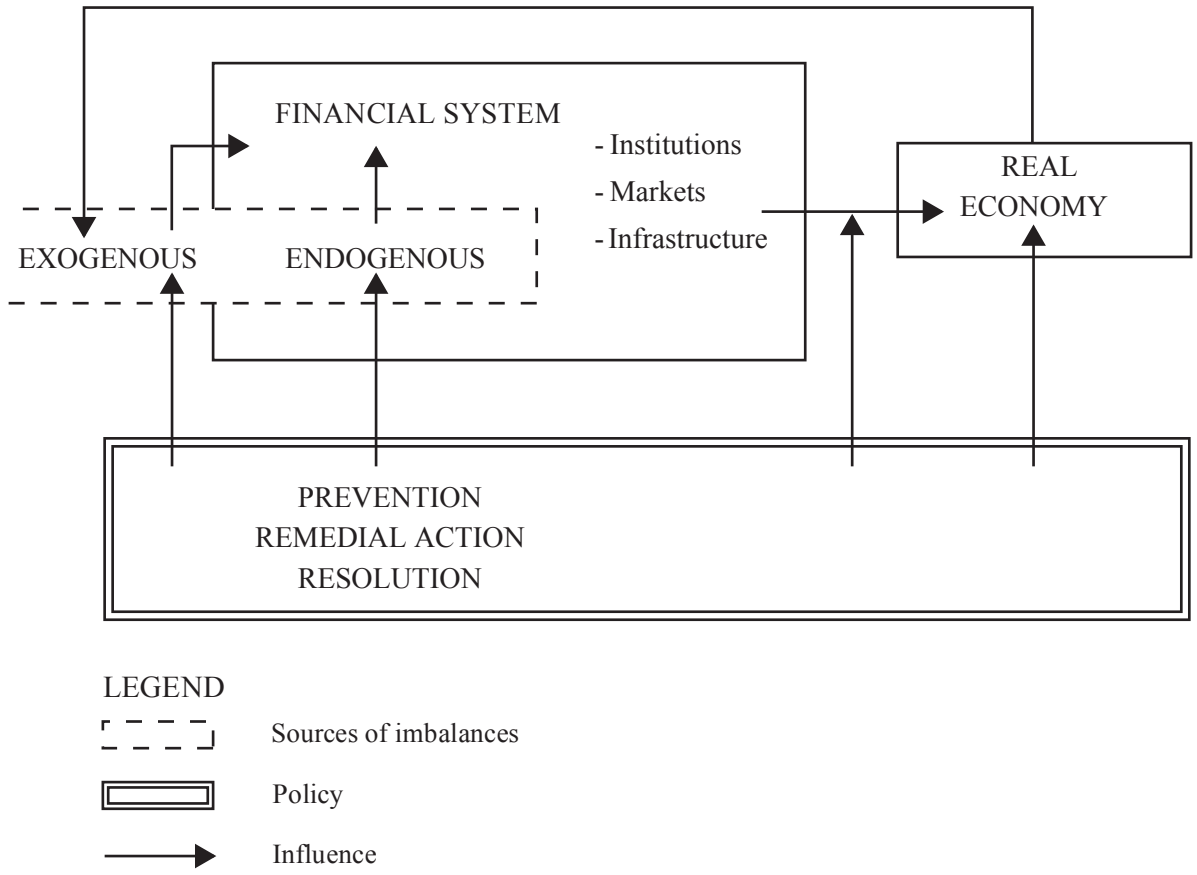
(c) financial systems have become more integrated, both nationally and internationally; and

(d) the financial system has become more complex, in terms of intricacy of financial instruments, the diversity of activities, and the associated mobility of risks.

2.24 Apart from their impact on financial stability, these developments (addressed in more detail in Section 6) have had a significant positive influence on economic performance and macroeconomic stability globally.

9. See Houben, 2004.

FIGURE 2.1: STYLISED VIEW OF FACTORS AFFECTING FINANCIAL SYSTEM PERFORMANCE



Source: Houben *et al* (2004), "Towards a Framework for Safeguarding Financial Stability", IMF Working Paper No.WP/04/101.

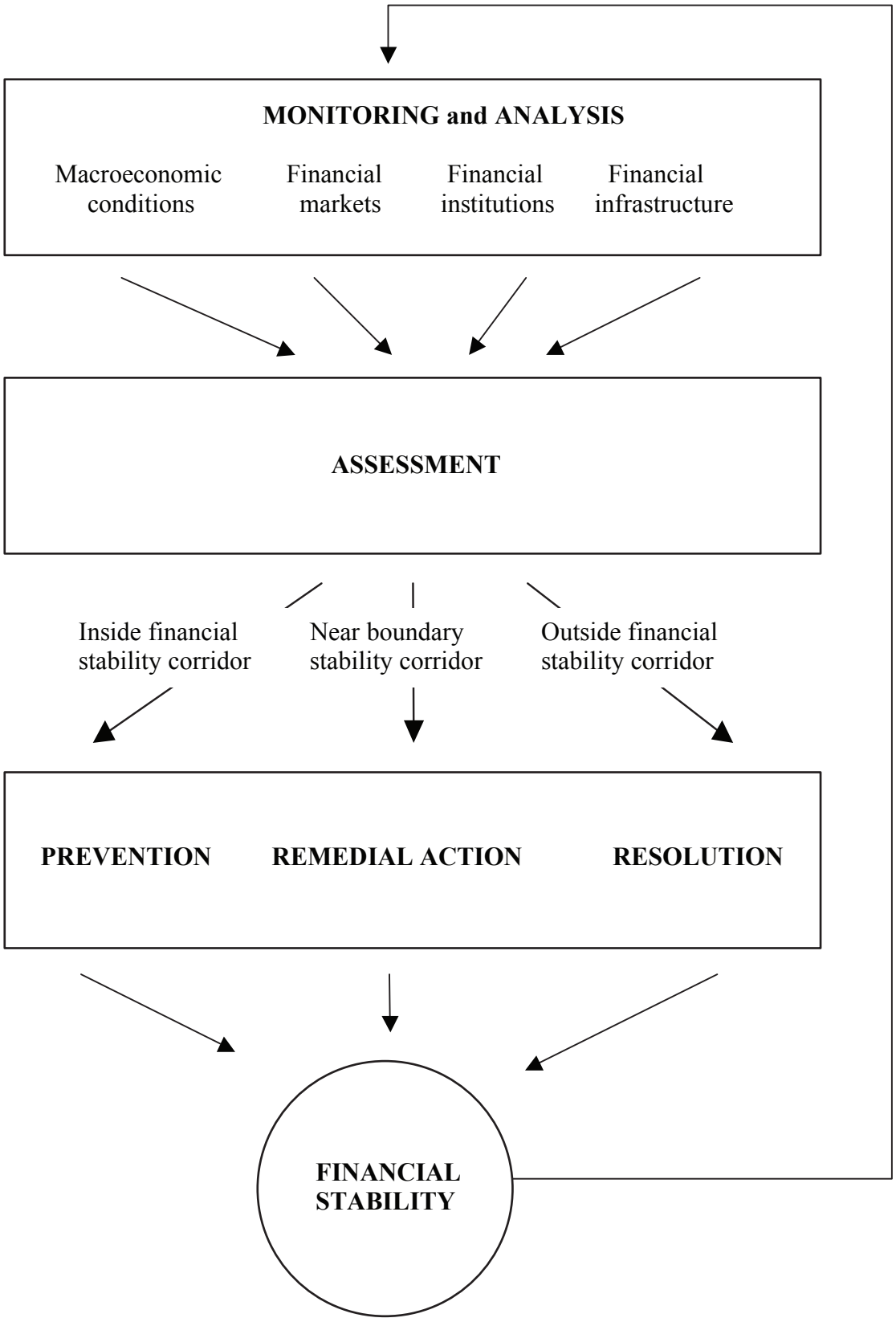
However, the developments could also be a source of instability and weak activity. Hence, both nationally and internationally, there are efforts to strengthen resilience and stability of the financial system, including self-corrective mechanisms and systems for intervention by the authorities. These include formal and legislated supervisory frameworks for the various elements of the financial system, support for the payments and settlement infrastructure and liquidity support arrangements.

Benefits of Macroeconomic Stability and Financial Stability

2.25 From the foregoing, it is apparent that macroeconomic and financial stability are prerequisites for sustainable growth in income and employment creation, which contribute to poverty reduction and improvement in living standards. Sustained low inflation, for example, facilitates economic decisions and planning by reducing uncertainties for economic agents and increasing prospects for successful policy implementation.

2.26 Macroeconomic stability also enables choices and prioritisation of policy and institutional development as well as the allocation of resources. A sustainable fiscal position, for example, makes it easier for a country to prioritise development expenditure and to decide on tax changes. Macroeconomic stability often derives from successful policy formulation and implementation, which usually encompasses mechanisms for responding to shocks successfully. Thus, good policies and stability strengthen an economy's resilience to shocks and enhances the country's credibility with

FIGURE 2.2: FRAMEWORK FOR MAINTAINING FINANCIAL SYSTEM STABILITY



Source: Houben *et al* (2004), "Towards a Framework for Safeguarding Financial Stability", IMF Working Paper No.WP/04/101.

other sovereigns, institutions, markets and investors. Capital tends to flow more to economies that have a stable macroeconomic environment, where investors are assured of the safety of their investment, while the incentive for capital flight by residents is minimised.

2.27 The importance of macroeconomic stability is further shown by international policy and institutional developments as well as trends in key policies and indicators (Table 2.3). For example, the decline in the level of inflation over the past two decades and its relative stability in recent years, despite the rapid increase in oil prices, are notable examples. Average inflation for the emerging markets and developing countries fell from 53.5 percent between 1988 and 1997 to an average of 6.8 percent between 1998 and 2007.[10] For Africa, the decline was from an average of 29.1 percent to 14.1 percent over the same period while for Botswana, the decline was from an average of 11.3 percent to 8.1 percent. This development, in part, reflects an increased focus on institutional arrangements that are supportive of price stability across several countries that have also encouraged low inflation expectations.[11] There has also been an improvement in fiscal discipline, which is a contributory factor to price stability. For example, for emerging markets and developing countries, the fiscal balance (as a percentage of GDP)[12] was –3.7 percent in 1998; it dropped to –3.1 percent in 2001 and –1.6 percent in 2004 with a further decrease to –0.8 percent in 2007.

2.28 Financial market liberalisation is another significant global development, especially associated with the removal of exchange controls on the current account and reduction of capital controls starting with the industrial countries in the 1970s and 1980s and spreading to developing countries in the 1990s. In the circumstances, stability and policy credibility are crucial in terms of attracting capital and minimising the risk to investments, as well as lessening disruptive capital movements. For example, there were significant economic costs due to the major financial disruption in Asia, Russia and Latin America in the late 1990s which led to initiatives to improve and entrench oversight of the broader financial sector and monitoring of the impact of economic policy and developments on the financial sector.[13] At a broader level, this involves global cooperation with respect to policies, institutional arrangements and regulatory oversight. Individual central banks, as well as the international financial institutions, namely, the International Monetary Fund, World Bank and the Bank for International Settlements have adopted financial stability as part of their mandate with regular publication of financial stability reports.

2.29 However, there remains potential for instability as is clearly demonstrated by developments in 2007 and into 2008, where internally generated financial instability (USA sub-prime lending) threatened a system-wide disruption globally and a near-collapse of Northern Rock, a major UK bank. Going forward there are potential ramifications in terms of a weakening US economy which, in turn, affects export demand from other areas of the world. It is notable, however, that the existence of frameworks for corrective intervention as indicated above, were instrumental in guiding the response by the authorities, albeit still subject to market and general public criticism.

10. World Economic Outlook, IMF.

11. Technology and productivity improvements, including increased production in low cost areas of the world, as well as trade liberalisation, contribute to the lower rate of price increase.

12. This is the weighted average of the central government fiscal balance.

13. For example, the Asian, Russian and Latin American crises were due to the fixed exchange rate regimes being untenable in an environment of large capital flows. The subsequent floatation and sharp currency adjustments resulted in a significant currency mismatch and a financial crisis which reduced real economic activity as banks and large corporations experienced operational difficulties.

TABLE 2.3: MAIN MACROECONOMIC STABILITY INDICATORS IN BOTSWANA AND COMPARISON WITH SELECTED EMERGING MARKETS (PERIOD AVERAGES)

	1980–84	1985–89	1990–94	1995–99	2000–04	2005–06
Inflation (percent)						
Botswana	12.1	9.6	12.9	8.8	7.9	10.1
Malaysia	6.0	1.4	3.8	3.5	1.5	3.3
Thailand	8.4	3.2	4.8	5.1	1.7	4.6
Singapore	4.9	0.7	2.9	1.0	0.8	0.8
Saudi Arabia	1.3	–1.2	1.7	0.9	–0.2	1.5
Nigeria	15.9	25.9	35.8	25.4	13.5	13.1
South Africa	13.5	15.7	12.4	7.3	5.5	4.0
Zambia	n.a.	69.3	121.7	30.7	21.8	18.3
Months of Import Cover						
Botswana	6.4	17.5	26.0	31.7	27.6	25.4
Malaysia	n.a.	n.a.	5.0	4.4	5.9	7.9
Thailand	n.a.	n.a.	4.8	5.3	5.2	4.8
Singapore	n.a.	n.a.	5.6	6.5	6.2	5.5
Saudi Arabia	15.0	12.0	4.2	5.9	7.4	5.2
Nigeria	n.a.	n.a.	2.6	1.2	1.8	2.5
South Africa	n.a.	n.a.	0.6	1.5	2.3	3.3
Zambia	n.a.	n.a.	1.8	0.6	1.6 4	n.a
Current Account Balance (percent of GDP)						
Botswana	–25.6	8.5	5.5	9.0	6.1	16.9
Malaysia	–8.1	2.3	–5.3	1.8	10.3	16.3
Thailand	–5.7	–2.1	–6.3	1.0	4.2	–1.5
Singapore	–7.5	3.9	11	17.4	16.7	26
Saudi Arabia	5	–11.2	–11.7	–2.4	10.6	28
Nigeria	–6.5	–5.6	–2.3	–2.4	1.4	10.8
South Africa	–1.9	3.7	1.2	–1.3	–0.7	–5.3
Zambia	–15.6	–7.5	–1.4	–8.9	–16	–4.8
Real GDP Growth (percent)						
Botswana	10.3	11.9	4.4	8.0	6.5	0.6
Malaysia	6.9	4.9	9.3	5.2	5.3	5.5
Thailand	5.5	9.0	9.0	1.5	5.1	4.8
Singapore	8.7	6.4	9.1	6.0	4.8	7.3
Saudi Arabia	–2.2	1.0	4.6	1.7	3.7	5.2
Nigeria	–1.0	4.5	2.8	2.8	5.3	6.4
South Africa	3.0	1.5	0.2	2.6	3.7	5.0
Zambia	1.0	2.0	–2.5	1.5	4.5	5.6
Budget Balance (percent of GDP)						
Botswana	–	0.1	0.1	–	–	0.1
Malaysia	–12.0[1]	–6.2	–0.7	–0.5	–5.1	–3.5
Thailand	–3.6[1]	–0.6	3.3	–0.5	–1.1	0.2
Singapore	2.2	2.2	12.9	9.5	4.0[2]	…
Saudi Arabia	4.9	–15.9	–10.9	–5.2	2.5	19.9
Nigeria	–2.1	–3.8	–5.8	–1.7	–2.4	…
South Africa	–2.2	–3.3	–4.3	–4	–1.6	–0.2
External Debt (percent of GDP)						
Botswana	14.7	15.6	12.1	11.4	6.5	4.3
Malaysia	n.a.	n.a.	38.0	46.6	47.8	36.8
Thailand	n.a.	n.a.	41.9	72.7	48.5	29.9
Singapore	n.a.	n.a.	10.6	13.9	21.6	19.4
Nigeria	7.8	39.7	55.5	24.4	45.1	…
South Africa	n.a.	n.a.	21.4	26.2	25.4	21.2

Notes: 1. Numbers represent an average over four years. 2. Average for 2002–04.

Source: *Bank of Botswana Annual Reports; International Financial Statistics*; *World Economic Outlook*, April 2006, Ministry of Economic Planning-Saudi Arabia (www.planning.gov.sa), South African Reserve Bank (www.resbank.co.za), African Development Bank (www.adb.org –Key Indicators 1999, 2002, 2007), Central Bank of Nigeria Statistical Bulletin Volume 16 (www.cenbank.org).

Botswana's Approach to Macroeconomic Policy Stability

2.30 The national development planning process in Botswana provides a broad foundation for the formulation of macroeconomic policies. National Development Plan (NDP) 9, for example, underscores the need for macroeconomic stability in addressing the economic and social challenges of diversified growth, reducing unemployment and alleviating poverty and the impact of HIV/AIDS. The authorities, therefore, continue to strive for a balanced mix of fiscal, monetary and exchange rate policies to sustain macroeconomic stability and promote growth. Equally, attention is also given to financial policies that facilitate effective intermediation, including greater access and efficient pricing of financial services. However, the formulation of macroeconomic and financial policies evolves and there can be short-term trade-offs (in terms of costs and benefits) resulting from policy implementation, requiring a long-term perspective to policy formulation. For Botswana, the policy mix is also focused on socio-economic development consistent with the national aspirations of *Democracy, Development, Self-reliance* and *Unity* as articulated in *Vision 2016*.

2.31 The following are some of the short-run trade-offs in policy implementation:

(a) policies that boost expenditure to reduce unemployment may trigger higher inflation because of increased demand;

(b) an anti-inflation policy can cause unemployment to increase;

(c) policy geared towards expanding consumer spending could worsen the trade balance by increasing imports and reducing exports;

(d) strengthening the balance of payments through stringent policies could increase unemployment; and,

(e) measures that are meant to redistribute income may harm economic growth.

2.32 Overall, flexibility in macroeconomic policies is necessary in evolving economic and financial conditions involving transient and structural changes. The periodic changes in the various policies, do not, therefore, always disqualify them as having been inappropriate. It is often the case that the previous policies would have been appropriate for the challenges and conditions at the time. Therefore, the following discussion, which reviews key macroeconomic developments in Botswana, highlights policy evolution, influenced by, among others, structural changes, development imperatives, shifts in trade patterns, financial crises, developments in international economic relations, and policy changes in the trading partner countries.

3. ROLE OF MONETARY POLICY IN MACROECONOMIC STABILITY

3.1 Monetary policy encompasses the control of the cost and quantity of loanable funds in order to influence economic activity, as reflected in such variables as inflation, economic output, employment and the balance of payments (both trade and capital flows). To regulate economic activity, countries determine an appropriate monetary policy framework for their circumstances, which provides a structure for monetary policy formulation. The alternative frameworks include *exchange rate targeting, monetary targeting* and *inflation targeting,* where the target represents a nominal anchor for monetary policy. A nominal anchor is a single variable upon which economic agents can base their expectations about the level of inflation and its direction and, in turn, the likely policy response.

3.2 Generally, monetary policy frameworks have three elements. First, an instrument(s) of policy that is used to regulate the cost and quantity of loanable funds. Second, intermediate targets that are impacted upon by policy changes and influence demand/supply relationship in the economy. Third, a defined ultimate objective, typically inflation.

Exchange Rate Targeting

3.3 Under the exchange rate targeting framework, the value of the domestic currency is fixed to that of a low-inflation trading partner country, using interest rate changes and direct foreign exchange interventions as instruments. Exchange rate targeting could involve a fixed rate, a constant rate of adjustment or responsive discrete adjustments. Alternatively, in a flexible exchange rate environment, interest rates are adjusted to influence the level and direction of the exchange rate.[14] The rationale for an exchange rate targeting regime is to import both low inflation and policy credibility from the anchor country. Domestically, other macroeconomic policies, i.e., fiscal and monetary policies, should be supportive of the regime towards the maintenance of a low inflation differential vis-à-vis the anchor country (or trading partner countries in the case of a basket of currencies). This is in order to minimise the required margins of adjustment. Moreover, a sufficient level of international reserves is needed to accommodate the exchange rate adjustment to sustain the value of the peg. This framework, however, implies a loss of the independence of domestic monetary policy, especially in the fixed exchange rate regime.

3.4 Examples of countries with exchange rate target regimes include Lesotho, Namibia and Swaziland. These countries seek to achieve low inflation by pegging the local currencies to the South African rand on a one-to-one basis. In the circumstances, domestic policy developments are directly influenced by South African policy pronouncements.

Monetary Targeting

3.5 A monetary targeting central bank establishes targets for monetary aggregates (e.g., measures of money supply or credit) that are considered to have a proximate effect on inflation. It is, in addition, assumed that the monetary aggregates are controllable and that their relationship with the ultimate goals of low inflation and sustainable growth is stable and reliable. The policy instruments in this framework include open market operations (OMOs) and short-term interest rates, as well as direct control methods such as reserve requirements and limits to credit growth. The effectiveness of this approach is, however, undermined by uncertainty as to the appropriate monetary aggregate to target and a weakening relationship with domestic inflation due to financial innovation, use of technology and global accessibility of finance. In sub-Saharan Africa, countries that pursue monetary targeting include Malawi, Tanzania and Zambia.

Inflation Targeting

3.6 In an inflation targeting monetary policy framework, there is a time bound explicit commitment to conduct monetary policy to achieve a specified inflation rate target. In most cases the target is set by the political authorities and the central bank is given the freedom to formulate mechanisms to achieve the target (instrument independence). Alternatively, the central bank determines the target (goal independence). This regime is deemed to promote transparency, accountability and credibility of monetary policy. The explicit target provides an anchor for inflation expectations and, for countries that need to build credibility, it fosters discipline for the monetary authorities to adhere to the commitment to price stability.

3.7 The effectiveness of this framework is premised on an understanding of the price determination process and the transmission path for monetary policy. Knowledge of the price determination process allows for the generation of the inflation forecast based on an assessment of prospective economic developments. Given an understanding of the

14. There is also a distinction between a strong form of exchange rate targeting where there is an outright commitment to peg the exchange rate to a single currency or a basket of currencies and the form involving monetary policy responses conditioned on the exchange rate, without public announcement of targets.

transmission path for policy, including the time it takes for a policy change to affect price developments, the authorities would react to the inflation forecast (intermediate target) to influence the inflation outcome towards the target. The policy reaction is symmetrical; there is an equivalent response (albeit in the opposite direction) to a forecast that is either below or above the target. The main policy instruments in this framework are the interest rate and OMOs. However, the successful implementation of this framework is anchored on its influence on public expectations; hence transparency and communication are also crucial.

3.8 In the SADC region, only South Africa has formally adopted an inflation-targeting monetary policy framework. Other developing countries with inflation targeting frameworks include Colombia, Chile, Ghana and the Philippines. In the industrial countries, there is New Zealand, UK, Canada and Australia. Other countries (e.g., Mauritius and Indonesia) operate a variation referred to as *inflation targeting lite*. In this case, the central bank, on account of insufficient credibility, announces a broad objective for inflation, but is not able to specify inflation as the primary policy objective.

3.9 Overall, monetary policy, regardless of the framework chosen, aims to achieve low and predictable inflation as a contribution to overall macroeconomic stability, as well as being supportive of sustained economic growth. Apart from the use of instruments, the institutional set up and policy formulating processes are important in establishing credibility and effectiveness of the policy framework. A credible framework enables the anchoring of inflation expectations, which are an important channel for price determination. Inflation expectations influence the decisions by economic agents relating to the rate of price and wage adjustments, which ultimately impact on inflation.

3.10 Policy credibility and anchoring of expectations are also fostered by greater transparency, aided by the establishment of a formal communication strategy as part of the policy formulation process. Moreover, in the context of greater independence of the central bank, transparency fosters accountability.

3.11 In turn, a credible anchoring of inflation expectations strengthens the power of monetary policy in counteracting inflation or deflation threats. In such circumstances, there is less risk of inducing a recession even if interest rates are to be tightened sharply and, conversely, there is less risk of generating a sustained increase in inflation with any necessary sharp reduction in interest rates. For example, with an established credible policy framework, the US Federal Reserve Bank (Fed) was in, 1981-82, following a period of aggressively fighting inflation, able to substantially ease interest rates to end a recession without causing inflation. Similarly, in 1984, the Fed aggressively shifted the policy stance to fight inflation, without inducing a recession. More recently, despite the threat of inflation due to the increase in oil and food prices, the authorities in some of the major economies were able to loosen monetary policy to stimulate economic activity in the aftermath of the financial disruption that followed the sub-prime lending crisis in the USA.

Monetary Policy in Botswana

3.12 Monetary policy formulation in Botswana is guided by the provisions of the Bank of Botswana Act. Among the principal objectives of the Bank are: "to promote and maintain monetary stability; to promote an efficient payments mechanism; and to ensure the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system". While this mandate has not changed since the Bank was established in 1975, the monetary policy framework in Botswana has evolved over time, with a focus on macroeconomic stability and supporting sustainable economic growth.

3.13 The evolving interpretation of the mandate

over time can be discerned from successive NDPs, as well as policy formulation and implementation by the Bank of Botswana. NDP 5 (1979/80 – 1984/85), noted that monetary policy will primarily aim at achieving domestic price stability and, secondly, a liberal exchange control regime. However, monetary policy did not consistently focus on achieving and maintaining price stability. The bias was towards maintaining low levels of interest rates in order to stimulate lending for investment and promote faster economic growth. However, as noted in the Bank's 1982 Annual Report, interest rates had to be raised occasionally to encourage capital inflows.

3.14 Subsequently, in NDP 6 (1985/86 – 1990/91) the primary objective of monetary policy was stated as "to support fiscal policies in pursuing the objectives of macroeconomic stabilisation".[15] In addition, NDP 6 outlined the broad objectives of monetary policy as supporting the balance of payments; maintaining a liberal foreign exchange regime; and avoiding sharp shifts in aggregate demand. This suggests a broad interpretation of the mandate that was in keeping with the nation's development aspirations. Recognition of vulnerability to exogenous and external developments necessitated a desire for accumulation of foreign exchange reserves. The foreign exchange reserves would, in turn, enable a liberal foreign exchange environment, facilitating unrestricted imports and a perception of investor friendliness.[16]

3.15 The specific instruments for monetary policy implementation included direct controls on commercial banks' interest rates and lending, as well as exchange controls and primary reserve requirements. Monetary policy, through regulation of interest rates, was also aimed at mitigating sharp shifts in aggregate demand, with the focus on avoiding excessive credit creation and guarding against demand-pull inflation.

3.16 However, given the dominant perception that there was a limited flow of financial resources to the productive sectors, lending rates were kept low by holding down the central bank's Call Rate and by direct regulation of commercial bank interest rates. In the context of exchange controls which, if binding, would prevent the outflow of domestic savings to money and capital markets offering higher returns, the Bank imposed ceilings on the lending rates of commercial banks and floors on deposit rates. It was also required that all interest rate changes, as well as bank charges and fees, be approved by the Bank of Botswana. This approach was also in line with the wider price control regime in place at the time.

3.17 The increase in the number and funding of development finance institutions (DFIs) also indicated the desire to expand access to financial resources for investment. These institutions included the National Development Bank, Botswana Development Corporation, Botswana Cooperative Bank, Botswana Building Society and Botswana Savings Bank. Government lending to these institutions, at a lower rate of interest than that charged by commercial banks, grew quite substantially, enhancing their lending capability. For example, Government lending to these institutions rose from P5.4 million in 1980 to P366.4 million in 1992.

3.18 It appears, however, that the low interest rate policy was not a significant influence on investment. Rapid economic growth from the mid-1980s was mainly derived from buoyant mineral exports and the recycling of diamond revenues, through the Government budget into other economic activities. There was, therefore, a need to improve the contribution of monetary policy and the financial sector to the national objectives of diversification and sustainable growth, which was addressed through the financial sector strategy articulated in NDP 7 (2005 Annual Report). In this strategy, the

15. Objectives of stabilisation, as indicated in NDP 6, specifically referred to achievement of "external balance, internal balance and an efficient allocation of resources, together with reasonable price stability".

16. NDP 5 and 6; Hermans (1997) in *Aspects of the Botswana Economy: Selected Papers.*

authorities embarked on financial liberalisation that entailed increasing competition in the financial system, deregulation of interest rates,[17] relaxing and ultimately removing exchange controls, and moving to the use of indirect instruments of monetary policy to sterilise excess liquidity. It was considered that freeing interest rates would allow their movements to reflect relative scarcity of financial resources. The market determination of interest rates would be supported by OMOs to ensure that the level of interest rates was consistent with the desired monetary policy stance. Equally, the absence of credit and interest rate controls would allow the allocation of credit and its cost to be determined on the basis of market appraisal; leading to a more efficient use of financial resources.

3.19 The removal of controls necessitated the construction of a framework in which monetary control was achieved through indirect instruments working through an efficient financial system to transmit policy. Such a framework would be more likely to affect real economic variables in a predictable manner. However, the formulation of the financial strategy, as well as efforts to widen access to financial services and encourage more productive financing, occurred within an environment in which interest rates were low and generally negative in real terms, reflecting the excess liquidity in the economy. There was concern about the deleterious effects of negative real rates, which include undermining financial savings, lowering the profitability threshold of projects, and substantial inflationary growth in demand for credit. The interest rate policy objective was, therefore, revised to aim at achieving positive real rates of interest, comparable with those in the international financial markets.

17. This entailed allowing interest rates to be determined more by market forces. Accordingly, the Bank of Botswana removed interest rate floors on deposit rates and allowed commercial banks to set their interest rates. Meanwhile, the Government was to eventually raise interest rates on new long-term loans to DFIs in line with the revised policy objective of achieving positive real rates of interest.

3.20 In an environment in which the traditional monetary policy instruments, such as OMOs, the central bank's discount rate (Bank Rate) and reserve requirements, were not available or ineffective, there was a need to strengthen the capacity of monetary operations to mop up the excess liquidity and facilitate an upward movement in interest rates. The Bank of Botswana, therefore, began issuing Bank of Botswana Certificates (BoBCs) in 1991 to control the liquidity of the financial system.

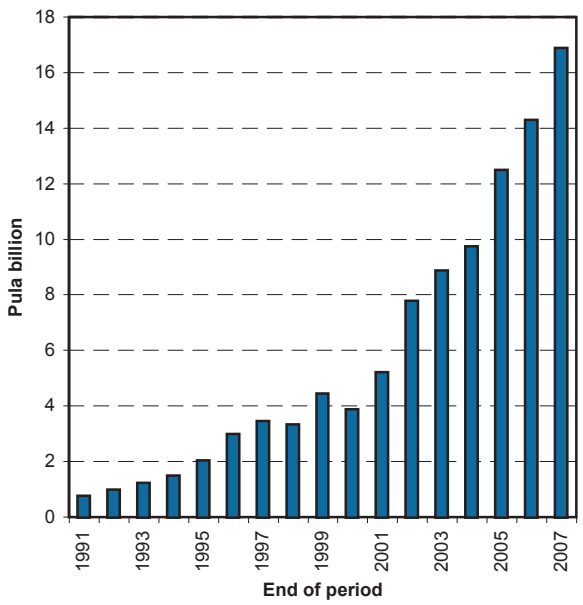
3.21 It was considered that enhancing the effectiveness of the instruments of monetary policy would improve policy performance by the Bank. OMOs, based on issuance of short-term certificates at market-determined prices to commercial banks and others with influence on excess liquidity, would strengthen the Bank's leverage over the market and influence the availability of loanable funds. This process would support the achievement of the price stability objective.

3.22 The current policy framework, therefore, incorporates use of the Bank Rate and BoBCs to influence other short- and long-term interest rates in the economy and to regulate excess liquidity in the banking system. The Bank also uses Repurchase Agreements (Repos) and the Secured Lending Facility to manage short-term and overnight liquidity fluctuations in the banking system. The Bank, therefore, influences the behaviour of commercial banks and other market participants, whose actions determine interest rates, through the market mechanism, rather than through administrative controls. The indirect approach is considered more effective in ensuring the efficient allocation of resources. Primary reserve requirements remain in place at a low level and, therefore, have limited effect on availability of loanable funds as banks remain liquid. However, to the extent that they can be increased substantially, they would affect the availability of loanable funds and contribute to a reduction in the cost of monetary operations.

3.23 Reflecting the extent of excess liquidity, BoBCs have grown substantially (Chart 2.1)

since their introduction, from P774 million at the end of December 1991 to over P16.6 billion in December 2007. Initially, primary participants in the BoBC market included commercial banks and non-bank financial institutions, as well as private and parastatal sector companies. However, with effect from March 2006, the primary counterparty status was confined to commercial banks and merchant banks, thus reflecting the primary use of BoBCs as a monetary policy instrument, rather than as an investment vehicle.

CHART 2.1: BoBCs OUTSTANDING



Source: Bank of Botswana.

3.24 The gradual evolution of the monetary policy framework from the early 1990s reflected a change in interpretation of the Bank's mandate, which influenced the specification of the primary objective of monetary policy and the implementation process. From the late 1990s, when the Monetary Policy Statement (MPS)[18] was initially published, there has been a consistent and explicit specification of the monetary policy objective as the achievement of a sustainable, low and predictable level of inflation (price stability) over the medium-term and long-term.[19] Attainment of this goal contributes to stability of the real effective exchange rate (REER) (Section 5) and macroeconomic stability. The combination of stable prices and the REER fosters economic diversification, export competitiveness and overall sustainable economic growth.

3.25 Since 2002, the Bank's framework entailed specifying, and announcing in the MPS, an inflation objective to be achieved over the ensuing year, based on forecast inflation for trading partner countries. Specification of the annual inflation objective also took into account a credible inflation path and a desire to influence inflation expectations, as well as a view on the transmission process for monetary policy to impact on inflation. There was also consideration of the impact on output and employment of any strong policy reaction aimed at quickly bringing inflation within target. Hence, an annual inflation objective tended to reflect the likely inflation outcome, but it was buttressed by the policy stance.

3.26 In 2006, the Bank introduced a medium-term inflation objective of 3–6 percent. The medium term is generally considered a more reasonable horizon over which policy could impact on price developments without unduly jeopardising output growth. The third element of the monetary policy framework was, up to 2007, the growth of credit to the private sector that was used as the intermediate target. This variable is considered an important contributor to the growth of both private consumption and investment, and can be directly influenced by changes in interest rates. Moreover, while experience has shown that there are limitations relating to its use, for Botswana, it is more immediately observable and measurable compared to other variables.[20] In addition, the rate of growth of government spending, while not subject to influence by monetary policy,

18. The first publication of the MPS was in 1998.

19. Various Budget Speeches, MPS, and Bank of Botswana Annual Reports.

20. There are constraints in the use of other data which could be relevant, which are limited in terms of availability, coverage and accuracy. For example, output data are published with a long lag, and are subject to large revisions.

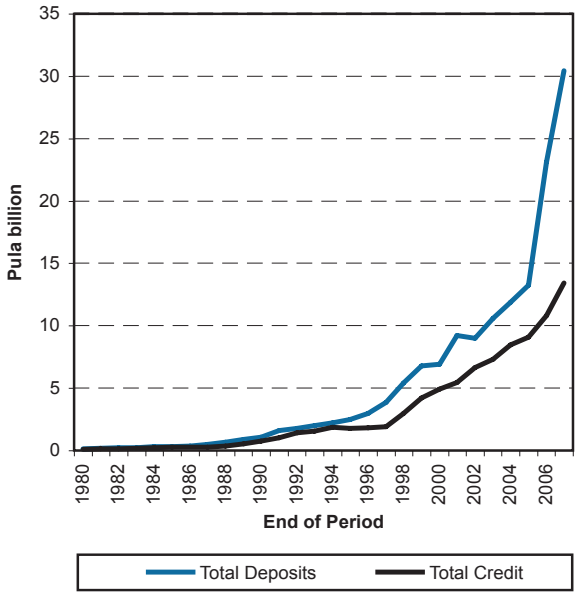
is a key variable monitored by the Bank due to its importance in determining domestic demand. Overall, the monetary policy framework incorporates variations of key elements of an inflation targeting regime, such as the announcement of an inflation objective and enhanced transparency involving established processes of communication.

3.27 Botswana's monetary policy framework also encompasses a crawling exchange rate mechanism characterised by periodic adjustments of the nominal exchange rate of the domestic currency in small continuous steps in a forward-looking manner.[21] The crawl is determined from the differential between the Bank's inflation objective and forecast inflation for trading partner countries. Monetary policy focuses on attaining a low and stable inflation to achieve real exchange rate stability in the longer term, while any substantial short term deviations of domestic inflation from trading partner countries' inflation would result in a depreciation or appreciation of the REER that would imply gradual adjustment of the nominal effective exchange rate to maintain stability.

Monetary Policy Performance and Impact on Economic Development

3.28 The assessment of economic developments alongside the policy position shows that the earlier low interest rate bias of monetary policy did not contribute to the expansion of the private sector. On the contrary, most of the period, there was relatively slower expansion in lending compared to the rapid growth in deposits, albeit mostly related to mining revenue, which contributed to excess liquidity in the financial system. However, in time, credit expansion accelerated, with a much faster growth in lending to households compared to the business sector (Chart 2.3). In the circumstances, it is more likely that a significant amount of borrowing would be for less productive uses and not supportive of the diversification and growth objectives. Moreover, any rapid expansion of lending to businesses in an environment of low interest rates (negative real rates), which characterised the period 1988-1992, could result in investment in projects that yield low returns. Significantly, real prime rates of commercial banks were negative for most of the period between 1986 and 1992 (Chart 2.4) and contributed to rapid credit expansion (Chart 2.5).

CHART 2.2: TOTAL DEPOSITS AND TOTAL COMMERCIAL BANK CREDIT



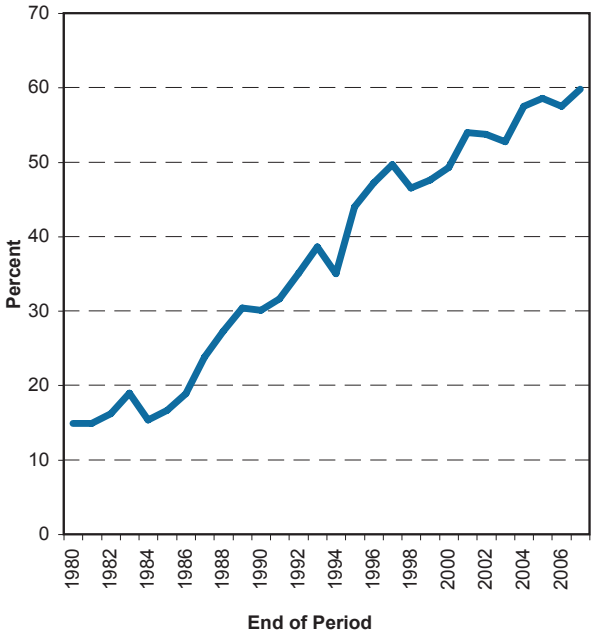
Source: Bank of Botswana.

3.29 Inevitably, the conditions of negative real interest rates and the associated substantial growth in bank credit exerted demand pressures in the economy leading to an increase in inflation.[22] Thus, as shown in Chart 2.6, prior to 1993, persistent high rates of credit growth corresponded with high levels of inflation. This was in addition to other sources of price increase, such as the devaluations of the Pula in 1985, 1990 and 1991. From 1993, there was a significant decline in inflation, in the context of

21. Under the crawling peg system, which was introduced in May 2005, the Pula remains pegged to a basket of currencies comprising the South African rand and the IMF's Special Drawing Right (SDR).

22. It is, however, noted that the substantial amount of long-term loans extended by Government to state-owned enterprises, coupled with the liberalisation of the exchange control regulations governing the borrowing of foreign companies, also added to demand pressures in the economy.

CHART 2.3: SHARE OF HOUSEHOLD CREDIT IN TOTAL COMMERCIAL BANK CREDIT

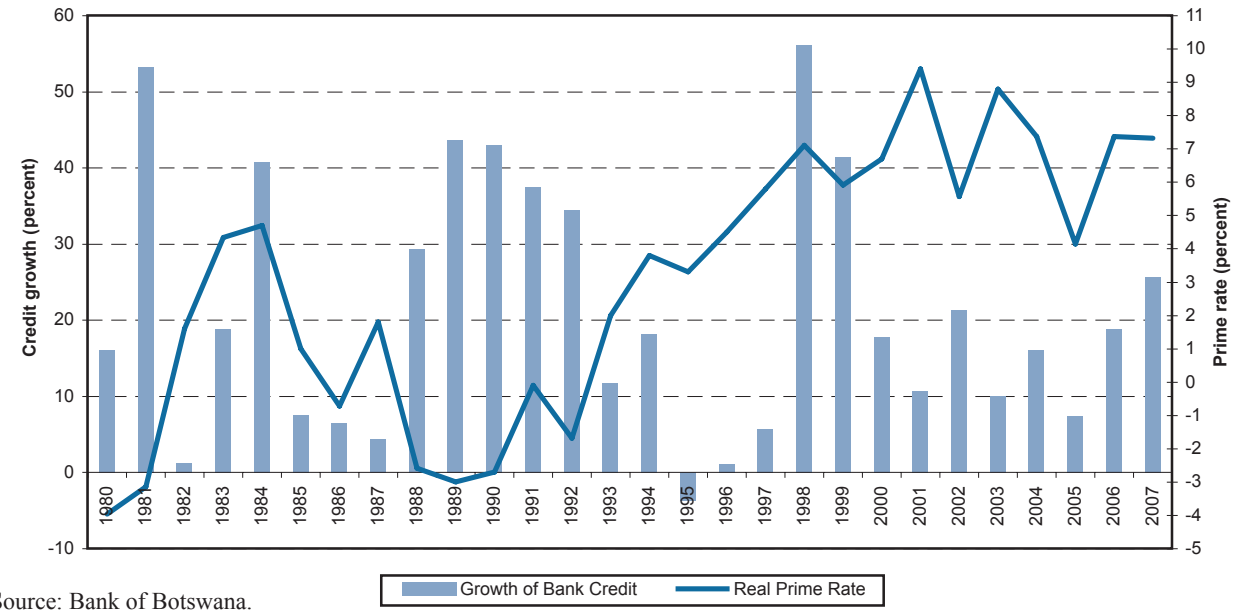


Source: Bank of Botswana.

while NDP 5 indicated that monetary policy aimed at attaining price stability, NDP 6 and other official publications identified the additional roles of promoting economic growth, and supporting fiscal policy to achieve external stability. This approach, for example, allowed for downward adjustment of the exchange rate to maintain export competitiveness, although it was inflationary in the short-term. While it appears that relatively high levels of inflation did not constrain growth led by mining activity (Chart 2.6), it is possible that other sectors would have benefited from a focus on price stability and positive real interest rates. In particular, any substantial unproductive lending engendered by negative real interest rates would have an adverse effect on long-term growth prospects.

3.31 Table 2.4 presents summary measures of inflation over two distinct periods representing different monetary policy regimes. It is notable that with an increasingly clearly defined focus on price stability, such as has been the case since the late 1990s, there has been improved inflation performance, both in terms of a lower level and reduced volatility (measured by the standard deviation). In particular, the focus on price stability has allowed for greater use of

CHART 2.4: GROWTH OF BANK CREDIT AND REAL PRIME RATE

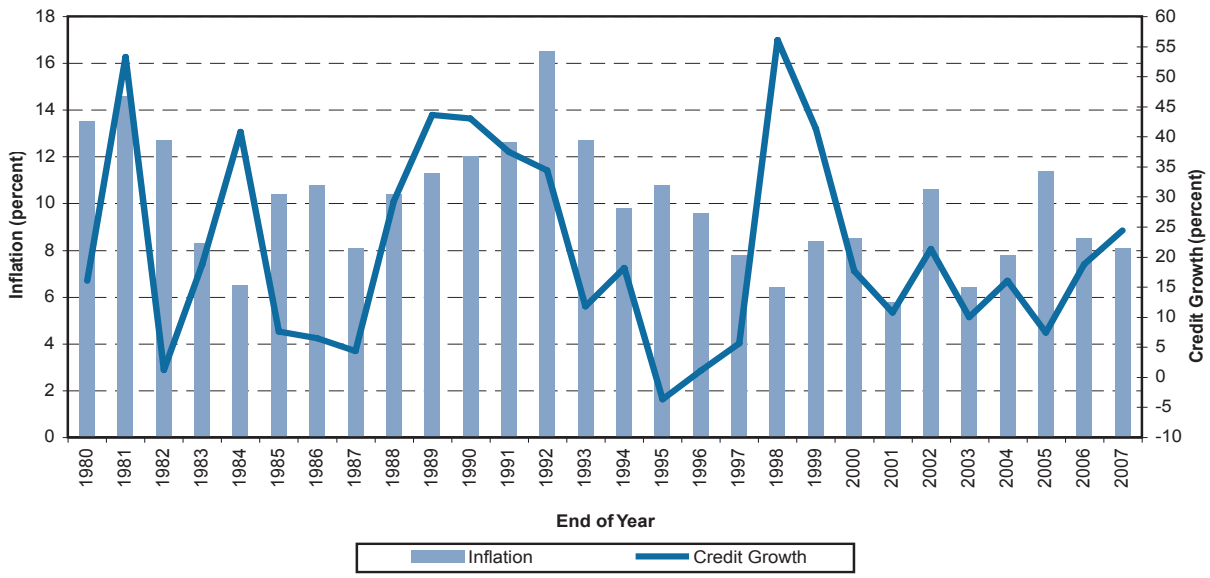


Source: Bank of Botswana.

the changes in the monetary policy framework, encompassing the focus on attaining positive real interest rates and subsequently in the 2002 MPS, explicit statement of a numerical price stability objective.

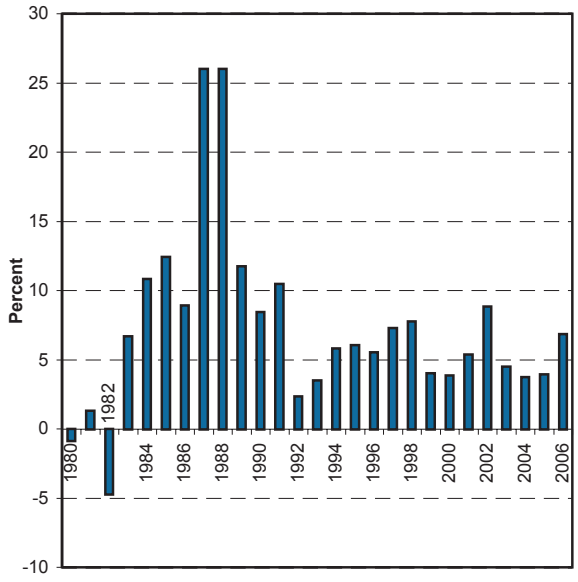
3.30 In the pre-liberalisation period, there was an apparent multiplicity of roles for monetary policy, possibly contributing to relatively high levels of inflation at the time. For example,

CHART 2.5: GROWTH OF BANK CREDIT AND INFLATION



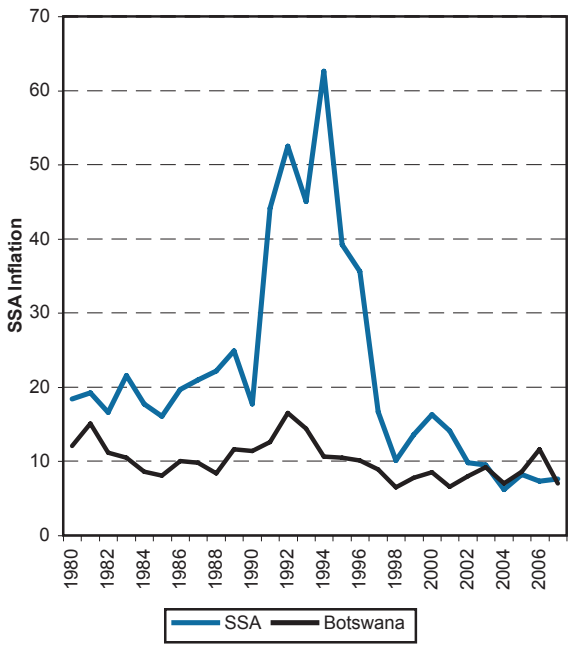
Source: Bank of Botswana.

CHART 2.6: GROWTH OF REAL NON-MINING GDP



Source: Bank of Botswana.

CHART 2.7: BOTSWANA AND SUB-SAHARAN AFRICA (SSA) INFLATION



Source: Bank of Botswana and IMF International Finance Statistics.

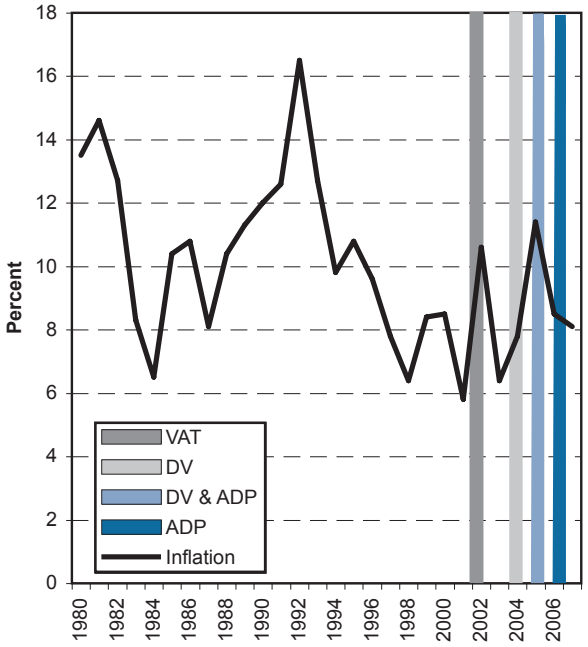
TABLE 2.4: INFLATION PERFORMANCE UNDER DIFFERENT POLICY FRAMEWORKS

Period	Annual CPI Inflation (mean)	Range	Annual CPI Inflation (standard deviation)
1980:1 to 1992:4	11.3	5.7–17.3	2.9
1993:1 to 2006:4	9.2	5.8–16.4	2.4

Source: Bank's calculations using IMF International Financial Statistics quarterly inflation data (monthly averages).

interest rates to influence credit growth and, therefore, reduce demand pressures on inflation. The global decline in inflation resulting from a greater influence of monetary policy on inflation expectations, improvements in technology and transfer of production to the lower cost Asian economies, has also contributed to lower inflationary pressures domestically. The

CHART 2.8: BOTSWANA INFLATION AND SELECTED PRICE SHOCKS



Notes: 1. VAT = Value Added Tax
2. DV = Devaluation
3. ADP = Administered Prices

Source: Bank of Botswana.

inflation performance in Botswana compares favourably with developments in Sub-Saharan Africa (SSA) (Chart 2.7). Inflation in Botswana has been lower than the average for SSA for the period under review, except in 2005 and 2006, when domestic inflation rose due to the devaluation of the Pula. It is, however, notable that recent policy improvements in several SSA economies and world price developments contributed to a generally lower inflation on the continent.

3.32 Operationally, the introduction of BoBCs in 1991 facilitated an effective mopping up of excess liquidity, albeit at a high cost, and the attainment of market interest rates, consistent with the monetary policy stance. Lending rates were, therefore, positive in real terms from 1993 (Chart 2.4), resulting from the combination of the increase in nominal interest rates and success in reducing inflation. In particular, the successive increase in interest rates, as the Bank Rate rose from 8.5 percent in 1990 to 14.25 percent in 1993, resulted in significant slowing of credit growth**.** Overall, credit expansion eased from 37.4 percent in 1991 to 24.4 percent in 2007, except for the spike in 1998 associated with the increase in personal disposable incomes resulting from a 25 percent increase in civil service salaries (Chart 2.5). Within the total, household credit expansion declined from 44.2 percent in 1991 to 29.4 percent in 2006; while business credit growth eased from 34.3 percent to 17.6 percent in the same period.

3.33 Success in restraining credit growth appears to have moderated domestic demand pressures on inflation as subsequent spikes in inflation can, in general, be attributed to transitory supply-side factors. For example, inflation rose due to the introduction of VAT in 2002, the devaluation of the Pula in February 2004 and May 2005 (Chart 2.8), as well as several significant increases in administered prices in 2005 and 2006.

3.34 Given that supply-side influences have been a constant feature of economic developments in Botswana, it can be argued that, in the absence of a clear price stability objective, such was the case in the period prior to 1993, monetary policy did not adequately respond to price developments; hence, inflation rose significantly. In contrast, monetary policy appears to have been much more responsive to the influence of transitory factors, from the beginning of the 1990s, restraining demand pressures, as well as the second-round effects of supply shocks, thereby keeping inflation generally low.

3.35 In addition, the explicit focus on price stability as the primary objective of monetary policy facilitated enhanced policy coordination, notably the restraint with respect to parastatal tariff increases. Broadly, better communication and transparency (e.g., through the annual MPS, their mid-year reviews and regular economic briefings) have added to policy credibility and, consequently, the extent of the Bank's influence on expectations.

3.36 Overall, monetary policy in Botswana has contributed to macroeconomic stability, but

with a notable aberration at the end of the 1980s and early 1990s, with a loose monetary policy that featured negative real interest rates, consumption led credit growth and high inflation. It is also not apparent that the policy of direct control over interest rates and maintaining them at a low level resulted in the envisaged industrialisation. It appears industrialisation at the time was mostly due to direct government involvement through the Botswana Development Corporation and other parastatals, as well as financial assistance made possible by increasingly high diamond revenues. However, the change in the monetary policy framework from the early 1990s has contributed to macroeconomic stability with no sustained period of demand-induced large price increases and spikes in inflation explained by exogenous and largely transitory factors.

3.37 Going forward, continuing efforts by the monetary authorities to sustain the effectiveness of monetary policy include the development of capacity to understand and communicate the transmission mechanism of monetary policy. Recent initiatives include:[23]

(a) specification of a medium-term policy horizon for the achievement of the inflation objective;

(b) determination of the medium-term inflation forecast as the intermediate target that signals a policy response;

(c) publication of three measures of inflation; and

(d) policy announcements following meetings of the Monetary Policy Committee.

4. ROLE OF FISCAL POLICY IN MACROECONOMIC STABILITY

4.1 Fiscal policy refers to the profile of government revenue and spending: the aggregate levels, the composition and overall balance between revenue and expenditure.[24] More specifically it refers to the use of changes in spending or revenue to influence the direction of the economy as reflected in the overall level of activity and the allocation of resources among sectors.

4.2 Since independence, fiscal policy in Botswana has been characterised by prudence to ensure that programmes of government spending are sustainable and that the allocation of resources between the public and private sectors is appropriate. The fiscal policy framework has also evolved to address both shortcomings and the changed circumstances of a rapidly developing economy.

Dimensions of Fiscal Stability

4.3 Fiscal policy has three major functions:

(a) allocation of resource use between the production of private and social goods, as well as directing resources within the private sector;

(b) distribution of income or wealth in a manner considered fair by society; and

(c) stabilisation role in support of macroeconomic stability.

4.4 In turn, each of these functions has both a short and long-term dimension, with the former looking at the immediate impact and the latter looking at the cumulative effect over many years. However, given these multiple dimensions, the various objectives of fiscal policy may come into conflict. In particular, the stabilisation function will often conflict with allocation and distribution, especially if stabilisation requires cutbacks in expenditure or tax increases. Similarly, even within the same function, the short-term and long-term objectives may not coincide. For example, a fiscal stimulus to reverse a downturn may impinge on long-term budget sustainability and the possible need to raise taxes in future to pay for current spending.

23. Monetary Policy Statement – 2008, Bank of Botswana.

24. The term is derived from 'fiscus', a Latin word literally meaning 'basket' or 'purse'. Once used to refer to the treasuries of ancient Roman emperors, usage was subsequently broadened to cover state finances more generally.

4.5 The potential for conflict is greater given the institutional framework within which fiscal policy is formulated. Approval of government budgets is part of the democratic process and the legislature may have less concern than technocratic policy makers with stabilisation than with allocation and distributional objectives.[25] In addition, legislative approval may be a lengthy process, thus undermining the timely implementation of policy.

4.6 Discussion of fiscal policy options, in particular for its role in macroeconomic stability, is informed by the use of a simple analytical framework. For the economy to be in equilibrium (neither accelerating nor slowing or, more generally, growing smoothly in line with potential output) 'injections' must be matched by 'leakages'. Using standard notation, this is reflected in the mathematical expression:

$$G + I + X = T + S + M \qquad (1)$$

where G is government spending (including investment); I is non-government investment; X is exports; T is taxation; S is non-government savings; and M is imports.

4.7 Rearranging equation (1) gives:

$$(G - T) = (S - I) + (M - X) \qquad (2)$$

Equation (2) pairs the injections and leakages into the major economic balances: the budget deficit/surplus (G-T), net private savings (S-I) and the trade balance (M-X). Shown this way, it illustrates the case for using fiscal policy as a tool for *demand management.* For example, a larger government budget deficit, either through higher government spending or reduced taxation, may help offset an excess of savings, while a reduction in the budget deficit can contribute to a narrowing of the trade deficit. This basic model also points to the potential for fiscal policy to *automatically stabilise* the economy, in particular as tax and, hence the budget balance move counter-cyclically.

4.8 As presented, the interpretation of equation (2) is the basic 'Keynesian' approach to macroeconomic stabilisation, emphasising the role of fiscal policy in demand management. However, this approach to using fiscal policy as a tool for economic stabilisation can be limited due to four main reasons:

(a) it ignores the interrelationships between the major balances, consideration of which points to several channels through which fiscal policy may 'crowd out' other economic activity. For instance, increased government expenditure, if financed by borrowing, may increase interest rates and hold back private investment or, alternatively, increase private savings as higher future taxes to pay off the increased debt are anticipated. Higher interest rates arising from increased government spending could also put upward pressure on the exchange rate, thus curtailing exports.

(b) focussing on the budget deficit (a flow) risks ignoring the accompanying build up of debt (a stock) and whether this is sustainable. This requires consideration of key ratios, including that of the budget deficit *(G-T)* and total debt (*D*) to national output *(Y)*.

(c) the deficit measure says nothing about the overall size of government in the economy, as the allocative function will have consequences for growth and, hence, the long-term sustainability of fiscal policy.[26] In addition to an increased risk that government spending will crowd out the private sector, the taxes needed to finance high levels of G could act as a disincentive to work, save and invest.

25. This is widely acknowledged to be a particular problem in the United States where the Congress (the US legislature) is widely perceived to be less guided by discipline within the political parties than is the case in European-style democracies.

26. If the scale and range of government activities promotes rapid growth, then this will ease concerns that any build up of debt resulting from a sustained period of budget deficits will be unsustainable.

Thus, consideration of *G/Y* is an important component of any analysis.

(d) there is also a view that there is no need for activist fiscal policy as the economy will naturally return both smoothly and quickly to grow in line with its potential. If there are obstacles to this, they lie on the supply side of the economy, with a poor functioning of markets. In this context, fiscal stabilisation is viewed as being, at best, irrelevant.

International Benchmarks

4.9 Since the early 1980s, there has been greater focus on 'tight' fiscal policy, where the emphasis is on restraining the growth of public expenditure in order to limit both the role of government and guard against the build up of government debt to unsustainable levels. For industrial countries, this was in reaction to the perceived failure of activist fiscal policies which, by the 1970s, were seen to have contributed little to stable growth and full employment while, at the same time, aggravating problems of inflation through monetary expansion to fund budget deficits. An example of this bias towards tight fiscal policy among developed economies is shown by the 'Maastricht Criteria' which apply strict rules for fiscal policy for members of the euro area.[27] This is despite the loss of independence in monetary policy for these economies, which would seem to provide a case for increasing, rather than reducing, the scope for fiscal flexibility.

4.10 For developing economies, the emphasis on tight fiscal policy has been a central focus of the policy advice provided by the IMF and the World Bank, the principal aim of avoiding an excessive build up of international debt which threatened national solvency.[28] During the 1990s, the case against using fiscal policy as a tool for economic stabilisation appeared to strengthen. With inflation increasingly under control, monetary policy was considered able to both maintain price stability and guide output and employment. Nevertheless, a role for stabilising fiscal policy had not been abandoned, as budgetary frameworks typically allowed some role for automatic fiscal stabilisers (e.g., the injection arising from reduced taxes and higher social welfare payments that occur during an economic downturn)[29] while, at the same time, the experience of price deflation in Japan pointed to the limits of monetary policy in providing economic stimulus (Section 3). More recently, the on-set of the 'sub-prime' crisis in mid-2007, triggered a debate on the pros and cons of an emergency fiscal stimulus to forestall an economic recession in the United States.

Fiscal Rules and Budgetary Convergence

4.11 Many countries have established fiscal rules and measures to ensure transparency in policy making, all of which help to promote fiscal consolidation and achieve sustainability. By limiting the scope for *ad hoc* and unaccountable decision making, fiscal rules and transparency strengthen discipline, thus helping governments maintain the commitment to sound and sustainable public finances. The three broad categories of such rules are:

(a) deficit and debt rules that limit the size of the budget deficit and/or public sector debt measured as a percentage of output;

(b) expenditure rules that put emphasis on spending, thus, restricting the size of government in the economy. Spending can be limited to a fixed proportion of GDP or determined within a medium-term expenditure framework (MTEF), which was pioneered in Australia; and

(c) a transparent approach to fiscal manage-

27. "Maastricht Criteria" is named after the Dutch town where the revision of the European Union Treaty to include the proposed Economic and Monetary Union was signed in 1992.

28. This is widely referred to as the 'Washington Consensus' due to both the IMF and World Bank having headquarters in Washington, D.C.

29. Similarly, in an upturn there is a counter-cyclical combination of high taxes and reduced welfare payments.

ment that places primary and explicit emphasis on opening the process of fiscal policy decision making to public scrutiny. This includes the structure and operations of government and public sector accounts, together with clearly-defined fiscal policy intentions and projections.

4.12 Each of these approaches has strengths and weaknesses. The deficit rule is clear and focuses on a generally well understood macroeconomic aggregate. However, it lacks flexibility and may tend to be pro-cyclical as spending must be curtailed during periods of slower growth and defining the rule to have a cyclically adjusted deficit or an average over the economic cycle can affect transparency.

4.13 Similarly, a limit on debt is only a crude indicator of debt sustainability, as capacity to service debt is determined not so much by the overall volume of borrowing, but how productively it is used. Hence the attraction of rules that limit borrowing to capital expenditure. However, this is only likely to be effective in an institutional environment where there is confidence that such spending is reserved for productive investments.

4.14 An expenditure rule is likely to be clearly understood and it tackles directly the likely upward bias in public spending arising from political and institutional pressures to increase expenditure. Imposing overall ceilings on expenditure can increase fiscal discipline, by ensuring recognition of trade-offs where rapid expenditure growth in one area must be matched by restraint elsewhere. However, as with deficit rules, a simple expenditure rule may be too rigid, while the frequent updates needed for a detailed MTEF to be maintained on a rolling basis are likely to be resource intensive.

4.15 Similarly, fiscal transparency increases credibility in the economy's fiscal policy even in cases where the government needs to temporarily deviate or change from an earlier adopted fiscal rule. However, additional transparency makes increased demands on reporting requirements, which can prove overly burdensome.

Main Components of Fiscal Policy in Botswana

National Development Plans (NDPs)

4.16 Botswana has a long experience in pursuing prudent fiscal policies that have contributed to a stable macroeconomic environment. The emphasis has always been on the longer-term dimension of sustainability. The foundations for this were laid well before mining developments helped transform the economy, when resources available to the Government were limited and largely dependent on foreign donors. Lessons were also drawn from the experience of other developing countries, especially those that were resource rich. Although endowed with natural resources, some of these countries were unable to sustain higher levels of economic growth due to weak fiscal management.

4.17 The centrepiece of fiscal policy has been the medium term development planning involving successive National Development Plans, with a mid-term review. Central to the process of preparing the plans are forecasts of resources, both financial and human, that will be available to the government. From these are derived the medium-term government budgets, where the main elements of capital and recurrent expenditure are explicitly linked to ensure consistency. Other than in exceptional circumstances, development projects to be included in the plan period must be explicitly identified in the NDP at the time of its approval.[30] Subsequent adjustments to spending allocations can be made through the annual budgeting process, but this is in the overall context of the planning process.

Evolving Fiscal Objectives

4.18 While the NDPs have remained a constant

30. When new projects are introduced, they are formally incorporated into the plan through parliamentary approval.

feature, fiscal policy in Botswana has evolved substantially. The original objective was to achieve 'financial independence' by removing reliance on the UK Government for funding the recurrent budget. In the first four years of independence, recurrent grants from donors made up nearly 40 percent of total government revenues. However, 'financial independence' was achieved in 1972/73, and indicated the commitment to fiscal prudence and self reliance.

4.19 Following from this early success, the objective of maintaining budgets that were generally in surplus gradually became entrenched. This was partly because, by the mid-1980s, budget surpluses had become the norm. In addition, the Government was aware of the problems encountered by other countries where fiscal discipline had not been adequately maintained. Hence, the focus on sustainability has been maintained as indicated by the pronouncements in successive budget speeches. For example, when a substantial deficit was budgeted for 2002/03, it was described as a 'temporary departure from the norm, and in no way a decision to jettison our time-tested principle of sustainable budgeting'.[31] The following year, it was made clear that, for budgetary purposes, macroeconomic balance 'translates into the requirement of a balanced budget'.[32] Meanwhile, the Government had in 1973, established the Public Debt Service Fund (PDSF) and the Revenue Stabilisation Fund (RSF) to help absorb surpluses, provide a cushion against economic shocks and meet the costs of servicing public debt.

4.20 However, recently, in adopting additional formal fiscal rules, the Government has clarified that the broad objective of budgetary balance is not to be followed rigidly on an annual basis. According to the MTR of NDP 9, 'Government's policy is to balance the budget over NDP 9,[33] an approach that allows fiscal policy to play a stabilising role in the economy, while maintaining overall balance in the medium term.[34]

4.21 A recurring concern of fiscal policy in Botswana has been the heavy reliance on the mining of diamonds, a non-renewable resource, as the principal source of government revenue. With the bulk of revenues coming from this asset sale proceeds, the fiscal position could only be sustainable in the long run if the revenues were channelled into productive use and not simply used to finance day-to-day government activities. Recognition of this became a key aspect of 'sustainable budgeting', and in the early 1990s this crystallised into the adoption of a fiscal rule under which non-investment spending must be financed by recurrent revenues. In turn, this implied that all non-recurrent revenues should be reserved for investment or saving.

4.22 Following this commitment, the MTR of NDP 7 adopted a 'budget sustainability ratio' (BSR) to monitor adherence to this rule.[35] This measures the ratio of non-investment spending to recurrent revenue, with the rule stipulating that the ratio should remain below one. However, as with other fiscal rules, the BSR is subject to potential limitations. At the macro level the division between investment and non-investment spending is not clear cut. In Botswana, for purposes of calculating the BSR, 30 percent of recurrent spending is counted as investment. This approximates to recurrent spending on health and education. However, whether all of this can legitimately be regarded as investment in human capital might be questioned. In addition, all spending in the development budget is counted as investment, even if this may not always be appropriate. For instance, while practical reasons might require priority activities such as

31. Budget Speech 2002.
32. Budget Speech 2003.
33. NDP 9, MTR.
34. Budget Speech 2005.
35. This is the term used by Government in discussions of sustainable budgeting, NDP 9, Box 3.1, p40. Elsewhere, an equivalent measure has been labelled the 'Sustainable Budget Index (SBI)', Bank of Botswana Annual Report, 1994, p29.

drought relief, deferred maintenance of public infrastructure, and the alleviation of HIV/AIDS, to be handled as development projects, it is questionable whether such expenditures will replace diamond wealth that has been used to fund the development budget.

4.23 At the same time, by focussing on aggregate components of spending, attention may be distracted from the returns yielded by individual components of government investment spending. If some development projects are likely to yield a very high return, then some non-renewable revenues could be freed up for other uses. Conversely, if some projects do not yield an effective return, then satisfying the BSR rule may not be sufficient to ensure sustainability. The Government has noted this potential problem in the MTR of NDP 9 and observed that '…some projects financed by the development budget did not yield a high social rate of return'; this was because either '…the projects were not high return projects' or there was '…insufficient attention to ongoing operating and maintenance…' of the completed projects. The MTR called for a 'paradigm shift' in the approach to project budgeting and implementation.[36]

4.24 Recently, the IMF has suggested that the BSR be augmented by a more sophisticated analysis based on measures of the government's 'permanent income'. This starts from the same premise as the BSR, that future government spending following the depletion of diamonds should be financed by returns on investing mineral revenue. It, however, involves more complex calculations of likely income flows arising from mineral revenues, together with an explicit consideration of a relevant inter-temporal social welfare function. The authorities have welcomed the advice, but have indicated that the current approach is sufficient, in the context of a proposed programme of public spending that is expected to yield high returns.[37]

4.25 The fiscal policy framework in Botswana has also been augmented by an additional fiscal rule as a result of the MTR of NDP 9. The new rule has two main components:

(a) other than in exceptional circumstances, total government spending is to be limited to 40 percent of GDP;

(b) the proportion of development spending in the overall budget should increase to 30 percent of total expenditure, from the then level of around 25 percent, by the end of NDP 9, and maintained at that level thereafter.

4.26 In addition, the discussion of the fiscal rule in the MTR includes extensive reference to the necessary institutional elements that indicate the commitment to transparency and ensuring that the budgeting process and the new rule are compatible.

4.27 The introduction of the new rule was the result of an explicit acknowledgment by the Government of shortcomings in the existing budgeting process.[38] In particular, growth in recurrent spending had been driven mainly by short-term revenue growth. As a result, when revenue growth slowed in the early 2000s, the budget entered a series of deficits which, in the last two years of NDP 8 (2001/02 and 2002/03), exceeded 3.5 percent of GDP. As well as dealing with the risk of excessive budget deficits, the adoption of a spending rule would also help limit the overall size of Government and its command over national resources.

4.28 Nevertheless, the new spending rule faces challenges of implementation. In particular, at the time the annual budget is prepared, the GDP for the relevant period must be forecast, a process which is currently internal to the Government. Moreover, at present, estimates of actual GDP are only known after a lag and then often subject to extensive revision; therefore, whether the fiscal rule has been adhered to may not be known for some time.

36. NDP 9 MTR, p100 and p110.

37. IMF 2007 Article IV Report, p9.

38. Mid-Term Review of NDP 9.

In practice, this has not yet been a problem, as underspending of the budget has meant that the rule has yet to be a binding constraint.

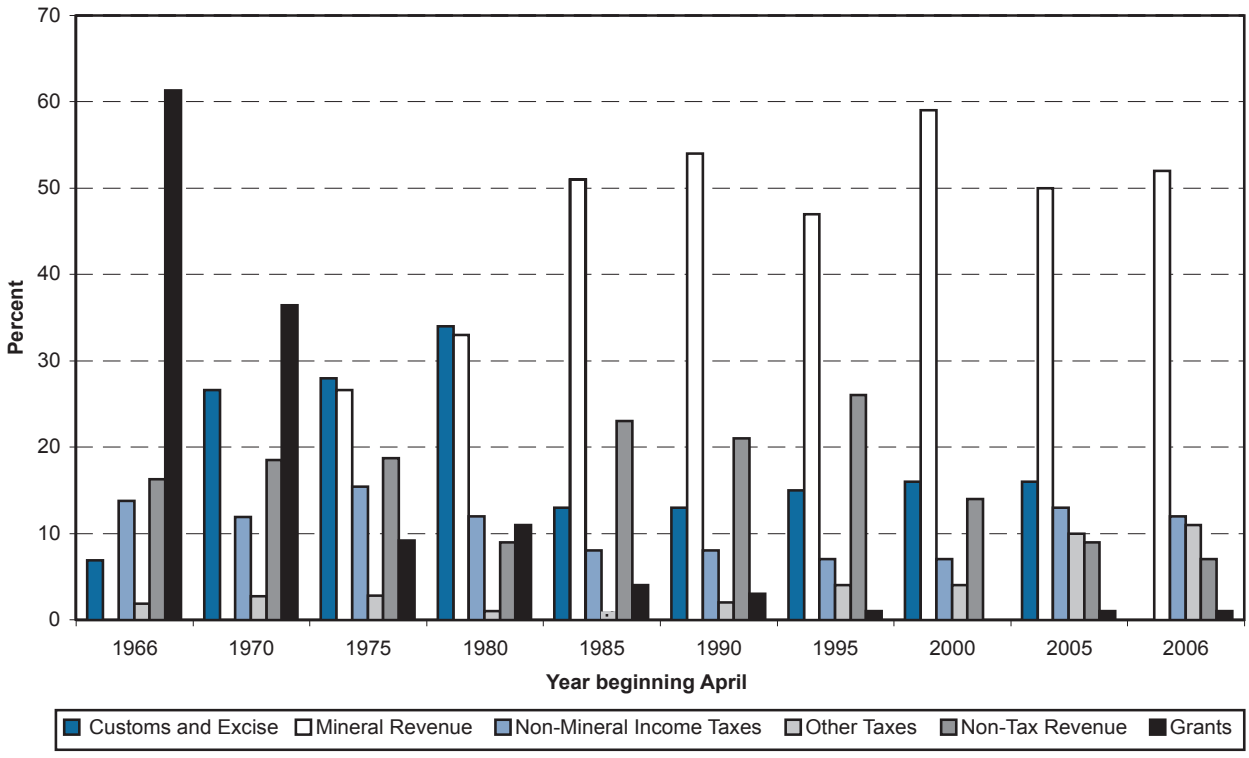
4.29 The commitment to increase the share of investment spending may also create difficulties. The goal of using public investment to boost growth in the economy is understandable. However, the emphasis should first be on the achievement of the 'paradigm shift' with regard to project implementation. Without this firmly in place, the risk is that the problems of low-return development projects may continue. This is especially the case given that an increased share for development spending necessarily implies that the share of recurrent spending is reduced at the same time that additional investment is adding further to recurrent commitments. So the problems with maintenance and operation can only be addressed in the context of improved efficiency and productivity.

Track Record of Fiscal Policy in Botswana

Sources of Revenue

4.30 Chart 2.9 indicates the changing balance in the source of government revenues since independence. The early period, when grants were the main revenue source, has already been addressed. Subsequently, for most of the 1970s, receipts from the Southern African Customs Union (SACU) were dominant. These grew rapidly from the late 1960s due to two factors. First, a new SACU agreement came into force in 1969 which introduced a sharing of revenues that was more favourable to the smaller member countries (Botswana, Lesotho and Swaziland). Second, this coincided with the initial stage of the mining boom which involved large-scale imports of capital goods (thus generating customs duty) for the development of mines and associated infrastructure. From the early 1970s the new mines started contributing to government revenue so that by the early 1980s the

CHART 2.9: GOVERNMENT REVENUE SHARE BY SOURCE 1966 – 2006



Source: Government of Botswana.

contribution of SACU payments and mining revenues was more or less equal. The trend was interrupted in the early 1980s by a slump in the world diamond market (Box 2.1, but from 1983/84 mineral revenues became firmly established as the major revenue source.

4.31 This has remained the position ever since, due to continued expansion of diamond production, although earlier on the Government was very cautious about the future prospects of the mining industry. The economic forecasts for NDP 6 (1985/86 – 1990/91), for example, assumed that diamond output had reached a plateau and that, in real terms, mineral revenues would peak in the first year of the plan. It was projected that by 1990/91 mineral receipts would contribute only 35 percent of total revenues; in fact the contribution was 54 percent.[39]

4.32 While mineral revenues have continued to contribute the largest share of government revenue, it is worth pointing to two other features in government revenue trends. First, there is the importance of non-tax revenues. The most important item in this category is the regular payments made to the Government by the Bank of Botswana derived from investing the foreign exchange reserves.

4.33 By the mid-1990s, payments from the central bank had become sufficiently substantial to exceed, in some years, revenues from SACU. However, they exhibited considerable volatility, which made budgetary planning more difficult, and since the revised Bank of Botswana Act was enacted in 1996, payments are agreed in advance, rather than based on actual operating profits. The relative importance has also declined due to both rapid growth in SACU revenues, especially since a new revenue sharing formula was introduced in 2004/05, and the rising costs to the Bank of absorbing domestic excess liquidity.

4.34 The second feature to be highlighted is the growing importance in the past few years of non-mineral taxes. In 2000/01, these made up 11 percent of total revenues, but by 2005/06 this had grown to 23 percent. This was despite the continued rapid growth in both mineral revenues and SACU receipts and reflects success in the diversification of the revenue base, which is essential for long term fiscal stability. In particular, the successful introduction of VAT in 2002 to replace the narrower sales tax, which has increased the importance of indirect taxes in the overall tax burden, and improved income tax collection, have contributed to this trend.

Overall Balance, Debt and Savings

4.35 Chart 2.10 shows the overall budget balance from 1966/67 to 2006/07, in constant 2006 prices. Also shown are the two main financing items for the budget: changes in government cash balances and net borrowing.[40] In the early years of independence, when deficits were a regular occurrence and the Government had limited resources, borrowing to supplement grants played a significant part in deficit financing. But thereafter, borrowing has played a very limited role with a declining debt to GDP ratio. This reflects the healthy financial situation that has generally prevailed, and the long-standing policy that only borrowing on concessional terms should be used (Chart 2.11).[41]

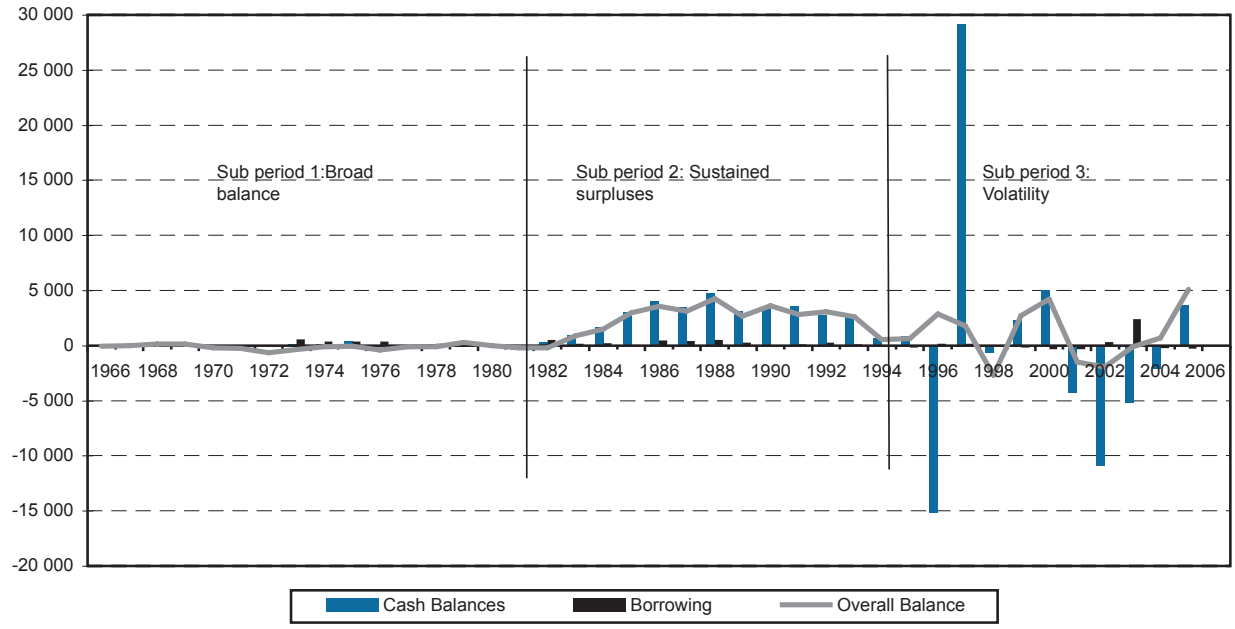
4.36 For a more detailed analysis, it is useful to consider three distinct sub-periods, first is the period up to the early 1980s when, relative to subsequent years, the budget was broadly in balance. In the early years of independence, fiscal balance was maintained through extensive reliance on donor grants. Although recurrent grants quickly reduced from 1969/70, grants for development spending made up 52 percent of total government revenues in 1972/73.

39. NDP 6, Table A.2.1.1 (p51) and (p69).

40. The financing items are not shown for the period prior to 1973/74, for which the necessary information is not available.

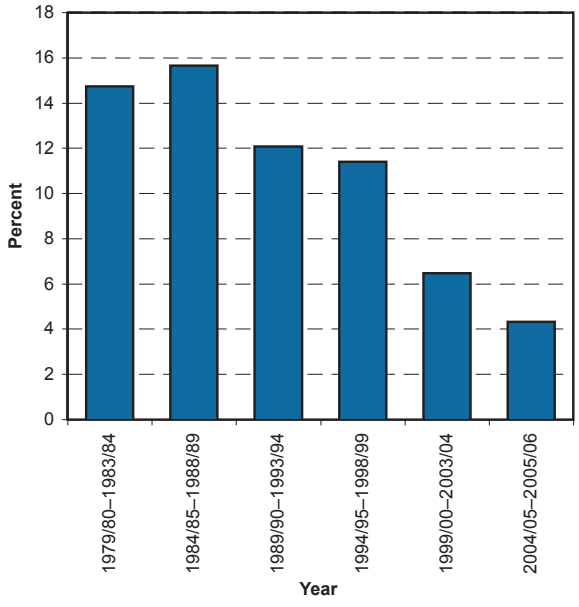
41. Such concessional funding has become increasingly difficult to access due to the country's classification as an upper middle income country.

CHART 2.10: BUDGET BALANCE AND FINANCING 1966/67 – 2006/07 (2006 PRICES, P MILLION)



Source: Botswana Government, Bank of Botswana.

CHART 2.11: EXTERNAL DEBT AS A PERCENTAGE OF GDP



Source: Bank of Botswana *Annual Reports*.

Furthermore, the fiscal imbalances, although small in absolute terms, were more significant as a proportion of GDP. The second sub-period was from the early 1980s to the mid-1990s when the budget was consistently in surplus due to a combination of growing mineral revenues and capacity constraints which resulted in underspending of the development budget. The surpluses were closely matched by the accumulation of government cash balances and their counterpart in the foreign exchange reserves.

4.37 In contrast, the period since the mid-1990s has been characterised by increased volatility. The budget has been in deficit on four occasions, including three successive years from 2001/2 to 2003/4. The principal cause of the deficits was the revenue shortfall at a time when previous buoyancy had encouraged growth in planned spending (Box 2.1). In addition, the main financing items have not simply matched the overall balance. This reflects several distinct actions by Government including:

(a) adjustments to the structure of government accounts following the revised Bank of Botswana Act in 1996, that resulted in large movements in recorded government cash balances in both 1996/97 and 1997/98, albeit, mainly due to changes in accounting practices rather than actual volatility in the government's financial position;[42]

(b) the establishment of the Public Officers Pension Fund which resulted in substantial

BOX 2.1: CONTRASTING EPISODES OF SHORT TERM FISCAL POLICY ACTIVISM IN BOTSWANA

Despite the generally longer-term approach to fiscal policy, there have been instances of short-term policy activism, with varying results. Three are discussed briefly below for illustrative purposes.

1. Global recession in the early 1980s: *In 1981 a global recession, triggered by sharply rising oil prices in 1979 and subsequent tightening of monetary policy, resulted in a sharp slowdown in world diamond markets. This led to a quota being imposed on the export of diamonds from Botswana, which threatened both the government budget and the balance of payments. Appropriate fiscal policy was required as part of a set of corrective measures (which also included monetary and exchange rate policies responses) to avert a balance of payments crisis. Fiscal restraint was introduced, including a freeze on government salaries and the withdrawal of spending warrants. However, spending growth did not stop, thus supporting stability in economic development. The budget was in deficit for three years from 1980/81 to 1982/83, with the deficits being financed through a mixture of borrowing and drawing down savings. Monetary policy tightening allowed public spending to continue by holding back spending by households and the private sector. Overall, this was a classic response to macroeconomic instability, with fiscal policy playing a leading role.*

2. Front-end loading of NDP 8: *In the late 1990s, concern at the slow pace of development spending in NDP 7 led the government to embark on 'front-end loading' of the budget. This aimed at implementing the bulk of the development programme in the early years of the plan in order to make up for earlier lost ground.[44] From 1996/97 to 1999/2000, the annual budgets indicated rapid growth in development spending, to the extent that if total development expenditure planned for the first half of NDP 8 had been realised, this would have accounted for 80 percent of the development budget for the whole plan.[45] However, it was soon realised that the strategy was not yielding the desired results, while risking economic instability. With capacity constraints on spending, costs were driven up, which both reduced the return on public investments and threatened to crowd out the private sector. As a result, the budget for 2000/01 saw sharply lower growth in budgeted development spending, which became negative in real terms. Such episodes point to the limitations on fiscal policy for driving economic development, especially in the presence of supply constraints.*

3. Balancing the budget in 2003/04*: The original budget for 2003/04 was broadly in balance, showing a small surplus of P206 million. However, subsequent estimates indicated that, due to a combination of revenue shortfalls and supplementary spending authorisations, a deficit of P2.2 billion was anticipated. Being the equivalent of five percent of GDP following two years of rising deficits, this was seen as unacceptable. As a result, the 2004 Budget Speech announced remedial measures in order to meet the original objective of a balanced budget. In particular, the Finance and Audit Act was invoked to withdraw 5 percent of the recurrent budget. Development spending was also cut, although this was less problematic due to persistent underspending, while additional measures to raise revenue were introduced.[46] This package was effective (the eventual deficit was only P78 million). The Government's prompt response in the face of impending budget deficits is understandable, helping to maintain credibility in fiscal policy, which had stressed the importance of balancing the budget. However, unlike the early 1980s when corrective action was needed to maintain macroeconomic stability, in the early 2000s, a third year of budget deficits would not, in itself, have been unduly harmful. Perhaps this experience contributed to the Government's subsequent clarification that the budget should be balanced over the medium-term, rather than on an annual basis.*

outflows from cash[43] balances between 2001/02 and 2005/06, even when the budget was in surplus; and

(c) the issuance of government bonds totalling P2.5 billion in 2003 in order to support the development of the domestic capital market, which substantially increased the volume of net borrowing during that period.

42. In both the years in question, the large movements in cash balances were broadly matched by equivalent movements in the 'other financing' component, which in other years has typically been insignificant.

43. Previously, pension liabilities had been funded on a 'pay as you go' basis directly from the annual budget.

44. Of the 179 projects included in the NDP 8 development programme, 156 were carried over from NDP 7 to NDP 8. However, not all the carried over projects reflected delays in project implementation, but rather natural overlaps between the plan periods.

45. Bank of Botswana Annual Report 1998, p51.

46. 2004 Budget Speech.

Challenges for Fiscal Policy Management

4.38 As illustrated earlier, fiscal policy in Botswana has gradually evolved to adapt to changing circumstances. Going forward, there are challenges relating to both the implementation of fiscal policy and its coordination with other macroeconomic polices, as well as to the need to improve the provision of economic data to support policy formulation.

Interpreting the fiscal stance

4.39 A long-standing difficulty with fiscal policy analysis in Botswana is the interpretation of the standard measure of the overall surplus/deficit.[47] Although a suitable guide for purposes of assessing overall budget sustainability, it does not correspond easily with the measure, which is used to gauge the expansionary or contractionary impact of fiscal policy on the domestic economy. This is because a large portion of revenues (including from minerals, Bank of Botswana and some payments from SACU) are derived from external sources and are not leakages from the economy in the same way that, for example, domestic taxes are. Fiscal policy has thus been more expansionary than the standard measure would indicate and, with the shares of revenue sources gradually changing, shifts in the overall balance may not adequately pick up changes in the fiscal stance. This suggests a need for analysis to be supplemented by an appropriate 'domestic balance' measure of fiscal policy.

Accuracy of the budget projections

4.40 The discussion so far has been based mainly on actual budget outcomes. However, it is instructive to look also at the original budgets presented at the time of the annual Budget Speech just before the start of the financial year, and subsequent revisions prior to the result being finalised.[48]

4.41 The budget outcome differs, sometimes significantly, from the initial projections as the major revenue items are largely outside government control, and are potentially volatile. In addition, plans for spending may change during the course of the year and, if expenditure switches (virements) from other categories cannot be effected, these are accommodated in supplementary spending estimates.

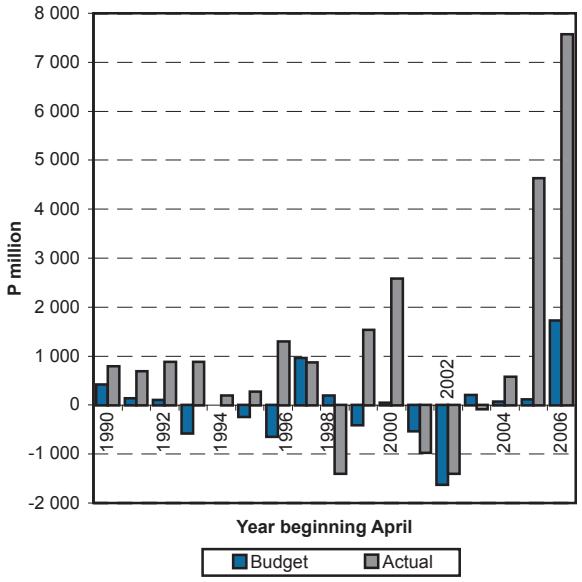
4.42 However, volatility is not the only explanation of deviations from the original budget. Analysis of budgets since the early 1990s suggests a tendency to understate the extent of budget surpluses (or, where relevant, overstate the size of expected deficits) and, in particular, to overestimate likely spending. This is shown in Chart 2.12. On several occasions in the mid-1990s, when a deficit was forecast, the final outcome was a surplus. In the 17 budgets from 1990/91 to 2006/07, on only four occasions was the outcome less favourable than budgeted and on only one of these, in 1998/99, was spending higher than in the original budget. In most cases where the balance was overstated, this was because of shortfalls in revenue, not over-expenditure.

4.43 The Government has, over a period of many years, acknowledged that underspending, especially of the development budget, has been a serious problem. However, for purposes of policy coordination, for which a realistic assessment of budgetary trends is essential, the problem is compounded by the way the budget is presented. This uses a forecast for revenue, but bases spending on agreed allocations to ministries, rather than on realistic estimates of what is likely to be spent. Fortunately, the more timely reporting of actual budget data during the course of the year has gone some way to address this issue.

47. This problem was also addressed in the 1998 Bank of Botswana Annual Report (see Box 2.II, p49).

48. By long-standing convention, the Budget Speech is delivered on a Monday of the first full week in February; the financial year begins on April 1. Formal revisions to the original estimates (known as 'revised estimates') are included as part of the following year's Budget Speech, with the final results being known only several months after the end of the financial year.

CHART 2.12: ORIGINAL BUDGET BALANCE COMPARED TO FINAL OUTCOME, 1990/91 – 2006/07



Source: Botswana Government.

Maintaining the discipline of the medium-term framework

4.44 The important role of the NDPs in providing a medium-term focus for fiscal policy has been stressed and to a large extent this has been successful. However, one of the reasons for the substantial underspending has been that spending growth in the annual budget has frequently far exceeded that envisaged in the original plan. For example, in NDP 9, the review of economic performance under NDP 8 calculated that spending growth had been twice as fast as anticipated in the original plan; the total estimated cost of the development budget had increased by 120 percent.[49]

4.45 Such accelerated spending growth is understandable to some extent since, as previously noted, the revenue projections have also typically been conservative. Yet, in justifying the fiscal rule, the government has recognised the dangers of spending growth that follows buoyant revenues rather than sound forward planning. These include both budget vulnerability in the face of revenue downturns, and eroding the return on government investments due to poor project preparation and follow up. Above all, perhaps, the availability of revenue to finance additional spending does not, by itself, ensure that the capacity to implement spending programmes effectively is available. In this context, the cautious and detailed approach adopted by the Government in improving implementation capacity is welcome, even though this has meant delays in meeting the ambitious targets for increasing investment spending by the public sector. However, while spending growth accelerated rapidly during 2007/08, it remains to be demonstrated whether the necessary 'paradigm shift' in the approach to project implementation, that government had identified as necessary and which focuses on the quality as well as speed of implementation, had yet taken place.

Data availability and compatibility

4.46 It is noted that progress still needs to be made in the reporting of budget and other relevant data. This is helpful to policy making, and will be essential if Botswana is to meet the requirements for subscription to the IMF's Special Data Dissemination Standards (SDDS). As well as budget data, where recent improvements in the timeliness of reporting have been noted, good quality GDP estimates are an essential component for fiscal policy analysis. This is especially the case since the government's fiscal rule to constrain spending is determined with reference to GDP. Improvements need to be made regarding both timeliness and the quality of provisional estimates in order to reduce the extent of subsequent revisions.

5. ROLE OF EXCHANGE RATE POLICY IN MACROECONOMIC STABILITY

5.1 As indicated in Section 2, exchange rate policy contributes to macroeconomic stability and can impact not only on the external sector, but on price and fiscal developments, and as financial stability. Exchange rates are typically classified as floating or fixed, but

49. NDP 9, (p39) and Table 5.1 (p76).

with a continuum of intermediate exchange rate arrangements between the two extremes. The choice of an exchange rate regime is influenced by country conditions and policy direction, particularly as it relates to the desired level and ability to manage or tolerate volatility, given the potential impact that exchange rates can have on broad economic developments.

Fixed Exchange Rates

5.2 In a fixed exchange rate framework, the value of the domestic currency vis-à-vis a foreign currency is held constant (pegged) through government intervention in the foreign exchange market (buying and selling foreign currency). The foreign currency, to which the domestic currency is pegged, is normally that of a major economy, or important trading partner, especially if it is stable relative to other major currencies. Alternatively, a fixed exchange rate can be achieved by belonging to a monetary union, effectively surrendering the power to independently change the exchange rate. For small developing economies, in particular, a fixed exchange rate can serve as a nominal anchor for inflation (Section 3), if it is fixed against the currency of a country with relatively low inflation. Moreover, there is a confidence effect where the link to a stable foreign currency encourages the holding of the domestic currency or domestic currency denominated assets. This derives from the assumed discipline effect since, generally, there are political and economic costs associated with abandoning a peg, as there may be a need to adjust other policies. A fixed exchange rate is also more feasible where the financial sector is not well developed and where it is unlikely that there will be an efficient determination of the market exchange rate. Examples include instances where the public sector or a dominant industry is a major supplier of foreign exchange. Fixed exchange rates are, however, less viable or difficult to maintain where there is a significant foreign exchange constraint. In particular, there is less scope to intervene to maintain the value of the currency at the fixed rate where there is a net outflow of foreign exchange (large current account deficit) and external borrowing constraint.

Floating Exchange Rates

5.3 The value of the domestic currency in a floating exchange rate regime is determined by the forces of demand and supply in the foreign exchange market. Although determined in the market, the monetary authorities can use domestic policy instruments such as interest rates to influence the exchange rate. Price stabilisation measures, such as an increase in interest rates, are likely to result in an appreciation of the exchange rate and, *ceteris paribus*, lower inflation. Conversely, an expansionary monetary policy leads to a depreciation of the exchange rate and, to the extent that resulting inflationary pressures can be mitigated, can have a positive impact on export competitiveness that is consistent with an output stimulating policy stance.

5.4 In practice there is a range of intermediate exchange rate arrangements that are influenced by the structural characteristics of an economy, as well as the environment within which policy operates. Moreover, the intermediate exchange rate regimes provide scope for short-term flexibility, whereby changes can be made without costly adjustments or loss of credibility. The alternatives include pegging to a basket of currencies, crawling pegs and bands, and managed floating exchange

TABLE 2.5: DEVELOPING COUNTRIES' OFFICIAL EXCHANGE RATE ARRANGEMENTS

	1976	1981	1986	1991	1996
Pegged	**86**	**85**	**80**	**70**	**55**
US Dollar	62	54	48	40	36
Composite	24	31	32	30	19
Limited Flexibility	**3**	**11**	**6**	**5**	**4**
More Flexible	**5**	**14**	**28**	**43**	**62**
Floating	4	10	15	20	26
Independently Floating	1	4	13	23	36
Number of Countries	**100**	**113**	**119**	**123**	**123**

Source: The IMF World Economic Outlook, October 1997.

rate regimes. A peg to a basket of currencies, while usually necessitated by trading patterns, is also intended to dampen the impact of external sources of exchange rate instability, in particular fluctuations in real exchange rates of industrial countries or related large changes vis-à-vis a large trading partner country. As an alternative, a crawling peg arrangement can help a country avoid domestic sources of instability, and alleviate periodic overvaluations associated with a fixed peg in circumstances of high inflation. A crawling arrangement also facilitates transparent, measured and consistent adjustment of the exchange rate.

5.5 Exchange rate arrangements in developing countries have changed significantly since

FIGURE 2.3: EVOLUTION OF FLOATING EXCHANGE RATE ARRANGEMENTS 1996 (60 IMF MEMBERS)

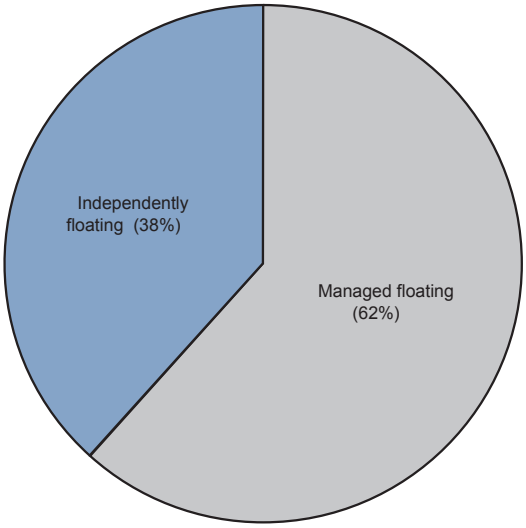


FIGURE 2.4: EVOLUTION OF FLOATING EXCHANGE RATE ARRANGEMENTS 2007 (83 IMF MEMBERS)

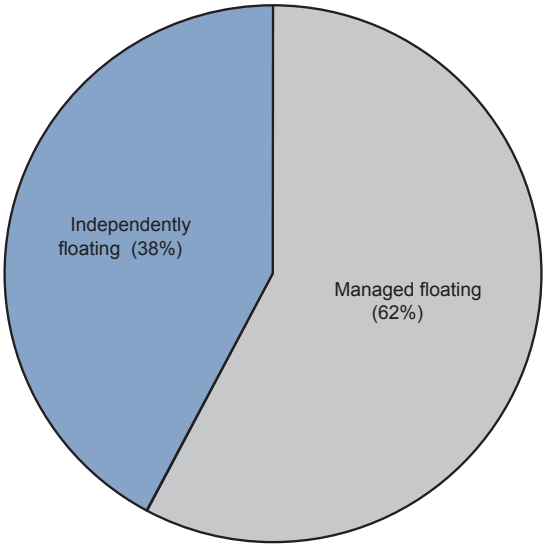


FIGURE 2.5: EVOLUTION OF SOFT PEGS – 1996 (107 IMF MEMBERS)

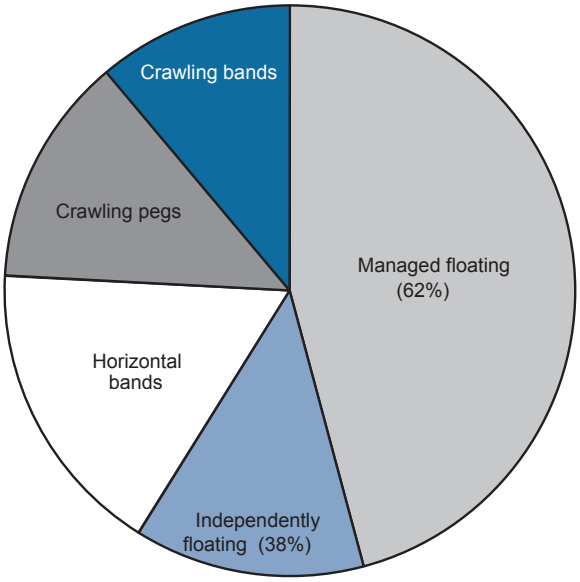
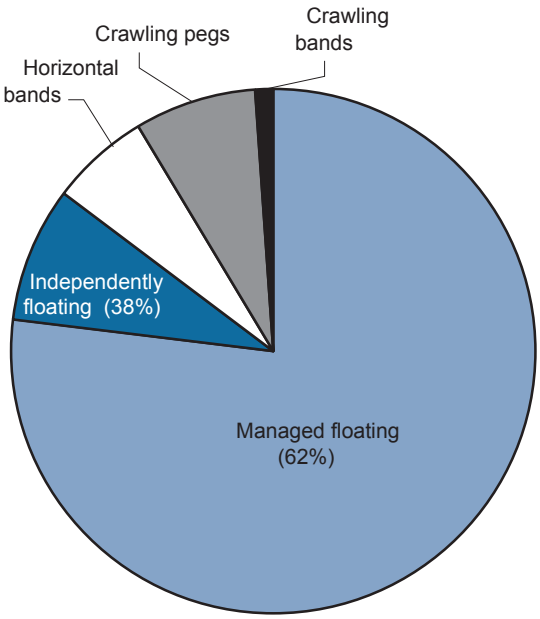


FIGURE 2.6: EVOLUTION OF SOFT PEGS – 2007 (82 IMF MEMBERS)



Source: IMF [50]

50. IMF (2007), *Review of Exchange Arrangements, Restrictions and Controls*, prepared by Monetary and Capital Markets Department.

TABLE 2.6: EXCHANGE RATE REGIMES – SELECTED ECONOMIES

Country	Fixed Regime		Intermediate Regime	Flexible Regime
	Single	Basket		
		Transition		
Botswana	Pegged to US dollar	Pegged to the SDR and Rand	Crawling band	
South Africa	Pegged to the US dollar Pegged to the British pound		Managed float	Floating
Zambia	Pegged to the British pound Pegged to the US dollar	Pegged to the SDR and rand	Managed float	
Malaysia	Pegged to the British pound Pegged to the US dollar	Pegged to a basket of currencies Pegged to undisclosed basket of currencies	Managed float against the Singapore dollar and the US dollar	Floating
Singapore	Pegged to the British pound	Monetary union with Malaysia and Brunei	Managed float with an undisclosed policy band	
Thailand	Pegged to the US dollar	Pegged to a basket of Thailand's major trading partners	Managed float	
Saudi Arabia	Pegged to the US dollar	Pegged to the SDR		
Nigeria	Pegged to the British pound Pegged to the US dollar	Pegged to a basket of 12 currencies	Managed float	
		Transition		

Source: IMF and various central banks' reports.

the breakdown of the Bretton Woods fixed exchange rate system. The general transition for most developing countries was a shift, first, from a peg to a key currency to pegging to a basket of currencies and, ultimately, moving towards more flexible exchange rate arrangements. A summary of part of this transition for developing countries is given in Table 2.6, highlighting the decline in the number of developing countries with pegged exchange rates and an increasing preference for floating exchange rates. As at the end of 1996, a total of 55 developing countries (down from 86 countries in 1976) had pegged exchange rates, with 19 countries pegging to a composite basket, while 26 countries had a managed floating exchange rate and 36 countries had exchange rates that were floating independently. Figures 2.3 to 2.6 also indicate a decline in the number of countries with pegged exchange rates and a move towards more flexible exchange rate systems.[51]

5.6 Table 2.6 highlights the evolution of exchange rate policies for selected countries, which reflects similar trends of a general movement from fixing to a single currency, followed by a basket peg and, subsequently, managed

51. See Caruana (2007), IMF.

flexibility. In addition, in several cases, there have been adjustments to the exchange rate and basket composition to reflect changes with respect to trade direction and policy. Another similarity is the use of currencies of the proximate larger trading partners and those of the major economies.

5.7 There is a distinct feature for Sub-Saharan countries relating to episodes of exchange rate overvaluation, where the real effective exchange rate appreciated significantly in the context of large windfall-type mineral related foreign exchange earnings. This partly explains the limited success on economic diversification and low productivity and competitiveness of the agricultural and manufacturing sectors in Sub-Saharan Africa (SSA) leaving SSA countries more vulnerable to shocks such as collapse of the primary commodities markets and increase in oil prices.

Botswana's Exchange Rate Policy

5.8 As indicated above, macroeconomic policies in Botswana are guided by a national development strategy focused on achieving rapid and sustainable growth, as well as economic diversification. In the broader framework, the efficacy of the exchange rate policy depends on the extent to which it complements the other macroeconomic policies towards the objective of sustainable growth. Notably, there might be a need to balance the sometimes competing alternatives of using the exchange rate to stabilise inflation or to promote external competitiveness. The price stability objective of achieving low inflation is a desirable element of macroeconomic stability and contributes to efficiency in resource allocation (Section 3), while the export competitiveness objective is directly linked to expansion of the domestic industry and economic diversification. Both these objectives contribute to durable growth.

5.9 At independence in 1966, Botswana maintained its membership of the Rand Monetary Area (RMA), a monetary union with South Africa, Lesotho and Swaziland and South West Africa (now Namibia), with the rand pegged to the US dollar.[52] Policy within the union was largely dictated by South Africa as the largest regional economy. This arrangement was, at the time, considered appropriate for Botswana, given the limited resources in terms of foreign exchange earnings, as well as institutional and administrative capacity. The country's financial position, however, improved with the commencement of diamond mining in Orapa in the early 1970s and enabled the pursuit of independent economic strategies.[53] In the circumstances, it was considered that remaining in the monetary union was not beneficial to Botswana as it limited the country's control over its resources; there were also costs to the extent that the country could not use those resources to pursue independent monetary or exchange rate policies in line with the desired development path.

5.10 Botswana, therefore, withdrew from the RMA in August 1976 and introduced its own currency, Pula, a crucial step which required formulation of an appropriate exchange rate regime and policy. On its introduction, the Pula was pegged to the US dollar at P1=US$1.15, in order to achieve, as desired, parity with the rand. The initial placement of the Pula at par with the rand allowed for a smooth transition which helped to mitigate possible macroeconomic instability that could have resulted from introducing a new currency and a new exchange rate regime simultaneously, particularly if the exchange rate did not quite match the country's economic fundamentals. Subsequently, the Pula was revalued by 5 percent against the US dollar in April 1977 to counter imported inflation and also for strategic reasons to demonstrate the strength of the Pula, which was backed by rising

52. South West Africa was a member by virtue of being an administrative region controlled by South Africa.

53. Hermans (1997) in *Aspects of the Botswana Economy: Selected Papers.*

foreign exchange reserves and, in the process, discourage further substantial transfers of funds to South Africa.[54]

5.11 The Pula remained pegged to the US dollar until June 1980, even though South Africa decided to introduce a managed float in January 1979 following the breakdown of the Bretton Woods system of fixed exchange rates. However, by June 1980, significant appreciation of the rand against the US dollar, due to the increase in gold prices, necessitated a change in strategy. In particular, the depreciation of the Pula against the rand as the rand appreciated against the US dollar caused inflation in Botswana to accelerate. To moderate the influence of developments in South Africa and achieve a more stable relationship of the Pula vis-à-vis the rand, the Pula was pegged to a basket of currencies comprising the rand and the SDR.

5.12 The choice of the peg currencies for the fixed Pula exchange rate was guided by trade patterns and the need to include the major currencies used in international trade and payments. Botswana's trade patterns have been largely constant over the years, despite progress with economic diversification. A fixed peg regime was also considered appropriate for the relatively small undiversified Botswana economy that was unlikely to sustain a floating currency. With a large inflow of foreign exchange, it was likely that the Pula, if allowed to float freely, would appreciate substantially, a manifestation of the so-called 'Dutch Disease' which, potentially, could be detrimental to industrial development and long-run growth prospects for the economy,[55] where substantial mineral earnings would cause the exchange rate to appreciate to levels that diminish the competitiveness of other sectors.

5.13 Botswana's choice of an exchange rate regime was largely consistent with the preference among developing countries for intermediate exchange rate frameworks, which capture the positive aspects of the two extremes of fixed and flexible currency arrangements. For Botswana, a fixed basket peg enabled occasional adjustments to alternatively support the competitiveness of tradeable goods producers or the objective of price stability, or to change the currency composition of the basket in line with evolving conditions relating to the direction of trade. Thus, the exchange rate was from 1980 intermittently adjusted, as both an anti-inflation tool and to promote domestic industry competitiveness. However, from the early 1990s, the export competitiveness objective became more dominant. This was also against the background of an enhanced monetary policy framework that increasingly became more effective in mitigating inflationary pressures (Section 3).

5.14 The first major Pula devaluation of 10 percent, took place in May 1982 to alleviate the impact of the 1981 oil shock that precipitated a global recession and subsequent collapse of demand for diamonds. At the time, the depressed diamond market led to the imposition of a quota on Botswana's diamond sales, resulting in a sharp decrease in exports and, consequently, a balance of payments crisis, including a significant decline in foreign exchange reserves to only 3.5 months of import cover in March 1982. Notably, the adjustment measures in 1982 cut across the three main macroeconomic policies, an indication of policy coordination at a time of crisis (Sections 3 and 4).

5.15 Subsequently, the collapse of the rand due to economic sanctions and disinvestment in protest over the apartheid regime resulted in further devaluations of the Pula, by 5 percent in July 1984 and 15 percent in January 1985, in order to maintain viability and competitiveness of local producers. This objective also motivated the later devaluations, of 5 percent in each instance, in 1990 and 1991.

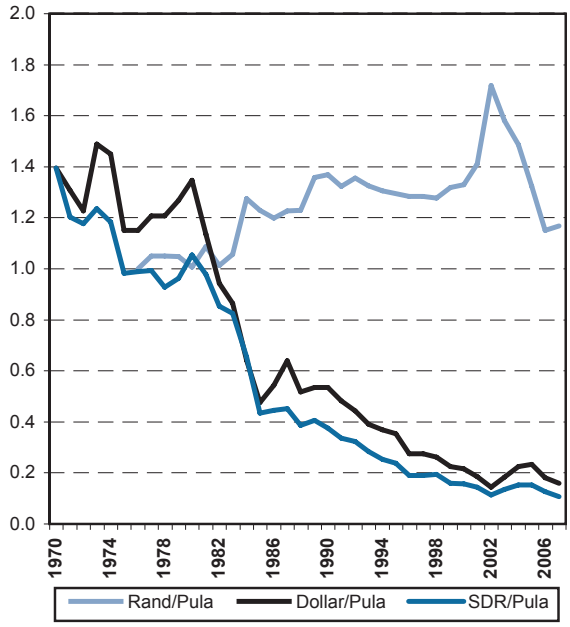
54. Hermans (1997) in *Aspects of the Botswana Economy: Selected Papers.*

55. The term "Dutch Disease" was coined in the 1970s following the experience of the discovery and exploitation of large deposits of natural gas in the Netherlands in 1959.

In between, the Pula had been revalued by 5 percent in June 1989 to mitigate inflationary pressures as the sharp depreciation against the major currencies threatened high inflation in South Africa and, in turn, imported inflation into Botswana.

5.16 In addition to adjusting the value of the Pula, the relative weights were also changed several times to reflect the relevant trade patterns. One such adjustment was the introduction of the Zimbabwean dollar in the Pula basket in recognition of significant trade relationship with Zimbabwe. This, however, was short-lived as the Zimbabwean dollar was dropped from the basket in 1994 due to changed trade flows which meant that its inclusion was no longer warranted. Overall, given the larger weight of the rand in the Pula basket, the local currency has over time depreciated substantially against the SDR and US dollar as the rand had depreciated. On the other hand, the variance in the rand/Pula exchange rate has been relatively small (Chart 2.13).

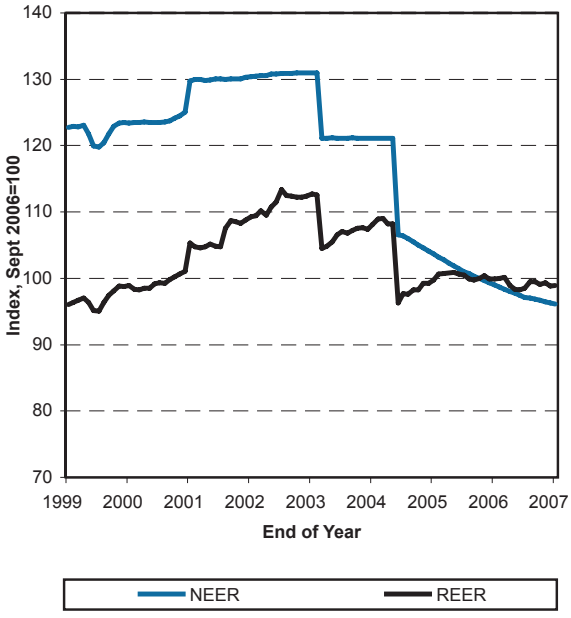
CHART 2.13: NOMINAL EXCHANGE RATES OF THE PULA AGAINST THE USD, SDR AND THE RAND



Source: Bank of Botswana.

5.17 While bilateral movements are important, the policy focus has been on the composite trade-weighted effective exchange rate, with a desire to attain a stable REER. The significant appreciation of the REER due to the combination of an appreciation of the NEER and higher inflation in Botswana compared to trading partner countries was, therefore, considered inimical to export competitiveness, which was needed to achieve the national economic diversification objective (Chart 2.14). To reverse the appreciation of the REER, two consecutive devaluations, of 7.5 percent and 12 percent, were implemented in February 2004 and May 2005, respectively. A crawling band exchange rate arrangement was also introduced in 2005, replacing the fixed peg, to ensure continual stability of the REER without the need for periodic large discrete adjustments of the exchange rate (Box 2.2). The annual rate of crawl is determined as the differential between the Bank of Botswana's inflation objective and forecast inflation for trading partner countries and is implemented through daily small adjustments of the NEER. The focus on the inflation objective ensures that monetary policy has a role in combating inflationary pressures. In turn, the exchange rate arrangement supports the price stability objective by facilitat-

CHART 2.14: REAL AND NOMINAL EFFECTIVE EXCHANGE RATES OF THE PULA



Source: Bank of Botswana.

BOX 2.2: A CRAWLING PEG/BAND MECHANISM

In a crawling peg mechanism, the currency is adjusted periodically (monthly or daily, for example) in small amounts either at a fixed rate or in response to changes in selective quantitative indicators, such as past inflation differentials vis-à-vis major trading partners or differentials between the inflation target and expected inflation in major trading partners. Authorities can choose to adopt either a backward-looking rate of crawl that generates inflation-adjusted changes in the exchange rate or adopt a forward-looking approach where the crawl is set at a predetermined fixed rate that could be below the projected inflation differentials. Other countries where the crawling peg is in operation include Bolivia, Costa Rica, Iran and Nicaragua. Under a crawling band mechanism, a currency is pegged to a central value in a band and is allowed to fluctuate within that band around the central value which is adjusted periodically.

Botswana's crawling band exchange rate mechanism was introduced with the objective of enabling an automatic nominal adjustment of the Pula exchange rate with a view to maintaining real effective exchange rate (REER) stability and avoiding the need for sizeable discrete adjustments as had been the case in the past. Once a crawling peg/band system is in place, discrete devaluations should be avoided as they undermine the credibility of the crawling peg/band mechanism and are also a reflection of policy failures in other areas. Maintaining a credible crawling peg/band mechanism imposes certain constraints on other economic policies, such as monetary and fiscal policies, where these policies have to complement the exchange rate policy, failing which it would be difficult to sustain the crawling peg/band regime and might call for the reintroduction of discrete adjustments.

The crawling band exchange rate regime is implemented through a continuous adjustment to the trade weighted nominal effective exchange rate (NEER) of the Pula at a rate of crawl equal to the differential between the Bank's inflation objective and the forecast inflation of trading partner countries. The rate of crawl is thus determined using a forward-looking approach and it is revised on a regular basis. In the forward-looking scheme, the authorities determine, at a given time, the rate of crawl for a subsequent period, such as the next six or twelve months. Since the introduction of the crawl, Botswana's inflation objective has been higher than that of its trading partners and this has necessitated a downward crawl.

ing a continuous, orderly and less inflationary response to changes in economic fundamentals. In contrast, unpredictable large discrete adjustments are less transparent and can result in sharp price increases. There is also the risk of introducing imbalances in the economy and undermining prospects for policy coordination and credibility.

Botswana: External Stability Measures and Performance

Exchange Rate

5.18 As outlined above, the exchange rate policy in Botswana has, in the context of substantial foreign exchange earnings, been focused on avoiding an appreciation of the REER that could undermine broad industrial and sustainable long-term growth. The maintenance of a stable REER is facilitated by a basket mechanism that moderates the impact on the Pula of sharp movements in individual currencies and may involve adjustment of the NEER.[56] Lowering inflation closer to that of trading partner countries also contributes to REER stability and obviates the need for adjustment of the nominal exchange rate.

5.19 In terms of policy effectiveness, while trends for the REER are an important indicator of competitiveness, adjustment of the exchange rate alone is unlikely to have a lasting effect on real economic activity. In the long-term, competitiveness is facilitated by productivity improvements and appropriate pricing. It is also notable that prior to the introduction of the crawling band mechanism, much of the impact of the devaluations was often quickly reversed as the currency adjustment resulted in higher inflation and a concomitant appreciation of the REER. Moreover, such measures undermined the price stability objective of monetary policy. Continuous small adjustments of the exchange rate through the rate of crawl and in the context of an effective monetary policy are less likely to be inflationary,

56. In the past through discrete devaluation/revaluation and from 2005 through the crawl.

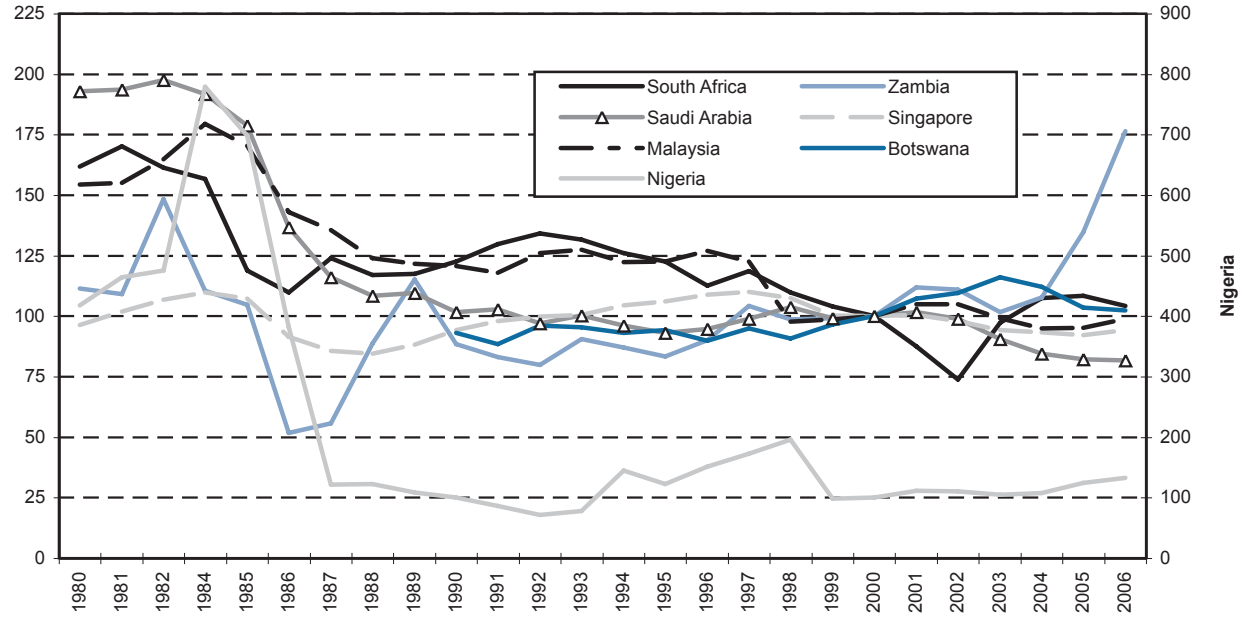
especially where the rate of crawl (inflation differential) is set in relation to the inflation objective. Therefore, by obviating the need for occasional sizeable discrete devaluations to attain REER stability, the crawling band exchange rate mechanism can sustain long-run export competitiveness without undermining the price stability objective.

5.20 In contrast to the deleterious effects of large discrete exchange rate adjustments, the NEER depreciated by 9.8 percent over the 32 months to December 2007 following the introduction of the crawling band in May 2005. Compared to the increase in inflation associated with the devaluations, the downward crawl has been much less inflationary.[57] Any increase in inflation, following the dissipation of the 2005 devaluation impact has been explained by changes in administered prices and sharp increases in foreign prices, while the exchange rate influence has been largely neutral. As a result of success in lowering inflation, the past trend appreciation of the REER has been largely mitigated and was stable between May 2005 and December 2007. Indeed, the rate of crawl was increasingly higher than the inflation differential as the rate of price changes in Botswana slowed.

5.21 It should be noted, however, that the downward trend of the NEER due to the crawl does not necessarily translate into similar movements for the bilateral exchange rates due to the basket arrangements and movements in cross rates. For example, while the Pula depreciated in nominal terms against all the major trading partner currencies between May 2005 and December 2007, the bilateral movements (23.3 percent against the euro, 19.6 percent against the pound sterling, 15.1 percent against the SDR, 8.7 percent against the US dollar and by 6.6 percent against the rand) varied substantially.

5.22 An overvaluation of the real exchange rate, which prevailed between 1998 and 2003, undermines export competitiveness and weakens the external position of a country. On the other hand, an undervalued exchange rate may create inflationary pressures. Hence, there is need to prevent the REER from diverging from its equilibrium level. Chart 2.15 indicates real exchange rate stability trends for selected

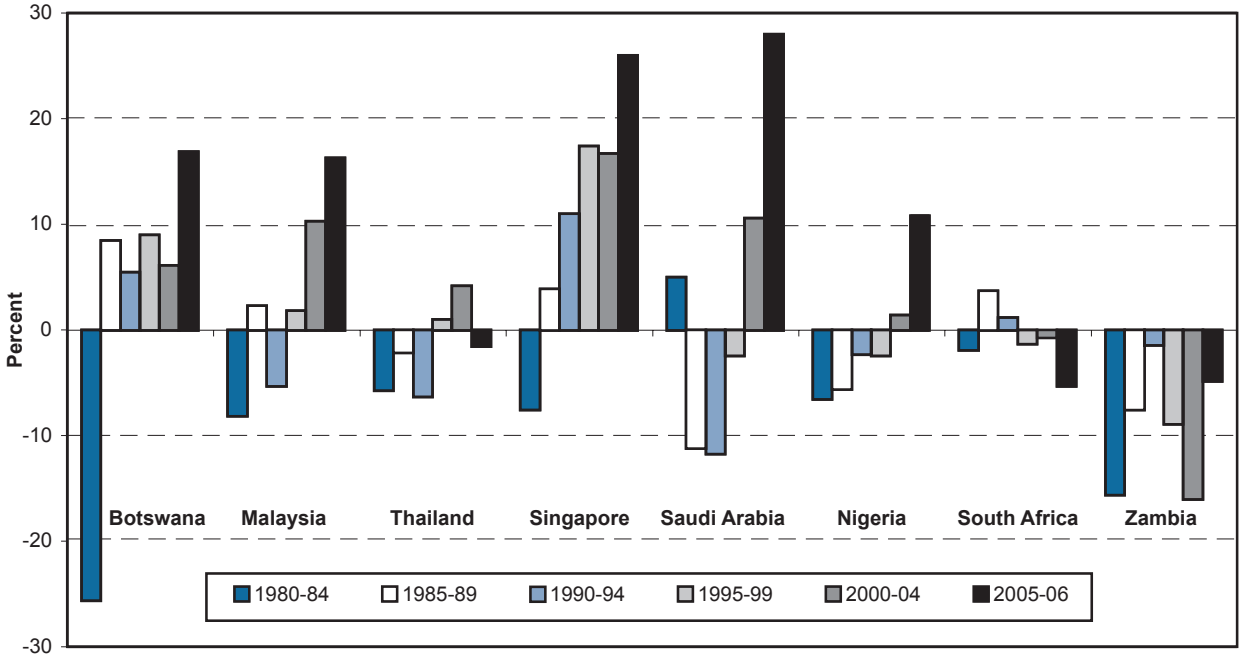
CHART 2.15: REAL EFFECTIVE EXCHANGE RATES FOR SELECTED ECONOMIES



Source: Bank of Botswana and IMF International Financial Statistics.

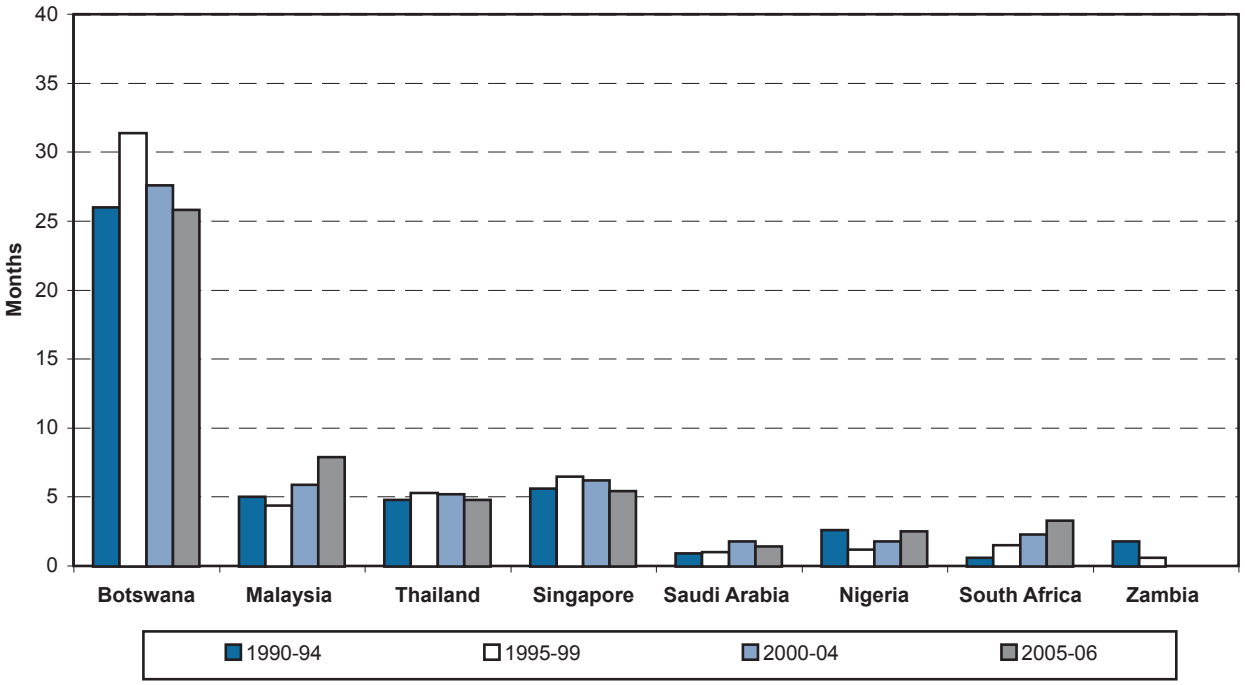
57. It is estimated that the 7.5 percent and 12 percent devaluations of 2004 and 2005 contributed 2 percentage points and 3–4 percentage points to inflation, respectively.

CHART 2.16: CURRENT ACCOUNT BALANCE TO GDP RATIO – SELECTED ECONOMIES



Source: Bank of Botswana and IMF International Financial Statistics.

CHART 2.17: FOREIGN RESERVES AS MONTHS OF IMPORT COVER – SELECTED ECONOMIES



Source: Bank of Botswana and IMF International Financial Statistics.

countries and shows fewer episodes of large fluctuations.

Balance of Payments and Foreign Exchange Reserves

5.23 External stability for Botswana is also illustrated by trends for the current account balance, which has been in surplus for most of the review period, as indicated in Chart 2.16, due to the dominant contribution of diamond export earnings, as well as large payments from SACU, which in recent years have entailed an increasing transfer payment to Botswana. The

TABLE 2.7: CHRONOLOGY OF THE PULA EXCHANGE RATE EVENTS

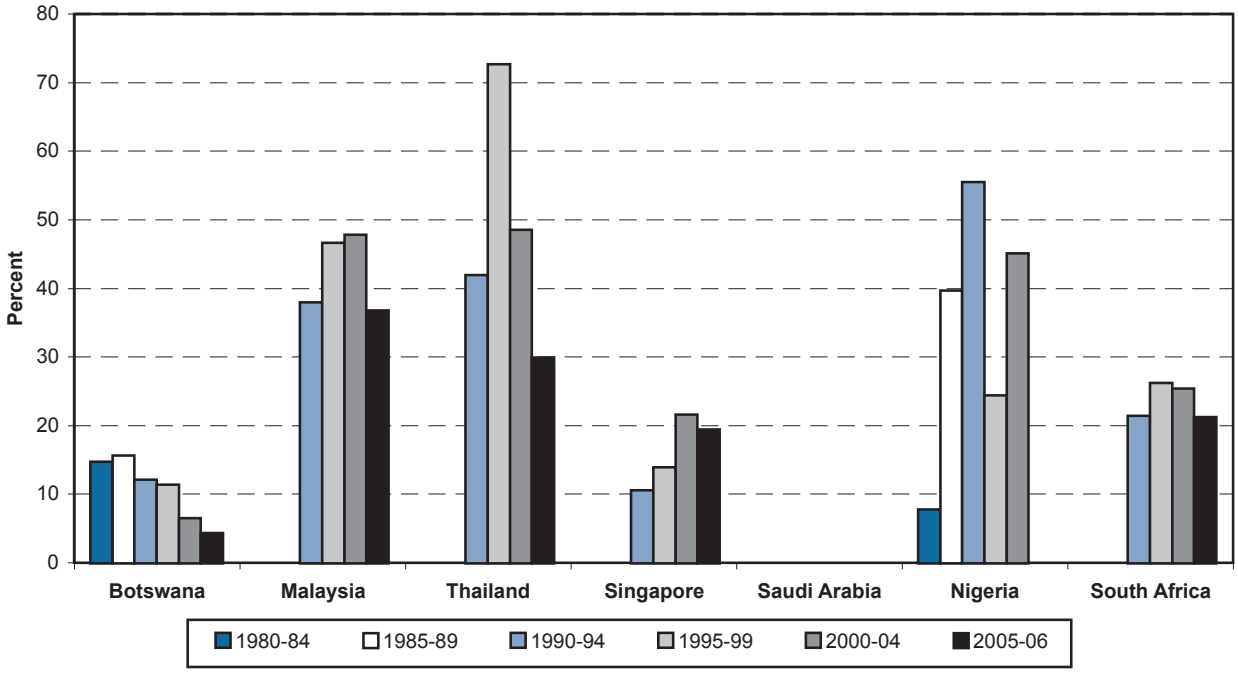
DATE	ACTION	COMMENTS
Pre-1976	Participation in Rand Monetary Area (RMA)	Exchange rate and monetary policies not independent – Botswana was dependent upon South Africa's policy frameworks
August 1976	Introduction of the Pula pegged to US dollar at P1=USD1.15 (Pula also at par with the rand)	Pula pegged to the US dollar at the same rate as Rand/US dollar peg
April 1977	5 percent revaluation of Pula to P1=USD1.2075=R1.05	Anti-inflationary measure against imported inflation following rand appreciation against the US dollar
September 1979	Rand taken off US dollar peg and SA introduced managed float	Rapid appreciation of the rand against the US dollar as gold prices rose
June 1980	Pula taken off the US dollar peg and Pula basket consisting of the SDR and Rand introduced	To reduce volatility of Rand/Pula exchange rate
November 1980	5 percent Pula revaluation	Anti-inflation measure to curb imported inflation following Pula depreciation against Rand and accelerated inflation in South Africa
January 1981	Steep drop in world gold price (from USD850 in January 1980 to USD493.75 per ounce in January 1981)	RSA exports earnings decline significantly and Rand depreciates rapidly
May 1982	10 percent Pula devaluation	Part of stabilisation measures in response to 1981/82 balance of payments crisis
February 1984	RSA freezes debt payments and run on the Rand	Rapid depreciation of the Pula against the US dollar as Rand deteriorated; Pula appreciates against the Rand
July 1984	5 percent Pula devaluation	To improve competitiveness as Pula appreciated against Rand following Rand collapse largely due to economic imbalances and loss of confidence in South Africa
August 1984	Rand weight in Pula basket adjusted	To reduce drift of Pula from Rand as Rand deteriorated against US dollar
January 1985	15 percent Pula devaluation	Further competitiveness measures in response to rapid Pula appreciation against Rand
January 1986	New Pula basket introduced	In response to the rapid Rand appreciation against the US dollar following the re-introduction of the Financial Rand
June 1989	5 percent Pula revaluation	Anti-inflation measure to curb imported inflation
August 1990	5 percent Pula devaluation	Competitiveness measure
August 1991	5 percent Pula devaluation	Competitiveness measure
September 1991	Zimbabwean dollar introduced to the Pula basket	To capture the increase of trade with Zimbabwe (both imports and exports)
June 1994	Technical adjustment and removal of Zimbabwe dollar from the basket	Changes made to Pula basket to reflect changes in trade patterns and aimed at maintaining competitiveness and real exchange rate stability
February 2004	7.5 percent Pula devaluation	Competitiveness measure
May 2005	12 percent Pula devaluation	Competitiveness measure
May 2005	Adoption of the crawling band mechanism	To avoid discrete adjustments to the exchange rate

Source: Bank of Botswana.

deficit in 1980-84 reflects the impact of the oil crisis and global recession in the early 1980s and was common for many oil importing economies. The large current account surpluses together with capital inflows have resulted in sustained balance of payments surpluses. However, while resulting in large foreign exchange earnings, these surpluses are also the result of limited absorptive capacity of the domestic economy.

5.24 The balance of payments surpluses have over time added to the foreign exchange reserves. There was a significant decline in reserves in 2002 and 2003 due to the funding by Government of the Public Officers Pension Fund (POPF); however, the country's overall

CHART 2.18: EXTERNAL DEBT TO GDP RATIO – SELECTED ECONOMIES



Source: Various central banks.

external assets were less affected as to a large extent the fall in official reserves was matched by the acquisition of foreign assets by the POPF. Compared to other economies, including mineral-rich countries, Botswana's level of international reserves is relatively high when measured in months of import cover. In contrast, between 1990 and 2006, Malaysia, Thailand and Singapore had reserves covering an average of 5 months of imports, while several countries had lower levels (Chart 2.17). It should be noted, however, that other countries transfer large commodity related earnings to independently managed funds or sovereign wealth funds (similar to Botswana's Pula Fund), while foreign exchange reserves are maintained for current external payments. For Botswana, benchmark levels for current payments are six months for the Liquidity Investment Tranche and three months for the Transactions Balance Tranche. This translates to nine months of import cover for the Liquidity Portfolio. External balance sustainability for Botswana is also indicated by the low external debt relative to the size of the economy.

6. CRITICAL FINANCIAL STABILITY ISSUES FOR MACROECONOMIC BALANCE AND GROWTH

6.1 The approach to financial stability in Botswana is largely similar to the framework highlighted in Section 2. Broadly, the framework aims to ensure the soundness of institutions, and the efficiency of markets and the payments and settlements system, as well as the resilience of the financial system to shocks based on self-correcting mechanisms and regulatory intervention by the authorities. Overall, the approach protects investors (savers and borrowers) from economic disruption due to financial imbalances/crises arising endogenously or as a result of adverse exogenous shocks. A stable financial system also facilitates growth through, among others, innovation, orderly integration and links with other sectors of the economy, leading to enhanced access to financial services which are important for a developing country such as Botswana.

6.2 The crucial intermediation role of the financial system in mobilising and ensuring the efficient

allocation and pricing of financial resources was discussed in the Bank of Botswana *Annual Report 2005*. The financial system is also critical in the payments process and settlement of transactions, which may also involve international capital flows. In performing these roles, there is an interactive relationship with the rest of the domestic economy and foreign markets such that imbalances or instability in any of the sectors is usually transmitted to the other sectors. Below are some examples of the relationship between economic performance and financial stability.

(a) Economic growth – low or declining output growth rates increase credit risk as the capacity to service debts is weakened, leading to a deterioration of the soundness of the financial system. In turn, any threat to bank solvency can result in reduced bank lending (a credit crunch), exacerbating the economic downturn.

(b) Inflation – volatile inflation renders accurate assessment of the market and credit risks difficult. Moreover, inflation is often positively correlated with asset price volatility, thus raising portfolio risk, and weakening industry access to capital.

(c) Balance of payments – unduly large current account deficits (which must be financed by matching capital inflows or drawdown of foreign reserves) expose the country to foreign exchange rate risk and destabilising withdrawal of capital. For example, a current account deficit financed by short-term portfolio investments is less sustainable as these assets can be easily liquidated when market conditions change with the risk of precipitating financial and foreign currency crises. Conversely, financing of the deficit through longer term investment is more stable. Capital outflows occurring in an environment where domestic banks' assets are predominantly held in domestic currency and are illiquid could weaken the liquidity of the banking sector. In turn, there is a risk of macroeconomic instability, especially in the absence of sufficient liquidity support by the central bank.

(d) Interest rates and exchange rates – volatility of these prices can lead to a deterioration of economic activity and the value of assets held by residents. For example, given the possibility of a higher level of non-performing loans, high real domestic interest rates increase credit risk and weaken the asset quality of banks. With respect to exchange rates, a large appreciation of the domestic currency could reduce the exporters' capacity to service their domestic debts as they become uncompetitive and their export proceeds convert into smaller amounts of domestic currency. Conversely, rapid exchange rate depreciation could weaken the financial position of residents with foreign currency liabilities.

(e) Contagion effects – given globally integrated financial systems, as well as trade and cross-country payments obligations, a crisis in a foreign country could trigger financial and macroeconomic distress in the domestic economy. There could also be the transmission of financial distress among banks in the domestic economy depending on the extent of integration, with possible adverse consequences for the real economy. This is demonstrated by the recent situation that followed the unwinding of the US sub-prime lending market, where the 'credit crunch' is in large part due to banks losing trust in each other.

Case for Regulation of the Financial System

6.3 Apart from the direct effects of exogenous factors and/or macroeconomic influences, the onset of a financial crisis is also associated with excessive risk taking, especially during booms, and it is often associated with reduced level of vigilance in assessing the quality of loan applications. Given the nature of links

within the financial system, operational problems in one institution often cascade to other financial organisations, leading to a system-wide crisis and potentially generating macroeconomic instability. Prudential supervision is, therefore, necessary to enable early detection of a potential crisis and to establish formal arrangements for supporting illiquid institutions.

6.4 Another important objective of regulation and supervision is to mitigate the information asymmetries between financial institutions and their customers. For example, customers would have limited knowledge of the overall financial position of banks and how their savings will be deployed. Banks, on the other hand, have limited information about the customers' capacity and motivation to service their loans. The unequal access to information, therefore, weakens the assessment of risks and returns and may reduce access to finance by potentially productive users. Indeed, financial friction arising from information asymmetry has been shown to have a significant impact on output growth.[58]

6.5 An effective framework for prudential regulation and supervision of the financial system is, therefore, essential to ensure sustained financial stability by upholding public confidence, minimising failure and possible systemic risks and ensuring ongoing effectiveness of intermediation, as well as the efficiency of the payments process. At a minimum, a supervisory framework encompasses the following:

(a) an infrastructure for monitoring the performance of individual institutions and the broader financial sector;

(b) a framework for continually assessing the soundness of financial institutions;

(c) supportive processes for an efficient operation of the inter-bank market and liquidity support; and

(d) supervisory action, including taking over the running of distressed institutions, curtailing operations or facilitating a merger/takeover.

6.6 It is important, however, that the supervisory framework does not excessively suppress risk-taking nor preclude failure and exit of institutions, which are checks and balances of a competitive environment and contribute to growth and even strengthening of the system. An important consideration, in this regard, relates to possible moral hazard and incentives for risk taking by banks that can be engendered by regulation. This is more likely to exist where the supervisory framework entails a deposit insurance scheme and the doctrine of *"too-big-to-fail"*. A deposit insurance scheme usually specifies levels or proportions that are payable upon failure of a bank, and the *"too-big-to-fail"* approach implies that uninsured depositors will be protected in full should an insolvent bank that is considered too large and important fail.

6.7 Moreover, even in the absence of an explicit insurance scheme, there is, generally, a presumption that the authorities will act in the best interest of the public, interpreted as the protection or compensation of the small and unsophisticated savers. It is considered that the minimisation of losses to the general public fosters stability as it helps to sustain confidence in the financial system and its role in enabling effective operation of macroeconomic policies. Hence, there is the presumption that the authorities will always act in the interest of long-term financial stability. This is clearly demonstrated by public debate and action that followed the September 2007 near collapse of Northern Rock in the UK, where the focus was on avoiding losses to the general public.

Regulation and Supervision of the Financial Sector in Botswana

6.8 The supervisory framework in Botswana features multiple regulatory authorities, as

58. Mishkin (2007), "Will Monetary Policy Become More of a Science?", National Bureau of Economic Research, Working Paper 13566.

TABLE 2.8: SUPERVISORY INFRASTRUCTURE FOR BOTSWANA'S FINANCIAL SECTOR AS AT DECEMBER 2007

			COVERAGE/MANDATE			With NBFIRA[2]
TYPE OF FINANCIAL INSTITUTION[1]	**LEGISLATION**	**SUPERVISORY AUTHORITY**	**Licensing/ Registration**	**Monitoring**	**Supervisory Action**	**Licensing, monitoring, supervisory action**
Commercial Banks	Banking Act 1995	BoB	√	√	√	
Investment Banks:		BoB				
African Banking Corporation Botswana	Banking Act 1995		√	√	√	
Development Financial Institutions:						
1. Botswana Savings Bank[3]	Botswana Savings Bank Act 1992	BoB /MFDP	X	√	√	√
2. National Development Bank[3]	National Development Bank Act 1964	BoB /MFDP	X	√	√	√
3. Botswana Development Corporation	Companies Act 1959, 1995	MFDP	X	√	X	√
4. Citizen Entrepreneurial Development Agency	Companies Act 1959, 1995	MFDP	X	√	X	√
Building Society						
Botswana Building Society[3]	Building Societies Act 1961	BoB /MFDP	√	√	√	√
Bureaux de Change	Bank of Botswana Act 1975, 1996, 1999	BoB	√	√	√	
Micro Finance Institutions	Exempted from Bank of Botswana Act 1975,1996,1999	BoB /MFDP				
Women's Finance House Botswana			√	√	√	√
International Financial Services Centre Companies	Exempted from Banking Act 1995	BoB /MFDP	√	√	√	√
Insurance Companies	Insurance Industry Act 1987	MFDP/The Registrar	√	√	√	√
Asset and Fund Managers	–	MFDP	X	√	X	√
Medical Aid Societies	–	Board of Directors	X	√	X	√
Stock Market	Botswana Stock Exchange 'Act 1994	MFDP	X	√	√	√
Savings and Credit Cooperative Societies	Companies Act 1959, 1995	Ministry of Trade and Industry/ Commissioner of Cooperative Societies Development	√	√	√	
Collective Investment Undertakings	CIUs Act 1999, 2001	BoB	√	√	√	√
Pension Funds	Pension and Provident Fund Act, 1987, 1988	MFDP	X	√	√	√

Abbreviations: BoB – Bank of Botswana, MFDP – Ministry of Finance and Development Planning, NBFIRA – Non-Bank Financial Institutions Regulatory Authority

1. Other than being incorporated and registered under the Companies Act, the asset fund management companies, investment advisory service providers and money lending activities are largely unsupervised. However, the NBFIRA is expected to regulate and supervise most of these institutions.
2. Once operational, all the institutions licensed and monitored by the NBFIRA will be supervised by the authority and governed by the NBFIRA Act, 2006. The remaining institutions will remain under their current supervisory authorities.
3. The Bank of Botswana carries out supervisory/oversight responsibilities on behalf of the Ministry of Finance and Development Planning.

Source: Various legislation.

TABLE 2.9: FINANCIAL SOUNDNESS INDICATORS: CORE AND ENCOURAGED SETS

Core Set	
Deposit-taking institutions	
Capital adequacy	Regulatory capital to risk-weighted assets
	Regulatory tier I capital to risk-weighted assets
Asset quality	Nonperforming loans to total gross loans
	Nonperforming loans net of provisions to capital
	Sectoral distribution of loans to total loans
Earnings and profitability	Return on assets
	Return on equity
	Interest margins to gross income
	Non-interest expenses to gross income
Liquidity	Liquid assets to total assets
	Liquid assets to short-term liabilities
Sensitivity to market risk	Net open position in foreign exchange to capital
Encouraged Set	
Deposit-taking institutions	Capital to assets
	Geographical distribution of loans to total loans
	Gross asset position in financial derivatives to capital
	Gross liability position in financial derivatives to capital
	Trading income to total income
	Personnel expenses to non-interest expenses
	Spread between reference lending and deposit rates
	Spread between highest and lowest inter-bank rate
	Customer deposits to total (noninterbank) loans
	Foreign currency-denominated loans to total loans
	Foreign currency-denominated liabilities to total liabilities
	Net open position in equities to capital
	Large foreign exposures
Other Financial Corporations	Assets to total financial system assets
	Assets to GDP
Non-financial Corporate Sector	Total debt to equity
	Return on equity
	Earnings to interest and principal expenses
	Net foreign exchange exposure to equity
	Number of applications for protection from creditors
Market Liquidity	Average bid-ask spread in the securities market
	Average daily turnover ratio in the securities market
Households	Household debt to GDP
	Household debt service and principal payments to income
Real Estate Markets	Real estate prices
	Resident real estate loans to total loans
	Commercial real estate loans to total loans

Source: Bank for International Settlements.

summarised in Table 2.8. The supervision of the banking system has over the years been comprehensive, but the supervisory mandate for development financial institutions given to the Bank of Botswana entailed limited supervisory action. At the same time, the

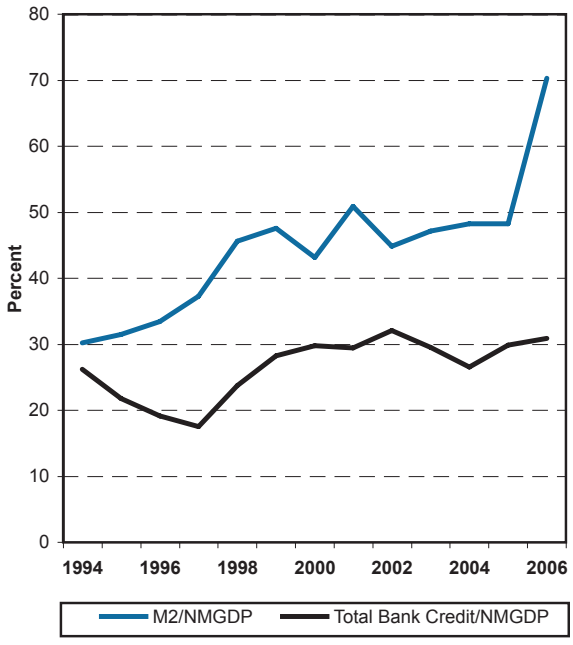
supervision of other entities in the capital market and microfinance institutions has been weak and ineffective. This view is also consistent with the findings of the 2007 IMF/World Bank Financial Sector Assessment Programme (FSAP). The limited supervisory action for some institutions could be understood in the context of the need to sustain the development mandate, which can be disrupted by significant curtailment of activity or closure. There are, however, stability concerns in terms of possible long-term retention of unsound institutions, while a singular developmental focus could lead to support for sub-optimal projects, with possible adverse implications for the wider economy. Moreover, there is the risk of weakening the systemic link between the development finance institutions and their customers, on the one hand, and the commercial banking system on the other, and, therefore, destabilising the latter. It should be noted, however, that the previous supervisory deficiencies are being addressed through the establishment of the Non-Bank Financial Institutions Regulatory Authority (NBFIRA).

6.9 While the NBFIRA should improve supervision of the financial system by consolidating the currently fragmented supervision of non-banks, it should (as highlighted in the FSAP report) be accompanied by a structured format for cooperation between supervisory bodies, including the sharing of information. The pooling of data through supervisory requirements should also facilitate compilation and dissemination of important aggregated information, such as the financial corporations survey to supplement the currently published depository corporations survey which only covers the central bank, commercial banks and other deposit taking institutions. This is important in terms of providing an overview of the financial sector and comprehensive reporting consistent with higher data collection and dissemination standards.

6.10 The envisaged transition from the 1988 Basel Accord (Basel I) to the Basel II supervisory framework also represents an improvement in the regulatory process. The inadequacy of Basel I relates to its sole focus on a limited number of risk categories and weights. Basel II is more holistic, as it encompasses most of the core aspects of banking regulation and supervision, as well as some aspects of disclosure and market discipline (Box 2.3).

6.11 The adequacy of the supervisory process is also assessed in relation to the financial soundness indicators (FSIs) which cover aggregated information on financial institutions and disaggregated analysis of specific markets. They are divided into core indicators, which are specific to the banking system, and an extended set, which looks at the banking system and the wider macro economy. The Bank of Botswana currently uses all the indicators in the core set, with the exception of the net position in foreign exchange to capital, relating to the monitoring of country and transfer risks. While the core set enables the monitoring of the soundness of

CHART 2.19: FINANCIAL INTERMEDIATION AND MONETISATION RATIOS



Notes: Up to 2001, M2 was defined as M1 plus call, savings, notice and time deposits excluding foreign currency accounts (FCAs) and the definition has since changed to include the FCAs.

Source: Bank of Botswana.

TABLE 2.10: DEVELOPMENT OF KEY FINANCIAL AGGREGATES

	1980	1985	1990	1995	2000	2005		1980	1985	1990	1995	2000	2005
Botswana							**Malaysia**						
Currency	3.2	2.4	2.2	1.8	1.5	1.3	Currency	18.3	18.2	21.3	28.6	23.1	24.8
M1	10.3	19.7	8.8	6.7	5.4	8.0	M1	18.3	17.5	20.4	23.3	22.8	25.0
M2	13.6	23.0	17.9	19.7	21.1	29.5	M2	52.5	65.1	70.5	89.4	103.3	124.4
M3	29.8	28.5	23.1	28.8	29.7	45.4	M3	61.3	84.7	96.9	122.2	133.0	134.7
Total Bank Assets	–	25.7	20.7	25.7	30.3	35.8	Total Bank Assets	60.4	95.8	108.6	131.3	149.4	178.6
Total Fin. Inst. Assets	27.9	36.4	24.2	40.5	38.6	98.3	Total Fin. Inst. Assets	–	–	–	73.6	45.1	16.7
Equity	–	–	6.5	9.1	18.6	27.0	Equity						
Bonds	–	–	–	0.4	1.8	8.8	Bonds						
Thailand							**Singapore**						
Currency	10.9	8.0	8.6	8.7	10.1	12.1	Currency	24.5	22.6	22.8	21.3	20.8	23.7
M1	10.8	8.1	8.9	9.3	10.7	12.8	M1	24.5	22.6	22.8	21.3	20.8	23.7
M2	38.0	56.2	70.0	79.1	102.2	90.7	M2	–	92.5	85.7	106.9	113.2	
M3	47.3	68.6	85.8	107.4	122.7	108.8	M3	–	106.8	123.3	114.9	114.4	116.2
Total Bank Assets	–	–	108.1	116.2	127.0	112.5	Total Bank Assets	–	200.3	188.8	210.1	218.9	
Total Fin. Inst. Assets							Total Fin. Inst. Assets	–	–	284.9	278.1	311.1	352.5
Equity							Equity	–	–	–	253.6	261.4	220.3
Bonds							Bonds						
Saudi Arabia							**Nigeria**						
Currency	10.8	21.7	23.3	23.5	23.4	24.1	Currency	15.7	6.8	5.7	5.4	5.5	3.9
M1	11.6	22.1	23.4	23.3	23.4	24.0	M1	45.5	18.3	14.3	10.2	12.8	10.5
M2	15.3	32.6	32.4	34.8	36.3	38.0	M2	71.0	32.9	24.9	16.1	20.8	18.0
M3	17.3	39.9	43.1	45.4	45.2	46.8	M3	–	–	–	–	–	–
Total Bank Assets	17.1	41.1	53.1	63.9	64.1	64.2	Total Bank Assets	80.6	44.2	31.8	19.5	31.9	0.0
Total Fin. Inst. Assets													
Equity							Equity	0	0	0.0	0.1	0.6	1.7
Bonds							Bonds	0.05	0.09	0.04	0.46	0.37	0.43
South Africa							**Zambia**						
Currency	13.1	16.5	17.4	20.4	28.9	18.9	Currency	17.0	17.4	11.3	7.6	7.7	6.7
M1	13.9	17.6	18.4	20.6	28.9	32.7	M1	–	–	–	–	7.9	6.7
M2	34.6	42.8	46.3	44.8	50.2	62.4	M2	–	–	–	–	23.9	17.0
M3	55.2	56.9	56.1	51.3	55.0	71.2	M3	–	–	–	–	24.3	17.8
Total Bank Assets	91.4	82.9	72.7	89.0	109.0		Total Bank Assets						
Total Fin. Inst. Assets	33.1	144.1	169.8	193.1	221.2		Total Fin. Inst. Assets						
Equity							Equity						
Bonds							Bonds						

Source: IMF International Financial Statistics and various central banks' Annual Reports.

the banking system, extending coverage to the encouraged set would facilitate an overview of potential risks to financial stability arising from sectoral and aggregated performance of the economy (Table 2.9). The potential for a wider assessment should, however, be viewed against inadequacy of data on the real sector. Therefore, ongoing efforts to improve data availability and quality should make an important contribution to measuring macroeconomic performance, and facilitate early detection of risks to financial stability.

6.12 The supervisory framework in Botswana

TABLE 2.11: EVOLUTION OF FINANCIAL AND NON-FINANCIAL INSTITUTIONS IN BOTSWANA

End of Period	Commercial Banks	Other Financial Institutions	Stock Exchange & Stock Broking Companies	Life Insurance Companies[1]	Pension Funds[2]	Bureaux de Change
Up to 1980	2	4	0	4	0	0
1981–1990	4	6	1	4	33	0
1991–2000	5	7	4	11	139	7
2001–2007	8	9	4	13	150	43

Notes: 1. Information on insurance companies is available up to 2006.

2. The total number of pension fund companies for the period 2001-2007 is less than the cumulative total because 3 companies de-registered during this period.

Source: Bank of Botswana, Ministry of Finance and Development Planning and Botswana Stock Exchange.

TABLE 2.12: MEASURES OF FINANCIAL INSTITUTION SOUNDNESS AND PRUDENTIAL STANDARDS FOR LICENSED BANKS FOR THE PERIOD 2002–2007[1]

Financial Soundness Indicators	Prudential Standard	2002	2003	2004	2005	2006	2007
Capital Adequacy	≥ 15	17	19	17	17	17	25
Liquid Asset Ratio	≥ 10	26	26	30	38	57	48
Profitability (Return on Assets)	Positive	4	4	4	4	4	3
Profitability (Return on Equity)	Positive	43	42	45	53	57	31
Asset Quality (Non-performing Loans /Total Loans)	≤2.5	3	5	5	5	6	7
Intermediation (Advances/Deposits)	≥ 50	72	70	71	67	45	52

1. The figures are generated from the quarterly returns submitted by banks. The figures represent the average for all the registered banks.

Source: Bank of Botswana.

has evolved in the context of significant growth, diversification and integration of the financial system. In particular, the changing composition of the financial system featuring an increase in the share of non-monetary assets shows trends in financial aggregates that are similar to those seen globally (Table 2.10). The financial system has also expanded faster than the real economy, consistent with global trends and increasing financial intermediation ratios (Chart 2.19). Moreover, as indicated in the 2005 Bank of Botswana Annual Report, there has been growth in the capital market attributable to an increase in value of the assets controlled by pension fund managers (which in turn arose from the rapid growth in) defined contribution pension schemes,[59] as well as life insurance, which have supported growth in both the equity and bond markets. The constituent institutions of Botswana's financial system are shown in Table 2.11, and this shows growth in the number and range of financial institutions. There have, of course, been some failures of institutions which were orderly and well managed.

6.13 The stability of the financial sector can, in part, be assessed by performance of the commercial banking system, which is a significant element in terms of its relative size and large role in financial intermediation, as well as being the conduit for most financial transactions and macroeconomic policy implementation. The usual prudential considerations are capital adequacy, asset quality, earnings (profitability) and liquidity. The relative performance and trends with respect to these prudential measures is summarised in Table 2.12, against international benchmarks.

59. In particular, in 2001 the Government established the Public Officers Pension Fund, which contributed to the development and growth of the capital market.

CHART 2.20: BANKING SECTOR ASSETS (P MILLION)

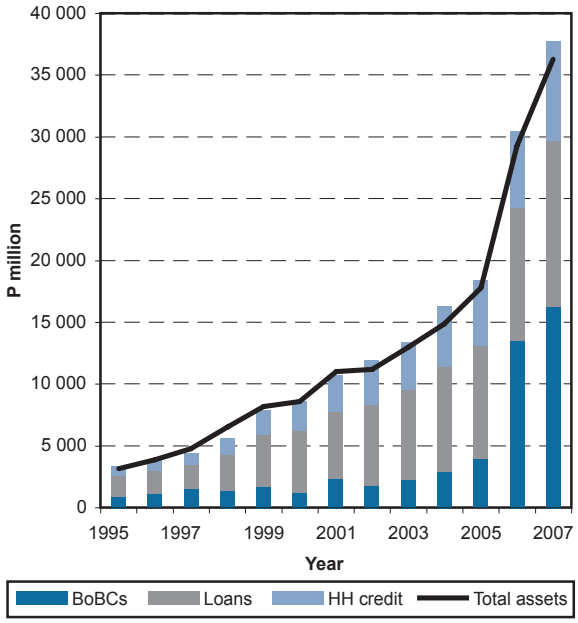


CHART 2.21: PROFITABILITY MEASURES

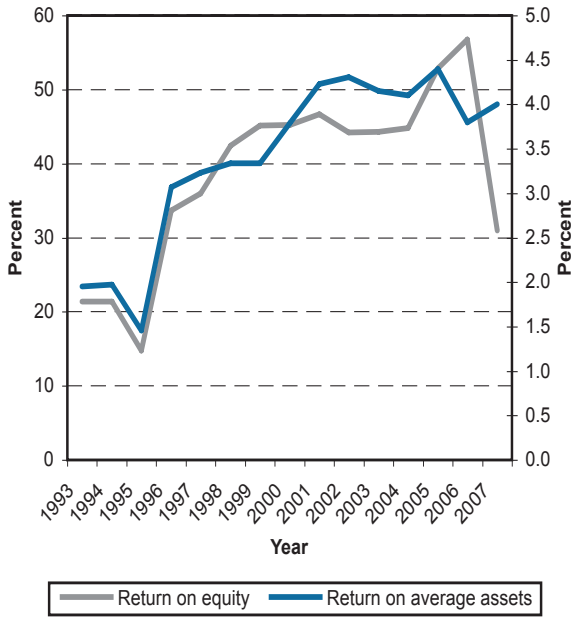


CHART 2.22: LIQUIDITY RATIOS

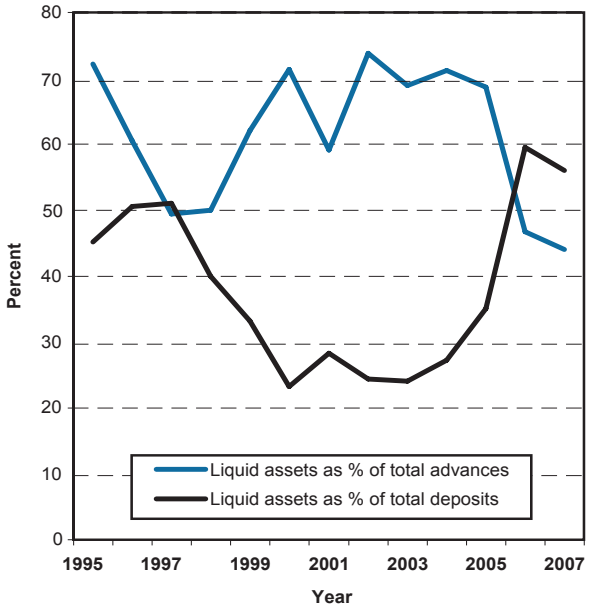
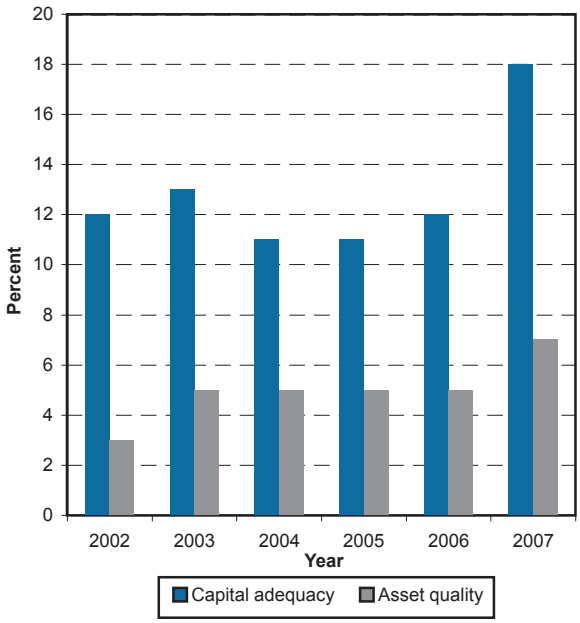


CHART 2.23: CAPITAL ADEQUACY AND ASSET QUALITY



Source: Bank of Botswana.

6.14 Historically, banks in Botswana have maintained capital above prudential requirements. These levels of capitalisation have supported asset generation by banks. It is notable, however, that there has been a recent deterioration in asset quality, in part reflecting reduced capability to service loans due to erosion of incomes associated with currency depreciation and relatively high inflation. This trend is also in the context of growth in lending encompassing expansion of the customer base and products in response to enhanced competition across the financial sector. The growth in assets also reflects expansion of deposits mainly linked to diamond earnings. In addition, government funding of parastatals and

BOX 2.3: BASEL II

Pillar I: Minimum Capital Requirements *include explicit capital charges for credit risk and operational risk, in addition to capital charges for market risk established in 1996. Pillar I has a menu of options for the computation of regulatory capital charges. In each risk category (market, credit and operational risks), there are simple and advanced methods. In each category, the simplest are the default methods where the Basel Committee has provided all the key inputs and guidance on how to calculate the capital. The more advanced methods are subject to supervisory approval and only available to banks with a greater level of sophistication, robust risk management systems and good governance framework. For credit risk, the structure includes the standardised approach, conceptually similar to the 1988 Capital Accord, although allowing a greater degree of risk weight differentiation based on external ratings of obligors, and the internal ratings-based (IRB) approach, which relies on banks' internal assessment of the components that define the risk of a credit exposure. The IRB approach, in turn, comprises two different methodologies: the foundation and advanced IRB approaches, depending on the sophistication of risk management systems of the banks. A foundation IRB bank is allowed to estimate only the probability of default and all other credit risk parameters are provided by the Basel Committee. However, an advanced IRB bank is allowed to rely on its internal estimates of the risk components, subject to meeting minimum standards, disclosure requirements and supervisory approval of the internal model, including probability of default (PD), loss given default (LGD), exposure at default (EAD) and effective maturity (M) except for the correlation factor (which is provided by the Basel Committee). A similar structure applies to operational risk. This new, risk-sensitive framework is strengthened with the introduction of rules for wider recognition of credit risk mitigation techniques and new rules for the treatment of asset securitisation.*

The new rules are geared to broadly maintain the current level of regulatory capital, and do not intend to raise or lower the overall level of capital requirements. However, these may increase or decrease for individual banks depending on their risk profiles. As the rules are more finely attuned to banking risks, banks with good risk management systems/and or lower risk profiles, may have lower capital requirements, and thus find incentives to move towards better risk management systems and practices.

Pillar II: The Supervisory Review Process, *closely linked to Basel Core Principles, goes beyond verifying that banks comply with minimum capital requirements, and ensures that banks' capital is aligned with their level of risk and degree of sophistication. Pillar II is based on four principles: (i) the bank is primarily responsible for calculating and maintaining proper level of capital; (ii) supervisors have the ability to evaluate banks' internal capital adequacy measurement systems; (iii) supervisors have the ability to require banks to hold capital above the minimum when they estimate that capital levels are not adequate or commensurate with the risks in the bank's balance sheet; and (iv) supervisors have the ability to intervene and enforce remedial actions if bank capital falls below prudential levels. Therefore, in addition to a statutory minimum capital adequacy ratio, it is within the power of national supervisory authorities to impose an "add-on" capital charge for any deficiencies in risk management or governance structures.*

Pillar III: Market Discipline *is a powerful tool that introduces strong incentives for banks to put in place safe and sound risk management policies and practices. Pillar III focuses on the core disclosures relevant to exercise market discipline: asset quality, amount of capital, risk profile and capital adequacy, as well as information on the details of internal systems of banks adopting IRB approach. The market plays a critical role in either punishing institutions with poor risk management practices by imposing a higher risk premium on financial instruments issued by the bank or, alternatively, compensating institutions with robust and effective risk management systems.*

local authorities also contributed to growth in deposits.

6.15 A notable feature of the Botswana banking system is the relatively low intermediation ratio, which is reflected in the high level of excess liquidity. The intermediation ratio was exceptionally low in 2006 and 2007, following the exclusion of non-banks from holding BoBCs; this led to a rapid increase in deposits at commercial banks. Nevertheless, the implication for financial and macroeconomic stability is that banks are not constrained in meeting their obligations and financing economic activity. There is no doubt that excess liquidity in the banking system poses a challenge for monetary operations. On the other hand, it is disturbingly a significant

source of banking sector profitability.

6.16 Botswana banks are, historically, highly profitable, thus contributing to broad financial sector stability. Interest from advances is associated with a higher proportion of lending to households (about 60 percent compared to 40 percent to businesses), and higher levels of interest for the riskier lending to persons. A consideration of financial stability would suggest that an excessive increase in unsecured household lending can be a risk to profitability, given the potential higher default risk, and may also impact on fee income to the extent that it is linked to lending transactions and customer retention. The recent formalisation of credit information sharing among banks should help the assessment of debt service capability and minimise defaults. Meanwhile, any significant fluctuations in income arising from BoBCs, due to policy and structural changes, would require significant changes in strategy by banks to sustain adequate levels of and support for overall financial stability.

6.17 Overall, except for limited sectoral disruptions that are associated more with some of the development finance institutions, Botswana has not experienced financial instability resulting from poor performance. There have also not been disruptions in the financial sector that have adversely impacted on real economic activity. Prudential concerns in the banking system have been successfully addressed through managed exits, mergers and reorganisation, with minimal disruption of economic activity. Moreover, any difficulties relating to the development finance institutions have had a limited effect on the economy, and have been confined to specific sectors or addressed by refinancing by the Government in the past. No doubt, the establishment of the NBFIRA should address the potential risks arising from limited supervision of some parts of the financial sector. However, going forward, there are challenges relating to coordination and sharing of information among financial institutions and supervisory authorities. Improvements in terms of timely publication of good quality economic data would enhance analysis of sectoral and macroeconomic performance and the assessment of potential impact on financial stability, as well as support the implementation of Basel II and the extension of the financial soundness indicators.

7. Conclusion

7.1 The theme section of the 2007 Bank of Botswana Annual Report has reviewed the importance for sustained economic growth of macroeconomic and financial stability. The choice of topic was motivated in large part by the preparation of NDP 10, which focuses on maintaining prudent policies and development programmes to foster economic diversification and the realisation of the *Vision 2016* goals. The objective is to complement the national planning process, where successive NDPs have highlighted the need for macroeconomic stability as a pre-condition for sustained growth, by expanding on this perspective in more detail.

7.2 The preparation of the theme topic coincided with the emergence of major uncertainty in the global economy resulting from the sub-prime credit crisis in the US housing market, which quickly spread across industrial countries through international financial markets, and highlighting potential structural weaknesses in these economies. While the direct effects on the Botswana economy have thus far been insignificant, this development illustrates the key points highlighted in this chapter.

7.3 First, macroeconomic and financial instability can emerge quickly and is often preceded by a long period of stability and buoyant economic performance. While there have been indications of the potential dangers of the inflated housing markets in the US and other countries, the general perception was that the advanced economies remained in robust good health. Increasing inflationary pressures rather than the risk of recession were seen as the main challenge.

7.4 Second, the crisis has demonstrated the link between financial and economic stability. The initial task confronting monetary authorities and financial regulators appeared to be ensuring that the problems facing specific financial institutions did not spread systemically while, at the same time avoiding blanket assistance to limit the dangers of moral hazard. There is the additional challenge of maintaining robust growth in the major economies of the US, UK and the euro zone and, in turn, prospects for global growth. The concern is that slower growth would feed back into the financial sector, further reinforcing negative perceptions and with heightened uncertainty amplifying the information asymmetries that are the main cause of financial instability.

7.5 The third feature of the crisis is that it has re-ignited the debate on the appropriate objectives and instruments of macroeconomic policy. During the 1980s and 1990s, a consensus had emerged that monetary policy was the main tool to ensure both price stability and, once expectations of inflation were successfully anchored, to dampen fluctuations in output. Fiscal policy was relegated to a minor role, largely focussed on the long-term sustainability of government finances. This consensus also gave primacy to medium-term frameworks, such as inflation targeting and fiscal rules, as opposed to discretionary policy responses.

7.6 However, the varying policy responses to the credit crisis have challenged key elements of this consensus. The series of interest rate cuts and the rapid approval of a fiscal stimulus in the US contrasts with the response of the euro area, where the ECB has maintained its focus on the inflation target, and finance ministers have restated the commitment to fiscal prudence. The IMF has also made the case for coordinated fiscal expansion among the major economies to support growth, and in the UK the relevance of the medium-term fiscal rule during a period of instability is under scrutiny.

7.7 In considering the importance of macroeconomic and financial stability in the Botswana context, the issues highlighted in this chapter include a detailed historical review for each of the key areas of monetary, fiscal and exchange rate policies, and financial stability. The review of country specific experiences is also in the light of broader global developments and benchmarks.

7.8 The process of policy development is inevitably evolutionary, adapting to improved knowledge and ever-changing circumstances. Notably, the policy instruments available and appropriate to the newly-independent Botswana in the 1960s would be of very limited relevance now. Similarly, in twenty years time, as both the global and domestic economies continue a process of dynamic development, policy frameworks suitable for NDP 10 are likely to be outdated.

7.9 The process of policy evolution and adaptation has, in recent years, been apparent with respect to both monetary and fiscal policies. In the case of monetary policy, the Bank of Botswana has gradually developed a framework that both reflects and supports the institutional capacity to monitor, forecast and react to trends in inflation. The domestic monetary policy framework has been explicitly aligned with the crawling band exchange rate mechanism that was introduced to support a key element of external stability (i.e., of the REER). Overall, monetary policy has broadly contributed to macroeconomic stability as the country has attained lower rates of inflation for most of the period under review. In comparison with the Sub-Saharan region, monetary policy in Botswana has delivered relatively low inflation. Similarly, the REER of the Pula has been stable compared to those of other emerging countries which reflect high volatility.

7.10 With respect to fiscal policy, the Government has explicitly recognised (in the MTR of NDP 9, for example), areas where the existing policy framework had some weaknesses and, accordingly, changes have been made. These have included benchmark indicators of both medium-term budget balance and the limits of

government expenditure, as well as specific measures to improve the quality of spending. With regard to policy performance, it is evident that the country has pursued prudent fiscal policies that have contributed to a stable macroeconomic environment.

7.11 A historical review has served to identify issues that have remained largely constant over the years. Low and predictable rates of price increase will always be preferable to high and volatile inflation, which disrupts growth and undermines welfare, especially for poor people. Decisions by the Government regarding revenue and expenditure will always have a major impact on the economy and must be managed so as to maintain both stability and national solvency. This together with an appropriate exchange rate policy are potentially supportive of broad-based industrialization and employment creation. Going forward, several key challenges can be identified over the period of NDP 10, if the foundation of macroeconomic and financial stability is to be maintained in Botswana. These include:

(a) **Monetary policy:** The monetary policy framework centred on the annual MPS has continued to evolve. In the 2008 MPS, the Bank of Botswana introduced several important changes to the framework, including abandoning both the short-term inflation objective and commercial bank credit growth as an intermediate target. Going forward, inflation forecasts produced by the Bank will be a principal guide for setting monetary policy to meet a three-year rolling inflation objective. For this to be effective, it is essential that the inflation forecasting capability of the Bank is further consolidated. In addition, effective communication concerning policy decisions will reinforce the credibility of the process and guide public expectations regarding the future path of inflation.

(b) **Fiscal policy:** The recent introduction of the fiscal rule to constrain expenditure growth has underscored the government's already well-established commitment to fiscal restraint. However, the rule may need a recalibration as the expected slowdown in mineral revenues puts a premium on building up adequate reserves to help ensure the sustainability of future budgets. Appropriate safeguards need to be in place to ensure that accelerated capital spending programmes are used productively. Improved budget forecast and availability of key macroeconomic data will help with the coordination of monetary and fiscal policies.

(c) **Exchange rate policy:** The crawling band mechanism has been effective in stabilising the REER and appears to be supportive of broad-based economic growth. However, the operation of the mechanism will need to be kept under regular review to take account of the balance of trading patterns, the alignment between trading partner currencies and the evolving sophistication and depth of the domestic foreign exchange market.

(d) **Financial stability:** Botswana's banking and wider financial sector is expected to develop rapidly. The new NBFIRA is scheduled to commence operations in the near future and to be successful this will require effective coordination with the parallel responsibilities of the central bank. While effective supervision should not be achieved at the expense of stifling innovation, the recent international financial crisis has emphasised the extent to which prudential regulation remains the cornerstone of financial stability.

The responsible authorities need to work together to ensure that the challenges posed in these distinct but interrelated areas are successfully met.