

**BANK  
OF  
BOTSWANA**

**ANNUAL REPORT**

**2010**





**BOARD MEMBERS**  
*as at December 31, 2010*



**L K Mohohlo**  
*Governor and Chairman*



**G K Cunliffe**



**S Sekwakwa**



**C S Botlhole-Mmopi**



**Prof H Siphambe**



**Dr J Sentsho**



**Prof P Collier**



**T Seretse**

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## ABBREVIATIONS USED IN THE REPORT

AACB	Association of African Central Banks
ABC	Activity Based Costing
AfDB	African Development Bank
ATMs	Automatic Teller Machines
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BES	Business Expectations Survey
BFS	Botswana Financial Statistics
BISS	Botswana Inter-bank Settlement System
BMC	Botswana Meat Commission
BoBCs	Bank of Botswana Certificates
BPOPF	Botswana Public Officers Pension Fund
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
BTC	Botswana Telecommunications Corporation
BURS	Botswana Unified Revenue Service
CCBG	Committee for Central Bank Governors
CIUs	Collective Investment Undertakings
CPI	Consumer Price Index
CSO	Central Statistics Office
DCI	Domestic Companies Index
DTC	Diamond Trading Company
ECB	European Central Bank
ECH	Electronic Clearing House
EDD	Economic Diversification Drive
EDDI	Enhanced Data Dissemination Initiative
EFT	Electronic Funds Transfers
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Programme
FSDS	Financial Sector Development Strategy
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
IFSC	International Financial Services Centre
IIP	International Investment Position

IMF	International Monetary Fund
IT	Inflation Targeting
M2	Broad Money
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
MMEWR	Ministry of Minerals, Energy and Water Resources
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NBFIs	Non-Bank Financial Institutions
NDB	National Development Bank
NEER	Nominal Effective Exchange Rate
OMAC	Open Market Auction Committee
OMCC	Open Market Coordination Committee
OMO	Open Market Operations
PPPs	Public-Private Partnerships
REER	Real Effective Exchange Rate
REMCO	Remuneration Committee
RMA	Rand Monetary Area
RTGS	Real Time Gross Settlement
S&P	Standard and Poor's
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
SDDS	Special Data Dissemination Standards
SDR	Special Drawing Right
SIPS	Systemically Important Payment Systems
SLF	Secured Lending Facility
SWIFT	Society for Worldwide Inter-bank Financial Telecommunication
TA	Technical Assistance
UK	United Kingdom
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax



# PART A

## STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK FOR 2010

BANK OF BOTSWANA

**SENIOR MANAGEMENT AS AT DECEMBER 31, 2010**

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**DEPUTY GOVERNORS**



**O A Motshidisi**



**M D Pelaelo**

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**GENERAL MANAGERS**



**R H Nlebesi**



**O Mabusa**

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**HEADS OF DEPARTMENT**



**O Modisa**  
*Payments & Settlement*



**A M Motsomi**  
*Banking Supervision*



**J Ghanie**  
*Information Technology*



**E T Rakhudu**  
*Human Resources*



**R E K Somolekae**  
*Banking & Currency*



**Dr K S Masalila**  
*Research*



**P D Siwawa-Ndai**  
*Management Services*



**D Loeto**  
*Accounting*



**S M Scaletsa**  
*Financial Markets (Acting)*

## STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK FOR 2010

### GOVERNOR'S FOREWORD

The 2010 Annual Report was prepared against the background of renewed hope about the global economic recovery. This optimism should, however, be tempered with caution given the recent increase in commodity prices, including oil and food prices, political unrest and natural disasters in some countries. Although the global economy grew strongly in 2010, performance of individual economies was mixed, with rapid expansion of major emerging market economies being offset by slower-than-expected growth elsewhere.

The domestic economy turned around strongly from an estimated 3.7 percent contraction in 2009 to growth of over 10 percent in the first nine months of 2010. This improved performance was led by the mining sector, which grew by 22 percent, following a decline of 27 percent in 2009. Non-mining activity increased by a robust 6.5 percent, compared to 6.2 percent the previous year. However, on the basis of other macroeconomic indicators, the performance of the economy was mixed. Growth in government spending and bank credit slowed. In addition, external deficit widened due to, among others, lower payments from the Southern African Customs Union (SACU) and limited additional external borrowing by the Government.

Inflation increased from 5.8 percent the previous year to 7.4 percent in December 2010 due, in the main, to supply shocks. These included the increase in Value Added Tax (VAT), upward pressure on fuel and food prices, and adjustments in some administered prices and government levies.

Much of the increase in inflation in 2010 is attributable to transient factors and, with underlying inflationary pressures remaining generally low, the Bank Rate was maintained at 10 percent for most of the year. Although the medium-term inflation forecast converged on the Bank's medium term inflation objective of 3 – 6 percent, the Monetary Policy Committee (MPC) took particular account of the need to limit the extent of possible second-round effects and the potential impact of rising headline inflation on inflation expectations. Accordingly, the Bank Rate was reduced to 9.5 percent in December when the inflation outlook had improved towards the end of the year.

The Pula strengthened against most major trading currencies but weakened by 7.4 percent against the South African rand. The consequent moderate 1.7 percent appreciation of the real effective exchange rate (REER) reflected the extent to which the downward crawl of the nominal effective exchange rate (NEER) was insufficient to fully stabilise the REER. This would have been achieved by offsetting the differential between domestic inflation and the average inflation of trading partner countries. It is expected that the modest appreciation of the REER would have been absorbed by producers focusing on improved productivity.

The foreign exchange reserves fell by 12.2 percent to P50.8 million and the months of import cover of reserves also declined from 19 months the previous year to 15 months. The decrease in reserves was due to the overall balance of payments deficit and the appreciation of the Pula.

Banks in Botswana increased their business activity during the year; they were well capitalised and remained sound and stable. The efficiency of the payments system was also enhanced.

Interaction with and accountability to stakeholders continued through the publication of the *Bank's Annual Report*, *Banking Supervision Annual Report*, *Monetary Policy Statement* and *Research Bulletin*. The Bank's regular economic briefings to stakeholders also took root and complemented public education initiatives.



In order to improve operational efficiency and institutional effectiveness, the Bank was restructured in July 2010 to among others; enhance financial sector stability and the Bank's risk management and property management undertakings. This organisational change is expected to enable the Bank to adapt to the evolving domestic and external situations and be in a position to effectively deliver on its mandate.

I would like to take this opportunity to thank the Board for their effectiveness in guiding the affairs of the Bank. The Management and staff of the Bank are commended for their dedicated service and hard work.

A handwritten signature in black ink, appearing to read 'Linah K. Mohohlo', with a stylized flourish at the end.

Linah K Mohohlo

**GOVERNOR**



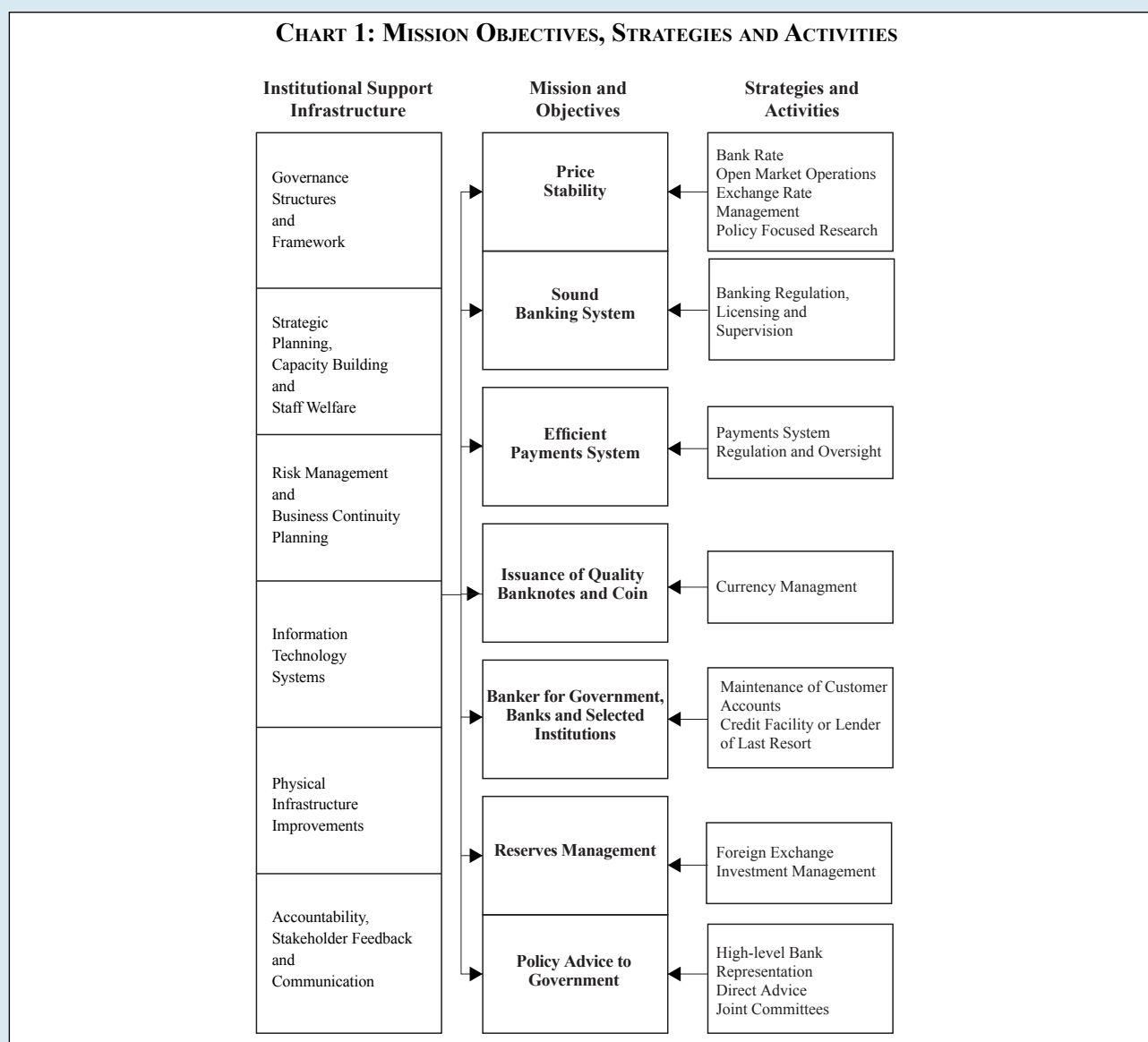
# STATUTORY REPORT ON THE OPERATIONS OF THE BANK – 2009

## THE BANK'S MISSION AND OBJECTIVES

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

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

Chart 1 presents the Bank's mission and objectives, as well as the strategies and activities that are undertaken to achieve the objectives.



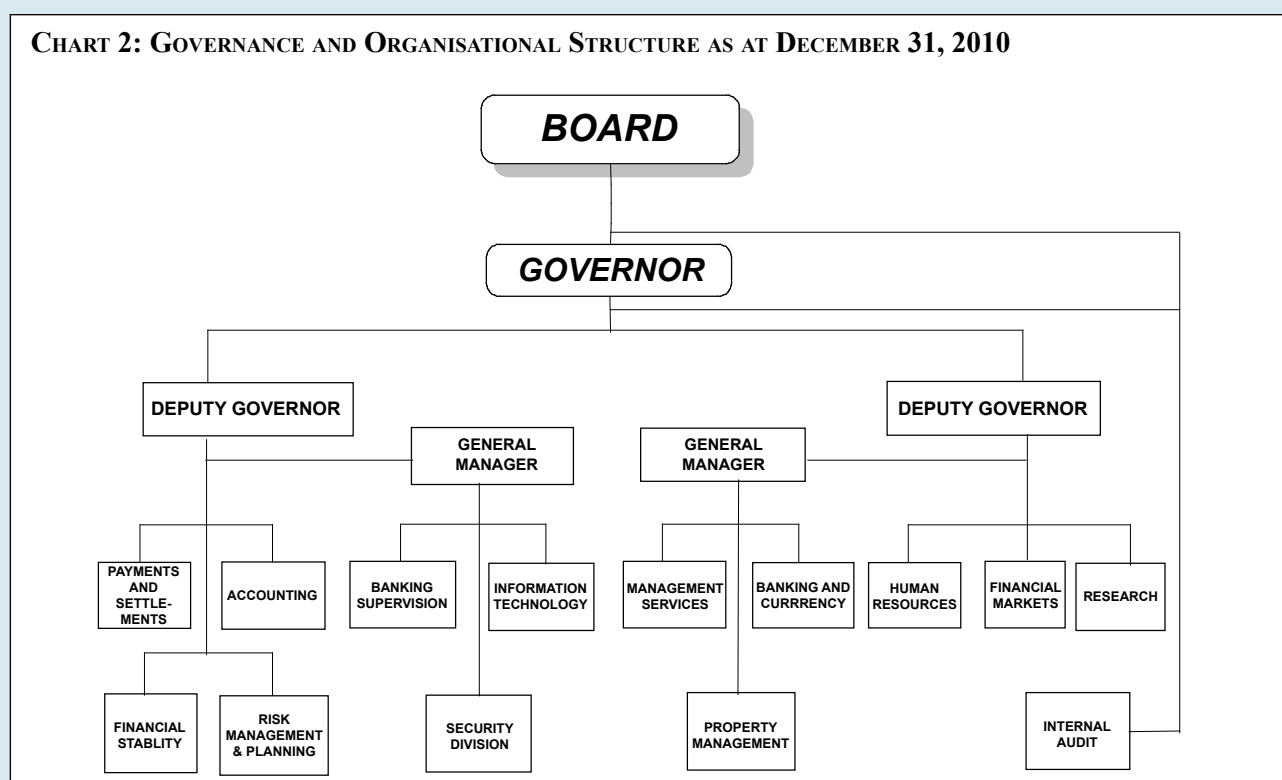
The Bank's objectives are attained through the formulation and implementation of monetary policy for the maintenance of a low, stable and predictable level of inflation; supervision and regulation of banks to foster safety and soundness of their operations, and oversight and regulation of the payments and settlement system to mitigate against systemic risk; provision of efficient banking services to the Government, commercial banks and selected public institutions; management of the foreign exchange reserves to meet the country's international transactions; and provision of advisory services to the Government on macroeconomic and financial policy matters. The functions of various Departments and Divisions are supported by corporate services, while the governance structure coordinates and creates synergies from the different activities through operational procedures, enforcement of a code of conduct and institutional values to fulfil the Bank's mission and objectives.

## GOVERNANCE AND ORGANISATIONAL STRUCTURE

As provided by the Bank of Botswana Act, the Minister of Finance and Development Planning submits the Annual Report on the operations and financial performance of the Bank to Parliament.

The Board is at the apex of the governance and organisational structure, followed by the Governor, two Deputy Governors, two General Managers, nine Departments and five Divisions, as depicted in Chart 2.

**CHART 2: GOVERNANCE AND ORGANISATIONAL STRUCTURE AS AT DECEMBER 31, 2010**



The Board has two sub-committees, viz., Remuneration Committee (REMCO) and Audit Committee (both of which comprise non-executive Board members). The Board sub-committees are mandated to consider the relevant Board matters and make recommendations to the Board.

### Board Membership and Appointments

The Board is responsible for the general policy direction and oversight of the Bank's operations in accordance with the Bank of Botswana Act and Bye-Laws. The current nine Board members are the Governor (ex-officio Chairman), Permanent Secretary of the Ministry of Finance and Development Planning (ex-officio member) and seven other members (citizen and non-citizen) in their individual capacities from different professional backgrounds.

The Governor and two Deputy Governors (who are not Board members) are appointed by the President, while the Minister of Finance and Development Planning appoints the Board members, only two of whom may be public officers. As at year-end, the Board had one vacancy. In line with the minimum legal requirement the Board held six meetings during 2010.

### Governor and Deputy Governors

Under the general direction of the Board, the Governor is the Chief Executive Officer of the Bank. In addition to the day-to-day management, the Governor submits the *Annual Report* on the operations of the Bank and the audited financial statements to the Minister within three months of the end of the Bank's financial year. The *Banking Supervision Annual Report* is submitted by June 30 each year. The Governor represents the Bank at relevant local, regional and international meetings, and is the country's representative on the Board of Governors of the International Monetary Fund (IMF). The two Deputy Governors share policy and operational oversight responsibilities for the Bank's Departments and Divisions, assisted in some areas by the two General Managers.

### General Managers

In order to improve operational efficiency and oversight, the two General Manager positions were established in 2010 to coordinate the activities of some Departments and Divisions, and report to the Governor through the Deputy Governors.

### The Executive Committee

The Executive Committee comprises the Governor, Deputy Governors, General Managers and Heads of Department; senior advisors may be co-opted as members. Under the Chairmanship of the Governor, the Committee meets each week to review the status of policy implementation of the Bank's annual, medium and long-term work programmes approved by the Board. The Executive Committee also monitors general performance of all Departments and Divisions, and coordinates and facilitates Bank-wide activities.

### Departments and Divisions

The organisational structure of the Bank changed significantly in 2010. In addition to the establishment of two General Manager positions, an additional Department and three Divisions were established to enhance management capacity to meet current and future demands in a changing economic and financial environment.

The newly established Management Services Department is responsible for policy and general operation of several internal management services, which include the Board Secretariat, Communications and Public Relations, Public Education, Records Management and Protocol. A new Financial Stability Division was established in response to the need to forestall domestic and global systemic financial problems following the recent international financial crisis which triggered the 2009 economic recession. The responsibilities of the new Division of Financial Stability include monitoring developments in money and capital markets and coordinating its activities with other relevant external entities to ensure stability of the financial sector as a whole. The Planning Unit was de-linked from the former Accounting and Planning Department and combined with risk management to form a new Risk Management and Planning Division. This Division consolidates all risk management policy and functions across the Bank and is also responsible for the formulation and implementation of the Bank's business continuity planning programme. In order to manage the increased workload of on-going and future major capital projects, the former Property Management Unit was upgraded to a Division.

The responsibilities for the attainment of the Bank's mission and objectives are carried out by the nine Departments and five Divisions. The Departments are Accounting, Banking and Currency, Banking Supervision,

Financial Markets, Human Resources, Information Technology (previously Technical Services), Management Services, Payments and Settlement, and Research. The five Divisions are Internal Audit, Financial Stability, Property Management, Risk Management and Planning, and Security. The Internal Audit Division reports functionally to the Board Audit Committee and administratively to the Governor.

## REVIEW OF THE BANK'S MAIN ACTIVITIES IN 2010

### Monetary Policy, Money and Capital Market Activities

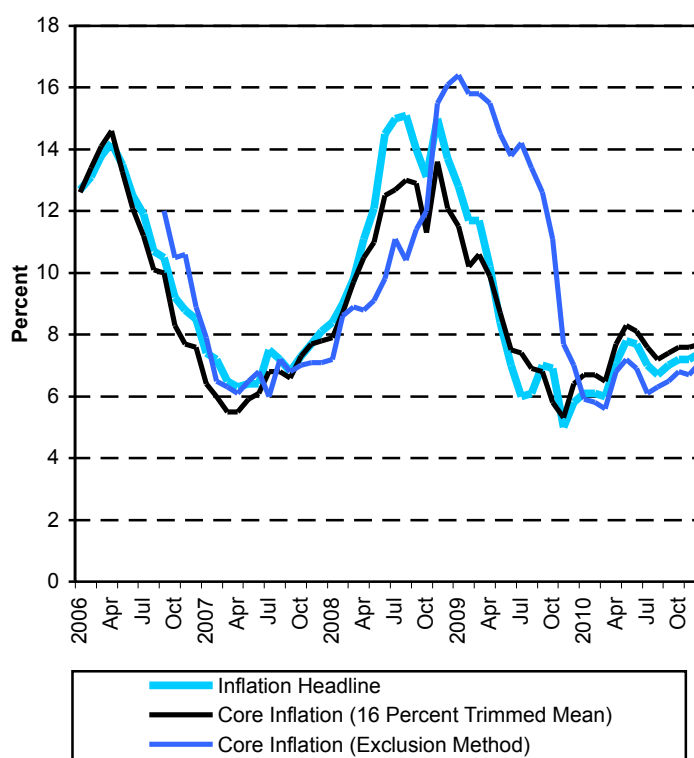
#### *(a) Monetary Policy*

The 2010 Monetary Policy Statement and Mid-Term review maintained the 3 – 6 percent medium-term inflation objective. The Statement projected an increase in inflation in the short-term, with expectations that it would fall within the objective range in 2011. This outlook provided some scope for monetary policy easing at a time when output growth was below trend. Inflation was virtually at the upper end of the 3 – 6 percent range at 6.1 percent in January 2010, before steadily rising in the course of the year and reaching 7.4 percent in December 2010. The increase in inflation was mostly explained by the increase in Value Added Tax (VAT) in April 2010, from 10 percent to 12 percent, together with upward adjustments to some administered prices. Nevertheless, the Bank Rate was unchanged at 10 percent for most of the year until December when it was lowered to 9.5 percent following an improvement in the medium-term inflation outlook. The positive inflation outlook was supported by the September 2010 biannual Business Expectations Survey (BES) that indicated improved domestic business confidence for 2011. Accordingly, businesses planned to build capacity in the period ahead, despite anticipated rising input costs. In addition, the survey indicated widespread support for the Bank's monetary policy objectives.

#### *(b) Money and Capital Markets*

Excess banking system liquidity continued to be absorbed through open market operations using Bank of Botswana Certificates (BoBCs) to ensure that the levels and movements in money market interest rates supported the Bank's monetary policy stance. Some of the excess liquidity was absorbed by increasing the primary reserve requirements for Pula-denominated deposits at commercial banks from 5 percent to 6.5 percent with effect from November 1, 2010. Notwithstanding these measures and the decline in foreign exchange reserves, as well as a slowdown in Government expenditure during the year, total BoBCs outstanding increased slightly to P17.6 billion at the end of December 2010 from P17 billion in the previous year (Chart 4). The decrease in the Bank Rate led to the lowering of respective yields for the 14-day and 91-day BoBCs to 6.56 percent and

CHART 3: INFLATION INDICATORS: 2006 - 2010



Source: Central Statistics Office

7.15 percent at the end of December 2010,<sup>1</sup> from 7.12 percent and 8.2 percent at the end of 2009.

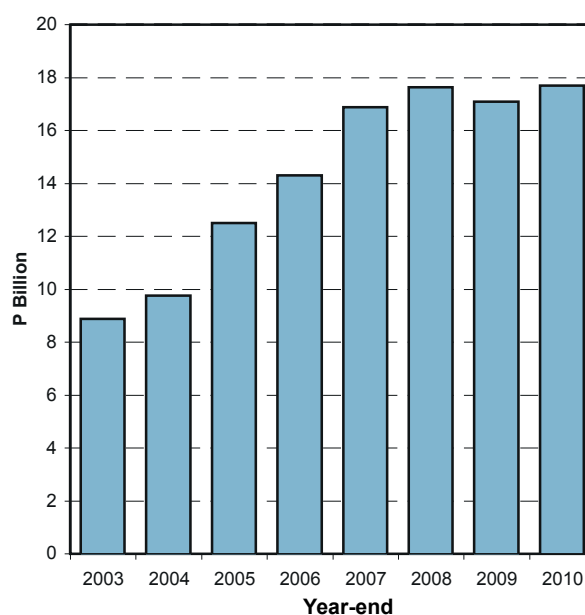
Real money market interest rates fell during the year, reflecting the combined effect of the reduction in the Bank Rate and the upward trend in inflation (Chart 5). The real prime rate decreased by 2 percentage points from 5.39 percent at the end of 2009 to 3.35 percent in 2010. Similarly, the 88-day real deposit interest rate declined by approximately 2 percentage points, from -0.01 percent to -1.78 percent in the same period.

As part of the P5 billion Government Note Issue Programme, a 15-year bond (BW007) and a 10-year bond (BW008) were issued in March and September 2010, respectively, totalling P1.8 billion. Treasury Bills issued amounted to P1.4 billion, thus bringing total Government paper outstanding to the P5 billion limit. Proceeds from the bonds and Treasury bills helped to finance the budget deficit and contributed to the development of the domestic money and capital markets.

### (c) Exchange Rate Policy

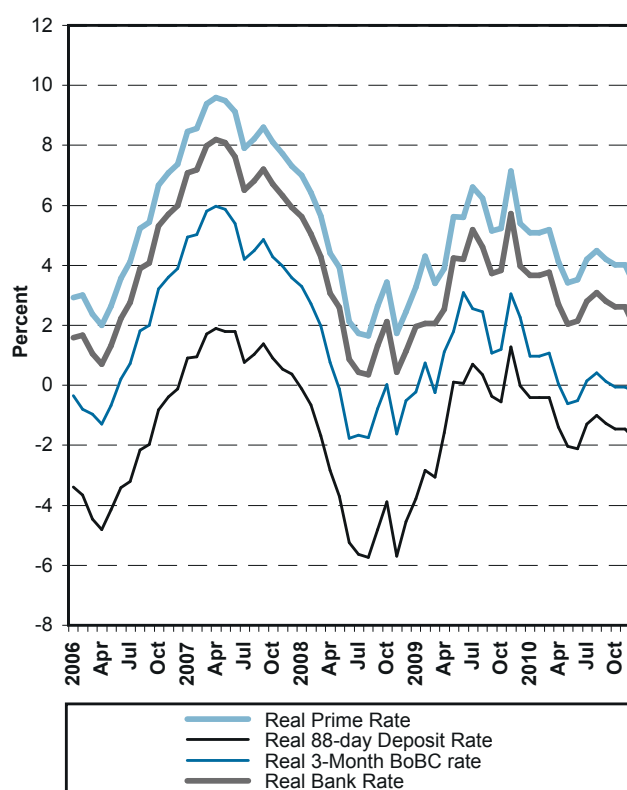
The Pula's strength against all the major international trading currencies was influenced by the 4.9 percent appreciation of the South African rand against the SDR.<sup>2</sup> The rand's appreciation against the major international currencies resulted from the capital inflows attracted by the relatively strong performance of the South African economy and the search for higher rates of return. Although the Pula weakened by 7.4 percent against the rand, the local currency strengthened by 11.4 percent against the euro, 7.7 percent against the British pound sterling, 3.6 percent against the US dollar and 4.9 percent against the SDR, while it depreciated against the Japanese yen by 8.8 percent.

**CHART 4: BANK OF BOTSWANA CERTIFICATES (DECEMBER 2003 - DECEMBER 2010)**



Source: Bank of Botswana

**CHART 5: SELECTED KEY REAL INTEREST RATES (2006 - 2010)**



Source: Bank of Botswana

1 For 91-day BoBCs, changes in the Bank Rate in December are reflected in changes in the 91-day yield of January of the following year since 91-day BoBCs are auctioned only monthly, not weekly as is the case with the 14-day BoBCs. Thus, in January 2011, the 91-day BoBC yield was 6.61 percent, lower than the 7.14 percent of January 2010.

2 SDR is the Unit of Account for the International Monetary Fund comprising the US dollar, euro, Japanese yen and British pound sterling.

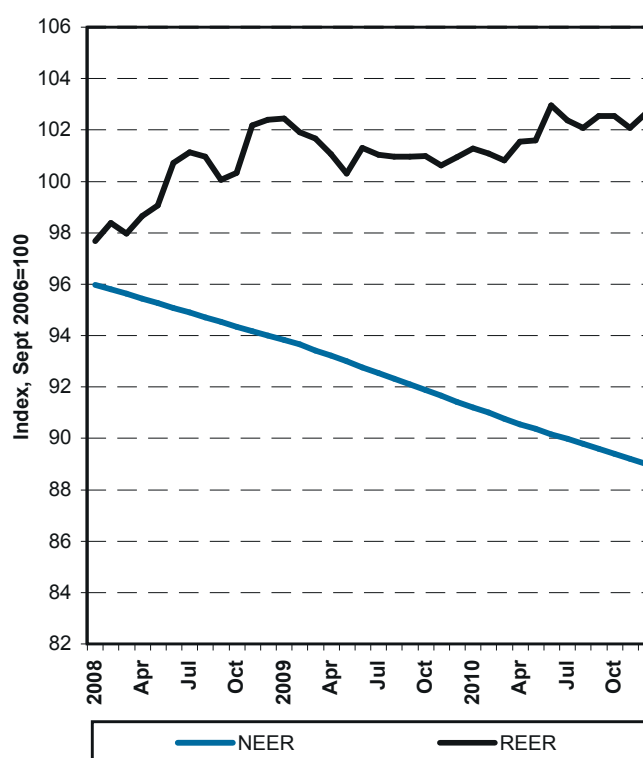
In real terms, the Pula depreciated by 3.9 percent against the rand, but appreciated by 10.7 percent against the SDR, in the 12 months to December 2010. In the event, however, the 2.7 percent depreciation of the trade-weighted Nominal Effective Exchange Rate (NEER), did not fully offset the inflation differential between Botswana and trading partner countries. As a result, the Real Effective Exchange Rate (REER) appreciated by 1.7 percent.

### Banking Supervision and Regulation

#### (d) Supervision and Regulation

While the number of licensed banks was unchanged at 11, the country-wide branch network increased by 4 and 29 additional ATMs were installed. Overall, the banking industry assets expanded by 12 percent from P44 billion in 2009 to slightly over P49 billion at the end of 2010. The bilateral and trilateral meetings with the Bank continued to be conducted, while off-site monitoring and on-site examinations showed that all banks complied with the regulatory requirements for capital adequacy, asset quality, governance and liquidity. The industry also continued to be profitable and robust as illustrated in Table 1 below.

**CHART 6: NOMINAL AND REAL EFFECTIVE EXCHANGE RATES (2008 - 2010)**



Source: Bank of Botswana

**TABLE 1: MEASURES OF FINANCIAL SOUNDNESS INDICATORS AND RANGE OF PRUDENTIAL STANDARDS FOR LICENSED BANKS (2007 – 2010)**

	Prudential Standard	Range of Prudential Standard for Local Banks (Percent)	
		2009	2010
Capital Adequacy	≥15	15.8 – 48.4	16.3 – 33.4
Liquid Asset Ratio	≥10	11.0 – 73.7	28.5 – 63.2
Profitability (Return on Assets)	Positive	0.6 – 5.2	0.3 – 5.0
Profitability (Return on Equity)	Positive	2.7 – 38.3	2.7 – 41.0
Asset quality (Non-performing Loans/Total Loans)	≤2.5	2.3 – 12.4	2.0 – 10.5
Intermediation (Advances/Deposits)	≥50	34.5 – 74.1	37.0 – 71.8

Source: Bank of Botswana

A Directive on Monthly and Quarterly Returns was issued and adopted by banks during the year to prepare for implementation of Basel II and compliance with the benchmark standards of the International Monetary Fund's Special Data Dissemination Standards (SDDS) for the collection and dissemination of financial data.

Abandoned funds received from the banking industry, in accordance with Section 39 of the Banking Act (CAP. 46:04), declined to P1.6 million in 2010 from P4.7 million in 2009. Of the amount received, P0.7 million was transferred to the Guardian's Fund compared to P1 million the previous year. The significant reduction in the receipt of abandoned funds during the year was, to a large extent, due to the Bank's strengthened information dissemination.



*Bureaux de Change Activities*

The number of Bureaux de Change increased by 10 during the year, bringing the total number to 63. The 14 bureaux examined during 2010 generally satisfied the Bureaux de Change Regulations (2004) requirements with a few exceptions. Accordingly, supervisory warnings were issued in respect of the violations, while two bureaux were fined for non-compliance.

Central Banking Services and Currency Issue

Since the introduction of the new family of banknotes in 2009, public acceptance has generally been favourable, with the exception of the general concern about the paper quality of the lowest denomination P10, which is the subject of continuous surveillance by the Bank. Total net issues of banknotes rose by 4.3 percent, thus reversing the 119 percent fall in 2009 due to the activities associated with the replacement of the old family of banknotes. By denomination, net issues rose fastest for the P200 denomination (by 68 percent), followed by the P10 (25 percent). The net issuance of the P100 and P20 banknotes dropped by 19 percent and 6 percent, respectively. There was no change for the smaller denominations. Coin issuance rose by 8.8 percent in 2010, with higher rates of increase than in 2009 for the P2, 50 thebe, 25 thebe and 5 thebe. However, net issues for the P1 and the 10 thebe coins rose at reduced rates of 3.6 percent and 8.6 percent respectively, compared to 2009.

**TABLE 2(A): NET ISSUANCE OF BANKNOTES BY DENOMINATION (2009 – 2010)**

	Banknotes (million)		Change (percent)	Distribution (percent)	
	2009	2010	2009–2010	2009	2010
<b>P200</b>	2.8	4.7	67.9	12.2	19.6
<b>P100</b>	7.4	6.0	–18.9	32.2	25.0
<b>P50</b>	2.9	2.9	0.0	12.6	12.1
<b>P20</b>	4.9	4.6	–6.1	21.2	19.2
<b>P10</b>	3.2	4.0	25.0	13.8	16.6
<b>P5</b>	0.5	0.5	0.0	2.2	2.1
<b>P2</b>	0.5	0.5	0.0	2.2	2.1
<b>P1</b>	0.8	0.8	0.0	3.6	3.3
<b>Total</b>	<b>23.0</b>	<b>24.0</b>	<b>4.3</b>	<b>100.0</b>	<b>100.0</b>

Source: Bank of Botswana

**TABLE 2(B): NET ISSUANCE OF COIN BY DENOMINATION (2009 – 2010)**

	Banknotes (million)		Change (percent)	Distribution (percent)	
	2009	2010	2009–2010	2009	2010
<b>P5</b>	5.5	5.9	7.3	2.1	2.1
<b>P2</b>	9.5	10.5	10.5	3.7	3.7
<b>P1</b>	16.8	17.4	3.6	6.6	6.3
<b>50t</b>	15.1	16.4	8.6	5.9	5.9
<b>25t</b>	24.5	27.2	11.0	9.6	9.8
<b>10t</b>	56.9	61.8	8.6	22.3	22.2
<b>5t</b>	127.4	139.0	9.1	49.8	50.0
<b>Total</b>	<b>255.7</b>	<b>278.2</b>	<b>8.0</b>	<b>100.0</b>	<b>100.0</b>

Source: Bank of Botswana

Payments and Settlement

The programme for the modernisation and reform of the national payments system, including the integration of cross border payments, progressed further during 2010 in line with the SADC payments framework and plans. In accordance with the programme, a risk-based oversight framework for on-site inspections was

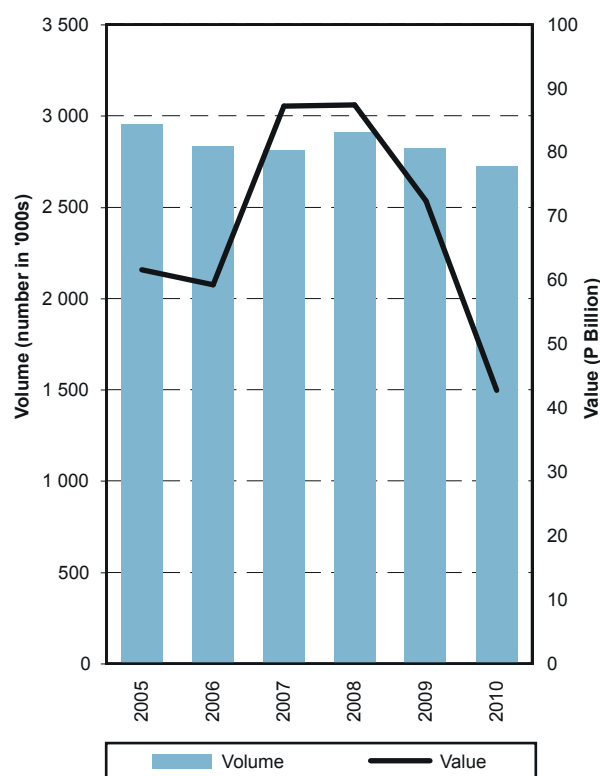
used for the first time in 2010 on the two Systemically Important Payment Systems (SIPS), comprising the Real Time Gross Settlement System [also known as Botswana Inter-bank Settlement System (BISS)] and the Electronic Clearing House (ECH). The Bank's inspections confirmed the robustness, safety and efficiency of the two components of the SIPS. In addition, the Society for Worldwide Inter-bank Financial Telecommunication (SWIFT), which is a messaging platform for both BISS and cross-border foreign exchange transactions, was stable throughout 2010.

Charts 7 – 9 show the volume and value of payments made by cheque, electronic funds (EFT) and BISS. As observed in Chart 7, there was a fall in value (41 percent) and volume (3.4 percent) of cheque payments in 2010 compared to 2009. This was partly due to cheque payment capping of P500 000 for retail payments effective October 1, 2009. Correspondingly, the value and volume of payments through electronic funds transfer rose by 55.6 percent and 13.2 percent, respectively (Chart 8). Similarly, the BISS transactions increased by 40.8 percent in volume and 13.9 percent in value (Chart 9).

### Foreign Exchange Reserves Management

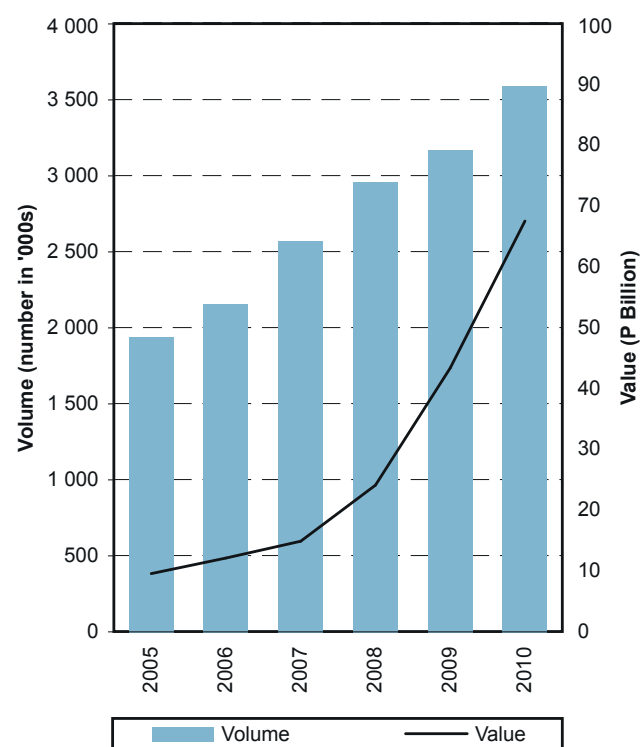
After increasing at the start of the year, the foreign exchange reserves followed a generally downward trend during 2010. This was despite strong growth in exports particularly diamonds, which was largely offset by imports resulting from both continued high levels of government spending and major capital projects. Reduced financial inflows, including those from the Southern African Customs Union (SACU) and an increase in drawdown by the Government from external loans also contributed to a reduction in the level of foreign exchange reserves. The reduction in the level of reserves was greater in local currency terms due to the appreciation of

**CHART 7: ELECTRONIC CLEARING HOUSE: CHEQUE PROCESSING (2005 – 2010)**



Source: Electronic Clearing House

**CHART 8: ELECTRONIC CLEARING HOUSE: ELECTRONIC FUNDS TRANSFERS (2005 – 2010)**



Source: Electronic Clearing House



the Pula against most major currencies. By the end of the year, the foreign exchange reserves had fallen by a cumulative P7.1 billion to P50.8 billion, the equivalent of 15 months of imports of goods and services, compared to 19 months for 2009.

### Human Resources, Staff Welfare and Information Technology

#### *(e) Human Resources and Staff Welfare*

As a result of the restructuring of the Bank, the Staff Establishment increased from 583 the previous year to 593 in 2010. The restructuring together with the virtual freeze in recruitment pending the completion of the Activity Based Costing project (ABC), increased the vacancy rate from 6.5 percent in 2009 to 9.8 percent at end of 2010. The implementation of the ABC project resulted in 32 redundant positions, of which eight were abolished.

#### *(f) Information Technology*

The computer network management system that was installed in the last quarter of 2009 enhanced the Bank's operational efficiency in 2010.

### Advisory Services, External Relations and Communication

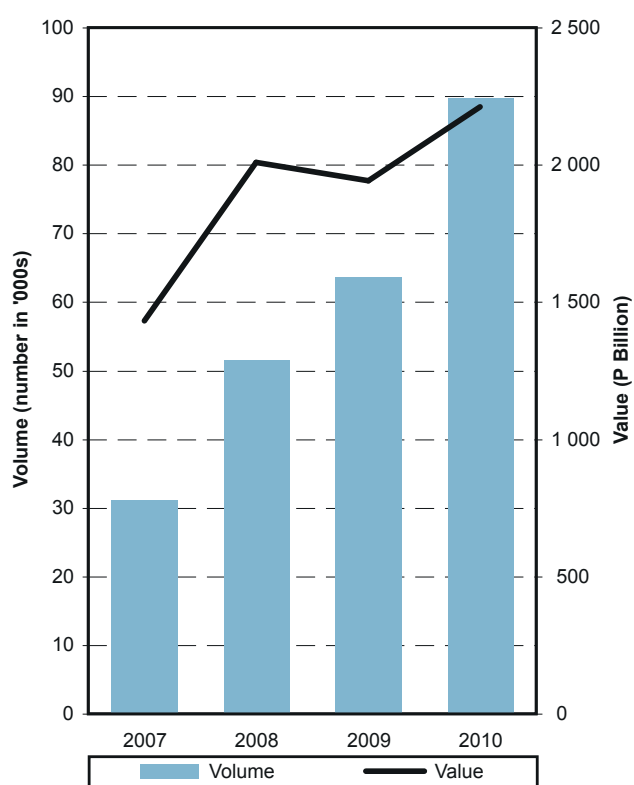
#### *(g) Advisory Services*

The Bank's close collaboration with and the delivery of advisory services to the Government continued throughout the year. This was done through joint Advisory and ad hoc Committees such as the Ministry of Finance and Development Planning/Bank of Botswana Working Group.

#### *(h) External Relations*

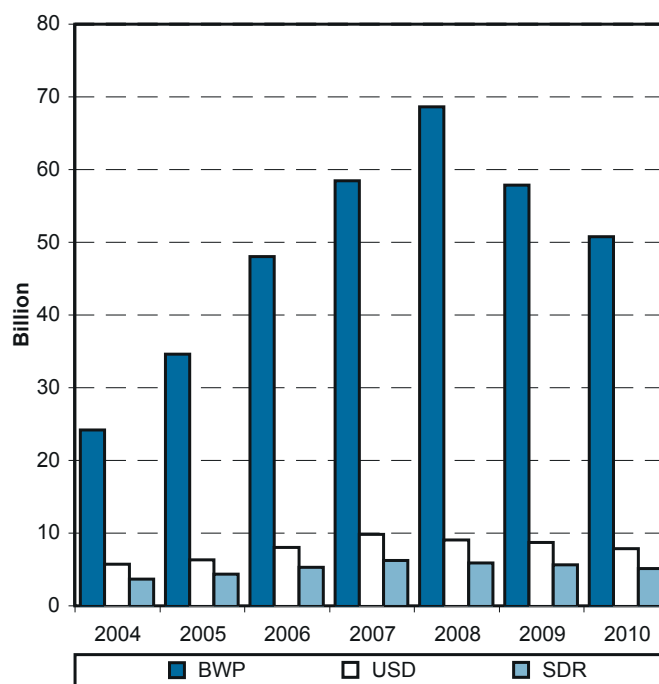
As a member central bank, the Bank attended meetings of both the SADC Committee of Central Bank Governors (CCBG) and the Association of African Central Banks (AACB). The Bank hosted and coordinated the IMF Article IV Surveillance Mission and attended the Joint World Bank/IMF Annual Meetings as the institutional representative on the Board of the IMF.

**CHART 9: BOTSWANA INTER-BANK SETTLEMENT SYSTEM (BISS) TRANSACTIONS (2007–2010)**



Source: Bank of Botswana

**CHART 10: FOREIGN EXCHANGE RESERVES**



Source: Bank of Botswana

The IMF continued to provide technical assistance (TA) for inflation forecasting modelling during the year. There was also TA missions on the preparation and compilation of a joint financial sector survey with the Non-Bank Financial Institutions Regulatory Authority. Phase II of the General Data Dissemination System (GDDS) project was launched and, in September 2010, the Bank hosted a workshop on “Strengthening the Data Framework and Dissemination” for Southern Africa within the Enhanced Data Dissemination Initiative (EDDI) for the African continent.

*(i) Publications, Communications and Public Education*

The *2009 Annual Report* was published with the theme ‘*Determinants and Trends in Household Financial Savings in Botswana*’ and was submitted to the Minister of Finance and Development Planning on March 31, 2010, as legally required. The *Banking Supervision Annual Report* was submitted on June 30, 2010. These and other Bank publications (the monthly *Botswana Financial Statistics (BFS)*, for example) were regularly posted on the upgraded website of the Bank. The Bank’s Business Expectations Survey continued to be carried out biannually.



## **ANNUAL FINANCIAL STATEMENTS**

**2010**

**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 the audit of the affairs of the Bank in accordance with International Standards on Auditing.

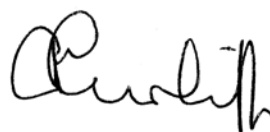
After making enquiries, the Board has no reason to believe that the Bank will not be a going concern in the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the annual financial statements.

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 all transactions are duly authorised. Against this background, the members of the Board accept responsibility for the annual financial statements and the information on pages 31 to 62 which were approved on March 28, 2011 and are signed on behalf of the Board by:



**Linah K Mohohlo**

**Governor**



**Gordon K Cunliffe**

**Board Member**



PO Box 778  
Gaborone  
Botswana

Deloitte & Touche  
Assurance & Advisory Services  
Certified Public Accountants  
(Botswana)  
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Plot 50664  
Fairgrounds Office Park  
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Botswana

Tel: +(267) 395 1611  
Fax: +(267) 397 3137  
www.deloitte.com

## INDEPENDENT AUDITOR'S REPORT

### TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the annual financial statements of Bank of Botswana, set out on pages 31 to 62, which comprise the Statement of Financial Position as at December 31, 2010, the Statement of Comprehensive Income, Statement of Distribution, Statement of Cash Flows and Statement of Changes in Shareholder's Funds for the year then ended, and a summary of significant accounting policies and other explanatory notes.

#### Board Members' Responsibility for the Financial Statements

The members of the Board are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01), and for such internal control as the members of the Board deem is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

#### 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, 2010, and of its financial performance, 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  
Practising Member: P Naik (19900296.14)

GABORONE  
March 28, 2011

National Executive: GG Gelink Chief Executive AE Swiegers Chief Operating Officer GM Pinnock Audit  
DL Kennedy Risk Advisory NB Kader Tax & Legal Services L Geeringh Consulting L Bam Corporate Finance  
JK Mazzocco Human Resources CR Beukman Finance TJ Brown Clients NT Mtoba Chairman of the Board  
MJ Comber Deputy Chairman of the Board  
Resident Partners: M Marinelli Senior Partner FC Els P Naik CV Ramatlapeng M Bardopoulos

A full list of partners and directors is available on request

Member of Deloitte Touche Tohmatsu Limited

## STATEMENT OF FINANCIAL POSITION

December 31, 2010

	Notes	2010 P'000	2009 P'000
<b>ASSETS</b>			
<b>Foreign Assets</b>			
Liquidity Portfolio	1.1	4 987 011	13 229 381
Pula Fund	1.2	44 732 663	43 529 661
International Monetary Fund (IMF)			
Reserve Tranche	2.1	135 404	118 042
Holdings of Special Drawing Rights	2.2	929 735	966 292
Administered Funds	2.3	62 159	64 692
<b>Total Foreign Assets</b>		<b>50 846 972</b>	<b>57 908 068</b>
<b>Domestic Assets</b>			
Property and Equipment	3	196 912	160 782
Government of Botswana Bonds	4	43 810	45 039
Other Assets	5	118 491	99 102
<b>Total Domestic Assets</b>		<b>359 213</b>	<b>304 923</b>
<b>TOTAL ASSETS</b>		<b>51 206 185</b>	<b>58 212 991</b>
<b>LIABILITIES AND SHAREHOLDER'S FUNDS</b>			
<b>Liabilities</b>			
<b>Foreign Liabilities</b>			
Allocation of IMF Special Drawing Rights	6	575 118	599 118
Liabilities to Government (IMF Reserve Tranche)	7	135 404	118 042
<b>Total Foreign Liabilities</b>		<b>710 522</b>	<b>717 160</b>
<b>Domestic Liabilities</b>			
Notes and Coin in Circulation	8	1 915 664	1 659 187
Bank of Botswana Certificates	9	17 641 597	17 030 315
Deposits	10	5 752 465	3 868 038
Dividend to Government	11	175 000	250 000
Other Liabilities	12	99 330	54 158
<b>Total Domestic Liabilities</b>		<b>25 584 056</b>	<b>22 861 698</b>
<b>Total Liabilities</b>		<b>26 294 578</b>	<b>23 578 858</b>
<b>Shareholder's Funds</b>			
Paid-up Capital	14	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		13 553 449	22 019 051
Currency Revaluation Reserve		6 985 871	8 842 895
Market Revaluation Reserve		2 747 287	2 147 187
General Reserve	15	1 600 000	1 600 000
<b>Total Shareholder's Funds</b>		<b>24 911 607</b>	<b>34 634 133</b>
<b>TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS</b>		<b>51 206 185</b>	<b>58 212 991</b>
<b>FOREIGN ASSETS IN US DOLLARS<sup>1</sup> (000)</b>			
		7 886 365	8 703 583
<b>FOREIGN ASSETS IN SDR<sup>2</sup> (000)</b>			
		5 084 697	5 564 965

<sup>1</sup> United States dollar/Pula – 0.1551 (2009: 0.1503)

<sup>2</sup> SDR/Pula – 0.1000 (2009: 0.0961)

## STATEMENT OF COMPREHENSIVE INCOME

Year ended December 31, 2010

	Notes	2010 P'000	2009 P'000
<b>INCOME</b>			
Interest – Foreign exchange reserves	16	1 389 877	1 659 958
Dividends – Foreign exchange reserves	17	216 711	208 913
Interest – Government of Botswana bonds		4 100	4 100
Net market gains on disposal of securities	18	418 539	–
Net realised currency gains	19	–	1 329 498
Profit on domestic foreign exchange deals		34 486	194 254
Other income		15 512	21 072
		<u>2 079 225</u>	<u>3 417 795</u>
<b>EXPENSES</b>			
Interest expense	22	1 253 412	1 649 609
Administration costs		307 797	301 723
Depreciation expense	3	15 397	12 288
Net market losses on disposal of securities	18	–	114 817
Net realised currency losses	19	527 720	–
Net unrealised currency losses	20	1 108 518	5 283 077
Net unrealised market losses	21	16 298	127 393
		<u>3 229 142</u>	<u>7 488 907</u>
<b>NET LOSS FOR THE YEAR</b>		<b>(1 149 917)</b>	<b>(4 071 112)</b>
<b>OTHER COMPREHENSIVE INCOME/(LOSS)</b>			
Net unrealised currency losses on non-monetary “available-for-sale” financial instruments		(221 942)	(1 409 838)
Net unrealised market gains on “available-for-sale” financial instruments		824 310	711 437
<b>Other comprehensive income/(loss) for the year</b>		<b>602 368</b>	<b>(698 401)</b>
<b>TOTAL COMPREHENSIVE LOSS FOR THE YEAR</b>		<b>(547 549)</b>	<b>(4 769 513)</b>



## STATEMENT OF DISTRIBUTION

Year ended December 31, 2010

	Note	2010 P'000	2009 P'000
<b>TOTAL COMPREHENSIVE LOSS FOR THE YEAR</b>		(547 549)	(4 769 513)
Net unrealised currency losses on non-monetary "available-for sale" financial instruments		221 942	1 409 838
Net unrealised market gains on "available-for-sale" financial instruments		(824 310)	(711 437)
<b>NET LOSS FOR THE YEAR</b>		(1 149 917)	(4 071 112)
TRANSFER FROM CURRENCY REVALUATION RESERVE	23	1 623 485	4 043 393
NET INCOME/(LOSS) BEFORE TRANSFER FROM GOVERNMENT INVESTMENT ACCOUNT		473 568	(27 719)
TRANSFERS FROM GOVERNMENT INVESTMENT ACCOUNT		226 432	1 027 719
<b>Dividend to Government</b>		700 000	1 000 000

## STATEMENT OF CASH FLOWS

Year ended December 31, 2010

	Notes	2010 P'000	2009 P'000
<b>OPERATING ACTIVITIES</b>			
Cash generated by operations	26	3 006 692	250 045
<b>INVESTING ACTIVITIES</b>			
Net withdrawals		6 034 570	6 526 354
Interest received from Government of Botswana bonds		4 100	4 100
Proceeds from disposal of property and equipment		608	308
Purchase of property and equipment	3	(52 470)	(25 810)
<b>NET CASH GENERATED FROM INVESTING ACTIVITIES</b>		5 986 808	6 504 952
<b>FINANCING ACTIVITIES</b>			
Dividend to Government	11	(775 000)	(1 075 500)
Government withdrawals		(8 474 977)	(5 744 714)
<b>NET CASH USED IN FINANCING ACTIVITIES</b>		(9 249 977)	(6 820 214)
<b>NET INCREASE IN CURRENCY IN CIRCULATION</b>		(256 477)	(65 217)
<b>CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR</b>		(1 659 187)	(1 593 970)
<b>CURRENCY IN CIRCULATION AT THE END OF THE YEAR</b>		(1 915 664)	(1 659 187)

**STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS**  
**Year ended December 31, 2010**

	<b>Paid-up Capital P'000</b>	<b>Currency Revaluation Reserve P'000</b>	<b>Market Revaluation Reserve P'000</b>	<b>General Reserve P'000</b>
<b>Balance at January 1, 2009</b>	25 000	12 509 032	1 494 884	1 600 000
Total comprehensive loss for the year	—	(1 409 838)	711 437	—
Transfers to/from Government Investment Account:				
Net unrealised market gains for the year	—	—	(59 134)	—
Net unrealised currency losses for the year	—	1 787 094	—	—
Deficit of Government Pula Fund Income over Pula Fund Dividend	—	—	—	—
Government withdrawals	—	—	—	—
Transfer from Currency Revaluation Reserve	—	(4 043 393)	—	—
Dividend to Government	—	—	—	—
<b>Balance at December 31, 2009</b>	25 000	8 842 895	2 147 187	1 600 000
Total comprehensive loss for the year	—	(221 942)	824 310	—
Transfers to/from Government Investment Account:				
Net unrealised market gains for the year	—	—	(224 210)	—
Net unrealised currency gains for the year	—	(11 597)	—	—
Deficit of Government Pula Fund Income over Pula Fund Dividend	—	—	—	—
Government withdrawals	—	—	—	—
Transfer from Currency Revaluation Reserve	—	(1 623 485)	—	—
Dividend to Government	—	—	—	—
<b>Balance at December 31, 2010</b>	25 000	6 985 871	2 747 287	1 600 000

<sup>1</sup> 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	
30 519 444	–	46 148 360	<b>Balance at January 1, 2009</b>
–	(4 071 112)	(4 769 513)	Total comprehensive loss for the year
			Transfers to/from Government Investment Account:
59 134	–	–	Net unrealised market gains for the year
(1 787 094)	–	–	Net unrealised currency losses for the year
			Deficit of Government Pula Fund Income over Pula Fund Dividend
(1 027 719)	1 027 719	–	Government withdrawals
(5 744 714)	–	(5 744 714)	Transfer from Currency Revaluation Reserve
–	4 043 393	–	Dividend to Government
–	(1 000 000)	(1 000 000)	
22 019 051	–	34 634 133	<b>Balance at December 31, 2009</b>
	(1 149 917)	(547 549)	Total comprehensive loss for the year
			Transfers to/from Government Investment Account:
224 210	–	–	Net unrealised market gains for the year
11 597	–	–	Net unrealised currency gains for the year
			Deficit of Government Pula Fund Income over Pula Fund Dividend
(226 432)	226 432	–	Government withdrawals
(8 474 977)	–	(8 474 977)	Transfer from Currency Revaluation Reserve
–	1 623 485	–	Dividend to Government
–	(700 000)	(700 000)	
13 553 449	–	24 911 607	<b>Balance at December 31, 2010</b>

## SIGNIFICANT ACCOUNTING POLICIES

December 31, 2010

## BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

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

## ADOPTION OF REVISED STANDARDS AND INTERPRETATIONS

As at the date of finalisation of the financial statements, the following Standards and Interpretations, relevant to the Bank's operations and available for adoption in the year, had been considered and were found not to have an impact on the financial statements.

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

## STANDARDS AND INTERPRETATIONS IN ISSUE NOT YET ADOPTED

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

Standard	Effective for annual periods beginning on or after
IFRS 7 - <i>Financial Instruments : Disclosures</i> - Amendments resulting from the May 2010 Annual Improvements to IFRSs	January 1, 2011
IFRS 7 - <i>Financial Instruments : Disclosures</i> - Amendments enhancing disclosures about transfers of financial assets	July 1, 2011
IFRS 9 - <i>Financial Instruments</i> - Classification and Measurement	January 1, 2013
IAS 1 - <i>Presentation of Financial Statements</i> - Amendments resulting from the May 2010 Annual Improvements to IFRSs	January 1, 2011
IAS 24 - <i>Related Parties Disclosures</i> - Revised definition of related parties	January 1, 2011

**SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****December 31, 2010****FINANCIAL INSTRUMENTS****General**

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

**Financial Assets**

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

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

**Short-term Investments (Liquidity Portfolio)**

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

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

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

**Long-term Investments (Pula Fund)**

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

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

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

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

**SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****December 31, 2010****FINANCIAL INSTRUMENTS (continued)****Government of Botswana Bonds**

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

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

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

**Derivative Financial Instruments**

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

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

**Loans and Receivables**

Other receivables that have fixed or determinable payments that are not quoted in an active market are classified as “loans and receivables”. Loans and receivables are measured at amortised cost using the effective interest method, less any impairment. Interest income is recognised by applying the effective interest rate, except for short-term receivables when the recognition of interest would be immaterial.

**Impairment of Financial Assets**

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

**Financial Liabilities**

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

**Bank of Botswana Certificates**

As one of the primary tools for maintaining monetary stability in the economy, the Bank of Botswana issues its own paper, Bank of Botswana Certificates (BoBCs), to absorb excess liquidity in the market and thereby influence short term

**SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****December 31, 2010****FINANCIAL INSTRUMENTS (continued)**

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 Statement of Comprehensive Income.

**Other Financial Liabilities**

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

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

**CREDIT FACILITY**

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

**SECURITIES LENDING PROGRAMME**

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

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

The Bank records income from lending securities as it accrues.

**REPURCHASE AND REVERSE REPURCHASE AGREEMENTS**

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

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

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

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

**SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****December 31, 2010****FINANCIAL INSTRUMENTS (continued)****FOREIGN CURRENCIES**

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

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

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

**ASSETS, LIABILITIES AND RECOGNITION OF PROVISIONS****Assets**

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

**Contingent Assets**

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

**Liabilities and Provisions**

The Bank recognises liabilities (including provisions) when:

- (a) it has a present legal obligation resulting from past events;
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle this obligation; and
- (c) a reliable estimate of the amount of the obligation can be made.

**Derecognition of Assets and Liabilities**

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

**INCOME AND EXPENSE RECOGNITION**

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



## **SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**December 31, 2010**

### **FINANCIAL INSTRUMENTS (continued)**

#### **OFFSETTING FINANCIAL INSTRUMENTS**

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

- (a) there is a legally enforceable right to set off;
- (b) there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously;
- (c) the maturity date for the financial assets and liability is the same; and
- (d) the financial asset and liability are denominated in the same currency.

#### **GENERAL RESERVE**

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

#### **CURRENCY REVALUATION RESERVE**

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

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

#### **MARKET REVALUATION RESERVE**

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

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

#### **PROPERTY AND EQUIPMENT**

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

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

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

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

**SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)****December 31, 2010****PROPERTY AND EQUIPMENT (continued)**

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

**Depreciation**

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

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

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

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

**RETIREMENT BENEFITS**

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

**FINANCE LEASES**

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

**SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**December 31, 2010**

**RELATED PARTY TRANSACTIONS**

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

**SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGMENTS 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 property and equipment at the end of each annual reporting period. In this financial year, no change was made to the useful lives hence the depreciation rates provided are similar with the prior year.

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS

December 31, 2010

	2010 P'000	2009 P'000
<b>1. FOREIGN EXCHANGE RESERVES</b>		
<b>1.1 Liquidity Portfolio</b>		
Bonds – held for trading	982 016	4 943 263
Amounts Due from Pula Fund	753 682	1 050 020
Cash and Cash Equivalents	3 251 313	7 236 098
	<u>4 987 011</u>	<u>13 229 381</u>
<b>1.2 Pula Fund</b>		
Equities – available-for-sale	10 312 453	9 543 049
Bonds – available-for-sale	31 432 514	32 985 460
Derivative Financial Instruments – assets (Note 13)	5 087	18 454
Amounts Due to Liquidity Portfolio	(753 682)	(1 050 020)
Derivative Financial Instruments – liabilities (Note 13)	(23 921)	(12 950)
Cash and Cash Equivalents	3 760 212	2 045 668
	<u>44 732 663</u>	<u>43 529 661</u>
<b>Statement of Financial Position</b>		
<i>Capital Employed</i>		
Government	13 552 189	21 818 442
Bank of Botswana	31 180 474	21 711 219
	<u>44 732 663</u>	<u>43 529 661</u>
<i>Employment of Capital</i>		
Investments	<u>44 732 663</u>	<u>43 529 661</u>
Investments expressed in US dollars ('000)	<u>6 938 036</u>	<u>6 542 508</u>
Investments expressed in SDR ('000)	<u>4 473 266</u>	<u>4 183 200</u>
<b>Statement of Comprehensive Income</b>		
<i>Income</i>		
Interest and dividends	1 393 295	1 517 559
Realised currency revaluation gains	–	1 502 233
Realised market gains	437 046	–
	<u>1 830 341</u>	<u>3 019 792</u>
<i>Expenses</i>		
Realised currency revaluation losses	274 707	–
Unrealised currency revaluation losses	1 199 218	4 520 650
Realised market losses	–	163 457
Administration charges	104 363	97 684
	<u>1 578 288</u>	<u>4 781 791</u>
Net income/(loss) for the year	252 053	(1 761 999)
<i>Other Comprehensive Income/(Loss)</i>		
Net unrealised currency losses on non-monetary “available-for-sale” financial instruments	(221 942)	(1 409 838)
Net unrealised market gains on “available-for-sale” financial instruments	825 539	707 416
Other comprehensive income/(loss) for the year	<u>603 597</u>	<u>(702 422)</u>
Total comprehensive income/(loss) for the year	<u>855 650</u>	<u>(2 464 421)</u>

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

	2010 P'000	2009 P'000
<b>2. INTERNATIONAL MONETARY FUND (IMF) ASSETS</b>		
<b>2.1 Reserve Tranche</b>		
<p>This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is the membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holding of Pula by the IMF, which initially was equal to 75 percent of the quota, has changed from time to time as a result of the use of the Pula by the IMF in lending to member countries.</p>		
Quota (SDR 63 000 000)	630 000	655 567
Less: IMF Holdings of Pula	(494 596)	(537 525)
Reserve Position in IMF	<u>135 404</u>	<u>118 042</u>
<p>The IMF Holdings of Pula are represented by the Non-Interest Bearing Note of P165 324 000 (2009 – 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 10).</p>		
<b>2.2 Holdings of Special Drawing Rights</b>		
<p>The balance on the account represents the value of Special Drawing Rights (SDR) allocated and purchased less utilisation to date.</p>		
	<u>929 735</u>	<u>966 292</u>
<b>2.3 Administered Funds</b>		
<p>This relates to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust. The amount represents SDR 6 200 000 (and interest accrued thereon) lent on May 20, 2008, to the Poverty Reduction Growth Facility/Heavy Indebted Poor Countries Trust Fund, a fund administered in trust by the IMF. This matures on May 20, 2013.</p>		
	<u>62 159</u>	<u>64 692</u>

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

3. PROPERTY AND EQUIPMENT	Freehold Land P'000	Leasehold Land P'000	Buildings P'000	Capital Works in Progress P'000	Other Assets P'000	Total P'000
<b>Cost - December 31, 2010</b>						
Balance at the beginning of the year	780	4 368	151 309	10 571	100 728	267 756
Reclassifications	1 285	(1 285)	—	—	—	—
Additions	—	—	—	42 456	10 014	52 470
Disposals	—	—	(315)	—	(3 760)	(4 075)
Transfers	—	—	60	(4 631)	4 571	—
Balance at year-end	2 065	3 083	151 054	48 396	111 553	316 151
<b>Accumulated Depreciation</b>						
Balance at the beginning of the year	—	—	47 771	—	59 203	106 974
Charge for the year	—	—	4 084	—	11 313	15 397
Disposals	—	—	(19)	—	(3 113)	(3 132)
Balance at year-end	—	—	51 836	—	67 403	119 239
Net book value at December 31, 2010	2 065	3 083	99 218	48 396	44 150	196 912
<b>Cost - December 31, 2009</b>						
Balance at the beginning of the year	780	4 368	140 977	17 044	82 603	245 772
Additions	—	—	—	12 955	12 855	25 810
Disposals	—	—	—	—	(3 826)	(3 826)
Transfers	—	—	10 332	(19 428)	9 096	—
Balance at year-end	780	4 368	151 309	10 571	100 728	267 756
<b>Accumulated Depreciation</b>						
Balance at the beginning of the year	—	—	44 201	—	53 926	98 127
Charge for the year	—	—	3 570	—	8 718	12 288
Disposals	—	—	—	—	(3 441)	(3 441)
Balance at year-end	—	—	47 771	—	59 203	106 974
Net book value at December 31, 2009	780	4 368	103 538	10 571	41 525	160 782

**Revaluation of Properties**

Freehold and leasehold land and buildings were valued by an independent professional property valuer in December 2010 at an open market value of P263 943 000 (2008: P179 460 000).

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

	2010 P'000	2009 P'000
<b>4. GOVERNMENT OF BOTSWANA BONDS – available-for-sale</b>		
(i) Government Bond BW004, maturing on March 12, 2011 bearing interest at the rate of 10.50 percent, receivable semi-annually in arrears:		
Market value	20 164	20 698
Interest accrued	644	644
	<u>20 808</u>	<u>21 342</u>
(ii) Government Bond BW005, maturing on September 12, 2018 bearing interest at the rate of 10 percent, receivable semi-annually in arrears:		
Market value	22 388	23 083
Interest accrued	614	614
	<u>23 002</u>	<u>23 697</u>
	<u>43 810</u>	<u>45 039</u>
<b>5. OTHER ASSETS</b>		
Staff loans and advances	79 362	79 871
Prepayments	1 980	3 952
Advances to Banks	–	3 050
Other	37 149	12 229
	<u>118 491</u>	<u>99 102</u>
<b>6. ALLOCATION OF IMF SPECIAL DRAWING RIGHTS</b>		
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.	<u>575 118</u>	<u>599 118</u>
<b>7. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)</b>		
This balance represents the Bank's liability to the Government in respect of the Reserve Tranche position in the IMF (Note 2.1).	<u>135 404</u>	<u>118 042</u>
<b>8. NOTES AND COIN IN CIRCULATION</b>		
Notes	1 819 607	1 570 173
Coin	96 057	89 014
	<u>1 915 664</u>	<u>1 659 187</u>
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.		
<b>9. BANK OF BOTSWANA CERTIFICATES – other financial liabilities</b>		
Face Value	17 700 500	17 087 390
Unmatured Discount	(58 903)	(57 075)
Carrying Amount	<u>17 641 597</u>	<u>17 030 315</u>
Bank of Botswana Certificates are issued at various short-term maturity dates and discount rates.		

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

	2010 P'000	2009 P'000
<b>10. DEPOSITS</b>		
Government	1 062 161	909 779
Bankers	2 338 918	1 658 508
Other	2 351 386	1 299 751
	<u>5 752 465</u>	<u>3 868 038</u>
These represent current accounts of Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free.		
<b>11. DIVIDEND TO GOVERNMENT</b>		
Balance due at the beginning of the year	250 000	325 500
Dividend to Government from Pula Fund	700 000	1 000 000
Paid during the year	(775 000)	(1 075 500)
Balance due at the end of the year	<u>175 000</u>	<u>250 000</u>
The final instalment of the pre-set dividend of P175 000 000 unpaid as at December 31, 2010 was provided for in accordance with Section 6 of the Bank of Botswana Act (CAP 55:01).		
<b>12. OTHER LIABILITIES</b>		
Accounts payable	26 670	5 104
Other creditors and accruals	72 660	49 054
	<u>99 330</u>	<u>54 158</u>
<b>13. CATEGORIES OF FINANCIAL INSTRUMENTS</b>		
<b>13.1 Financial Assets</b>		
Held for trading		
Bonds	982 016	4 943 263
Derivative Financial Instruments (Note 1.2)	5 087	18 454
Available-for-sale		
Bonds	31 432 514	32 985 460
Equities	10 312 453	9 543 049
Government Bonds	43 810	45 039
Loans and Receivables		
IMF Reserves	1 127 298	1 149 026
Staff loans and advances	79 362	79 871
Cash and cash equivalents	7 011 525	9 281 766
<b>Total Financial Assets</b>	<u>50 994 065</u>	<u>58 045 928</u>
The above is disclosed in the Statement of Financial Position as follows:		
Total Foreign Exchange Reserves	50 846 972	57 908 068
Add: Derivative Financial Instruments (liabilities)	23 921	12 950
Government of Botswana bonds	43 810	45 039
Other Assets – staff loans and advances (Note 5)	79 362	79 871
	<u>50 994 065</u>	<u>58 045 928</u>



## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

	2010 P'000	2009 P'000
<b>13. CATEGORIES OF FINANCIAL INSTRUMENTS (Continued)</b>		
<b>13.2 Financial Liabilities</b>		
Held for trading		
Derivative Financial Instruments (Note 1.2)	23 921	12 950
Other Financial Liabilities – at amortised cost		
Bank of Botswana Certificates	17 641 597	17 030 315
Allocation of SDR (IMF)	575 118	599 118
Liabilities to Government (IMF)	135 404	118 042
Deposits	5 752 465	3 868 038
Dividend to Government	175 000	250 000
Other Liabilities	99 330	54 158
	<u>24 402 835</u>	<u>21 932 621</u>

**13.3 Derivative Financial Instruments**

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

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

		Asset 2010 (P'000)	Liabilities 2010 (P'000)	Notional Amount 2010 (P'000)		Assets 2009 (P'000)	Liabilities 2009 (P'000)	Notional Amount 2009 (P'000)
Fixed Income Futures	– Buy	–	(17 259)	594 663		–	(12 641)	463 004
	– Sell	5 087	–	384 504		15 308	–	498 594
Currency Futures	– Buy	–	(980)	981		2 399	–	292 324
Other Options	– Sell	–	(3 009)	9 923		51	–	161
Swaps	– Buy	–	–	–		–	(309)	963
	– Sell	–	(2 673)	173 159		696	–	696
		<u>5 087</u>	<u>(23 921)</u>	<u>1 163 230</u>		<u>18 454</u>	<u>(12 950)</u>	<u>1 255 742</u>

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

**Futures**

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

**Options**

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

**Swaps**

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

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

	2010 P'000	2009 P'000
<b>14. PAID-UP CAPITAL</b>		
Authorised and Paid-up Capital	25 000	25 000
The capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act (CAP 55:01). 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.		
<b>15. GENERAL RESERVE</b>		
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
<b>16. INTEREST – FOREIGN EXCHANGE RESERVES</b>		
<b>Liquidity Portfolio</b>		
Cash and cash equivalents	87 608	179 064
Bonds – held for trading	123 694	169 119
IMF Reserves – loans and receivables	1 991	3 129
<b>Pula Fund</b>		
Cash and cash equivalents	16 653	28 014
Bonds – available-for-sale	1 159 931	1 280 632
	1 389 877	1 659 958
<b>17. DIVIDENDS – FOREIGN EXCHANGE RESERVES</b>		
<b>Pula Fund</b>		
Equities – available-for-sale	216 711	208 913
<b>18. NET MARKET GAINS/(LOSSES) ON DISPOSAL OF SECURITIES</b>		
<b>Liquidity Portfolio</b>		
Bonds – held for trading	(18 507)	48 640
<b>Pula Fund</b>		
Derivative instruments – held for trading	(244)	(13 485)
Bonds – available-for-sale	396 907	707 837
Equities – available-for-sale	40 383	(857 809)
	418 539	(114 817)
Included above are net market gains of P437 290 000 (2009: P149 972 000 losses) which have been recycled from equity on disposal of investments classified as available-for-sale.		
<b>19. NET REALISED CURRENCY (LOSSES)/GAINS</b>		
<b>Liquidity Portfolio</b>		
Cash and cash equivalents	(51 475)	(279 345)
Bonds – held for trading	(201 538)	106 610
<b>Pula Fund</b>		
Derivative instruments – held for trading	–	91 689
Cash and cash equivalents	(1 331)	(133 305)
Bonds – available-for-sale	(289 607)	1 102 384
Equities – available-for-sale	16 231	441 465
	(527 720)	1 329 498
Included above are net currency losses of P273 376 000 (2009: P1 543 849 000 gains) which have been recycled from equity on disposal of investments classified as available-for-sale.		

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

	2010 P'000	2009 P'000
20. NET UNREALISED CURRENCY LOSSES		
<b>Liquidity Portfolio</b>		
Cash and cash equivalents	44 697	(36 603)
Bonds - held for trading	62 439	(677 099)
IMF reserves - loans and receivables	(16 437)	(48 725)
<b>Pula Fund</b>		
Cash and cash equivalents	(5 510)	69 438
Bonds - available-for-sale	(1 194 173)	(4 590 058)
Derivative instruments - held for trading	466	(30)
	<u>(1 108 518)</u>	<u>(5 283 077)</u>
21. NET UNREALISED MARKET LOSSES		
<b>Liquidity Portfolio</b>		
Bonds - held for trading	(10 259)	(127 166)
<b>Pula Fund</b>		
Derivative instruments - held for trading	(6 039)	(227)
	<u>(16 298)</u>	<u>(127 393)</u>
22. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	1 229 387	1 622 466
Reverse Repurchase Agreements	24 025	27 143
	<u>1 253 412</u>	<u>1 649 609</u>
23. NET CURRENCY REVALUATION (LOSSES)/GAINS RETAINED IN THE STATEMENT OF COMPREHENSIVE INCOME		
Total net realised (losses)/gains (Note 19)	(527 720)	1 329 498
Total net unrealised losses (Note 20)	(1 108 518)	(5 283 077)
Total net currency revaluation losses	<u>(1 636 238)</u>	<u>(3 953 579)</u>
<b>Appropriated to Currency Revaluation Reserve:</b>		
Net realised and reinvested in foreign assets	514 967	(1 239 684)
Net unrealised currency losses	1 108 518	5 283 077
Transferred from Currency Revaluation Reserve	1 623 485	4 043 393
Net currency revaluation (losses)/gains retained in the Statement of Comprehensive Income	<u>(12 753)</u>	<u>89 814</u>
24. CONTRIBUTION TO THE BANK OF BOTSWANA DEFINED CONTRIBUTION STAFF PENSION FUND		
The Bank's contribution to the Bank of Botswana Defined Contribution Staff Pension Fund for the year ended December 31, 2010 is P15 551 000 (2009: P14 312 000).		
25. STATEMENT OF CASH FLOWS		

The definition of cash in IAS 7 is not wholly appropriate to the Bank. Due to its role in the creation and withdrawal of currency in circulation, the Bank has no cash balances on its Statement of Financial Position (see Note 8). However, the Bank has the ability to create cash when needed.

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

	2010 P'000	2009 P'000
<b>26. CASH GENERATED BY OPERATIONS</b>		
Net loss for the year adjusted for:	(1 149 917)	(4 071 112)
Net realised and unrealised exchange losses	1 623 485	4 043 393
Depreciation expense	15 397	12 288
Loss on disposal of Property and Equipment	335	77
Interest – Government of Botswana bonds	(4 100)	(4 100)
Operating cash flows before movements in working capital	485 200	(19 454)
Increase in Deposits – banks and other	1 732 045	758 880
Increase in Deposits – Government	152 382	43 855
Increase/(Decrease) in Bank of Botswana Certificates	611 282	(523 600)
Increase in other assets	(19 389)	(7 016)
Increase/(Decrease) in other liabilities	45 172	(2 620)
Cash generated by operations	3 006 692	250 045
<b>27. CAPITAL COMMITMENTS</b>		
Approved and contracted for	144 618	3 854
Approved, but not contracted for	19 201	130 488
	163 819	134 342

These capital commitments will be funded from internal resources.

**28. COLLATERAL****(i) Credit Facility**

There were no open positions as at December 31, 2010 (2009: P3 100 000) under the Credit Facility accounted for as “Advances to Banks”.

**(ii) Securities Lending Programme**

Under the Bank’s Securities Lending Programme, the Bank has lent securities with a fair value of P10.9 billion (2009: P11.8 billion). The Bank has accepted securities with a fair value of P11.3 billion (2009: P12.2 billion) as collateral for the securities lent under this programme.

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

## 29. GOVERNMENT OF BOTSWANA BONDS AND TREASURY BILLS

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

## Government of Botswana Bonds and Treasury Bills issued as at December 31, 2010

Bond/Treasury Bill Detail	BW 003	BW 004	BW 005	BW 006	BW 007	BW 008	BW 090311	Total
Date of Issue	May 6, Nov 3, 2003 and Sept 10, 2008, Mar 11 and Sept 9, 2009 and March 10 and Sept 8, 2010	Mar 12 and Sept 10, 2008 and Mar 11, 2009	Mar 12, Sept 10, 2008 and Mar 11 and Sept 9, 2009	Sept 9, 2009 and March 10 and Sept 8, 2010	March 10 and Sept 8, 2010	Sept 8, 2010	Sept 8, 2010	
Date of Maturity	Oct 31, 2015	Mar 12, 2011	Sept 12, 2018	Mar 9, 2012	Mar 10, 2025	Sept 8, 2020	Mar 9, 2011	
Interest Rate (per annum)	10.25 percent	10.50 percent	10.00 percent	7.50 percent	8.00 percent	7.75 percent	6.4 percent	
	P'000	P'000	P'000	P'000	P'000	P'000	P'000	P'000
Nominal Value	1 642 000	700 000	850 000	600 000	295 000	300 000	600 000	4 987 000
Net(Discount)/Premium	58 285	3 092	26 785	2 655	(23 471)	(13 019)	(18 558)	35 769
Net Proceeds	1 700 285	703 092	876 785	602 655	271 529	286 981	581 442	5 022 769
Interest Paid to date	775 618	168 000	180 000	30 000	7 800	–	–	1 161 418
Interest Accrued	28 827	22 538	26 062	14 171	7 367	7 386	11 646	117 997

- (i) Net proceeds realised from the issue of the bonds were invested in the Government Investment Account.
- (ii) Interest is payable on all bonds on a semi-annual basis in arrears. During the year to December 31, 2010, total interest payments of P414 689 000 were made (2009: P326 903 000) and were funded from the Government's current account maintained with the Bank.

## 30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS

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

## Risk Management Governance Structure

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

## (i) Board

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

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

(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.

**Tranching of Foreign Exchange Reserves – Liquidity Portfolio and Pula Fund**

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

**Pula Fund**

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

**Liquidity Portfolio**

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

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 the foreign assets and liabilities.

(i) Currency Risk

The foreign exchange reserves are invested in currencies that are freely convertible, less susceptible to frequent and sharp exchange rate fluctuations and are used in well-developed financial markets. The Bank's policy is to invest only in currencies with high ratings assigned by Moody's Investors Service and Standard and Poor's. Through a diversified currency allocation relative to an SDR weighted benchmark, the Bank ensures that the purchasing power of the foreign exchange reserves is preserved. In terms of the investment guidelines,

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

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 2010, the Bank's total exposure to SDR and related currencies was P49.4 billion (2009: P55.2 billion). The Bank is also exposed to SDR currency risk on net IMF balances amounting to P416 776 000 (2009: P431 866 000).

(ii) Interest Rate Risk

Interest rate risk is the possible loss in the value of a fixed income asset resulting from an unexpected and adverse movement in interest rates and a consequent change in price. Interest rate risk is measured by modified duration, which measures the sensitivity of the price of a bond to changes in interest rates expressed in years. The Bank benchmarks the interest rate risk for the Pula Fund (fixed income assets) to reflect the long-term nature of the portfolio with emphasis on higher return. The higher interest rate risk is generally compensated by higher returns expected from longer maturity bonds. The modified duration benchmark will vary over time, as changing market conditions and index weights impact the global modified duration of the index. At the end of 2010, the average modified duration of the fixed income portion of the Pula Fund was 6.1 years (2009: 5.8 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 2010, the Liquidity Portfolio's average modified duration was 1.4 years (2009: 1.5 years).

(iii) Equity Price Risk

Equity price risk is the risk that the value of equities decrease as a result of changes in the level of equity indices and diminution of value of individual stocks. The geographic allocation of equity exposure follows generally the market capitalisation among the major markets. The investment guidelines stipulate the holding levels of equities. Holdings of more than 5 percent in one company are not permitted. A reasonable spread among the industry sectors is maintained in the portfolio. There are no investments in private placements or unquoted stocks. At the end of 2010, the equity portion of the Pula Fund was P10.3 billion (2009: P9.5 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, 2010

Risk Variable	Adverse market change			Beneficial market change	
		Scenario	Effect on Statement of Comprehensive Income (P'000)	Scenario	Effect on Statement of Comprehensive Income (P'000)
Interest Rate Risk		Increase in yields by 50 basis points	(967 649)	Decrease in yields by 50 basis points	967 649
Currency Risk	SDR currencies	Strengthening of the Pula by 1%	(505 690)	Weakening of the Pula by 1%	505 690
	South African rand	Strengthening of the Pula by 1%	(2 780)	Weakening of the Pula by 1%	2 780
Equity Risk	Global Equities	Decline in global equity prices by 5%	(515 623)	Increase in global equity prices by 5%	515 623



## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

December 31, 2009

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

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

(iv) Credit risk

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

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

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

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

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



## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

## Exposure to Credit Risk

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

	Notes	2010 P'000	2009 P'000
<b>Financial Assets</b>			
Liquidity Portfolio			
Bonds – held for trading	1.1	982 016	4 943 263
Cash and cash equivalents		4 004 995	8 286 118
Pula Fund			
Bonds – available-for-sale	1.2	31 432 514	32 985 460
Derivative financial instruments – held for trading		5 087	18 454
Cash and cash equivalents		3 006 530	995 648
International Monetary Fund – loans and receivables			
Reserve tranche	2.1	135 404	118 042
Holdings of Special Drawing Rights	2.2	929 735	966 292
Administered Funds	2.3	62 159	64 692
Government of Botswana Bonds – available-for-sale	4	43 810	45 039
Other Assets-staff loans and advances – loans and receivables	5	79 362	79 871
Total		40 681 612	48 502 879
<b>Analysis of Credit Exposure by class:</b>			
Measured at fair value			
Bonds		32 414 530	37 928 723
Derivatives		5 087	18 454
Government of Botswana Bonds		43 810	45 039
Measured at amortised cost			
IMF Reserves		1 127 298	1 149 026
Staff advances		79 362	79 871
Cash and cash equivalents		7 011 525	9 281 766
Total		40 681 612	48 502 879

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, 2010.

## Credit Exposure on Bonds

Moody's/S&P Rating	Government (P'000)	Corporate (P'000)	Other (P'000)	2010 Total (P'000)	2009 Total (P'000)
Aaa/AAA	26 363 678	974 863	131 070	27 469 611	33 166 185
Aa1/AA+	817 548	259 142	–	1 076 690	1 256 399
Aa2/AA	3 489 236	206 982	–	3 696 218	3 450 308
A1	–	29 559	–	29 559	–
A+	–	–	–	–	31 295
A–	142 452	–	–	142 452	–
Other	–	–	–	–	24 536
	30 812 914	1 470 546	131 070	32 414 530	37 928 723

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

## Credit Exposure to Banks (Cash and Cash Equivalents)

Fitch Rating	2010 (P'000)	2009 (P'000)
A1 <sup>1</sup>	7 001 145	4 182 254
A/B1	7 995	547 382
A/B2	—	268 381
A/B4	—	584 232
AA—	—	4 462
B1	—	2 657 926
B2	—	333 516
B/C1	1 597	2 192
B/C2	49	698 549
Other <sup>2</sup>	739	2 872
	<u>7 011 525</u>	<u>9 281 766</u>

## Credit Exposure on Securities Lending Programme

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

(v) Instrument RiskSovereign Bonds

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

Corporate Bonds

The Bank invests in a small proportion of corporate bonds rated A1 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, the Management manages the assets with liquidity in mind and monitors future cash flows and liquidity on a daily basis. The Bank is exposed to daily Pula liquidity requirements on the deposits it holds on behalf of the shareholder, Government of Botswana, the banking system and other clients holding deposits with the Bank (mainly parastatals). For the purpose of managing foreign exchange reserves, the Bank keeps some of its assets in cash, call deposits and other liquid money market instruments to enable the availability of liquidity to meet outflows without incurring undue capital loss and to provide flexibility to respond effectively to changing market requirements.

1 Included in A1 for 2010 is P5 501 065 000 held by the global custodian Northern Trust, P887 829 000 held by central banks and residual for banks rated A1. In 2009, the corresponding figures are P1 664 853 000 for global custodian and P2 517 401 000 for central banks.

2 Overnight positions with clearing banks

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

## Financial Liabilities at Undiscounted Cash Flows

The table below summarises the maturity profile of the Bank's financial liabilities as at December 31, 2010 based on contractual undiscounted repayments obligations.

	Less than 3 months (P'000)	3–12 months (P'000)	1–5 years (P'000)	Over 5 years (P'000)	Total (P'000)
<b>December 31, 2010</b>					
Bank of Botswana Certificates	17 700 500	–	–	–	17 700 500
Deposits	5 752 465	–	–	–	5 752 465
Allocation of SDR–IMF	–	–	–	575 118	575 118
Liabilities to Government–IMF	–	–	–	135 404	135 404
Dividend to Government	175 000	–	–	–	175 000
Other Liabilities	99 330	–	–	–	99 330
	23 727 295	–	–	710 522	24 437 817

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

(vii) Fair value of financial instruments

## Fair value of financial instruments carried at amortised cost

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

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

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

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

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

## Fair value measurements recognised in the Statement of Financial Position

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

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

## December 31, 2010

	Total	Level 1	Level 2	Level 3
	P'000	P'000	P'000	P'000
<b><i>Financial assets at fair value through profit or loss</i></b>				
Bonds	982 016	982 016		
Derivative Financial Instruments	5 087	5 087	–	–
<b><i>Available-for-sale financial assets</i></b>				
Bonds	31 432 514	31 432 514	–	–
Equities	10 312 453	10 312 453	–	–
Government of Botswana bonds	43 810	43 810	–	–
	<u>472 775 880</u>	<u>42 775 880</u>	<u>–</u>	<u>–</u>

## December 31, 2009

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

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

## Other Risks

(viii) External Fund Managers

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

(ix) Custody

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

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

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

(x) Operational Risk

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

## 31. RELATED PARTY BALANCES AND TRANSACTIONS

**Balances and Transactions with the Government**

The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2010, were:

- (i) provision of banking services, including holding of the principal accounts of the Government;
- (ii) management of the Notes and Coin in issue, including printing and minting of notes and coin; and
- (iii) being the Government agent for government bonds and treasury bills.

The aggregate balances in Government accounts are disclosed in Note 10.

No charge is made to the Government for provision of these services, except for commissions charged on domestic foreign exchange transactions, which are included in "Profit on domestic foreign exchange deals" in the Statement of Comprehensive Income. This amounted to P12 296 000 (2009: P82 905 000).

The Bank earned interest on its holding of the Government of Botswana bonds (as described in Note 4) of P4 100 000 (2009: P4 100 000).

**Other Related Party Balances and Transactions**

- (i) Amounts due to related parties.

Included in the balance of outstanding "Deposits – Other" in Note 10 are the following balances with Government-owned institutions.

	2010 P'000	2009 P'000
Botswana Savings Bank	2 749	4 919
Botswana Unified Revenue Service	1 383 620	244 038
Total	1 386 369	248 957

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

- (ii) Remuneration of Key Management Personnel

Key management personnel comprise the Governor, Board Members, Deputy Governors, General Managers and Heads of Departments.

## NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2010

## 31. RELATED PARTY BALANCES AND TRANSACTIONS (Continued)

Gross emoluments of the key management personnel are:

	2010 P'000	2009 P'000
Non-Executive Board members	142	138
Executive Management		
Short term benefits	8 205	7 330
Post-employment benefits	1 394	1 197
	<u>9 741</u>	<u>8 665</u>

Of the Staff Loans and Advances per Note 5, P2 335 000 (2009: P2 005 000) are attributable to Executive Management.

## 32. EVENTS AFTER THE REPORTING DATE

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

# PART B

## THE BOTSWANA ECONOMY IN 2010 AND THEME CHAPTER

BANK OF BOTSWANA





## THE BOTSWANA ECONOMY IN 2010

## 1. OUTPUT, EMPLOYMENT AND PRICES

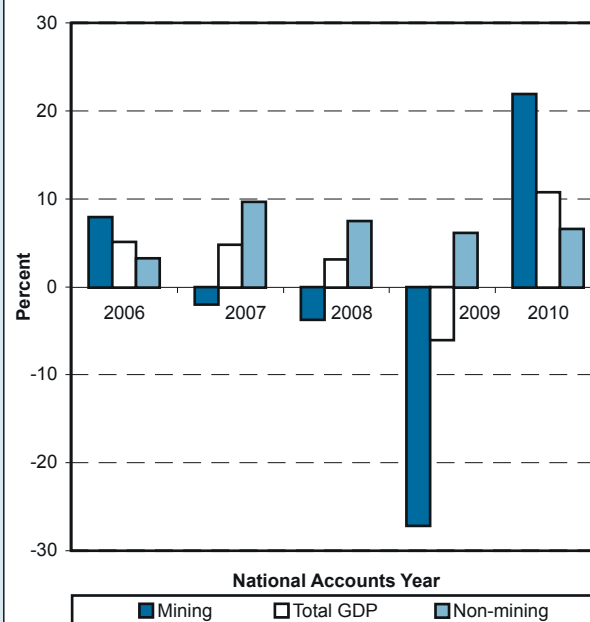
## (a) National Income Accounts

*Overview*

- 1.1 The economy continued to show signs of steady recovery from the effects of the 2009 global recession. Gross domestic product (GDP) grew in real terms at an annual rate of 10.8 percent in the first nine months of 2010, compared to a contraction of 3.7 percent in 2009.<sup>1</sup> The main contributory factor to the turnaround has been mining sector output, which increased by 21.9 percent compared to a decrease of 27.1 percent in 2009 while non-mining GDP grew by 6.5 percent in 2010 compared to 6.2 percent in 2009 (Chart 1.1). The mining sector accounted for 30.8 percent of total GDP, up from 25.9 percent in 2009, but still below the longer-term trend level of close to 40 percent.

*Performance by Economic Sector*

- 1.2 Mining output was dominated by the recovery of the diamond sub-sector which rebounded, in terms of volume and price, from the weak demand for exports that led to the temporary suspension of production in the first quarter of 2009. In the first three quarters of 2010, diamond production was 41.6 percent higher than production during the same period in 2009, and included output from a small new mine. Copper and nickel production also recovered markedly, boosted by higher prices that rebounded to pre-recession levels and reflecting strengthening demand, notably from

CHART 1.1: REAL GDP GROWTH, 2006 – 2010<sup>1</sup> (PERCENT)

1. Data for 2010 are for the first three quarters of the year (footnote 1).

Source: Central Statistics Office

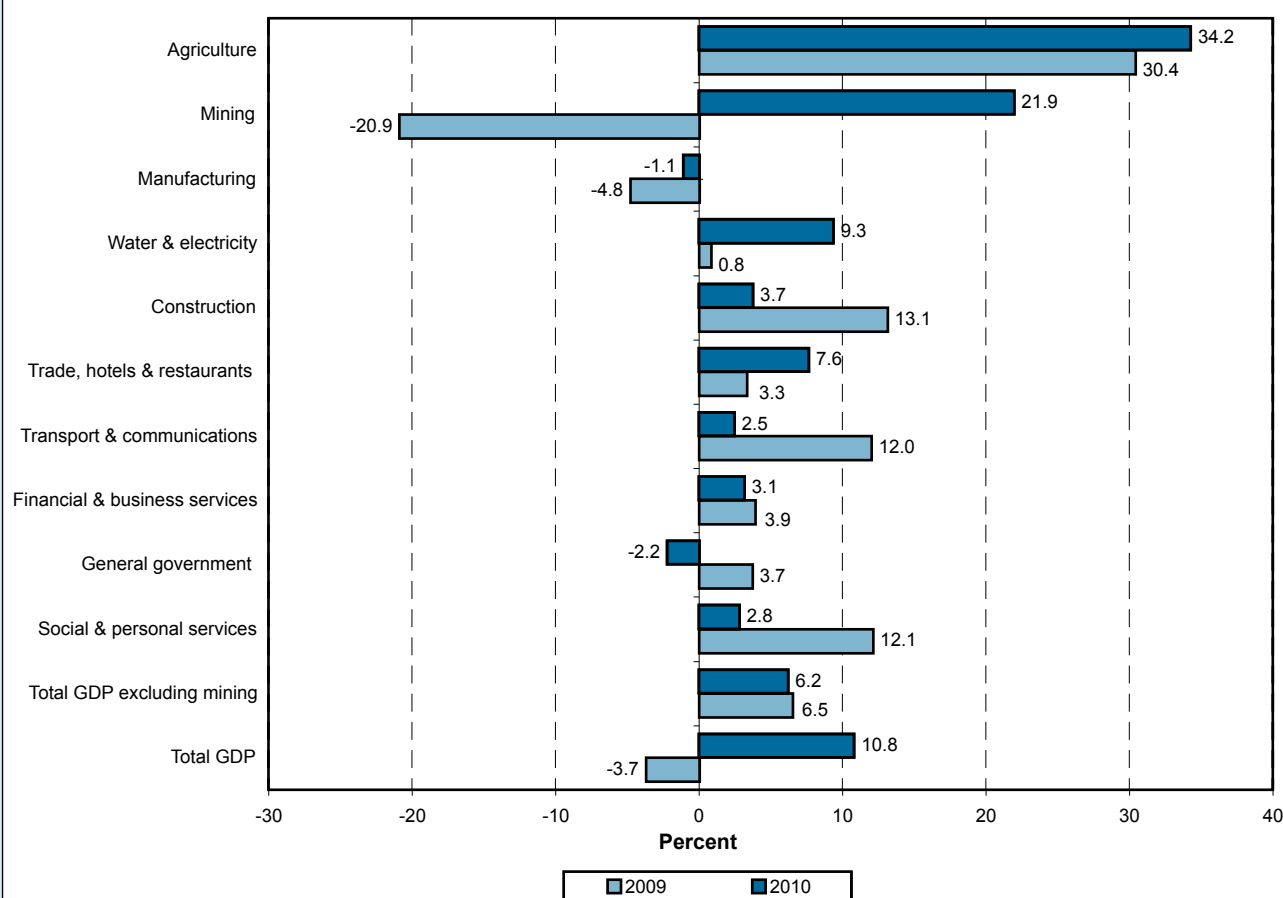
buoyant emerging economies such as China and India.<sup>2</sup>

- 1.3 Among the non-mining sectors, *agriculture* grew most rapidly at 34.2 percent, thus outpacing the 21.9 percent increase in mining output. This is indicative of a generalised increase in activity in the sector, but most notably in livestock production. Caution should be exercised in interpreting this figure, however, given the difficulties in accurately measuring the output of large numbers of typically small, and often informal, farming operations. Moreover, despite the estimate of rapid growth, the sector only accounted for 2.7 percent of total GDP.
- 1.4 The *water and electricity* sector also grew strongly, by 9.3 percent, partly influenced by the recovery of mining, as it is a major

<sup>1</sup> Unless stated otherwise, year-on-year growth rates reported for 2010 refer to the first three quarters, in comparison with the same period in 2009. For earlier years, the full calendar year is used. Data for the final quarter of 2010 were subsequently received. While this was too late for incorporation in the text, the relevant tables in section 1 of the Statistics Section of this Annual Report have been updated accordingly.

<sup>2</sup> De Beers has reported that, while global demand for diamonds grew by approximately 8 percent in 2010, growth in China and India was 25 percent and 31 percent, respectively.

CHART 1.2: REAL GDP GROWTH BY SECTOR, 2009 – 2010 (PERCENT)



Source: Central Statistics Office

consumer of electricity. The *trade, hotels and restaurants* sector also expanded more rapidly than non-mining GDP as a whole, at 7.6 percent, thus indicating a continued growth of commercial activity. Most other sectors showed positive growth, albeit at more moderate rates compared to 2009. Notably, *construction*, which had expanded by 13.1 percent in 2009, grew at a slower 3.7 percent in the first nine months of 2010 as government development spending slowed.

- 1.5 Two sectors contracted in the first nine months of 2010. Output of *manufacturing*, which declined by 4.8 percent in 2009, shrunk by a further 1.1 percent; this suggests that the sector did not benefit from the generally improved economic climate.<sup>3</sup> The *general government* sector also contracted by 2.2 percent.

<sup>3</sup> There are challenges in estimating the output of manufacturing where the range of participating businesses changes more rapidly than in some other sectors. As a result, there may be a degree of underestimation.

## (b) Domestic Economic Outlook

- 1.6 As the global economic recovery continues, growth prospects for Botswana are positive in the context of forecasts of robust world economic performance in the medium-term (Table 1.1). Sustained buoyant growth in emerging market economies together with the gradual recovery of advanced economies will underpin demand for Botswana's exports and help attract additional investment. However, this outlook is accompanied by downside risks, including the possible disruption of the global recovery due to, among others, continuing instability resulting from the lingering effects of the global financial crisis, volatile commodity prices and rising inflationary pressures,<sup>4</sup> as well as political unrest.

<sup>4</sup> In 2010, some economies, notably in emerging markets, were already starting to experience incipient inflationary pressures due to overheating and responded by tightening monetary policy.

TABLE 1.1: GLOBAL GROWTH ESTIMATES 2010 – 2012 (PERCENT)

	2010	2011 <sup>1</sup>	2012 <sup>1</sup>
<b>Global</b>	5.0	4.4	4.5
<b>Advanced economies, of which,</b>	3.0	2.5	2.5
USA	2.8	3.0	2.7
Euro area	1.8	1.5	1.7
Japan	4.3	1.6	1.8
<b>Emerging markets, of which,</b>	7.1	6.5	6.5
Sub-Saharan Africa	5.0	5.5	5.8
China	10.3	9.6	9.5
India	9.7	8.4	8.0
1. Forecast			
Source: International Monetary Fund, <i>World Economic Outlook</i> , January 2011 update.			

1.7 Diamond production by Debswana is projected to increase by about 20 percent in 2011 to 27 million carats, and then to 30 million carats in 2012. Capacity at the existing diamond mines is being expanded<sup>5</sup> and plans to open more new mines are at various stages of development, ranging from preliminary prospecting to mine construction. A major new copper and silver mine is being developed close to Maun, and other developments in the same area are anticipated. Plans to invest in uranium mining are at an advanced stage, while the focus for exploiting Botswana's large coal reserves has shifted away from regional power supply to exports of thermal coal.

1.8 The emergence of a more broadly-based mining sector (which will help diversify the economy away from diamond mining) is likely to stimulate activity in the non-mining economy, with the provision of infrastructure and support services. As part of the Economic Diversification Drive (EDD) that was launched in April 2010, the Government intends to support domestic businesses through greater emphasis on local procurement. Nevertheless, growth in public expenditure is expected to be restrained due to efforts to balance the budget and to minimise waste and inefficiency. In

the circumstances, it will be increasingly important for the business environment to be further improved to encourage enterprise and initiative, and remove the burden of unnecessary administration and regulations. Increased emphasis on developing service industries, including investment by the Government in improved international telecommunications links, will support increased investment and commercial activity.

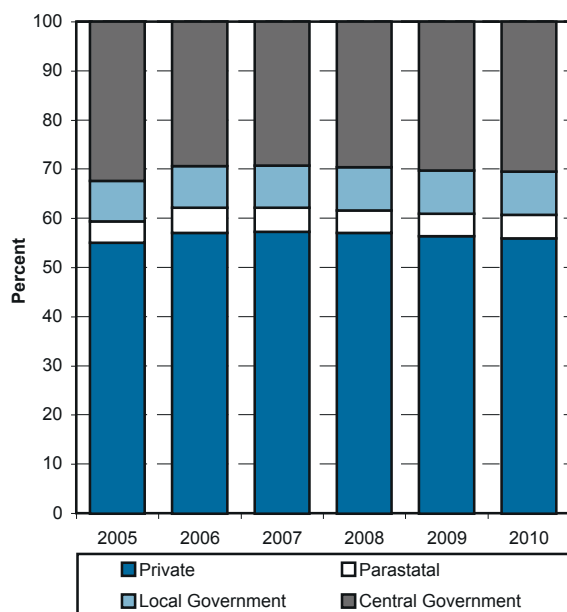
### (c) Employment

1.9 The latest quarterly employment survey indicates that the total number of people employed in the formal sector increased by 3.3 percent, from 317 827 in March 2009 to 328 310 in March 2010.<sup>6</sup> Of the total increase in employment, the private and parastatal sectors accounted for 5 622, while the central government accounts for 3 930 and local government for 930. As shown in Chart 1.3, the broad distribution of employment between the public and private sectors is largely unchanged over a six-year period. The latest estimate of the unemployment rate is 17.5 percent; this is from the Labour Force Survey for 2005/06 and is, therefore, substantially out of date.

<sup>5</sup> For example, the Cut 8 project at Jwaneng that will extend the life of mine by 8 years from 2017 to 2025.

<sup>6</sup> Employment figures in this section do not include people engaged in the labour intensive public works, *Ipelegeng* programme of labour intensive public works.

**CHART 1.3: SECTORAL COMPOSITION OF FORMAL SECTOR EMPLOYMENT (EXCLUDING IPELEGENG) – MARCH 2010**



Source: Central Statistics Office

- 1.10 According to estimates, in March 2010 all sub-sectors in the private and parastatal sectors were employing more workers than in the previous year. This is consistent with the positive growth in the same period of both the mining and non-mining sectors. Unfilled vacancies provided scope for employment by central and local governments to increase, a process that may have been accelerated by greater decentralisation of employment decisions.

#### (d) Inflation

- 1.11 Global inflationary pressures were generally restrained for most of 2010, particularly in advanced economies where, despite continued economic recovery, output remained below capacity, resulting in high levels of unemployment. Inflation expectations also remained well-anchored, despite the continued prevalence of loose monetary conditions in many countries. However, there were signs of emerging inflationary pressures in some of the fast-growing emerging economies, particularly China, resulting in world inflation increasing from an average of 2.5 percent in 2009 to 3.7

percent in 2010. In the same period, inflation in SDR countries<sup>7</sup> rose slightly from an average of zero percent to 1.6 percent,<sup>8</sup> while in South Africa average headline inflation declined substantially from 7.1 percent to 4.3 percent, thus falling within the South African Reserve Bank's (SARB) medium-term target range of 3 – 6 percent from February 2010.<sup>9</sup>

- 1.12 Towards the end of 2010, there were increasing concerns about the possible impact of rapidly rising commodity prices. Oil prices had mainly fluctuated within a narrow range, but mostly above USD70 per barrel, thus reflecting contrasting influences of uncertain prospects for global economic recovery and buoyant demand by some of the emerging market economies. However, oil prices rose above USD90 per barrel towards the end of the year (the highest level in two years) against the background of optimism about the global economic recovery gaining momentum.<sup>10</sup> Key food prices also rose markedly in the international markets by the end of the year (also reaching two-year highs), although countries in Sub-Saharan Africa were partially insulated from higher food prices owing to good harvests of staple crops.
- 1.13 In Botswana, headline consumer price inflation was above the medium-term objective range of 3 – 6 percent for most of 2010, mostly due to domestic factors including, in particular, an increase in value added tax (VAT) and the upward adjustment of some administered prices. Headline inflation rose from 5.8 percent in December 2009 to 6.1 percent in both January and February 2010, thus reflecting higher prices of motor vehicles and base effects associated with fuel price reductions of

<sup>7</sup> USA, UK, Japan and Euro zone.

<sup>8</sup> However, there was considerable variation in price developments across constituent economies. For instance, throughout 2010 UK inflation remained significantly higher than in 2009, but was offset by the continued decrease in the level of prices in Japan.

<sup>9</sup> Inflation was above the SARB's target only in January 2010 (6.2 percent).

<sup>10</sup> Political developments in North Africa and the Middle East in early 2011 also contribute to uncertainty on international oil supplies and prices.

early 2009. While inflation eased marginally to 6 percent in March, it resumed an upward trend to reach 7.8 percent in May due to the impact of the increase in VAT from 10 percent to 12 percent, higher electricity tariffs and the additional levy on power consumption,<sup>11</sup> and an increase in fuel prices. In August, inflation moderated to 6.7 percent following a decrease in fuel prices, but increased thereafter to finish the year at 7.4 percent due to, among others, higher public transport fares and an upward adjustment of the alcohol levy. On average, inflation was 6.9 percent in 2010, compared to 8.2 percent in 2009.

- 1.14 The initial impact of the adjustments in VAT and administered prices contributed approximately 3 percentage points to the level of inflation. This means that, if these events had not taken place, inflation could have been within the medium-term objective range from the second quarter of 2010. The general stability in food price inflation, which has the largest weight in the Consumer Price

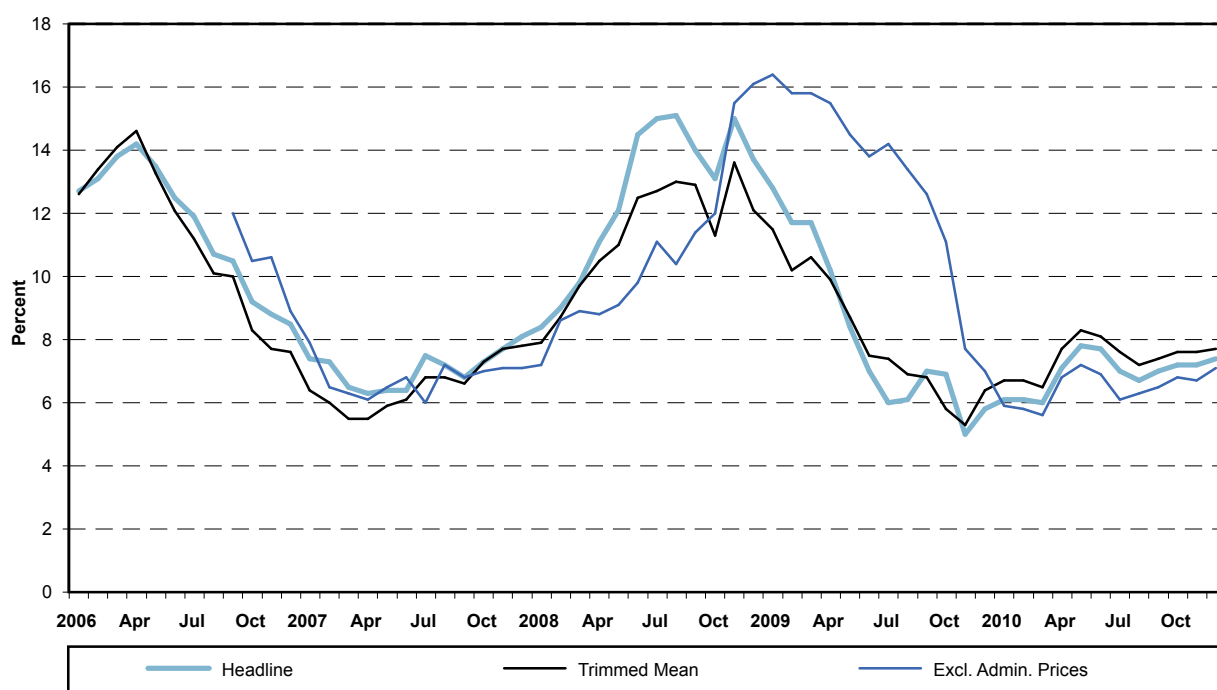
Index (CPI) basket, had a dampening effect on overall inflation during the year.

- 1.15 The 16 percent trimmed mean measure of core inflation rose from 6.4 percent in December 2009 to 7.7 percent in December 2010.<sup>12</sup> In contrast, the measure of core inflation that excludes administered prices increased marginally in the same period, from 7 percent to 7.1 percent, which is an indication of the importance of these prices in the overall increase.

### (e) Inflation Outlook

- 1.16 Global economic recovery is expected to continue in 2011, albeit at a slower rate compared to the previous year. The outlook also shows variation in the pace of recovery for developed versus emerging market economies and developing countries, with prospects for growth generally lower among the former. Low growth in some of the advanced countries reflects the withdrawal of fiscal stimulus packages and the commitment

CHART 1.4: BOTSWANA HEADLINE AND CORE INFLATION, 2006 – 2010



Source: Central Statistics Office

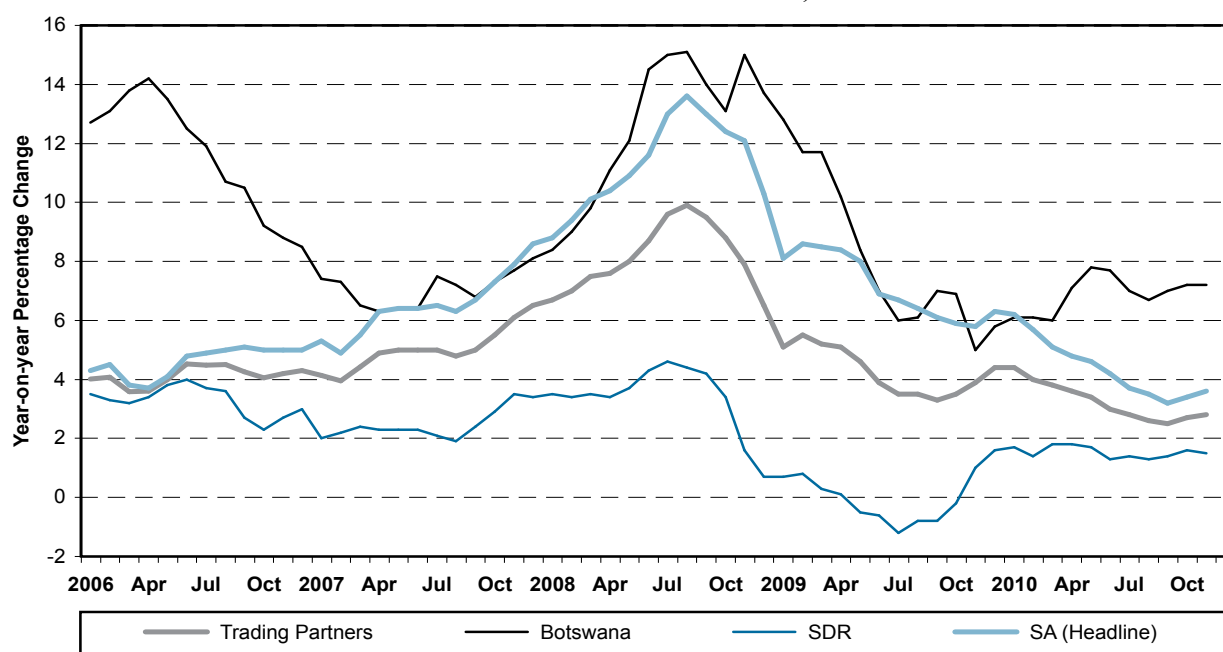
<sup>11</sup> In addition to increasing household tariffs by between 15 percent and 30 percent depending on usage, a levy of 5 thebe/kilowatt-hour was also introduced to help fund the cost of new grid connections.

<sup>12</sup> This measure excludes the most volatile prices in the CPI basket, which can help provide a clearer picture of underlying inflationary trends.

to fiscal consolidation to achieve long-term fiscal and debt sustainability.<sup>13</sup> Moreover, the combination of high rates of unemployment and low income growth contributed to subdued domestic demand. In contrast, growth in emerging market and developing economies is expected to be generally strong, although less robust than in 2010, thus contributing to inflationary pressures in those countries. Although global inflationary pressures are expected to be generally restrained, upside risks have increased substantially. Growing demand has resulted in upward pressures on the international prices of oil and other commodities, and there are heightened concerns about the adequacy of supplies. As of early 2011, world inflation was forecast to decline from 3.7 percent in 2010 to 3.1 percent in 2011. In SDR countries, average inflation is forecast at 1.5 percent in 2011, which is unchanged from the 2010 level. Average headline inflation in South Africa is forecast to increase from 4.3 percent in 2010 to 4.6 percent in 2011, but still remaining within the country's 3 – 6 percent inflation target.

1.17 It is expected that as global economic recovery continues, and demand improves, especially in emerging market economies, the international diamond market conditions will improve further, and support growth in the domestic economy. Although non-mining output gap<sup>14</sup> is projected to remain negative in the forecast horizon, it is expected to narrow, as influenced mainly by similar expected improvements in economic activity in South Africa as that economy grows towards the trend level. The anticipated below-trend level of output will also occur in the context of sluggish growth in personal incomes and a slowdown in government expenditure growth, particularly development spending, which might weaken the stimulus effect that the public sector has on domestic economic activity. In an environment of below-trend economic activity and subdued disposable incomes, it is anticipated that domestic demand pressures on inflation will be low. Nevertheless, there is an upside risk to the inflation outlook arising from any substantial upward adjustment in administered prices and levies for government

**CHART 1.5: BOTSWANA AND TRADING PARTNER COUNTRIES INFLATION, 2006 – 2010**



Source: Central Statistics Office and Bank of Botswana

13 Notable examples include Greece and Ireland, both of which were compelled to seek assistance from other Euro zone countries and the IMF in 2010.

14 The output gap refers to the difference between actual and projected output (as indicated by the quarterly GDP estimates) and long-term trend output, as an indicator of productive capacity.



services. In addition, international oil prices could increase significantly if the global economic recovery accelerates or if there are significant disruptions in supply, which would exert upward pressure on domestic fuel prices and, in turn, inflation. The possibility of acceleration in food price inflation is also a significant risk to the inflation outlook. Overall, based on current information, inflation is forecast to remain above the objective range in the short term, but would fall within the Bank's medium-term objective range of 3 – 6 percent in the second quarter of 2012.

## 2. PUBLIC FINANCE AND THE 2011/12 BUDGET

2.1 Following the slowdown in the global economy that commenced in late 2008, there was an adverse impact on government revenue that led to the government budget incurring significant deficits. However, with the global recovery more robust than had been initially anticipated, the 2011/12 budget<sup>15</sup> gave rise to optimism that the planned reduction of the deficit, so that it is in balance by 2012/13, would be achieved. The envisaged balancing of the budget will continue to depend on successful prioritisation and streamlining of expenditure to ensure efficient use of resources. Such gains in efficiency are essential if the Government is to ensure fiscal sustainability alongside commitment to promoting economic diversification and poverty eradication.

### (a) Budget Performance: 2009/10 and 2010/11<sup>16</sup>

#### *2009/10 Budget Outturn*

2.2 The budget outturn for the 2009/10 financial year was an overall deficit of P9.5 billion, compared to the previous estimate of P13.5 billion. This improved outturn is attributed to both a greater-than-expected increase in revenue and budget underspending.

2.3 Total revenue and grants in 2009/10 amounted to P30.3 billion, which was marginally lower than that of the previous year (by P0.4 billion), but was considerably higher than the projection of P27.8 billion as reflected in the revised budget. The robust recovery in the diamond market resulted in mineral revenue being P2.3 billion above the revised budget. Nevertheless, mineral revenue in 2009/10 fell by P1.1 billion compared to 2008/09, while revenue from VAT was down by P0.4 billion. This shortfall was partly offset by payments from the Southern African Customs Union (SACU), which increased by P0.2 billion, together with P1 billion additional revenue from non-mineral income tax. The latter represented growth of 20.6 percent, as boosted by improved tax collections by the Botswana Unified Revenue Service (BURS).

2.4 Total expenditure and net lending for 2009/10 amounted to P39.5 billion compared to P41.3 billion in the revised budget. This under-expenditure of P1.8 billion was mainly concentrated in development spending, thus reflecting continuing capacity constraints in the context of the rapid expansion of the development budget, which had almost doubled between 2007/8 and 2009/10. Nonetheless, compared to 2008/09, total spending rose by 12.3 percent (P4.3 billion) in 2009/10 in line with the Government's countercyclical fiscal policy stance. Recurrent expenditure rose by 7.2 percent (P1.8 billion), while development expenditure rose by 13.5 percent (P1.5 billion). Recurrent and development expenditure accounted for 45.2 percent and 35.7 percent of the total increase in expenditure, respectively, with the balance due to net lending.<sup>17</sup>

#### *2010/11 Revised Budget*

2.5 The revised budget for 2010/11 shows a deficit of P10.2 billion, compared to the original

15 The 2011/12 budget was presented as part of the 2011 Budget Speech on February 7, 2011.

16 The Government financial year runs from April to March.

17 In recent years, net lending has typically been only a minor item, comprising only loan repayments, as the Government has largely ceased making additional loans. However, for 2009/10, financial support for De Beers to help offset the impact of the global recession was included in this category.

projection of P12.1 billion. Although the expenditure budget increased by P1.3 billion, this was expected to be more than offset by P3.2 billion in additional revenue resulting from the continuing economic recovery.

- 2.6 Total government revenue in the same period is estimated at P30.3 billion compared with the original budget of P27.1 billion. Most of the increase is attributable to mineral receipts which are expected to be P2.8 billion more than previously forecast, while SACU receipts benefited from an additional one-off payment of P1 billion that was not included in the original budget. The projections for both non-mineral income tax and VAT collections have been reduced, although this may reflect caution in the budgeting process.
- 2.7 Total budgeted expenditure in 2010/11 has been revised from P39.2 billion to P40.5 billion; this is largely explained by an increase in development spending. At P27.2

that was implemented effective May 1, 2010, in compliance with the new Public Service Act. The increase of P1.1 billion in the development budget to P13.2 billion was due to the insufficient allocation of funds to various projects that was subsequently addressed through parliamentary approval of a supplementary budget in December 2010. However, despite this increase in authorised spending, the implementation track record indicates that a significant degree of underspending can be anticipated. In turn, this suggests that the budget deficit for 2010/11 could ultimately be smaller than projected in the revised budget.

### (b) 2011/12 Budget Proposals

- 2.8 The 2011/12 budget proposals were presented against the background of an evolving approach to budgetary management that entails greater emphasis on transparency and accountability. This is part of a wide-ranging programme of

**TABLE 1.2: GOVERNMENT BUDGET FOR 2009/10 – 2011/12 (P BILLION)**

	2009/10			2010/11		2011/12
	Budget	Revised	Final	Budget	Revised	Budget
<b>Revenue</b>	<b>24 393</b>	<b>27 782</b>	<b>30 023</b>	<b>27 077</b>	<b>30 288</b>	<b>34 098</b>
Mineral	6 835	6 835	9 088	6 481	9 317	11 197
Non-mineral	17 558	20 947	20 935	20 595	20 971	22 901
<b>Expenditure</b>	<b>37 787</b>	<b>41 265</b>	<b>39 489</b>	<b>39 194</b>	<b>40 509</b>	<b>41 028</b>
Recurrent	27 357	26 378	25 732	27 143	27 223	30 348
Personal emoluments	9 576	10 883	9 252	11 935	11 935	11 626
Other charges	17 481	15 196	16 110	14 708	14 789	18 165
Development	10 558	14 445	13 006	12 182	13 312	10 774
Net lending	- 128	442	752	- 130	- 27	- 94
<b>Balance</b>	<b>-13 394</b>	<b>-13 483</b>	<b>-9 466</b>	<b>-12 117</b>	<b>-10 220</b>	<b>-6 930</b>

Source: Ministry of Finance and Development Planning.

billion, the budget for recurrent spending was virtually unchanged as it was P27.1 billion in the original budget. The budget for personal emoluments was unchanged at P11.9 billion, and this shows that the Government had successfully absorbed the costs of the 10 percent salary increase for civil servants

reforms to the management of public finances that is currently being implemented. In this regard, the Budget Speech was preceded in August 2010 by discussions of a Budget Strategy Paper at the inaugural consultative meeting referred to as the Budget 'Pitso'. The Budget Speech was also accompanied



by the provision of additional supplementary documents to further improve access to information. Other complementary reforms include the new Public Finance Management legislation that replaces the existing Finance and Audit Act.

- 2.9 In line with the objective of returning the budget to a sustainable path, the fiscal deficit for 2011/12 is estimated at P6.9 billion, P3.3 billion lower than in the revised budget for 2010/11 and amounts to 6.3 percent of forecast GDP. Although total expenditure is budgeted to increase by P0.5 billion, this is more than offset by the expected P3.8 billion growth in revenue.
- 2.10 Medium-term projections indicate that the budget will be in balance in 2012/13 and move into surplus thereafter (Table 1.3). The projected sequence of budget outturns is consistent with plans for fiscal consolidation announced at the time of the 2010 Budget Speech. However, even with favourable growth in the economy that could result in additional revenue, the projections imply significant cuts in both development and recurrent spending in real terms.

### Revenue

- 2.11 Projections for revenue and grants for 2011/12 total P34.1 billion, of which grants account for P0.3 billion. Mineral receipts are estimated at P11.2 billion, comprising one-third of total revenue and accounting for 49 percent (P1.9 billion) of the increase compared to the revised budget for 2010/11. The other main source of additional revenue will be the receipts expected from SACU which are budgeted to increase from P6 billion to P8.5 billion (24.8 percent of the total). Non-mineral income tax and VAT receipts are projected to increase by 3.3 percent and 12.5 percent, respectively. Revenue from the sale of government assets is budgeted to fall substantially from P1.1 billion in 2010/11 to P0.1 billion, although this could change depending on the timing of the partial privatisation of the Botswana Telecommunications Corporation (BTC). The continuing heavy dependence on revenue from minerals and SACU, which together account for almost 60 percent of the total, underscores the need to diversify the revenue base.

### Expenditure

- 2.12 The expenditure budget for 2011/12 is P41

**TABLE 1.3: GOVERNMENT BUDGET FOR 2005/6 – 2014/15**

Fiscal Years	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
<b>GDP, current prices, (P million) FY</b>	54 419	68 221	80 024	87 446	88 769	101 592	109 506	118 085	127 161	136 760
<b>Growth rate (percent)</b>	10.7	25.4	17.3	9.3	1.5	14.4	7.8	7.8	7.7	7.5
<b>Budget</b>							<b>Rev. Budget</b>	<b>Budget</b>	<b>Budget Projections</b>	
Revenue & Grants	22 267	27 398	28 629	30 455	30 023	30 288	34 098	36 769	39 595	42 584
Recurrent Expenditure	14 155	15 954	18 579	23 889	25 732	27 223	30 348	29 415	30 546	31 699
Development Expenditure	3 783	4 055	6 548	11 458	13 006	13 312	10 774	7 354	7 636	7 925
Net Lending	-306	-272	-305	-197	752	-27	-94	-1	-1	-1
Expenditure & Net Lending	17 632	19 737	24 822	34 151	39 489	40 509	41 028	36 769	38 182	39 623
Balance	4 635	7 660	3 808	-4 696	-9 466	-10 220	-6 930	0	1 413	2 961
<b>Shares of GDP (percent)</b>										
Revenue & Grants	40.9	40.2	35.8	34.8	33.8	29.8	31.1	31.1	31.1	31.1
Recurrent Expenditure	26.0	23.4	23.2	27.3	29.0	26.8	27.7	24.9	24.0	23.2
Development Expenditure	7.0	5.9	8.2	13.1	14.7	13.1	9.8	6.2	6.0	5.8
Expenditure & Net Lending	32.4	28.9	31.0	40.2	44.5	39.9	37.5	31.1	30.0	29.0
Balance	8.5	11.2	4.8	-5.4	-10.7	-10.1	-6.3	0.0	1.1	2.2

Note: Figures in the shaded area are forecasts.

Source: Ministry of Finance and Development Planning

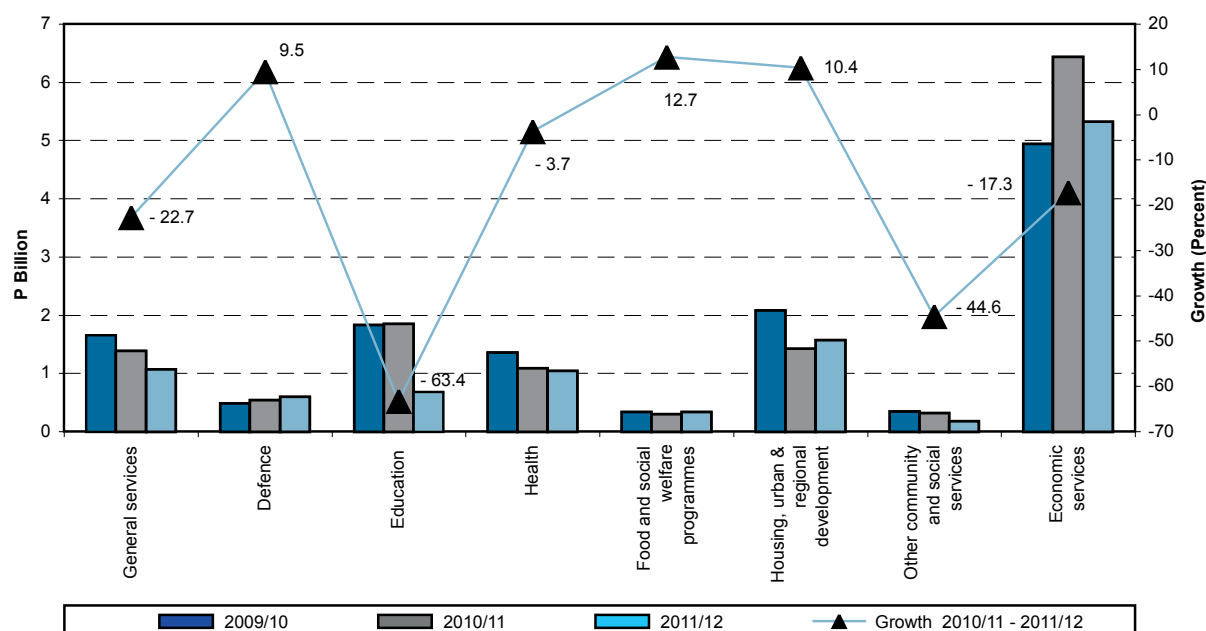
billion, which is a marginal increase of P0.5 billion (1.3 percent), compared to the revised estimate for 2010/11. Recurrent expenditure is estimated at P30.3 billion, while the development budget is projected to fall by 23.1 percent to P10.8 billion.

- 2.13 By sector, the largest recurrent allocations are for education, general administration, health and economic services, with respective shares of 29.5 percent, 16.5 percent, 11.7 percent and 10.7 percent. The increase in allocations is mostly concentrated in health,<sup>18</sup> economic services, education and housing and urban infrastructure. In terms of expenditure category, increased allocations are predominantly in 'other charges', which cover all recurrent spending except salaries and related allowances, and is budgeted to increase by 22.8 percent to P18.2 billion. This reflects the growing costs of the employer's contributions to the Public Officers Pension Fund, together with the renewed commitment to maintain government assets, together with the additional costs of outsourcing non-core activities such as office cleaning and security.

In contrast, the budget for personal emoluments is projected to fall slightly from P11.9 billion to P11.6 billion. This is in line with Government's position that a salary increment would not be affordable in 2011/12,<sup>19</sup> together with the anticipated savings from the planned outsourcing of non-core activities.

- 2.14 The allocation of the development budget is based on the need to complete ongoing projects. In line with this, the Ministry of Minerals, Energy and Water Resources (MMEWR) is allocated the largest share of P2.4 billion (22 percent). This will be divided between the Government's contribution to the costs of the new Morupule B Power Station (including the costs of emergency power generation while construction is in progress), dam construction and water supply to major villages. The second largest share of P2.1 billion (19.8 percent) is for projects that come under the Ministry of Transport and Communications, including construction of roads and airports. Other significant recipients include the Ministries of Local Government, State President (the bulk

**CHART 1.6: DEVELOPMENT SPENDING BY ECONOMIC SECTOR 2009/10 – 2011/12**



Source: Ministry of Finance and Development Planning

<sup>18</sup> The large increase in the recurrent allocation to health in part reflects the transfer of responsibility for primary health care from local authorities to the Ministry of Health. This is matched by associated reductions elsewhere.

<sup>19</sup> Negotiations between the Government and public sector unions under the collective bargaining were on-going.

of which is for HIV/AIDS programmes) and Justice, Defence and Security.

- 2.15 Consistent with the priority accorded to maintenance of existing Government assets, there are very few new projects, except in cases where the need was deemed urgent. These exceptions include sewerage networks in four major villages, border posts and rehabilitation of schools.

#### *Debt Management and Deficit Financing*

- 2.16 The recent global economic recession and resulting impact on Government revenue underscored the need for a robust debt management strategy. As part of this, the Budget Speech included additional information on outstanding public debt, which is limited by law to not more than 40 percent of GDP, allocated equally between external and domestic debt.<sup>20</sup>
- 2.17 According to the most recent projections,

external debt will increase to P19.4 billion (19.1 percent of forecast GDP) by the end of 2010/11. This compares to P11 billion (12.5 percent of GDP) at the end of 2009/10, with the large increase due to the drawdown of the outstanding balance of USD0.5 billion from the USD1.5 billion budgetary support provided by the African Development Bank (AfDB),<sup>21</sup> together with financing of major infrastructure projects (Table 1.4).

- 2.18 In contrast, while external borrowing is expected to be close to the statutory limit, domestic borrowing remains comparatively low, projected at P6 billion (6.8 percent of GDP), at the end of 2010/11. For this reason, while the emphasis has previously been on taking advantage of favourable terms from international financial institutions, financing of future budget deficits will be more reliant on domestic borrowing; this will be combined with judicious use of Government's accumulated savings. In this

**TABLE 1.4: GOVERNMENT DEBT AND GUARANTEES FOR 2009/10 – 2010/11 (P MILLION)**

<b>Debt &amp; Liabilities as at March 31, 2010</b>	<b>External</b>	<b>Internal</b>	<b>Total</b>
External Debt	9 288		
External Contingent Liabilities	1 699		
Internal Debt		4 650	
Internal Contingent Liabilities		1 346	
<b>Total Debt &amp; Contingent Liabilities as at March 31, 2010</b>	<b>10 987</b>	<b>5 996</b>	<b>16 984</b>
GDP for FY 2009/10			87 824
Debt as % of GDP	12.5	6.8	19.3
<b>New Loans and Guarantees Drawn since March 31, 2010 and in Process</b>			
New Loans Drawn, External	7 519		
New External Contingent Liabilities	1 185		
Repayments scheduled, External	-280		
Net New Issue of Domestic Bonds & T-Bills		2 600	
Repayments scheduled, Internal		-2 101	
<b>Sub-Total</b>	<b>8 423</b>	<b>496</b>	<b>8 919</b>
<b>Total Debt &amp; Contingent Liabilities anticipated March 31, 2011</b>	<b>19 410</b>	<b>6 493</b>	<b>25 903</b>
GDP forecast for FY 2010/11			101 592
Debt as percentage of GDP	19.1	6.4	25.5
Source: Ministry of Finance and Development Planning.			

<sup>20</sup> Stock, Bonds and Treasury Bills Act. This provision is expected to be retained under the planned new Public Finance Management legislation. The total includes government guarantees.

<sup>21</sup> USD1 billion of this loan was drawn down in August 2009.

**TABLE 1.5: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES****Nominal Exchange Rates (foreign currency per Pula)**

As at end of	2009	2010	Percentage change
South African rand	1.1086	1.0265	-7.4
United States dollar	0.1499	0.1533	3.6
British pound sterling	0.0932	0.1004	7.7
Japanese yen	13.85	12.64	-8.8
SDR	0.0957	0.1005	4.9
Euro	0.1043	0.1162	11.4
<b>NEER (index, September 2006 = 100)</b>	<b>91.4</b>	<b>89.0</b>	<b>-2.7</b>

**Real Pula Exchange Rate Indices (September 2006 = 100)**

South African rand <sup>1</sup>	94.6	90.9	-3.9
United States dollar	117.7	129.1	9.6
British pound sterling	133.6	149.0	11.5
Japanese yen	98.9	96.9	-2.0
Euro	104.5	122.4	17.1
SDR	111.8	123.7	10.7
<b>REER (headline)<sup>1</sup></b>	<b>100.9</b>	<b>102.6</b>	<b>1.7</b>

1. Calculated using South African headline inflation.

Source: Bank of Botswana

regard, Parliament has approved an increase in the existing domestic issuance programme of bonds and treasury bills from P5 billion to P15 billion. This will be more than sufficient to cover the projected deficits for 2010/11 and 2011/12.

### (c) Fiscal and Other Legislation

2.19 Reviews of the Income Tax, Value Added Tax, and Transfer Duty legislation were completed in 2010, and proposed amendments will be discussed by Parliament in 2011. Proposals include replacing the existing two-tier system of corporate tax with a single unified rate, while the threshold for paying personal income tax is to be raised from P30 000 per annum to P36 000. Similarly, an adjustment to allow for inflation is to be applied to the allowance for tax free imports of personal goods. In addition, it is also proposed that farming implements should be exempted from value added tax (VAT) in line with other government incentives to promote farming.

2.20 Several pieces of legislation that cover the regulation of the financial sector, especially non-bank financial institutions, are under consideration with a view to improving the

regulatory structure. In addition to a new Securities Bill, these include reviews of the Insurance Industry Act and Pensions and Provident Funds Act, to overhaul the regulatory and supervisory framework from a compliance-based to a risk-based system, in conformity with international best practice. Moreover, regulations to cover the activities of micro-lenders are due to be gazetted, while new regulations have been introduced to set up a tribunal that will handle disputes between non-bank financial institutions and the Non-Bank Financial Institutions Regulatory Authority (NBFIRA).

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

### (a) Exchange Rates

3.1 The exchange rate policy continues to focus on maintaining the country's competitiveness as measured by the real effective exchange rate (REER).<sup>22</sup> To achieve this, the major thrust of

<sup>22</sup> The REER is a trade-weighted exchange rate of the Pula (against a fixed basket of currencies), after allowing for relative inflation. It is used as an indicator of the relative competitiveness of a country's tradeable goods and services.

policy is maintenance of a stable real exchange rate of the Pula against a basket of currencies of major trading partners (comprising the SDR and the South African rand), as a means of supporting competitiveness of local producers of tradeable goods and services. The crawling band exchange rate mechanism, that was introduced, in May 2005 supports REER stability through a continuous gradual adjustment of the Pula at a rate based on the differential between the Bank's inflation objective and forecast inflation for trading partner countries.

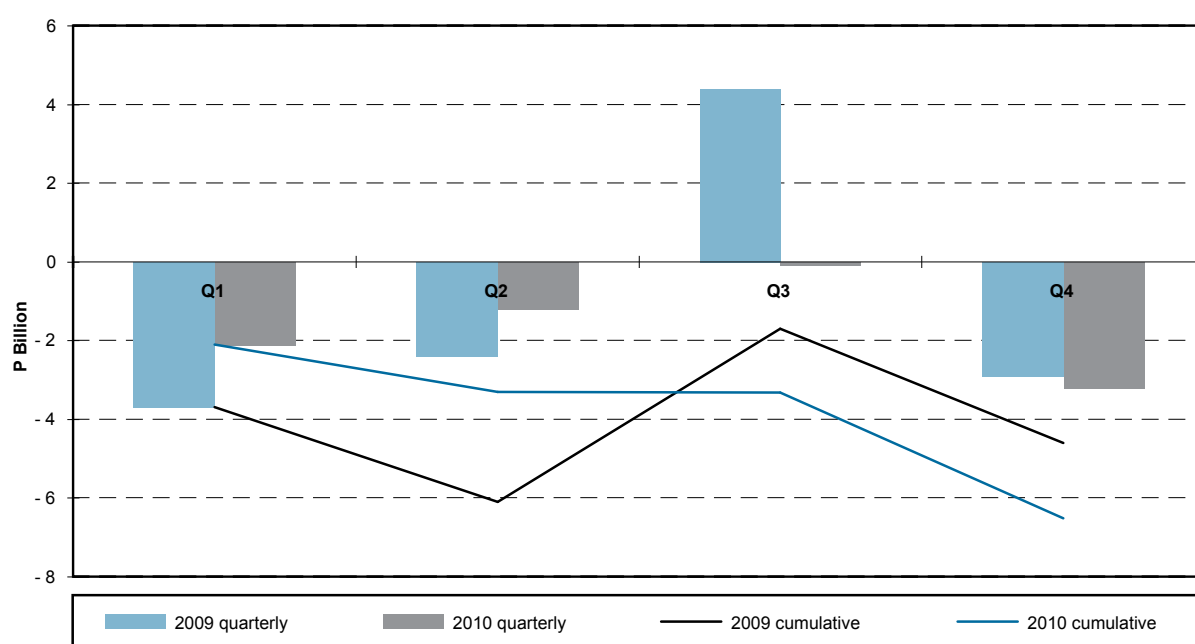
- 3.2 Consistent with the crawling band mechanism and given higher inflation in Botswana compared to that in trading partner countries, the nominal exchange rate of the Pula crawled downwards in 2010. The trade-weighted nominal effective exchange rate, therefore, depreciated by 2.7 percent. Bilaterally, the Pula appreciated in nominal terms against most major currencies, strengthening against the euro, British pound sterling and US dollar by 11.4 percent, 7.7 percent and 3.6 percent, respectively, and depreciated by 8.8 percent against the Japanese yen. The overall appreciation of the Pula against the SDR was 4.9 percent, while it depreciated by 7.4 percent against the rand.

- 3.3 The REER of the Pula appreciated by 1.7 percent (on headline measure), due to the positive differential between inflation in Botswana and major trading partner countries that exceeded the rate of crawl. Nevertheless, since the crawling band exchange rate policy was introduced in 2005, the cumulative appreciation of the REER has been modest (2.6 percent), a margin that should be comfortably accommodated by producers, in particular because the primary source of competitiveness is improved productivity. The movement of the REER of the Pula was in the context of continued extreme volatility in bilateral real exchange rates. Against major trading partner currencies, the Pula depreciated by 3.9 percent against the rand (using South African headline inflation), in real terms, while appreciating by 10.7 percent against the SDR. With respect to the constituent SDR currencies, the Pula appreciated in real terms by 17.1 percent, 11.5 percent and 9.6 percent against the euro, pound and US dollar, respectively, while depreciating by 2 percent against the yen.

### (b) Overview of the Balance of Payments

- 3.4 The balance of payments was in overall deficit

CHART 1.7: QUARTERLY BALANCE OF PAYMENTS, 2009 – 2010



Source: Bank of Botswana

**TABLE 1.6: BALANCE OF PAYMENTS, 2006 – 2010 (P MILLION)**

	2006	2007	2008 <sup>1</sup>	2009 <sup>1</sup>	2010 <sup>2</sup>
Current Account	11 317	12 390	6 314	-3 885	-5 120
Of which:					
Merchandise trade	11 115	10 467	2 982	-4 029	-1 200
Services	-372	-1 104	544	-4 478	-6 142
Income	-4 512	-4 531	-4 315	287	-1 417
Net current transfers	5 086	7 558	7 103	4 335	3 639
Financial account	-1 030	-1 434	3 728	5 390	-2 203
Capital account	33	546	521	639	129
Net errors and omissions	-65	-808	-3 111	-6 707	683
Overall balance	10 256	10 694	7 452	-4 563	-6 511

1. Revised

2. Provisional

Source: Bank of Botswana

by P6.5 billion in 2010, compared to P4.6 billion in 2009.<sup>23</sup> However, in 2009, financial inflows were boosted by Government's utilisation of part of the loan from the AfDB, which helped cushion the size of the deficit, whereas no equivalent inflows occurred in 2010. Chart 1.7 shows a substantial overall surplus in the third quarter of 2009 when the funds from the AfDB were received. In most other respects, the balance of payments in 2010 was healthier than in 2009 when the impact of the global recession on exports had been most severe.

#### *Current Account*

- 3.5 Preliminary 2010 estimates of the current account (i.e., the sum of the balance of trade in goods and services, income account and current transfers) show a deficit of P5.1 billion, compared to a deficit of P3.9 billion in the revised estimates for 2009.

#### **Merchandise Trade<sup>24</sup>**

- 3.6 For the second successive year, the merchandise

trade account was in deficit, estimated at P1.2 billion, but smaller than P4 billion in 2009. The smaller deficit was mainly due to rapid growth in exports, particularly diamonds, as a result of increased global demand.

- 3.7 Total exports are estimated at P31.2 billion, an increase of 26.8 percent from the revised estimate of P24.6 billion for 2009. The increase was led by growing diamond and copper-nickel exports, which increased by 40.6 percent and 14.7 percent, respectively, as supported by increased production volumes and favourable prices. Average prices for diamonds sold by the Diamond Trading Company (DTC)<sup>25</sup> increased by 27 percent compared to 2009, while international prices for copper and nickel rose by 46 percent and 56 percent, respectively. Gold exports also increased due to higher gold prices and a 12 percent increase in production. However, the impact of high commodity prices on the local currency value of exports was offset somewhat by the weakness of the US dollar during much of the year. In contrast to performance of other minerals, exports of soda ash declined by 3.7 percent.

- 3.8 Exports of beef by the Botswana Meat Commission (BMC) grew rapidly to P869 million in 2010, compared to P480 million in 2009, an increase of 80.8 percent. Europe

23 The overall balance is equal to the change in total official reserves adjusted for unrealised market and currency revaluation gains/losses.

24 Note that the trade data used in preparing the balance of payments does not fully match the monthly trade statistics prepared by the CSO. For some exports, the trade statistics are supplemented by additional information collected directly from exporters. More significantly, imports are substantially below the estimates in the trade statistics as a portion of their value has been allocated to transport costs, which are service imports.

25 The DTC is the sales arm for De Beers, which operates the main diamond mines in Botswana in a joint venture with the Government.



TABLE 1.7: IMPORTS, 2009 – 2010 (P MILLION)

	2009	2010	Percentage share		Percentage Change
			2009	2010	
Total Imports	33 559	38 359			14.3
<i>of which:</i>					
Diamonds	2 608	4 471	7.8	11.7	71.4
Fuel	4 516	5 702	13.5	14.9	26.3
Food	4 437	4 806	13.2	12.5	8.3
Machinery & Electrical Equipment	5 794	6 574	17.3	17.1	13.5
Chemicals & Rubber Products	3 753	4 178	11.2	10.9	11.3
Metals & Metal Products	2 391	2 832	7.1	7.4	18.4
Other	1 373	1 596	4.0	4.2	19.5

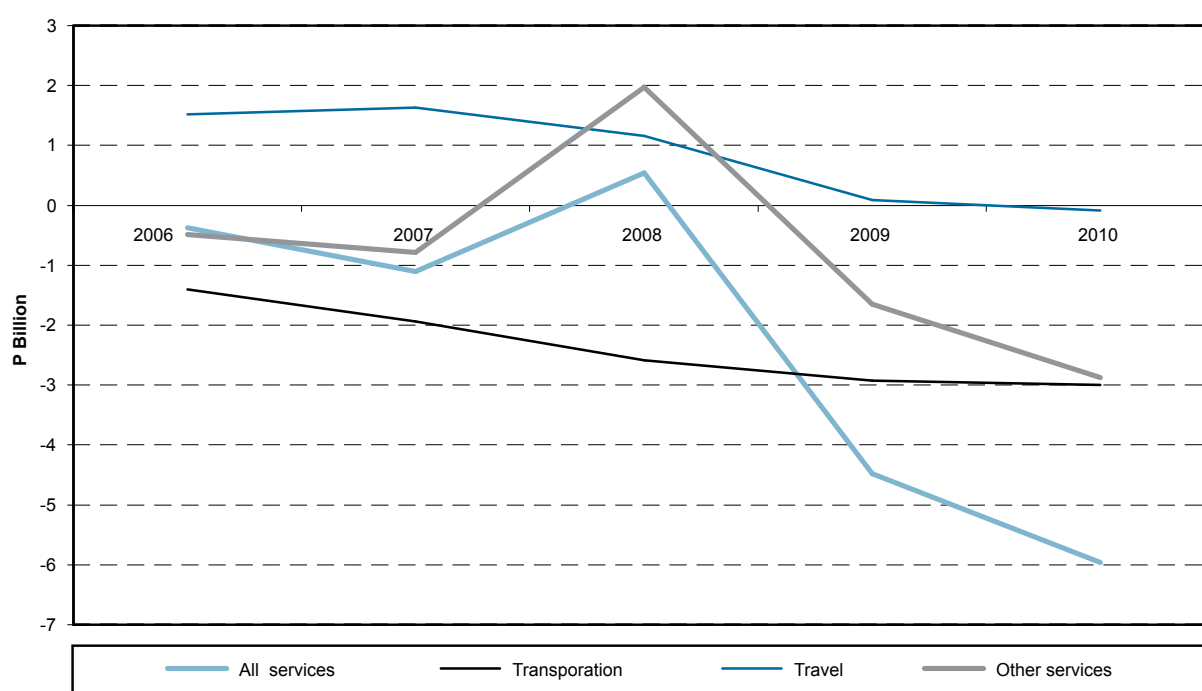
Source: Central Statistics Office

remained the largest market, but the main source of growth was sales to other African countries.<sup>26</sup> Growth in beef exports was supported by improvement in the number of cattle sold to the BMC by local farmers. With respect to other manufactured goods, textile producers continued to experience difficulties, with exports declining by 21.8 percent from

P1.4 billion in 2009 to P1.1 billion in 2010. However, detailed analysis of monthly trade statistics indicates continuing emergence of manufactured exports, among them veterinary vaccines, steel cans and chewing gum.

3.9 Imports for 2010 are estimated at P32.9 billion, an increase of 13.3 percent from P28.6

CHART 1.8: BALANCE OF TRADE IN SERVICES (2006 – 2010)



Source: Central Statistics Office

<sup>26</sup> BMC currently has a monopoly on beef exports, which totalled P869 million in 2010. Sales were divided between Europe (P569 million), Africa (P289 million) and Asia (P10 million). In 2009, the equivalent figures were P392 million, P84 million and P4 million, respectively.

billion in 2009. This reflects growth across most product categories, especially capital goods and inputs to production. Machinery and equipment remained the largest import

category, growing by 38 percent to P6.6 billion. Imports of fuel also grew substantially, by 26.4 percent, to P5.7 billion due to, among others, higher costs for petroleum products and imported electricity. Imports of diamonds rose by 71 percent to P4.5 billion, thus signifying a marked recovery of the local diamond polishing industry.

### Services

- 3.10 The services account deficit is estimated to have widened to P6.1 billion in 2010, compared to P4.5 billion in the revised estimates for 2009. This is mainly due to lower service exports, arising from falling exports of transportation and other services.<sup>27</sup> At the same time, imports of services have continued to grow steadily, mainly as a result of rising costs of transport associated with merchandise imports.

### Income Account

- 3.11 The income account registered a deficit of P1.4 billion in 2010, compared to the revised surplus of P286.7 million in 2009. The credit side of this account mainly comprises earnings from foreign exchange reserves and offshore investments of pension funds. The debit components consist of dividends and profits of foreign companies operating in Botswana, and include both actual remittances and retained earnings.<sup>28</sup>

### Current Transfers

- 3.12 The surplus on current transfers in 2010 was

<sup>27</sup> This category covers a wide range of services, including communication, insurance, legal services, business services, etc., together with receipts from tourism. It should be noted that, while the data indicate a considerable decline, there is significant margin of error in these estimates. This is due to the continued reliance on the submission of information on sales of foreign exchange by the commercial banks which sometimes lacks relevant information. Also, the information does not include transactions (e.g., credit cards) that use other channels. This could be one of the factors contributing to the large net errors and omissions in the overall estimates. The Bank of Botswana is actively looking for practical ways to improve its estimates in this area.

<sup>28</sup> Retained earnings by foreign-owned businesses are treated as an imputed outflow on the income account matched by an offsetting inflow for foreign direct investment.

P3.6 billion, down by P697 million (16.1 percent) from P4.3 billion in 2009. This is due to significantly lower receipts from SACU, which were reduced by the need to offset earlier overpayments. The decline would have been larger in the absence of an additional one-off payment from the SACU revenue pool of P893 million.

### Capital and Financial Accounts

- 3.13 The capital account mainly comprises capital grants to government and transfer of migrants' assets. In recent years, a rising flow of foreign grants in support of government social programmes had significantly increased the surplus on the account. However, this trend was reversed in 2010, resulting in an estimated lower surplus of P129 million compared to P639 million in 2009.
- 3.14 The financial account, which is made up of direct investment, portfolio investment and 'other' investment, shows an estimated net outflow of P2.2 billion in 2010, as opposed to an inflow of P5.4 billion in 2009.<sup>29</sup> The estimated outflow in 2010 is attributable to the combined effects of a change in 'other investment' and the accumulation of offshore assets that, in 2010, included Government participation in a rights issue by De Beers.

### Foreign Exchange Reserves

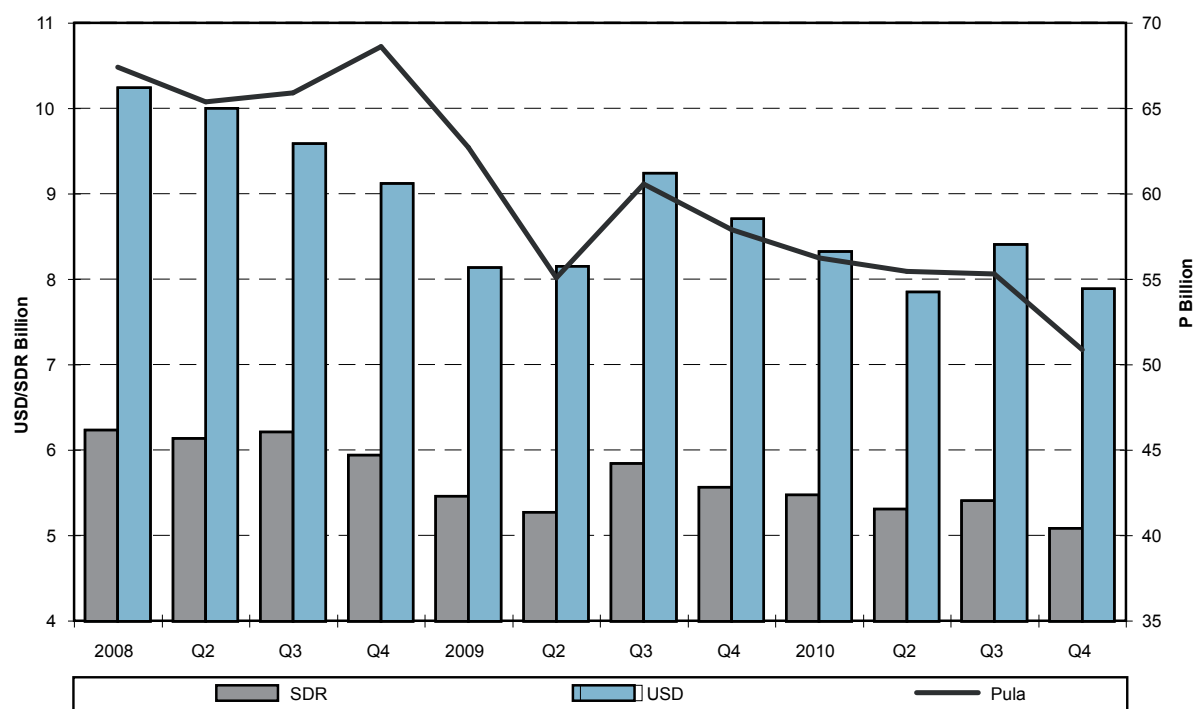
- 3.15 At the end of 2010, the foreign exchange reserves amounted to P50.8 billion down by P7.1 billion (12.2 percent) from P57.9 billion in December 2009, and equivalent to 15 months of imports of goods and services.<sup>30</sup> The decline in reserves was due to a combination of the overall balance of payments deficit and exchange rate movements, with appreciation of the Pula against most major currencies lowering the value of reserves in domestic currency terms. When measured in foreign currency, the value of reserves in SDR and US

<sup>29</sup> The 2010 position is subject to revision due to the unavailability of FDI data, for which the survey is still on-going.

<sup>30</sup> Calculated using average monthly imports of goods and services in 2010.



CHART 1.9: QUARTERLY FOREIGN EXCHANGE RESERVES (2008 – 2010)



Source: Bank of Botswana

dollar terms declined by 9.4 percent and 11.4 percent, respectively, in 2010, from SDR5.6 billion and USD8.7 billion in 2009 to SDR5.1 billion and USD7.9 billion, respectively.

### (c) Balance of Payments Outlook

- 3.16 Revival in demand for major mineral exports is expected to continue, led by diamonds, where major mines will return to full production in 2012, while there will be additional output from new mines. High prices for other metals will support exports and encourage further exploration and investment, notably in copper and nickel and untapped mineral resources such as silver, uranium and export-grade coal. Although planned scaling down of the Government's development spending will reduce demand for capital imports, this is likely to be offset by increased demand from developers of new mines and related projects, as well as investment in transport infrastructure and large-scale agricultural developments. If maintained, higher fuel prices will also add to imports, although, in the medium term, additional domestic power generating capacity should reduce import requirements.

Current transfers will continue to be in surplus due to net receipts from SACU, although the scale is uncertain at a time when the basis for their distribution is under review. Inflows on the financial account will accompany capital imports required for new private sector investments, thus limiting the adverse impact on the overall balance of payments.

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

#### (i) International Investment Position

- 3.17 Detailed estimates for the IIP which records the stock of Botswana's holdings of foreign financial assets and liabilities, are available up to 2009.<sup>31</sup> For 2010, only preliminary estimates of major aggregates are available, using information on financial flows during the year.

- 3.18 According to revised estimates, foreign financial assets held by Botswana declined

<sup>31</sup> Although closely related to the balance of payments, the time lag in producing estimates for the IIP is longer, due to the nature of the information that is required, which is more dependent on survey responses.

**TABLE 1.8: FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY, DECEMBER 31, 2009 (P MILLION)**

	Direct Investment			Other Investment			Grand Total
	Equity	Non-Equity	Total	Equity	Non-Equity	Total	
Mining	3 542	172	3 714	3	128	131	3 845
Manufacturing	91	7	98	0	186	186	284
Finance	3 478	348	3 826	584	546	1 130	4 956
Retail and Wholesale	707	12	719	14	241	255	974
Electricity, Gas and Water	0	0	0	0	569	569	569
Real Estate and Business Services	590	0	590	0	4	4	594
Transport, Storage and Communication	9	5	14	0	7	7	21
Construction	1	0	1	0	0	0	1
Hospitality	9	0	9	0	0	0	9
Public Administration	0	0	0	0	13 914	13 914	13 914
Other	472	3	475	0	67	67	542
<b>Total</b>	<b>8 899</b>	<b>547</b>	<b>9 446</b>	<b>601</b>	<b>15 662</b>	<b>16 263</b>	<b>25 709</b>

Source: Bank of Botswana

during 2009 by 12.4 percent from P96.8 billion in 2008 to P84.8 billion. This is largely explained by the fall in foreign exchange reserves by P10.7 billion. Direct investment abroad also fell, by P1.4 billion, because of smaller equity holdings, while “other investment” decreased by P1.2 billion, due to reduced holdings of foreign currency and deposits. Based on preliminary estimates for 2010, Botswana’s total foreign assets fell further in 2010, by P6.3 billion to P78.5 billion, as the increase in direct and portfolio investment was more than offset by the further fall of P7.1 billion in the foreign exchange reserves.

3.19 Foreign liabilities (i.e., foreign-owned assets in Botswana or foreign liabilities of Botswana residents) are estimated to have increased by 81.9 percent in 2009 (from P11.6 billion in 2008 to P25.7 billion) due to growth in both direct investment and other investment in Botswana. Direct investment increased by 41 percent to P9.4 billion, mainly due to growth in other capital, which includes loans between affiliated enterprises and retained earnings. Portfolio investment in Botswana also rose from P286 million to P413 million, due to an increase in equity holdings. Most important was a substantial increase in “other investment”, which rose

from P4.7 billion to P12.6 billion. This was mainly due to foreign borrowing by the Government, which increased from P3 billion in 2008 to P10.6 billion in 2009. For 2010, total foreign liabilities are estimated at P25.1 billion, a decline of P0.6 billion compared to 2009, mainly because lower estimates for the stock of direct investment offset additional external borrowing. Overall, the net IIP for 2010 indicates a decline to P53.4 billion, from P59.1 billion in 2009.

(ii) *Investment in Botswana in 2009 by Industry and Country Classification*

3.20 Tables 1.8 and 1.9 show Botswana’s stock of foreign liabilities at the end of 2009 classified, respectively, by industry and country.<sup>32</sup> This indicates that foreign direct investment in the finance sector was slightly higher than in mining (P3.8 billion compared to P3.7 billion), due mainly to investment in the insurance industry. While this appears to reverse the previous dominance of mining, the data need to be treated with caution and

32 These figures are based on the 2009 Balance of Payments Survey conducted by the Bank of Botswana. It is a measure of the stock of accumulated foreign investment in Botswana at the end of 2009. This should not be confused with the amount of new foreign investment in the country during 2009.

**TABLE 1.9: FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY, DECEMBER 31, 2009 (P MILLION)**

	Direct Investment			Other Investment			Grand Total
	Equity	Non-Equity	Total	Equity	Non-Equity	Total	
<b>North and Central America</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>175</b>	<b>44</b>	<b>219</b>	<b>219</b>
Of which:							
United States	0	0	0	175	44	219	219
<b>Europe</b>	<b>4 988</b>	<b>4</b>	<b>4 992</b>	<b>221</b>	<b>533</b>	<b>754</b>	<b>5 746</b>
Of which:							
United Kingdom	884	4	888	221	450	671	1 559
Netherlands	34	0	34	0	0	0	34
Luxemburg	4 017	0	4 017	0	4	4	4 021
Germany	0	0	0	0	0	0	0
Other Europe	53	0	53	0	79	79	132
<b>Asia Pacific</b>	<b>530</b>	<b>6</b>	<b>536</b>	<b>85</b>	<b>259</b>	<b>344</b>	<b>880</b>
<b>Africa</b>	<b>3 381</b>	<b>537</b>	<b>3 918</b>	<b>117</b>	<b>911</b>	<b>1 028</b>	<b>4 946</b>
Of which:							
South Africa	2 041	296	2 337	68	495	563	2 900
Mauritius	1 014	203	1 217	79	302	381	1 598
<b>Middle East</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Other</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>3</b>	<b>13 914</b>	<b>13 917</b>	<b>13 917</b>
<b>Total</b>	<b>8 899</b>	<b>547</b>	<b>9 446</b>	<b>601</b>	<b>15 662</b>	<b>16 263</b>	<b>25 709</b>

Source: Bank of Botswana

may be subject to revision as survey coverage and response rates need further improvement to fully pick up recent trends, including establishment of new mining entities. Europe, which accounts for 52.8 percent of the total, continues to dominate as the main source of direct investment. Luxemburg makes up 80.5 percent of Europe's total investment in Botswana, due to the residence status of major mining investors. Africa accounted for 41.5 percent of the stock of direct investment, mainly due to South African and Mauritian interests in the finance sector.

- 3.21 In 2009, the 'other' location category became the dominant source of 'other investment' at P13.9 billion, mainly due to Government borrowing, which is classified under public administration and comprises 79.8 percent of the total. By country, Africa was the largest source of "other investment" at P1 billion, followed by Europe at P754 million. The bulk of this is in finance, mainly from investors resident in South Africa, Mauritius and the United Kingdom.

## 4. MONEY AND CAPITAL MARKETS

### (a) Monetary Policy and Liquidity Management

- 4.1 The Bank's monetary policy objective is to achieve price stability defined as sustained inflation within the medium term objective range range of 3 – 6 percent. Maintaining inflation within this range contributes towards the broader national objective of attaining sustainable economic growth and development through promoting savings mobilisation and productive investment. Price stability also supports international competitiveness of domestic producers without the need for repeated and disruptive adjustments to the nominal exchange rate.
- 4.2 In pursuit of price stability, the Bank uses interest rates and open market operations to influence demand conditions and, ultimately, inflation. In this regard, changes in interest rates and availability of loanable funds influence credit demand and saving and, therefore, aggregate demand. Domestic demand conditions and other economic factors, such as foreign inflation, the exchange

rate, changes in administered prices and taxes, contribute to the level of inflation. Expectations with respect to future inflation also influence decisions by firms and resource suppliers on price increases and wage adjustments.

4.3 Based on an evaluation of future developments regarding various determinants of inflation, the Bank is able to derive an inclusive and broad-based, medium-term forecast for inflation that contributes to better informed monetary policy decision making. The Bank distinguishes factors that are likely to lead to any sustained deviation of inflation from the objective range from those that are only expected to have a transitory impact, as indicated by the duration of their disaggregated effects on the inflation forecast. In general, the Bank will change the monetary policy stance in response to a sustained deviation of the inflation forecast from the objective range and where causal factors could be influenced by domestic monetary policy. In addition, analysis of alternative measures of inflation (i.e., headline, 16 percent trimmed mean and inflation excluding administered prices) continues to be useful in pinpointing sources of changes in the price level and, thus, inflation.

4.4 In addition to considering adverse effects of high inflation, which erodes the purchasing power of incomes and financial savings, the price stability objective takes into account that sustained periods of low or rapidly falling inflation could indicate subdued economic activity that requires policy easing to stimulate growth. In this regard, as central components of the forecast, the Bank monitors as leading indicators of the direction of inflation both the output gap<sup>33</sup> and the net impact of changes in real interest rates and real exchange rates (which is referred to as ‘real monetary conditions’) on availability of credit and competitiveness of domestic industry. A sustained level of economic performance above trend is potentially inflationary and could signal a need to increase interest rates

to dampen inflationary pressures, while output below trend could require a reduction of interest rates to stimulate economic activity.

4.5 In 2010, monetary policy was conducted in an environment of uncertainty with regard to the pace of global economic recovery and generally subdued inflationary pressures. Thus, in consideration of the positive medium-term inflation outlook resulting from low demand pressures and projected benign external inflationary pressures, the Bank Rate was maintained at 10 percent for most of the year, until December when it was reduced by 50 basis points to 9.5 percent. This was judged to be consistent with achieving the inflation objective while, at the same time, providing support to domestic economic activity.

4.6 In conducting monetary policy, the Bank uses open market operations to manage liquidity in the banking system in order to maintain short-term interest rates at the desired levels. The yield on 14-day Bank of Botswana Certificates (BoBCs) fell from 7.12 percent in December 2009 to 6.56 percent in December 2010, while the 3-month BoBC rate fell from 8.12 percent to 7.15 percent in the same period.<sup>34</sup> In December 2010, the total outstanding market value of BoBCs was P17.6 billion, up by 3.6 percent from P17 billion in December 2009. In contrast, during 2009 the stock of outstanding BoBCs had contracted by 3 percent.

## (b) Interest Rates

4.7 In line with the reduction of the Bank Rate in December 2010, the prime lending rates of commercial banks were lowered by the same margin, from 11.5 percent to 11 percent. The benchmark 3-month deposit rate also fell, although by a smaller amount than the Bank Rate, from an average of 5.8 percent in

<sup>33</sup> See footnote 16.

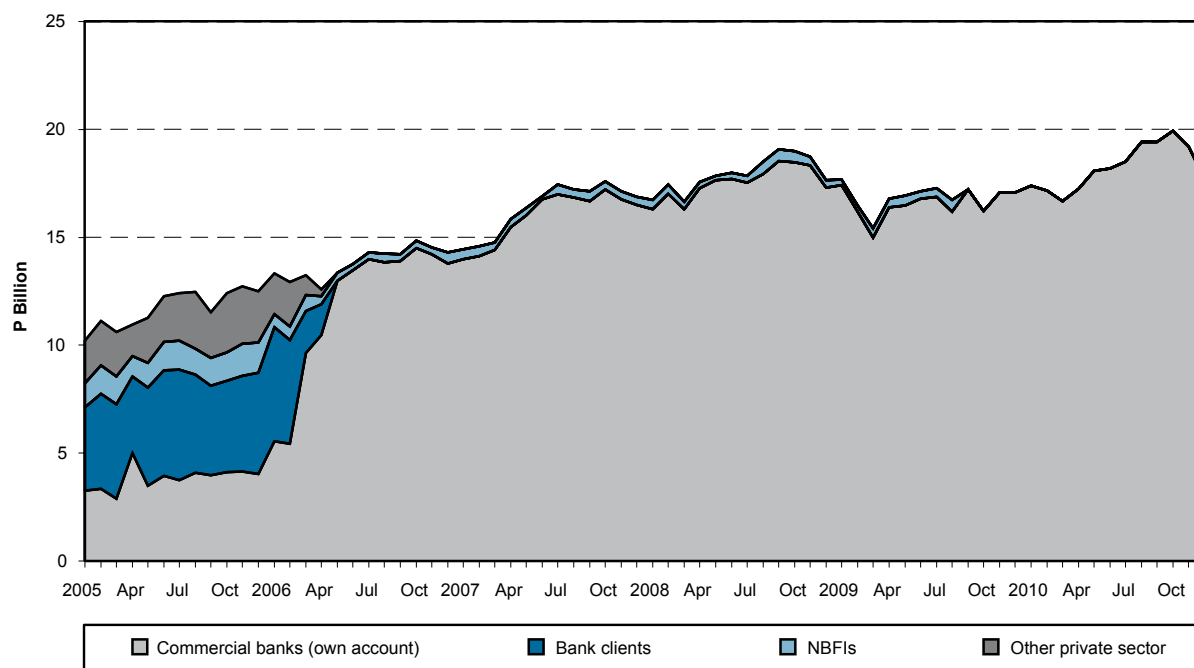
<sup>34</sup> The larger fall in the 3-month BoBC rate reflects the longer time taken for adjustments in the Bank Rate to affect this, as 3-month BoBCs are only auctioned on a monthly basis. As a result, the recorded fall during 2010 is a consequence of the cut of 1 percentage point in the Bank Rate in December 2009, whereas the change in the 14-day BoBC rate reflects the 50 basis point change in December 2010.

December 2009 to 5.5 percent in December 2010.

- 4.8 Prior to the change in the Bank Rate in December, nominal interest rates fluctuated within a narrow range during 2010. However,

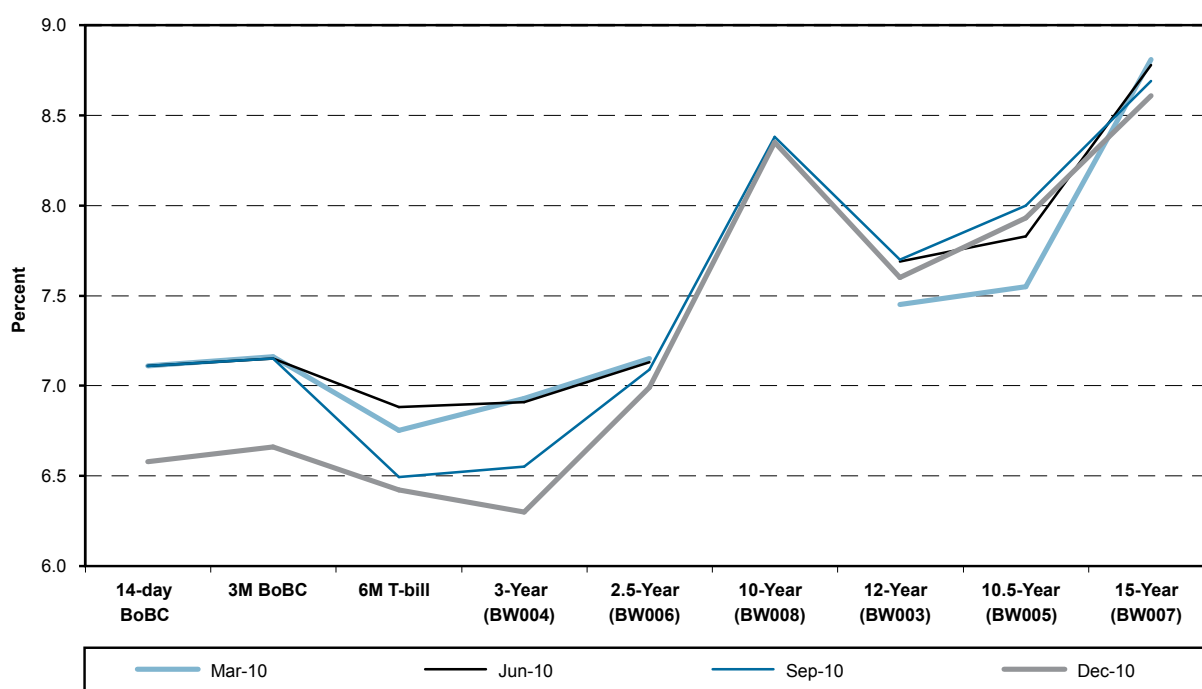
real interest rates declined due to the increase in inflation. The real interest rate for 14-day BoBCs decreased from 1.3 percent in December 2009 to -0.8 percent at the end of 2010, while for 3-month BoBCs, it fell from 2.3 percent to -0.2 percent.

CHART 1.10: OUTSTANDING BANK OF BOTSWANA CERTIFICATES



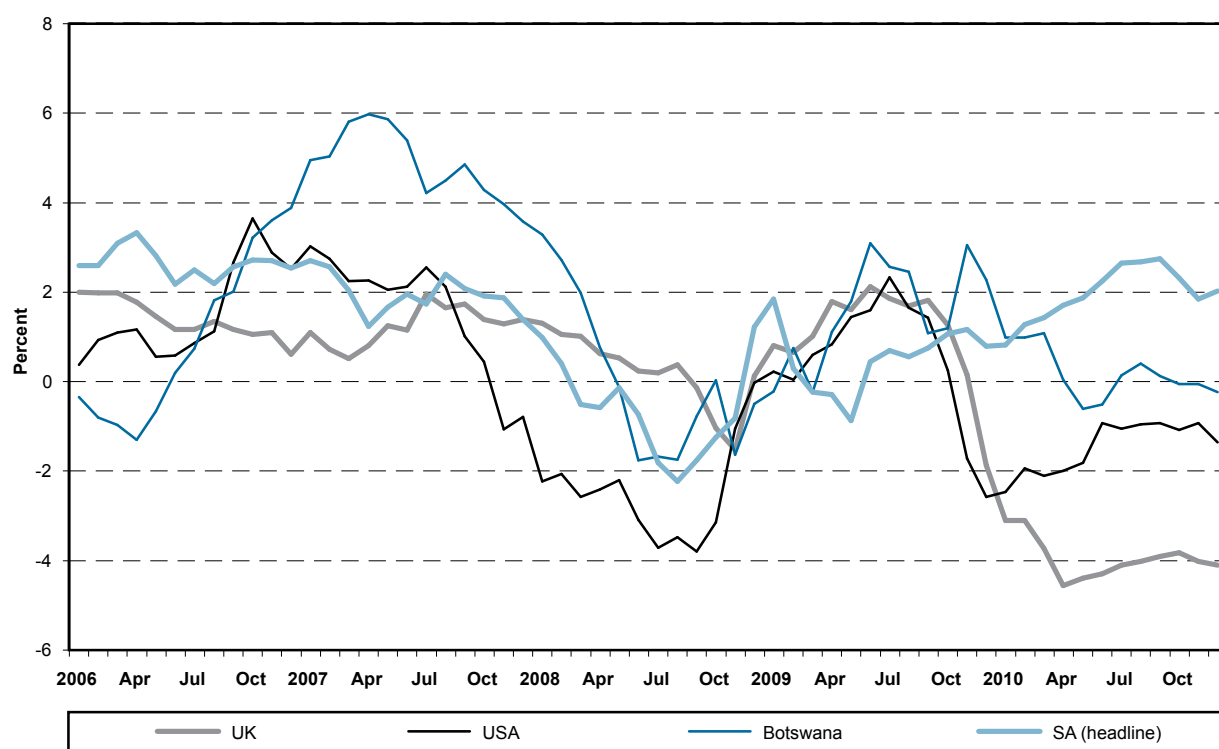
Source: Bank of Botswana

CHART 1.11: YIELD TO MATURITY ON BANK OF BOTSWANA CERTIFICATES AND GOVERNMENT BONDS



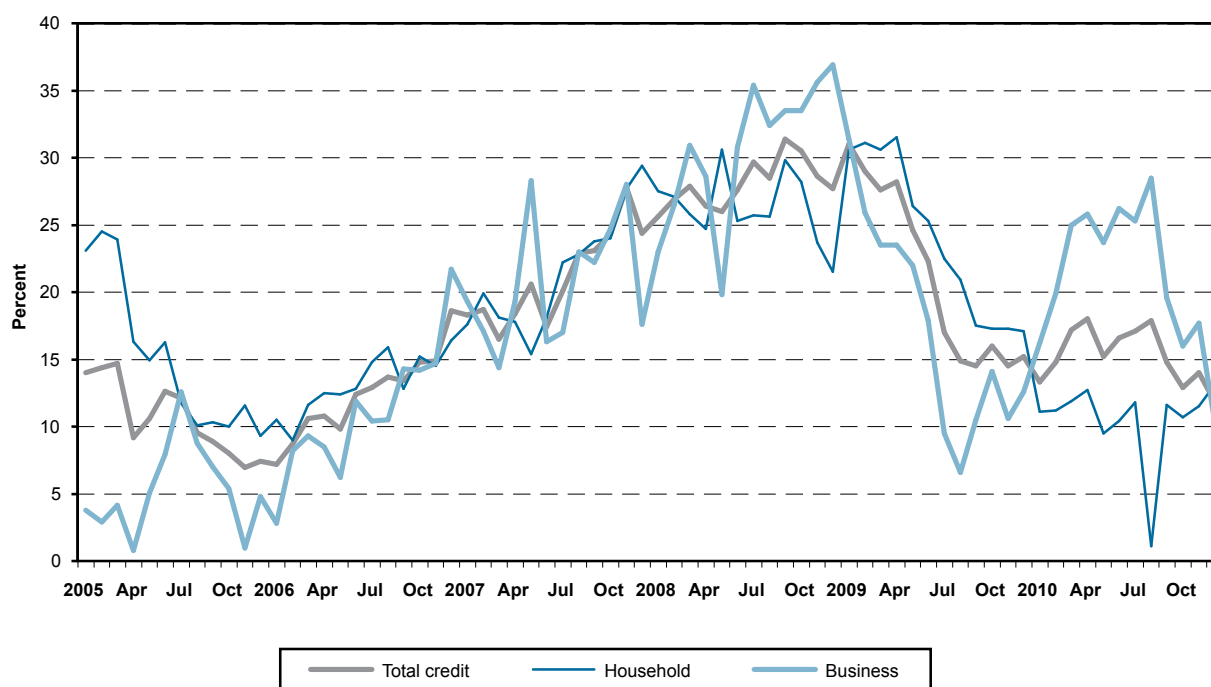
Source: Bank of Botswana

CHART 1.12: REAL INTEREST RATES – INTERNATIONAL COMPARISONS



Source: Bank of Botswana

CHART 1.13: YEAR-ON-YEAR COMMERCIAL BANK CREDIT GROWTH



Source: Bank of Botswana

### (c) Banking System

#### *Domestic Credit*

#### 4.9 Annual growth in commercial bank credit to

the private sector, which decelerated markedly in 2009 (from a peak of 31 percent in January 2009), was 11.9 percent in December 2010



(Chart 1.13).<sup>35</sup> When disaggregated, growth in lending to businesses fell from 12.6 percent in December 2009 to 10.5 percent in December 2010, in an environment of lower interest rates. The expansion of credit to households in 2010 was 13.1 percent, down from 17.1 percent in the previous year, as demand was restrained due to sluggish growth in personal incomes.

#### *Monetary Aggregates*

- 4.10 After contracting by 0.8 percent in 2009, the supply of broad money (M2) grew by 10.7 percent in 2010. The main contributory factor was a slower rate of decline of foreign exchange reserves.<sup>36</sup> The contribution of credit growth to the money supply was less expansionary in the context of cautious lending by banks and restrained credit demand given uncertain economic and income prospects. Monetary expansion was also held back by slow growth in government spending.
- 4.11 During 2010, currency outside depository corporations<sup>37</sup> grew by 8.4 percent, while transferable deposits increased by 34.5 percent and non-transferable deposits expanded by 6.3 percent. Balances in foreign currency accounts (FCAs) grew by 22 percent in 2010, thus making up 14.8 percent of total deposits. Holdings of FCAs provide a hedge against the impact of any adverse movements in the Pula exchange rate on foreign currency transactions. Following a significant decline in 2009, the positive growth may reflect an improvement in funds available to importers alongside recovery in trading conditions.

<sup>35</sup> Credit figures are distorted somewhat by the reclassification by a major commercial bank of credit card debt as domestic credit and the reclassification of a merchant bank into a commercial bank in January and September 2009, respectively. For example, adjusting for the impact of the reclassification results in lower credit growth of 11.3 percent in December 2009.

<sup>36</sup> A fall in the foreign reserves reduces the domestic money supply. However, as this rate slows it may be offset by expansionary factors, such as credit expansion.

<sup>37</sup> In addition to the central bank and commercial banks, the depository corporations in Botswana also include the Botswana Building Society (BBS) and Botswana Savings Bank (BSB).

#### *Bank of Botswana*

- 4.12 Total assets/liabilities of the Bank of Botswana declined by 5 percent from P58.2 billion in December 2009 to P51.2 billion in December 2010. The contraction in the balance sheet in 2010 was mainly due to a reduction of 36.3 percent in Government deposits to help finance the budget deficit, while the value of BoBCs increased by 3.6 percent to P17.6 billion. On the asset side, the foreign exchange reserves contracted by 12.2 percent.

#### *Commercial Banks*

- 4.13 Total commercial bank assets grew by 12.1 percent in 2010 from P44.1 billion to P49.4 billion, compared to growth of only 0.5 percent in 2009. Loans and advances, other assets, holdings of BoBCs<sup>38</sup> and deposits held in foreign banks grew by 12 percent, 32.1 percent, 0.4 percent and 54.2 percent, respectively. The increase in overall assets was funded mainly by a higher level of bank deposits, which rose by 7.5 percent to P40.4 billion in December 2010, the largest proportion of which (51.5 percent) were held in current and call accounts.

#### **(d) Other Financial Institutions**

- 4.14 The balance sheet of the Botswana Building Society (BBS) increased by 10.7 percent to P2.1 billion, compared to a growth of 7.8 percent the previous year. This was largely due to loans and advances (mainly comprising secured loans for property purchases or developments), which expanded by 13.3 percent to P1.7 billion in the same period. Total assets of the Botswana Development Corporation (BDC) grew by 20.3 percent to P2.1 billion having fallen by 8 percent in 2009. Growth in 2010 was mainly due to an increase in deposits at commercial banks, which rose by 320 percent to P543 million, while loans and advances increased by 33.1 percent, albeit from a low base, and investments in related

<sup>38</sup> The growth in BoBCs reported as assets of the commercial banks differs from the total stock of BoBCs (paragraph 4.6); due to classification differences (see notes to statistical tables 3.8 and 4.4).

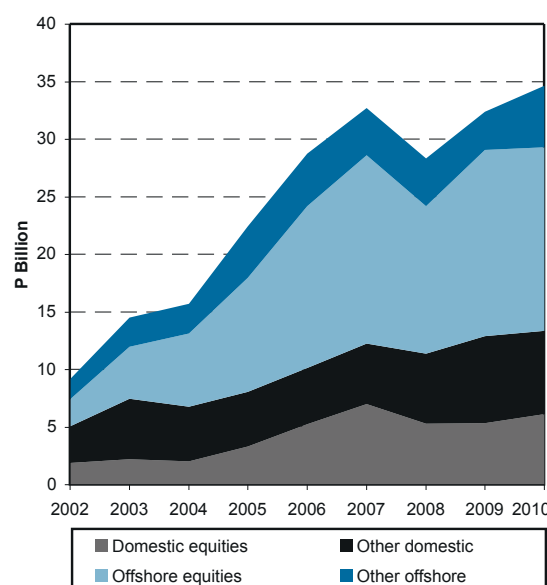
companies fell by 10.1 percent to P1.3 billion. For the National Development Bank (NDB), asset growth slowed to 5.5 percent in 2010 down from 11.6 percent in 2009, with lending growing by 1.4 percent. Similarly, at 7.6 percent, asset growth for the Botswana Savings Bank (BSB) slowed in 2010, compared to 16.2 percent in 2009.

4.15 The Domestic Companies Index (DCI) of the Botswana Stock Exchange (BSE) lost 829 points (or 11.5 percent) in 2010, compared to a recovery of 206.4 points (2.9 percent) in 2009. Having risen sharply at the start of the year, the index generally trended downwards although losses were limited until mid-December when the index was weighed down by negative sentiment toward banking shares, which comprise the bulk of the DCI. Trading was active during the year, with 310 million shares valued at P963 million being exchanged. However, the market capitalisation of domestic companies contracted by 7.2 percent to P26.4 billion. As the global economic recovery continued, the Foreign Companies Index rose by 18 percent (gaining 255 points), compared to 19 percent in 2009. As an addition to BSE activities, there was the listing of the first Exchange Traded Fund, New Gold, which tracks international gold prices.

4.16 Assets of pension funds increased by 6.9 percent in 2010 to P34.7 billion, compared to P32.4 billion in December 2009 (Chart 1.14). Contributing to this growth were holdings of both domestic and foreign equities, which rose by 14.7 percent and 10.7 percent, respectively, while the value of offshore bonds increased by 2.3 percent. In contrast, the value of domestic bond holdings declined by 5.8 percent. The proportion of total assets invested offshore decreased marginally, from 60.2 percent to 59.4 percent.<sup>39</sup>

4.17 The Government continued to support capital market development by funding part of the fiscal deficit through a bond issuance

**CHART 1.14: BOTSWANA PENSION FUND ASSETS, 2002 – 2010**



Source: Ministry of Finance and Development Planning and NBFIRA

programme. To this end, the Government issued six-month Treasury Bills and bonds of varying maturities amounting to P1.4 billion and P1.3 billion in March and September 2010, respectively. As at December 2010, the total par value of outstanding bonds and Treasury Bills was P5 billion. The bulk of the securities (97.6 percent) were held by commercial banks, and their customers, while foreign investors held 1.6 percent and the Bank of Botswana had 0.8 percent for potential secondary market activity.

#### (e) Credit Rating

4.18 In the update for 2010, Moody's Investors Service (Moody's) maintained the A2 rating for Botswana. The assessment took into account the impact of the recent global slowdown and resulting reduction of government revenue and represents a strong vote of confidence in the authorities' record of prudent macroeconomic management. Nevertheless, the outlook was retained at 'negative', thus indicating that there are remaining challenges in achieving the necessary fiscal consolidation, together with the pressing need for effective diversification of the economy away from diamond mining. Earlier in the year, in the update for 2009,

<sup>39</sup> The maximum permitted offshore holding is 70 percent of total assets.



Standard and Poor's (S & P) had lowered the country's rating from 'A' to 'A minus' and upgraded the outlook from 'negative' to 'stable'.

**(f) Other Financial Sector Developments**

- 4.19 The number of licensed banks was unchanged in 2010, with 9 operating commercial banks, three statutory banks and an offshore bank. The continued development of the banking sector was evident from the establishment of new bank branches and installation of additional automated teller machines (ATMs) countrywide, as banks sought to increase their representation across the country. Moreover, the banking industry continued to take advantage of technological innovation, including wider access to internet banking facilities and use of mobile phones to facilitate both transfers of funds and their access through ATMs. In other developments, 10 new licenses were issued for bureaux de change operations, while two bureaux de change had their licenses revoked, resulting in 61 operating bureaux de change at the end of 2010.
- 4.20 In 2010, the number of non-bank entities operating in the International Financial Services Centre (IFSC) was 23, compared to 20 in 2009. Since 2009, the responsibility for regulating the activities of the IFSC and Collective Investment Undertaking (CIUs) has rested with the Non-Bank Financial Institutions Regulatory Authority (NBFIRA), while preparations continued for consolidating guidelines for IFSC activities under a single piece of comprehensive legislation.



# MONETARY POLICY IN BOTSWANA: IMPLEMENTATION, ECONOMIC BENEFITS AND CHALLENGES

## 1. INTRODUCTION

- 1.1 The purpose of monetary policy is to attain price stability as part of the broader macroeconomic goal of sustainable long-term economic growth and employment creation. Institutionally, central banks have the responsibility for implementing monetary policy, which is supported and facilitated by other complementary functions, which include issuance of currency, banking regulation and supervision, lender of last resort and oversight for payments and settlement systems (Bank of Botswana *Annual Report*, 2008). Monetary policy can be adjusted to be expansionary, contractionary or neutral, depending on prevailing economic conditions. An expansionary monetary policy stimulates economic activity by making loanable funds cheaper and would be appropriate to combat subdued economic conditions. Conversely, a contractionary monetary policy involves raising interest rates to reduce demand and, therefore, moderate inflation. A typical monetary policy framework has three elements. First, a defined ultimate objective or target, usually the level of inflation, but could also include other measures of economic performance such as growth or employment.<sup>1</sup> Second, instruments used to regulate the cost and quantity of loanable funds, such as interest rates, reserve requirements or open market operations (OMO). Third, a nominal anchor<sup>2</sup> or intermediate target that responds to policy

changes and has an influence on demand and supply relationships in the economy. Nominal anchors could be in terms of quantity or price-based. The quantity-based nominal anchor involves some measure of money,<sup>3</sup> while the price-based nominal anchor would involve exchange or interest rates. The choice of a nominal anchor implies a commitment by a central bank to systematic policy formulation. However, the commitment to systematic policy does not necessarily imply adopting a mechanical rule, but helps to restrain arbitrary actions and fosters policy predictability. A systematic policy framework, therefore, enhances public understanding of policy and guides expectations.

- 1.2 The design of monetary policy takes into account the economic structure and the level of development of a country, where choices include monetary targeting, exchange rate targeting or inflation targeting. Nevertheless, the policy regime would evolve as circumstances change in order to preserve effectiveness. However, globally monetary policy has been characterised by periodic trends and commonalities in monetary policy preferences.
- 1.3 The 2008 Bank of Botswana *Annual Report* theme topic examined the case for an inflation targeting (IT) monetary policy regime. The assessment was broadly positive about the benefits of IT, although it was emphasised that it is important to take into account the prevailing institutional, economic and policy environment. In the light of these considerations, currently monetary policy in Botswana does not include certain key elements of IT. The focus on price stability

1 In the United States of America, for example, the goals of monetary policy as prescribed in a 1977 amendment to the Federal Reserve Act include maximising of sustainable output and employment as well as stable prices.

2 See Krugman (2003), 'Inflation targeting in world economy', who defines a nominal anchor for monetary policy as a single variable or device which the central bank uses to pin down expectations of private agents about the nominal price level or its path or about what the central bank might do with respect to achieving that path, cited in Ibeabuchi (2007), "Overview of Monetary Policy in Nigeria", Central Bank of Nigeria, Economic and Financial Review, Volume 45, Number 4.

3 The measure of money can vary according to the definition used, ranging from notes and coin in circulation to also include other financial assets that, at least to a significant extent, have the main characteristics of money as a means of transaction and store of value.

entails measures to absorb endemic excess liquidity in the banking system. In turn, this poses a challenge in terms of both the perceived high cost of monetary operations and public perceptions about the trade-offs involved in seeking to attain the Bank's policy objective.

1.4 Therefore, it is appropriate to undertake a follow-up review that focuses on a closer examination of monetary policy implementation, including the rationale for monetary operations, an assessment of the potential benefits and scope for alleviating any constraints. Some of the pertinent issues have been highlighted by the recent global financial turmoil and economic crisis, which underscored the extent of support that monetary authorities across the world undertook to protect the policy transmission process and macroeconomic stability. At the same time, questions have been raised about the adequacy of the inflation objective and the analytical processes underlying the attainment of price stability that tend to exclude other potentially destabilising factors. One such concern is that, leading up to the financial crisis, insufficient attention was paid to financial stability or at least there was a misreading of the symptoms that pointed to possible development of asset price bubbles. Subsequently, the unprecedented monetary policy response that has included various "unconventional" measures has also raised questions about the appropriate boundary between monetary and fiscal policies. In an environment of excess liquidity, as is the case of Botswana, there are issues of the interface between deficit financing options, patterns of government expenditure and liquidity management.

1.5 Although the global crisis had a significant impact on Botswana through a contraction in GDP and sharply-reduced government revenues, the easing of inflation from the second half of 2008 resulted in a sequence of interest rate reductions that also supported increased economic activity. Moreover, the financial sector was largely insulated from

the fallout from the crisis, and thus there was no liquidity crunch in Botswana. However, the fall in economic performance emanating from loss of export markets contributed to a rise in the rates of loan defaults, albeit muted, and a slight dent in the banks' balance sheets. Accordingly, as in other countries, there is recognition that the crisis has implications for the future conduct of monetary policy in Botswana. In order to strengthen oversight and gain a broader view and analysis of developments, the Bank of Botswana has recently established a new division to oversee financial stability issues due to their increased importance in monetary policy formulation.

1.6 In addition, despite the inevitable costs associated with monetary operations, regardless of the monetary policy framework, it is important to continually review the scope for enhancing efficiency. For example, banking system excess liquidity and the cost of absorption could be reduced by reviewing government disbursement procedures and incentives surrounding domestic and foreign investment of funds. Overall, however, any consideration of costs needs to be balanced against the likely, though not easily quantifiable, disadvantages of not absorbing liquidity, including possible macroeconomic instability, reduced saving incentives, curtailed access to banking services, and muted financial sector development. Technological developments that may have an impact on monetary policy operations, such as electronic payments and the use of e-money, are also important considerations.<sup>4</sup>

1.7 This chapter, therefore, reviews the formulation and implementation of monetary policy in Botswana. Section 2 outlines the alternative

4 In their paper, "Development of Electronic Money and Its Impact on the Central Bank Role and Monetary Policy", Laham et al (2009) argue that e-money, as a network good, could become an important form of currency in the future. Such a development would influence the effectiveness and implementation of monetary policy. If an increased use of e-money substantially limits demand for central bank reserves, it would require changes in the operational target of the central bank and a closer coordination of monetary and fiscal policies.

monetary policy regimes and operational methods. Section 3 addresses the conduct of monetary policy in Botswana, focusing on policy formulation and implementation, economic benefits, challenges and constraints to effective implementation. Section 4 examines opportunities for improvements in the monetary policy framework and implementation, and the conclusions are outlined in section 5.

## 2. ALTERNATIVE MONETARY POLICY REGIMES, OPERATIONS AND SELECTED COUNTRY EXPERIENCES

### (a) Alternative Monetary Policy Regimes<sup>5</sup>

2.1 The monetary policy frameworks used in different countries reflect the level of development, structure of the economy and the depth and resilience of the money and capital markets. Nevertheless, a common feature of the conduct of monetary policy is that it generally entails regulation of liquidity in the banking system to influence the cost and quantity of loanable funds available. The 2008 Bank of Botswana *Annual Report* discusses the three common monetary policy regimes, namely, monetary targeting, exchange rate targeting and inflation targeting. While all the approaches focus on price stability, they are likely to result in different outcomes in terms of the extent of monetary operations (including the choice of instruments) and accumulation of foreign exchange reserves (Annex Tables 2.1 to 2.3).

#### *Monetary Targeting*

2.2 The monetary targeting approach involves influencing the growth of the money supply to a level that is consistent with price stability, defined as inflation that does not undermine long-run output growth. This approach is based on the 'monetarist' theory in economics

which postulates that, while the pace of monetary growth may have some influence on output in the short run, these effects are generally small and temporary; and, in the long run, the main effect is on the price level. The approach also entails a determination of the definition of a monetary aggregate that can be used as the intermediate variable for which a growth target is set. Furthermore, the policy framework assumes knowledge of the causal relationship between inflation and the targeted monetary aggregate, and an assumption that such a relationship is also stable over time. It is also necessary for the growth path for the chosen monetary aggregate to be verifiable with a reasonably short lag, so that any necessary policy adjustments can be made in a timely manner.

2.3 Proponents of the monetary targeting regime emphasise the central bank's responsibility for monetary conditions and associated price dynamics over the longer term. In informing the public about the central bank's orientation to control the growth of the money supply within a level that is commensurate with stable prices, the policy framework anchors inflation expectations. The adoption of a monetary aggregate also clarifies the central bank's responsibility and provides a transparent measure for accountability.

2.4 Some countries adopt monetary targeting in consideration of their analytical capabilities and prospects for its effective implementation. In particular, it is recognised that alternatives, such as inflation targeting, have prerequisites which are sometimes difficult to attain, especially in developing economies. These include the technical capacity to build and maintain macroeconomic models, institutional and legal mandates for central banks, and composition of monetary policy committees. The experience of the European Central Bank (ECB) is instructive, where the focus on monetary aggregates is a key element of monetary policy formulation in large part due to the technical prerequisites for a monetary targeting strategy being in place at the time

<sup>5</sup> See the Bank of Botswana Annual Report of 2008, pages 98-110, where these are discussed in more detail.

of its establishment in 1998. In particular, the demand for broad money in the euro area appeared to have been stable over the preceding two decades. Given that policy is formulated at this level (i.e., the ECB determines a single policy for all countries in the euro zone), this stability at the area-wide level was considered particularly relevant. Conversely, the development of economic models necessary to underpin an inflation targeting regime was more difficult. Currently, the ECB conducts monetary policy on the basis of the two-pillar approach that combines broad-based economic analysis with detailed assessment of monetary aggregates, thus backing up policy decisions with more information.

#### *Exchange Rate Targeting*

- 2.5 In an exchange rate targeting regime, the value of a country's currency is fixed to that of a low-inflation trading partner or reserve currency, such as the US dollar or euro. This approach to the pursuit of price stability is more common with low and middle-income countries that may lack policy credibility and/or member countries of a regional economic community. More generally, developing countries tend to prefer exchange rate targeting because it helps to bring down inflation expectations and inflation by benefiting from the policy credibility and resulting low inflation of the anchor country.<sup>6</sup> Moreover, as developing countries rely heavily on international trade, as exporters of primary commodities, the fixed exchange rate regime helps to reduce transactions costs and exchange rate uncertainty in international trade and, thereby, helps to ensure stable prices of traded goods. Developing countries also choose the fixed exchange rate regime in order to avoid the 'Dutch' disease, especially the appreciation of the local currency that could occur under a flexible exchange rate regime due to large foreign exchange

inflows arising from the favourable export performance of one commodity, making it difficult for other exporters, notably of manufactures to find external markets because the appreciated exchange rate makes their products relatively expensive. The negative effect of the appreciated exchange rate is not confined to the export market. It is also felt by other producers and suppliers of tradeable goods and services, including those that have to compete with imports.

- 2.6 The policy instruments in the exchange rate targeting framework include interest rates and foreign exchange market interventions. The target exchange rate may be defined as a fixed rate, one with a dynamic adjustment or one with responsive discrete adjustments. To maintain the desired official parity, the central bank commits itself to managing the demand and supply of foreign exchange, which inevitably requires the country to hold substantial international foreign exchange reserves.

#### *Inflation Targeting*

- 2.7 An inflation targeting framework involves a focus on inflation as the single and specific primary objective for monetary policy. The targeted inflation is a reference yardstick with which to hold the responsible authority accountable. The framework, therefore, entails a numerical definition of price stability, in terms of the desired level of inflation. However, this does not imply that other economic goals are not important. Rather, it is considered that the use of monetary policy to achieve the defined level of price stability is a more optimal approach to supporting and facilitating the achievement of the other socio-economic objectives, including sustainable long-run economic growth, employment creation and a rise in living standards. The inflation targeting framework is forward-looking, giving a central bank an opportunity to adjust policy proactively to maintain inflation at a targeted level in the medium term. This approach encompasses three steps, viz.: first, the central

<sup>6</sup> This can also apply to more advanced economies. Notably, prior to the introduction of the euro, many European economies pursued monetary policies that effectively linked their currencies to the Deutsche mark, thus benefiting from the anti-inflation policy credibility of the German authorities.



bank forecasts the future path of inflation; second, the forecast is compared with the target; and third, the difference between the forecast and the target determines the quantum of monetary policy adjustment required to achieve the inflation target. The approach also allows for discretion by taking into account information that is not routinely factored into the forecasting models. Beyond this, there are essential institutional, capacity and technical requirements that are necessary for successful operation of an inflation targeting regime.

- 2.8 The inflation targeting framework has the advantage that the commitment and announcement by a government of an explicit inflation target provides a central bank with a clear objective and precise definition of price stability. Attempts at pursuing multiple policy objectives tend to result in ineffective monetary policy, especially in situations of limited credibility of a central bank or a government that is biased towards having an expansionary monetary policy. The pressure to achieve lower unemployment rates through expansionary monetary policies often results in high average inflation, but without leading to any sustained boost to employment and growth. For this reason, the inflation targeting regime has the advantage of focusing the policy debate on what a central bank can achieve in the long run (i.e., control of inflation), rather

than what it cannot affect to a significant degree through monetary policy (i.e., factors that are linked to productivity and technology improvements and structural changes such as higher output growth, lower unemployment and increased external competitiveness).

- 2.9 In the absence of competing objectives, the framework enhances the central bank's credibility in maintaining stable and low inflation in the long run. In turn, it helps sustain and anchor inflation expectations in the economy, as it allows economic agents to have a reasonable prediction of inflation when making saving and investment decisions. The inflation targeting framework thus helps to project a clearer path for inflation in the medium term and, as a result, it reduces the potential for erratic inflation changes. Given that interest rates may need to be adjusted in response to movements in inflation expectations, targeting and attaining a low and stable rate of inflation also fosters more stable and lower long-term interest rates that are more supportive of economic activity. Moreover, the associated reduction in uncertainty in both inflation and interest rates is beneficial for long-term stability and development of both the financial and capital markets and, also, better informs the processes of price and wage setting and investment decisions.

### BOX 2.1: MONETARY POLICY IN THE CONTEXT OF THE GLOBAL FINANCIAL AND ECONOMIC CRISES

*The recent global financial crisis has shaken many people's beliefs about economics and economic policy. Prior to the crisis, there was talk about 'Great Moderation', reflecting a belief that macroeconomic volatility had been effectively eliminated through improved policy design and implementation, notably monetary policy. However, the crisis has seriously dented confidence in macroeconomic management and financial sector regulation. This has motivated research on the causes of the crisis, as well as the possible actions to avoid recurrence of such a calamity. The crisis has directed attention to a number of salient issues of central banking, among them, new challenges for monetary policy, a central bank's role in financial stability and management of volatile capital flows.*

*One of the most prominent issues in the current debate regarding monetary policy is the question of the desirability of inflation targeting, which has been replacing exchange rate and monetary targeting frameworks in many countries. Various proposals have been made, ranging from abolition of inflation targeting or at least moderating it (through more flexible targets, for example) or combining it with other objectives, such as greater attention to financial stability (Section 4), to those that seek to strengthen the commitment to price stability. An example of the last alternative is price level targeting, where inflation expectations would act as an automatic stabiliser. The crisis has also sparked debate on monetary policy measures with regard to their timing, effectiveness and when and how the central banks should ultimately withdraw them. Some central banks, such as the ECB, have argued that the crisis has underscored the importance of monitoring monetary aggregates that have largely been ignored or at least accorded only secondary importance in most inflation targeting frameworks.*

**(b) Operations**

- 2.10 The distinguishing features of alternative monetary policy frameworks are primarily the set of instruments used and intermediate target chosen by the monetary authority to achieve price stability. Approaches to controlling money supply growth mainly involve direct control of sources of money or indirect market-oriented measures. Direct control strategies include the imposition of limits on levels and growth rates of sources of monetary expansion, such as an increase in domestic credit and net foreign assets, as well as administrative regulation of the level of interest rates, and cash, reserve and liquid asset requirements for commercial banks and non-bank financial institutions. The market-oriented approach utilises a number of instruments to indirectly influence the level of market interest rates and/or the quantity of loanable funds. In general, the use of direct administrative controls has been replaced by indirect measures. This reflects the general trend towards economic and financial liberalisation, as well as the effect of competition, enhanced speed of product innovation and widening of sources of money growth and payment methods and blurring of roles of the various types of financial sector institutions.
- 2.11 Whereas direct administrative instruments do not necessarily require highly-developed financial markets, the extent to which inflation and economic activity are influenced by market-based instruments depends on the stage of the development of the financial markets. However, direct administrative instruments tend to lose potency as the economy becomes more open, market participants become sophisticated and new instruments and processes emerge to effectively circumvent direct controls. Thus, the design and choice of policy and operational instruments is a common challenge facing central banks (Box 2.2 highlights the common instruments in monetary policy formulation).<sup>7</sup>

2.12 In general, the use of indirect monetary policy tools requires prior identification of a suitable nominal anchor or intermediate target. For inflation targeting, the forecast of inflation is the intermediate target; while the exchange rate level is used in an exchange rate targeting framework; and the growth rate of some measure of money in a monetary targeting approach. To be useful, intermediate targets must be amenable to control by the policy instruments in use, have a stable and strong relationship with the ultimate objective and relevant data being regularly available. By focusing on an intermediate target variable, monetary authorities observe its response to the policy instrument(s) being deployed and the impact on the ultimate policy goal. In turn, this allows for pre-emptive policy action (realignment of the instrument) to influence the ultimate target in the desired manner. The overall mechanism describes the monetary policy transmission mechanism or process and reflects the view of the authorities (ideally based on statistical analysis of relevant economic and financial data) about the quantitative and dynamic (time lag) relationships between the instruments, intermediate target and ultimate target.

2.13 Therefore, to the extent that the deployment of monetary policy instruments is intended to affect, in a predictable manner, a defined ultimate objective, such as a level of inflation through an indirect target, a proper understanding of the monetary policy transmission mechanism is an indispensable requirement in the design of the monetary policy framework.

**(c) Monetary Policy: Contribution and Challenges**

2.14 Successful conduct of monetary policy contributes to the attainment of price stability; it is an important element of broader macroeconomic stability which fosters sustainable economic growth and rising living standards. In contrast, both high inflation and deflation are detrimental to economic

<sup>7</sup> Updated information from the 2008 Bank of Botswana Annual Report.



**Box 2.2: COMMON INDIRECT MONETARY POLICY INSTRUMENTS**

*(a) Policy Interest Rate*

*This is the rate of interest a central bank uses to signal the stance of monetary policy to economic agents. For example, when a central bank desires to reduce aggregate spending in the economy, it raises the policy interest rate, which is typically very short term, as a signal that commercial banks and other financial institutions should respond in a similar manner with respect to lending and deposit interest rates. Increasing the lending interest rates directly raises the cost of borrowing which, in the case of firms, signals the prospect of reduced profitability from investment using borrowed funds; the firms are, therefore, likely to borrow less. In respect of households, there is likely to be an increase in the debt service burden, which should force them to reduce their borrowing and perhaps increase their saving. A reduction in the policy interest rate should have the opposite effect on borrowing and, consequently, aggregate spending in the economy.*

*(b) Open Market Operations*

*Open market operations (OMOs) involve the purchase and sale of securities by a central bank, and typically supplement the changes in the policy rate in effecting monetary policy decisions. OMOs can be conducted at two levels: either outright purchase (or sales) of securities or repurchase agreements (repos and reverse repos, where there is a commitment to reverse the transaction in the future). When a central bank purchases securities, more money is injected into the banking system, as holders of securities receive funds which they deposit into their bank accounts. As a result, deposits at commercial banks increase with the effect of increasing the money supply and lowering interest rates. In the case of the sale of securities by a central bank, the buyers' deposits at commercial banks decrease, thus lowering the money supply; for a given level of money demand, a reduction in the money supply would result in an increase in interest rates.*

*Depending on circumstances, relevant securities may not be available for OMOs in the secondary markets. In such a case, a central bank may decide to issue its own securities as a means to absorb liquidity, e.g., Bank of Botswana Certificates (BoBCs).*

*(c) Statutory Reserve Ratio*

*This instrument requires commercial banks to hold a proportion of their deposit liabilities in an account at the central bank. This constrains the lending ability of commercial banks, as these funds are not available for lending. When the central bank increases this ratio, commercial banks have less to lend, which leads to a reduction in the amount of credit expansion and spending potential. Conversely, a reduction in the ratio increases commercial banks' funds available for lending, which has the effect of raising the level of credit and, thereby, investment and aggregate spending.*

*(d) Communication Strategy*

*In the absence of direct policy instruments, such as directives setting interest rates, effective monetary policy requires one or more of the indirect instruments listed above. However, their impact can be enhanced through effective communication both with financial institutions and economic agents more widely. This is particularly important for magnifying the more direct influence that short term interest rates have on those of longer maturity financial instruments. In addition, central bank transparency and communication is increasingly used to influence inflation expectations and, therefore, economic decisions. For this reason, it is increasingly common for central banks, to communicate policy decisions and the rationale for them. It is also possible for such announcements to include indications of the expected future direction of policy; for example, whether interest rates are likely to increase, decrease or remain the same.*

performance and development. In particular, a continuous and sharp increase in the general level of prices (high inflation) over an extended period leads to a quick decline in the value of money and purchasing power, which erodes incentives for financial saving and creates uncertainties for investment

decisions. Deflation, which is the continuous decrease in the general level of prices, results in the loss of return on financial savings and the postponement of purchases in anticipation of a further decrease in prices. This results in a fall in demand, thus undermining output. In addition, the consequent rise in the real

value of debts further depresses the economy. Moreover, a decrease in asset prices (including residential and commercial property and shares) results in loss of wealth against which any liabilities backing such assets remain at a high level, thus, potentially resulting in negative equity and bankruptcy.

2.15 Price stability has a positive impact on economic activity through the following channels:

- (i) Price stability increases the transparency of changes in the relative prices of various goods and services, since such changes are not obscured by fluctuations in the overall price level. Both businesses and consumers are less likely to misinterpret price changes and, thus, are able to make better informed consumption and investment decisions based on changes in relative prices, leading to more efficient market allocation of resources. By helping the market to steer resources to where they can be used most productively, price stability increases the overall productive potential of the economy, which is a necessary condition for improvements in welfare in general.
- (ii) When creditors are assured that prices will remain stable in the future, they will not demand an inflation risk premium in their pricing to compensate for holding long-term debt or financial assets. In turn, the lower the inflation risk premium, the greater the efficiency with which capital markets allocate resources to productive investments.
- (iii) A credible monetary policy that maintains price stability also reduces the need for inflation hedges. A high inflation environment creates incentives for stockpiling goods, since their ultimate sale value is adjusted for inflation more readily than money and most other financial assets. It is considered that stockpiling of goods and widespread acquisition of inflation hedges diverts the use of financial

resources away from promoting productive investments through intermediation. Over the long term, the cost of savings tied up in inventories of goods and other inflation hedges impair welfare growth.

- (iv) Price stability also minimises the effect of the so-called 'tax bracket creep' phenomenon, associated with progressive, nominal income-based tax systems. Such systems raise the average tax rate over time alongside the rise in prices and nominal incomes. This may be most harmful to those with lower incomes, while those already in the highest tax bracket will be relatively unaffected. Moreover, higher income earners are more likely to be able to find tax shelters to insulate themselves from tax bracket creep.
- (v) High inflation is a disincentive to holding money; it is in effect a tax on cash holdings. When inflation is high, economic agents respond by holding less cash than they would under conditions of price stability, in which case, they will incur additional transactions costs due to more frequent conversion of other assets to meet cash requirements.<sup>8</sup> Similarly, vendors of goods and services face additional costs of making more frequent adjustments to prices.<sup>9</sup>
- (vi) Overall, maintaining price stability lessens the potential for a skewed redistribution of wealth and income against the less well-off members of society that arises under inflationary conditions as well as deflationary situations, since the poor are typically least able to protect themselves from adverse price movements.

2.16 Price stability also facilitates development of the financial system as it contributes to stable

8 These are known as 'shoe leather costs', referring to the costs of additional trips to the bank. To some extent these have been mitigated by technological developments (the internet, for example), but they are not negligible, especially for poorer people.

9 These are known as 'menu costs' and refer to the need and costs associated with frequent reprinting of restaurant menus when prices rise rapidly.

monetary conditions that are conducive to financial saving and allocation of financial resources for investment. In addition to financial development, there is also empirical evidence that suggests that price stability contributes to the maintenance of financial stability and that the two goals are complementary.

2.17 More generally, the attainment of price stability is compatible with the achievement of other economic objectives, including sustainable output growth and employment creation. However, the role of monetary policy in reducing unemployment is indirect. In many cases, high unemployment is largely a consequence of structural rigidities in the labour and product markets; it is, therefore, best addressed by reforms that allow for flexible responses to economic shocks and encouragement of innovation. In addition, in most instances, any impact of monetary policy on output/employment is likely to be temporary in nature as inflation expectations adjust. Thus, it is important to recognise the limitations of monetary policy, as undue focus on factors it cannot affect permanently could, apart from giving rise to inappropriate policy responses, lead to delays in implementing economic reforms that are crucial to achieving high levels of sustained growth and employment.

2.18 Furthermore, it is important to expand the environment in which monetary policy is conducted in order to underscore its relevance and the resources committed to its success. Among others, the transmission of monetary policy, from its influence on market interest rates to demand, economic activity and ultimately inflation, could be deficient due to several reasons, including the following:

(i) *Lack of competition in the banking sector:* where competition among financial institutions is weak and profit margins are high, monetary policy changes will be transmitted less forcefully than under full competition. Large monopolistic banks tend to be less responsive to changes in policy rates.

(ii) *Shallow markets:* if the financial markets are 'shallow', with few transactions and participants, both competition and efficiency of the financial system are reduced. The lower threat of potential entrants and competitive innovation increases the relative power of existing banks,<sup>10</sup> and undermines the effectiveness of the transmission mechanism of monetary policy that links policy decisions to the real economy through the financial markets. Also, banks experiencing distress, e.g., undercapitalised, high default rates and liquidity problems, do not transmit monetary policy signals properly. For example, banks can raise deposit interest rates even if interest rates are falling to address liquidity problems.

(iii) *The impact of changes in administered prices:* these prices are regulated and adjusted by governments, sometimes on an *ad hoc* basis and often unrelated to developments in market-determined prices. While, by their nature, these are generally not directly responsive to changes in monetary policy, they are, nevertheless, still important to monetary policy formulation and implementation, as they contribute to inflation and there is always the potential for their impact to spill over to other prices through second-round effects, including their effect on inflation expectations.

(iv) *Large informal sector:* the implication of a large informal sector relative to the overall economy is that information, such as statistics on which policy decisions are based, is often incomplete and/or wrong, as it is likely to focus on the formal economy.<sup>11</sup> As a result, the basis of policy decisions can be seriously undermined.

10 Since existing banks are assured of market share due to less or non-existent competition, they have less incentive to be innovative and/or efficient in their operations.

11 For example, informal lending to businesses and households is typically very hard to measure.

(v) *The link between the output gap and inflation*: where this is not sufficiently robust, there is resultant uncertainty in the policy transmission mechanism that could undermine policy effectiveness. This could arise in instances of significant structural changes that can rapidly alter the productive capacity of the economy or where trends in domestic output are dominated by external demand.

(vi) *Role of the central bank*: where the monetary authority's policy actions are not well-understood by economic agents, their effectiveness is undermined, in particular through the erosion of their impact on expectations.

(vii) *Timing of policy decisions*: if the policy transmission mechanism is not clear to policymakers, the timing of monetary policy decisions can be counterproductive and destabilising. In this regard, it is important that the policy transmission mechanism is kept under regular review, within any given economy, it varies over time.

2.19 Overall, there are significant influences on the conduct of monetary policy derived from developments in the financial markets, including financial market innovation, the emergence of new financial institutions and products and the increasing globalisation and interconnectedness of financial markets. A corollary of these developments is that asset price dynamics and their possible departure from fundamentals-based valuation must be taken into account when the risks to domestic price stability are assessed.

2.20 Moreover, given the global dimension of financial intermediation, it is important to monitor broader international developments and take into account the impact of the international transmission of shocks (including economic policy shocks) that come through both financial market linkages and prices on domestic monetary policy formulation. Initially, globalisation encompassed the

rationalisation of global production, including a movement of production to low-cost centres that contributed to the dampening of price pressures, which aided the attainment of price stability globally and anchoring of low inflation expectations. However, the impact of globalisation on the conduct and efficacy of monetary policy is increasingly multifaceted and includes not only the potential to influence price developments, but also the rapid transmission of financial shocks across countries. This process has generated questions relating to the ability of central banks to effectively control inflation and conduct OMOs at the national level in such circumstances.

2.21 Economic development and globalisation engender the proliferation of non-bank financial institutions (NBFIs), which compete with banks in the financial intermediation business. In addition to institutions, methods of payments and accessing financial resources are no longer limited to cash, bank loans and drawing of bills (including cheques) against bank balances, but also cover e-money, credit cards, smart cash and related operators; as a result, the link with the conduct of monetary policy is less direct. Furthermore, as previously pointed out, for several developing countries, monetary policy is formulated in economies that have relatively large non-monetised sectors as well as informal economic activities. In such an environment, monetary policy, which depends on the existence and responsiveness of formal financial institutions to policy signals, could become less effective and its impact indeterminant for a significant part of the economy.

2.22 Monetary policy could also be hampered by weak legal frameworks for the monetary authorities and deficiencies in supporting institutions and other areas of macroeconomic policy. A lack of well-developed financial markets, for example, hampers effective operation of the government securities market and/or conduct of open market operations, which is key for liquidity management. On the other hand,



excessive growth in government expenditure often results in high government debt and inflation, placing a heavy burden on monetary policy. Lack of central bank independence and an opaque mandate could result in an unfavourable trade-off between the long-term economic considerations of monetary policy formulation and a government's short-term spending priorities based on broader socio-economic considerations and a greater weight being attached to expediency. In essence, poor coordination between monetary and fiscal policies could erode the credibility of the responsible authorities and long-term efficacy of the respective policies.

#### (d) Liquidity Management and Country Experiences<sup>12</sup>

2.23 The conduct of monetary policy in developing economies is often influenced and, at times, constrained by excess liquidity. In a growing economy, the deposit base of the banking system often expands rapidly (relative to productive deployment of loans and advances), resulting in excess liquidity. In such a situation, when a central bank increases its policy rate, the action would be less effective in restraining credit creation by the commercial banks as they have little need for borrowing from the central bank. In such a case, open market operations would play a major role in absorbing excess liquidity. However, the experience of several countries point to significant challenges in liquidity management, especially in the absence of well-developed secondary markets for government securities. The first challenge relates to the likelihood of substantial costs associated with the issuance of central bank securities to absorb the excess liquidity, which could result in an overall financial loss for the central bank. The counterpart to this potential outcome is the perceived income benefit that banks (and any other primary counterparties)

may derive from earnings on central bank securities. The second major concern is the absence of, or at best sluggish, spillover effects of central bank debt in liquidity management to foster money and capital market development in general. In the absence of liquidity and funding constraints, there is less incentive for product innovation that could spur market development. In the circumstances, there is potential for underwriting standards and bank behaviour to be distorted.

2.24 Table 2.1 shows the percentage share of central bank securities in total central bank liabilities for selected countries. The cost of excess liquidity control depends on both the volume of securities and the level of interest rates. For a number of developing countries, high interest rates occur in an effort to moderate inflation where it has been historically high; the high interest rates together with the volume of securities result in the cost of mopping up excess liquidity.

2.25 In instances where costs of liquidity absorption may result in an overall loss for central banks, the associated challenges include countering the perception that such losses undermine the prestige and autonomy of the monetary authority. This also includes the perception that interest payments due on outstanding debt and, perhaps, together with the accompanying losses, will undermine monetary policy effectiveness. From this perspective, the loss could have the effect of neutralising the very effectiveness of liquidity absorption due to the likely loss of central bank credibility. The risk of central bank losses resulting from the use of its securities for liquidity management is the greatest in the initial stages of the transition to an indirect monetary policy regime. This is because of the need to sterilise large amounts of excess liquidity that would have built up during the period of financial repression induced by direct monetary control and, in some instances, exchange controls.

2.26 Another challenge to monetary policy derives from the fact that markets for central bank securities often remain very thin, a

<sup>12</sup> The discussion of country experiences partly draws from Quintyn (1994), "Government Securities versus Central Bank Securities in Developing Open Market Operations, Evaluation and Need for Coordinating Arrangements", IMF Working Paper (WP/94/62), 1–36.

TABLE 2.1: CENTRAL BANK PAPER IN THE BALANCE SHEET OF SELECTED CENTRAL BANKS

Central Bank	Instrument	Percentage share of central bank paper in total liabilities
Argentina	Central bank securities	13.1
Brazil	Central bank securities	2.4
Chile	Central bank bonds/indexed promissory notes/indexed coupons/deposit certificates	82.7
Indonesia	Bank Indonesia Certificates	22.1
South Korea	Monetary Stabilisation Bonds	56.4
Malaysia	Bank Negara Malaysia Paper	5.9
Mexico	Mexico Regulation Bonds	24.6
South Africa	Reserve Bank Debentures (unsecured - issued to the market on tender for 28 or 56 days)	10.1
Thailand	Bank of Thailand Bonds	25.1
UK	Debt Securities	26.7
Botswana	Bank of Botswana Certificates	25.5

Source: VIII Report on Currency and Finance, Reserve Bank of India and Bank of Botswana.

NB: For Botswana, the data are up to 2008; for Brazil and South Africa, 2005; while for the rest the data are for 2004.

situation that may constrain flexibility in using these instruments for both monetary policy intervention and for financial market development, more generally. When issuing securities, central banks tend to focus on the specific requirement of the cost-effective absorption of liquidity. Therefore, a broader range of complementary measures may also be needed to stimulate market development, which would depend on the central bank for the issuance of short-term marketable debt and its role as a market maker. The constraint to market development is generally more acute when there is an absence of a regular programme for issuance of government securities. Such a programme, incorporating proper market-stimulating features, helps to promote the development of money and capital markets; it also facilitates the separation of debt and monetary management, an arrangement which enhances the operational independence of the central bank. It is, nevertheless, equally important that central bank securities embody features that contribute to financial market development, since the extent of deepening and maturity of the market ultimately has an influence on the efficiency and effectiveness of the central bank's policy interventions. If the markets, in which the central bank intervenes, remain underdeveloped, segmented and disjointed, there could be disruption of the

transmission of monetary policy actions.

2.27 There is, however, no 'one-size-fits-all' approach in the conduct of monetary policy and management; and changes in, among others, the economic and financial environment, institutional infrastructure and analytical capability determine the choice of optimal arrangements for both the framework and operation of monetary policy. This explains the different country experiences, although, in general, there has been a movement from direct controls to the use of indirect instruments operating through market-based mechanisms. In addition, regardless of the framework and operational methods, the conduct of monetary policy entails costs and trade-offs. In the circumstances, it is considered that the benefits of price stability and efficient financial intermediation (which also provides channels for saving and productive deployment of financial resources) are paramount to sustainable growth and economic development. Countries generally face evolving challenges and continually vary the instruments used in monetary operations in terms of the following:

- (i) the choice between government and central bank securities;
- (ii) participants in the primary market;

- (iii) the size and scope for primary or secondary market activities;
- (iv) the optimal range of maturities;
- (v) auctioning methods;
- (vi) supplementary instruments for the management of liquidity (e.g., reserve requirements).

2.28 The following brief country experiences of Ghana, Chile, Mauritius, the Philippines, Poland and South Africa illustrate the challenges discussed above.

### *Ghana*

2.29 Since the promulgation of the Bank of Ghana Act of 2002, Ghana has operated an inflation targeting monetary policy framework. It became the second country in Africa to adopt such a framework after South Africa. The target is set on an annual basis by the central bank, in consultation with the Ministry of Finance, and announced in the annual budget statement; it is guided by the medium-term objective of reducing inflation to single digit while maintaining economic growth. In addition, there has been a transformation in the use of monetary policy instruments, mostly reflecting developments in the financial system, as well as the influence of global factors. The Bank of Ghana shifted from direct instruments to indirect and market-based instruments for its conduct of monetary policy in the early 1990s as part of the financial sector adjustment programme that resulted in the liberalisation of interest rates and credit allocation (which facilitated and required the system of indirect monetary management).

2.30 As with other developing countries, the conduct of monetary management in Ghana has been guided by the need to absorb excess liquidity. This has required the central bank to intervene frequently in large amounts, through issuance of its own debt instruments to absorb excess liquidity. In addition to there being insufficient government treasury bills for the central bank to conduct effective OMOs in the secondary

market, there were rigidities in the procedures for the weekly auctions of treasury bills, with the result that the central bank securities became the main instrument for liquidity absorption. Nevertheless, by broadening both the range of maturities of its own bills and the eligible holders, the central bank contributed significantly to the development of the money and capital markets at a time when the government, looking to further consolidate its financial position, minimised the issuance of its securities in order to control interest costs. The Bank of Ghana also employs reserve requirements, which are set at 9 percent of total deposits, to reduce the cost of mopping up excess liquidity.

### *Chile*

2.31 Monetary policy evolution in Chile involved adoption of an inflation targeting regime and transition to indirect monetary operations that was part of broader financial reforms, when the central bank began auctions of its promissory notes and government treasury bills. However, over time central bank securities became the main instrument for liquidity management as the government was less inclined to issue debt securities in an environment of a favourable fiscal position. Therefore, the central bank had to rely on its own securities for managing excess liquidity and for market development. To foster market development, the Bank of Chile also extended the range of maturities of its promissory notes to 10 years. As in Ghana, the operations have had an unfavourable impact on the central bank's operational income.

### *Mauritius*

2.32 Since 2004, the Bank of Mauritius has operated under a legal mandate to pursue price stability, although there is no mention of a specific inflation target. The policy framework is similar to that of the ECB; it is based on the two pillars of, first, economic analysis of short- and medium-term risks to price stability and, second, monetary developments that

**Box 2.3: GOVERNMENT SECURITIES VERSUS CENTRAL BANK SECURITIES**

*In most cases, government securities are preferred over central bank securities because of their capacity to develop financial markets and restrict the role of the central bank to its core mandate. Well-developed government securities markets allow indirect monetary policy to be conducted from the onset in secondary markets, thereby insulating monetary policy from debt management operations, which take place, for the most part, in the primary market for government securities. In this way, the government securities market can also strengthen the transmission and implementation of monetary policy, including the achievement of monetary targets or inflation objectives, and can enable the use of market-based indirect monetary policy instruments. Moreover, efficient debt management by governments will typically require the issuance of securities of varying maturity that are open to a wide range of investors; in contrast, central banks will focus on instruments that are effective to absorb liquidity and guide short-term interest rates. Provided government finances are sound, issuance of government bonds can be particularly supportive of the early stages of capital market development as they are considered to be safe investments. However, if this pre-condition is not in place, the central bank may have to take on such activities.*

affect longer-term risks. Changes in the policy stance are signalled through adjustments to the repo rate, and are implemented through controlling the supply of narrow money and reserve requirements set at 4 percent.

- 2.33 Mauritius has followed a gradual transition from direct to indirect monetary control instruments since the late 1980s, at a time when the banking system faced significant liquidity injections through external accounts. Initially, the Government of Mauritius took on the role of issuing short-term, fixed-price government securities to sterilise excess liquidity. However, from July 1991, the Bank of Mauritius started to issue its own paper after the Government withdrew from operations to stabilise liquidity due to concern over rising interest costs. Nonetheless, the Government continues to issue securities when there is a funding need. Since the instruments issued by both institutions have the same characteristics and given that the central bank conducts auctions on behalf of the government, there is effectively one market.

**The Philippines**

- 2.34 The Philippines' experience also exemplifies the alternative use of government securities and the central bank's debt instruments in conducting open market operations. During the early part of the transition to indirect monetary policy instruments, the volume of primary issues of government securities was determined solely on the basis of the government's borrowing requirements, leaving little room for the central bank to use the debt issue for monetary control purposes. In order to improve monetary control, the central bank subsequently issued its own paper. There was, nevertheless, a challenge relating to the tendency for bidding up of yields for the government securities due to competition with central bank securities, which complicated domestic public debt management. Moreover, the high interest costs associated with central bank securities contributed to central bank losses, which affected domestic liquidity management.<sup>13</sup> In the light of these challenges, central bank securities were phased out and government securities retained as the main instrument for monetary management. To ensure that primary issues of government securities satisfied both fiscal and monetary objectives, a coordination forum was set up to determine the auction volumes of government securities on the basis of both deficit financing requirements and monetary policy considerations. Even then, the central bank was still required, on occasion, to issue its own securities to fine tune its monetary management.

**Poland**

- 2.35 The Polish experience also highlights conflicting interests and roles associated with

<sup>13</sup> However, switching from central bank securities to government securities was equivalent to shifting the burden of interest payments from the former to the latter, possibly to save the central bank from losing credibility as a result of possible losses. The challenge to central banks is that as long as there is excess liquidity in the economic system, it has to be mopped up at a cost in the form of interest payments in order to reduce inflationary pressures in the economy, irrespective of who incurs interest costs.



the issuance of government and central bank securities. Although a programme for issuance of government debt existed at the time of transition to the use of indirect monetary management instruments, the central bank had to issue its own paper for liquidity control. In the event, while central bank securities were effective in liquidity management, they were in direct competition with treasury bills. Eventually, central bank securities were phased out and the central bank allowed the use of the primary treasury bill market for monetary management. However, coordination of government funding needs and liquidity management by the central bank remained a challenge and the central bank's effectiveness in monetary control was constrained. The central bank, therefore, initiated repurchase operations<sup>14</sup> as its main indirect intervention tool.

### *South Africa*

- 2.36 Monetary policy implementation in South Africa is possibly more advanced than in other countries under review and, by now, it is fully based on market-oriented policy measures. The South African Reserve Bank (SARB) creates incentives through buying and selling securities in the financial markets to influence economic agents' behaviour in a desired direction. In this regard, the key policy instrument is the repo rate, which is both the policy rate and the rate of interest at which the SARB lends to the banking sector to influence adjustment of their own borrowing and lending rates accordingly. A key difference is that, in South Africa, excess liquidity is not as pervasive as in the other countries surveyed, due to the greater depth of financial markets, including for government debt. This enables the SARB to follow the practice that is more in line with that of developed economies, of creating a liquidity shortage in the money market. The shortage is then refinanced at the
- repo rate which, in turn, is set by the bank's Monetary Policy Committee, in line with the inflation target.
- 2.37 Overall, country experiences show that, while many developing countries have experimented with both central bank and government securities, there are other small, open developing economies which have, from the period of adoption of indirect monetary policy instruments, consistently used government securities in the development of open market operations. Such countries include Pakistan, Kenya, Israel and Mexico. In these countries, some forms of government securities were already being issued prior to the introduction of indirect instruments of monetary policy.
- 2.38 The transition to indirect monetary policies in Pakistan started with the central bank intervention in the primary government securities markets. However, the government has continued to maintain ultimate responsibility for determining auction volumes and cut-off rates in the primary market, often to the detriment of monetary management. Moreover, unlike in the case of The Philippines, no explicit coordinating arrangements have been established to ensure that monetary policy considerations are included in determining the terms of primary market issues.
- 2.39 In other countries, the introduction of open market operations in government paper was supported explicitly by arrangements aimed at operational independence for monetary policy. In Kenya, the central bank had been actively involved in the management of government securities markets since 1985. The central bank conducted weekly treasury bill auctions and was fully responsible for issuing and redeeming treasury bills. At the point of transition to indirect monetary policy instruments in 1990, the Bank of Kenya was also given responsibility for determining the volume and terms of primary issues of government securities in line with monetary policy requirements, thereby receiving a high degree of monetary policy autonomy.

<sup>14</sup> A repurchase operation entails selling a security or instrument to a counterparty with a promise to subsequently repurchase it at a specified later date at a slightly higher price or at the original value plus interest.

- 2.40 Open market interventions in Israel also take place in the primary markets for government securities. The Bank of Israel uses a specifically designed government security, the “Government Short-Term Loan”, which is issued at weekly tenders and available in maturities of six- and twelve-months. The central bank has full autonomy in deciding the volumes to be issued within a legislated limit. The proceeds from the sale of this government paper are not used to finance the government deficit; instead, they are deposited in a government account at the central bank.
- 2.41 The Central Bank of Mexico started open market operations through primary issues of government securities at a time when direct controls were in place. Following the transition to indirect measures, open market operations were conducted in the secondary market for government securities. Of all the developing countries reviewed, Mexico is the only one that has moved to genuine open market operations in the secondary market. The other central banks still use the primary issue securities as their main intervention tool, along with other instruments such as reserve requirements and central bank credit to banks.
- 2.42 Overall, the key challenge that faces many developing economies in developing frameworks for implementing monetary policy is how to conduct open market operations when, for various reasons, there are insufficient quantities of government debt for the effective absorption of excess liquidity. It is evident that the transition from direct to indirect forms of monetary control is easier where the market for government securities is well established and the government has a track record of prudent fiscal management. Even then, irrespective of the financial instrument used for open market operations and the supporting institutional arrangements that are in place, the development of active secondary markets for the intervention instrument, in general, seems to be slow and sporadic in developing and emerging economies. Only a few developing countries have moved to genuine open market operations in the secondary market, while a smaller number use repos and reverse repos. It is also evident that the development of government securities market is, in general, the least advanced in those countries where central bank securities play a leading role in fostering open market operations. Nevertheless, even in developed economies, on occasion, central banks may resort to issuing their own securities to supplement instruments available for policy implementation.<sup>15</sup>
- 2.43 As a complementary tool to the indirect monetary control instruments, primary reserve requirements are used to a varying degree and for differing purposes in different countries. Table 2.2 lists the functions of reserve requirements for selected countries. The primary reserve requirement legally compels banks to hold a designated proportion of their deposits (liabilities to the public) in an account with the central bank, usually in a non-interest earning account. Overall, an increase in the primary reserve requirements held against the liabilities of banks reduces the ability of banks to extend credit. However, the importance of primary reserve requirements as an instrument of monetary control has been diminishing over time as countries adopted open market operations. As shown in Table 2.3, this ratio varies widely across countries; from zero (Australia, Mexico, Canada, UK and Sweden) to 80 percent (Jordan). The variation reflects different circumstances in terms of the availability and effectiveness of other instruments of monetary control, as well as the extent of the prevalence and the need to sterilise excess liquidity.
- 2.44 The use of reserve requirements has diminished over time in developed economies, while they continue to play an important role in developing economies where financial markets are thin and, generally, the transmission

<sup>15</sup> For example, in the financial statement for 2008/09, the Bank of England reported that GBP 42.2 billion, or 28.5 percent of total liabilities, were in the form of issued money market instruments. These consisted of short duration bills issued by the Bank as part of its OMOs. However, this is not always a feature of the Bank's operations; by the end of 2009/10, the figure had fallen to zero.

**TABLE 2.2: FUNCTIONS OF RESERVE REQUIREMENTS**

	Interest rate buffer	Liquidity Management <sup>1</sup>	Monetary Control	Seignorage Income <sup>2</sup>
Brazil			Yes	Yes
Chile				Yes
Colombia		Yes		Yes
India		Yes	Yes	Yes
Indonesia		Yes	Yes	Yes
Israel				Yes
Korea	Yes	Yes		Yes
Malaysia	Yes	Yes		Yes
Mexico	Yes	Yes		
Peru		Yes	Yes	Yes
Poland	Yes			Yes
Russia		Yes		Yes
Saudi Arabia		Yes	Yes	Yes
Singapore		Yes		Yes
South Africa	Yes <sup>3</sup>	Yes		Yes
Thailand			Yes	Yes

1. Where the requirement is adjusted to absorb excess liquidity.

2. The profit that results from the difference in the cost of printing money and the face value of that.

3. Since March 1998.

Source: Jozef Van't dack, 'Implementing monetary policy in emerging market economies: an overview of issues.' (www.bis.org/pub/plcy05b.pdf)

**TABLE 2.3: RESERVE REQUIREMENT RATIO BY COUNTRY**

Rank	Countries	Reserve requirement (percent)
1	Jordan	80
2	Suriname	35
3	Tajikistan	20
4	Croatia	19
5	Zambia	17.5
6	Estonia	15
7	China	10.5
8	United States	10
9	Ghana	9
10	Hungary	8.75
11	Burundi	8.5
12	Latvia	8
12	Bulgaria	8
14	Pakistan	7
15	India	6.5
15	Botswana	6.5
16	Chile	4.5
17	Switzerland	2.5
18	Slovakia	2
19	Sweden	0
19	Canada	0
19	Australia	0
19	Mexico	0
19	United Kingdom	0

Source: NationMaster.com (Economy Statistics)

mechanism of monetary policy is less effective. There are a number of limitations to using primary reserve requirements as an instrument of monetary policy. First, the effects of adjustments of the primary reserve requirements are only felt after a time lag when the need for adjustment may have fallen away. This is caused by administrative requirements, such as in Botswana, where there has to be an announcement of the adjustment (in an issue of the *Government Gazette*) and give a lead time notice (for example, a month) and a maintenance period that is ahead of the original decision. In contrast, changes in interest rates can be introduced quickly and as frequently as required. Second, primary reserve requirements can be seen as an implicit tax on banks, which distorts their operations and aids non-bank competitors. The reason for this is that such reserves typically do not earn interest, thus squeezing banks' margins and putting compensating upward and downward pressure on borrowing and savings rates, respectively. As a result, this could lead to disintermediation as borrowers and savers choose to conduct financial transactions

outside the banking system; in the process the transmission channels of monetary policy could also be adversely affected.

### 3. CONDUCT OF MONETARY POLICY IN BOTSWANA

#### (a) Evolution of the Monetary Policy Framework

3.1 The fundamental objectives of the Bank of Botswana have not changed since its establishment in 1975, with a continuing focus on maintaining monetary and price stability, a sound banking and financial system and an efficient payments mechanism.<sup>16</sup> However, over time the monetary policy framework has evolved to align the interpretation of these objectives with the transformation of the economy, including regional and international linkages, as well as improvements in institutional and operational capacity.

3.2 As is common elsewhere, the monetary policy framework specifies the ultimate policy objective, together with the relevant intermediate targets and policy instruments. As indicated in Table 2.4, the history of monetary policy in Botswana can be considered in terms of five distinct episodes. From the time of monetary independence in 1976<sup>17</sup> to 1991 (pre-financial liberalisation), monetary policy focused mainly on the smooth running of the financial/banking system and moderating the cost of credit. For much of this period, inflation was frequently in double digits; although at the time this was generally regarded as manageable, in part through revaluation of the exchange rate. Implementation of monetary policy in this period was through direct controls, including prescribing both lending and deposit interest rates, credit limits and reserve requirements.<sup>18</sup> However, the increase

in financial flows associated with the growth of the economy and, in particular, the large surpluses and liquidity inflows generated by diamond mining resulted in a rapid build-up of excess liquidity in the financial system. In turn, these posed challenges for the conduct of monetary policy. This was because instruments, such as the Bank Rate and reserve requirements, were not adequate to deal with the evolving liquidity situation, while the regulated interest rates were often set too low relative to inflation, a situation that encouraged excess demand for credit, which contributed to inflationary pressure. Moreover, efficient deployment of financial resources was constrained due to the limited range of financial institutions and instruments while external outflow was restricted by exchange controls.<sup>19</sup>

3.3 Major financial reforms took place in 1989 when there was a change in policy direction from a rigid regime of low interest rates as a stimulus for investment and economic growth to absorption of excess funds from the banking sector. Initially, the main focus of the reform was on attaining positive real interest rates in order to encourage savings and promote lending for productive purposes, although price stability was also an important consideration. To facilitate the absorption of excess liquidity, a call account facility at the Bank of Botswana was opened to the public. The report, 'Botswana: Financial Policies for Diversified Growth' (World Bank, 1989),<sup>20</sup> provided the impetus for accelerating financial liberalisation; this included the introduction of regular auctions of Bank of Botswana Certificates (BoBCs), which replaced the Bank's call account facility. The reforms encompassed removal of direct controls on the financial sector, as a move towards greater reliance on, and development of, market-based

<sup>16</sup> Bank of Botswana Acts, 1975 and 1996

<sup>17</sup> The introduction of the Pula as the national currency, replacing the South African rand.

<sup>18</sup> Depending on the purpose for which they are used, reserve requirements can be considered either as a direct instrument (setting a prudential minimum level of reserves to underpin depositors'

confidence in the banks) or an indirect one (influencing overall monetary expansion through the money multiplier). During the period in question, the former interpretation is more relevant.

<sup>19</sup> Various Bank of Botswana *Annual Reports*.

<sup>20</sup> The report received input from the IMF, Ministry of Finance and Development Planning and Bank of Botswana.

**TABLE 2.4: EVOLUTION OF THE MONETARY POLICY FRAMEWORK**

Period	Primary objective of monetary policy	Operational methods/instruments of monetary policy
Pre–1991	To resolve anomalies in the banking system caused by rising excess liquidity, including commercial banks' unwillingness to take deposits from certain large depositors and a shift out of longer-term interest bearing deposits into shorter-term deposits (current and call deposits).	<ul style="list-style-type: none"> <li>• Direct tools of monetary control.</li> <li>• Major policy instrument: regulated interest rates for deposits and lending.</li> <li>• Other policy instruments (primary reserve requirements and Bank Rate) also existed, but were not effective due to excess liquidity.</li> <li>• Bank of Botswana call account was used to absorb excess liquidity from commercial banks and certain large depositors.</li> </ul>
1991–1998	The principal objective was to maintain real interest rates in line with those prevailing in major international markets to stabilise capital flows, while price stability was increasingly emphasised.	<ul style="list-style-type: none"> <li>• Commencement of financial liberalisation.</li> <li>• Indirect monetary policy tools: BoBCs introduced in 1991 to absorb excess liquidity.</li> <li>• The call account facility at the Bank of Botswana was discontinued.</li> <li>• Major policy instrument: Bank Rate became relevant as a signalling device.</li> <li>• Determination of auction amounts and pricing of BoBC and the Bank Rate through monthly meetings of the Open Market Coordination Committee (OMCC).<sup>1</sup></li> </ul>
1998–2001	Promoting and maintaining monetary stability (as reflected in low and stable rate of inflation) and maintaining positive real interest rates as measured by short-term effective yield on three-month BoBCs.	<ul style="list-style-type: none"> <li>• The annual Monetary Policy Statement (MPS) was introduced in 1998, and became an important pillar of monetary policy.<sup>2</sup> However, the MPS did not initially specify price stability in terms of a numerical objective.</li> <li>• Repos and reverse repos were introduced in 1998 to supplement use of Bank of Botswana Certificates (BoBCs) in money market operations.</li> <li>• The delineation of responsibilities was clarified with the Monetary Policy Committee (MPC)<sup>3</sup> setting the Bank Rate and giving guidance on the pricing of BoBCs to the Open Market Auction Committee (OMAC), which also determines auction amounts.</li> </ul>
2002–2007	To achieve a sustainable, low and predictable level of inflation.	<ul style="list-style-type: none"> <li>• An annual objective for inflation was introduced in 2002, initially at 4 – 6 percent (see Table 3.2).</li> <li>• A rolling medium-term (3-year) objective was introduced in 2006, initially running concurrently with the annual objective.</li> <li>• Growth in commercial bank credit used as an intermediate target, consistent with economic growth, the inflation objective and taking into account financial deepening.</li> <li>• The increase in government spending was also monitored for consistency with expected output and credit growth and the inflation objective.</li> </ul>
2008–	To achieve a sustainable, low and predictable level of inflation.	<ul style="list-style-type: none"> <li>• Annual objective and credit growth target dropped.</li> <li>• Medium-term objective maintained, with an enhanced role for the medium-term inflation forecast in guiding policy decisions. The inflation forecast effectively becomes the intermediate target, although other factors are also considered.</li> </ul>
<p><sup>1</sup> The OMCC included representation from the Ministry of Finance and Development Planning.</p> <p><sup>2</sup> See, for example the 2000 MPS, which explains the role of the Statement in establishing the framework and objectives for domestic monetary policy.</p> <p><sup>3</sup> The MPC comprises Bank of Botswana senior management staff.</p>		

mechanisms. The new approach contributed to improvement in monetary policy formulation. Other financial sector developments included enhanced competition through an increase in the number of financial institutions and range of products, as well as the strengthening of prudential regulation and the supervisory

framework. Correspondingly, the Banking Act replaced the Financial Institutions Act in 1995, while a new Bank of Botswana Act was promulgated in 1996.

3.4 By the late 1990s, price stability had become the unambiguous objective of monetary



policy,<sup>21</sup> and this was underscored by the publication of the annual MPS from 1998, which set out a transparent framework for the conduct of monetary policy. Initially, the MPS did not include a specific (i.e., numeric) definition of price stability; this was introduced in the 2002 MPS, which included an annual inflation objective of 4 – 6 percent (Table 2.5). Alongside the annual inflation objective, an intermediate target for growth in commercial bank credit was introduced in 2006. Credit growth was chosen as a target because it is an important driver of domestic demand that can be monitored on a timely basis; it is also directly influenced by monetary policy through adjustments to interest rates. The intermediate target for credit growth was set to be consistent with the expected real growth in the economy and the inflation objective, while also taking into account financial deepening. Growth in government expenditure, which is another important influence on domestic demand, was monitored in relation to the expected rate of output expansion and the inflation objective.

3.5 Monetary policy decisions also took account of other relevant domestic and international economic information. To supplement this, the Bank of Botswana has since 2003 also conducted a bi-annual Business Expectations Survey (BES) to help gauge current and prospective economic conditions as perceived by the business community in Botswana, including expectations of future inflation.

3.6 During this time, the Bank commenced work to develop capacity to forecast inflation through a more formal modelling process, which led to the next major changes in the monetary policy framework that were introduced in 2008. Since 2006, a medium-term objective for inflation was also included in the annual MPS, in consideration of the fact that a three-year horizon is the more relevant period for monetary policy decisions to have an impact on the real sector and inflation. In 2008, the medium-term inflation objective set at 3 – 6 percent became the sole definition

of price stability. At the same time, a formal medium-term forecasting framework was introduced. The intermediate target of credit growth, which is only one of several factors that determine inflation, was replaced with the medium-term inflation objective, the forecast of which includes more variables that have an impact on inflation, covering factors that affect both supply and demand.

3.7 In this framework, the policy response to inflationary pressures is based on an evaluation of the sources of inflation and the likely impact on future price developments. In particular, a distinction is made between factors that have a transitory impact, such as changes in consumption taxes, supply price shocks and those that are likely to have an enduring influence on inflation, especially changes in demand conditions, which are subject to monetary policy influence. Although the policy objective is set in terms of the headline measure of consumer price inflation, the analysis is supplemented by alternative measures of inflation, particularly the trimmed mean measure which removes volatile price movements that may obscure underlying trends and inflation excluding prices that are set administratively. This approach to policy formulation facilitates appropriate and timely responses to any sustained deviation of inflation from the objective.

3.8 It should be emphasised, however, that the monetary policy framework operated by the Bank of Botswana does not amount to inflation targeting. Even though there may be some similarities, there are important differences between the two policy regimes. Significantly, both the medium-term inflation objective and the conduct of monetary policy through decisions of the MPC are the Bank's operational interpretations of the price stability objective implied in the Bank of Botswana Act.<sup>22</sup>

<sup>21</sup> 1997 Bank of Botswana *Annual Report*, p.52.

<sup>22</sup> The 2008 Bank of Botswana *Annual Report* highlights the nuances in this regard.

## (b) Operational Methods/Instruments of Monetary Policy

- 3.9 Monetary policy decisions are made by the Monetary Policy Committee (MPC) and related monetary control aspects are implemented through the Open Market Auction Committee (OMAC).<sup>23</sup> The MPC meets six times a year and makes decisions guided by the policy stance as announced in the annual MPS that is reviewed mid-year. Each meeting of the MPC is followed by a press release containing the policy stance and highlights of recent economic developments and the inflation outlook. The policy decision, which may be the adjustment to the Bank Rate, guides the OMAC, which meets on a weekly basis to undertake BoBC auctions and decide on the quantum and pricing of BoBCs issued.
- 3.10 The main instruments used for the implementation of monetary policy in Botswana are the Bank Rate and open market operations; the latter consists mainly of the primary auctioning of BoBCs. Although the primary reserve requirements have also occasionally been adjusted to influence liquidity, the use of this instrument has been very rare. Open market operations are used to manage liquidity in the banking system and maintain short-term interest rates at levels that are supportive of the monetary policy stance and consistent with the price stability objective. The current practice is to auction 14-day and 91-day (3-month) BoBCs on a weekly and monthly basis, respectively. However, from their introduction in 1991 and up to 2001, a wider range of maturities was used for liquidity management (Table 2.5).<sup>24</sup> The primary counterparties for monetary operations are commercial and merchant banks, with other investors being excluded from participating in BoBC auctions since 2006.

3.11 To facilitate the day-to-day liquidity management between BoBC auctions, the Bank of Botswana also uses repurchase agreements (repos) and reverse repurchase agreements (reverse repos),<sup>25</sup> which were introduced in September 1998 and are available at the Bank's discretion to primary counterparties for periods ranging from overnight to one month. To further fine tune liquidity management both during the day and overnight, the Bank offers two credit facilities, the intra-day lending facility and the Secured Lending Facility (SLF). The latter provides emergency funding to commercial banks to bridge overnight liquidity shortages, but has a high penalty rate of 6 percent above the Bank Rate.

3.12 Although the Bank Rate is notionally the interest rate charged by the Bank for short-term borrowing by commercial banks (and has some practical relevance in determining the lending rate for the SLF), its principal use is to signal changes in the monetary policy stance. The banks typically respond to such signals by adjusting their own interest rates in line with changes in the BoBC Rate. While primary reserve requirements have been used sparingly in Botswana, they have been increased in recent years in response to the rapid growth in the stock of BoBCs. The level of primary reserve requirements was increased from 3.25 percent to 5 percent in February 2006 and from 5 percent to 6.5 percent in November 2010 (Table 2.5).

## (c) Evaluating Monetary Policy Performance

3.13 This review of policy operation and performance examines developments with respect to control of liquidity, interest rate structure and the success or otherwise of achieving price stability. Among the factors affecting the operation of monetary policy are

23 The previous Open Market Coordinating Committee (OMCC) was replaced by the MPC and OMAC in 2001.

24 Republic of Botswana *Government Gazette* of April 26, 1991, stipulated that the Bank of Botswana may at any time issue BoBCs for any maturities up to one year.

25 For a repo, the primary counterpart (commercial bank) sells BoBCs back to the Bank, at lower interest rate than the original purchase yield, while for a reverse repo the commercial bank buys back BoBCs at a higher interest rate (currently four percentage points above the repo rate).



**TABLE 2.5: SIGNIFICANT CHANGES IN MONETARY OPERATIONS AND OBJECTIVES**

Year	Nature of Changes	Objective
1991	• Introduction of BoBCs with varying maturities of up to 12 months	• Liquidity absorption measure
1994	• Change from multiple reserve requirements to a single reserve requirements based on total deposits of 3.25 percent	• Efficiency measure
1996	• Streamlining of disbursement arrangements between Bank of Botswana and Government of Botswana	• Cost cutting measure on monetary operations
1998	• Repos and Reserve Repos introduced	• Short-term liquidity management
	• Secured Lending Facility (set at 6 percent above Bank Rate)	• Bridging commercial banks' overnight liquidity shortages
2001	• 3-month BoBC (91-days) used as the primary instrument	• Effectiveness of OMOs and development measure
2002	• Annual inflation objective introduced and set at 4 – 6 percent	• Anchoring inflation expectations
	• Inflation objective 4 – 7 percent	
	• Outright purchase of BoBCs between Bank of Botswana and commercial banks discontinued	• Accommodation of inflationary effect of 7.5 percent Pula devaluation
	• 14-day BoBCs introduced	• Secondary market development measure
2004	• BoBC auction changed from fixed to uniform price auction	• Efficiency measure
2005	• Inflation objective of 3-6 percent and mid-year adjustment to 4-7 percent	• Accommodation of inflationary effects of 12 percent Pula devaluation
	• Medium-term (3-year rolling horizon) inflation objective set at 3-6 percent	• Price stability objective can reasonably be achieved in the medium-term
	• Participation of BoBCs auctions confined to commercial and merchant banks	• Efficiency and international best practice
	• Reserve requirement adjusted upward to 5 percent	• Liquidity control measure
2006	• Introduction of Intra-Day Lending Facility	• Promote efficient settlement
2008	• Annual inflation objective dropped	• Price stability objective can reasonably be achieved in the medium-term
2010	• Upward adjustment of reserve requirements to 6.5 percent	• Liquidity control measure

excess liquidity, the degree to which the money market is developed and the competitiveness of participants in the primary and secondary money markets. Beyond the objectives of the monetary policy framework, a further criterion of success is the extent to which there has been progress in easing constraints to effective liquidity management.

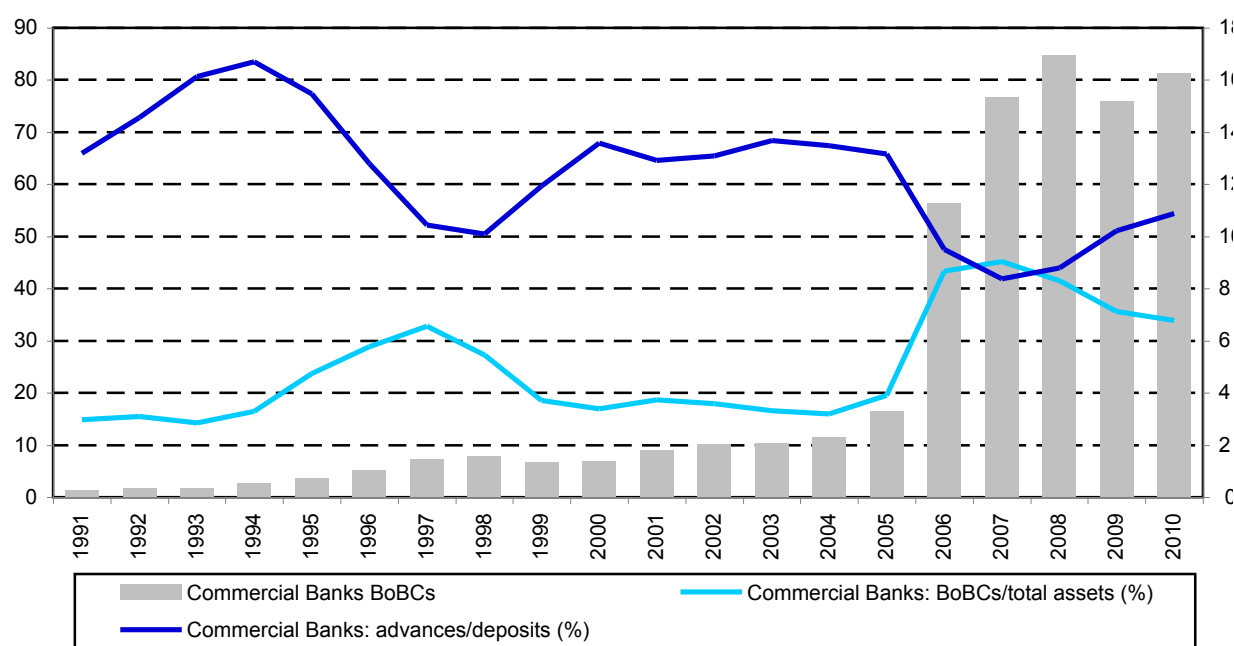
#### *Liquidity control*

- 3.14 The objective of liquidity management is to facilitate the attainment of market interest rates at levels that are consistent with the monetary policy stance. Liquidity imbalances (excess or shortage) can have a major impact on the economy, as well as the costs and efficiency of monetary operations. Surplus funds may spill over into the economy through excessive and risky lending, which would contribute to inflationary pressures and financial instability. Conversely, a shortage of liquidity could result in tighter credit conditions that could

undermine demand, production and economic growth. Such effects have recently been demonstrated during the global financial crisis, whereby excess liquidity and easy access to credit were followed by the 'credit crunch', and the ensuing recession in many countries.

- 3.15 Since introducing BoBCs in 1991, they have been largely successful in reducing excess liquidity in the banking system. The early success of the instrument was documented in the 1991 *Bank of Botswana Annual Report*. Notably, for the first time since the establishment of the Bank of Botswana, commercial banks borrowed from the central bank to meet shortfalls in their primary reserve requirements, because their excess funds had been used up in BoBCs. Similarly, banks' refusal to accept deposits, as had happened in the 1980s, did not recur. Since BoBCs earn interest, some banks are able to remunerate deposits by offering BoBC-linked deposit facilities.
- 3.16 Nevertheless, the success in absorbing liquidity

**CHART 2.1: COMMERCIAL BANKS-RATIOS OF LOANS AND ADVANCES TO DEPOSITS AND BoBCs TO ASSETS (LHS), AND AVERAGE OUTSTANDING BoBCs (RHS)**



Source: Commercial and Merchant Banks

is based on a continued willingness by the central bank to absorb surplus funds from banks, a factor that has led to a rapid growth in outstanding stock of BoBCs. In particular, the establishment and funding of the Public Officers Pension Fund, which resulted in the effective repatriation of a large portion of the country's foreign exchange reserves, led to a rapid expansion in BoBCs, despite increased availability of alternative investments, including both government and corporate bonds. Overall, however, it is notable that the cost of monetary operations has been stable over time (Table 2.6). Moreover, Chart 2.1 shows that, up to 2005, BoBCs have been largely stable relative to total commercial banks' assets. The significant fall in advances to deposit ratio in the 1990s partly reflects the increase in deposit mobilisation associated with entry of new banks; while monetary policy focus on price stability and the attainment of positive real interest rates restrained credit growth. As explained below, the surge in the ratio of BoBCs to banking assets in the latter period partly reflects the funding of the Public Officers Pension Fund and the Bank's decision to confine access to BoBCs solely to commercial and merchant banks (market makers or primary counterparts), given BoBCs role as an instrument of monetary policy.

### *Interest Rate Structure*

3.17 Implementation of monetary policy through indirect tools has also improved the role of interest rates in the monetary transmission process. Sales of BoBCs to absorb excess liquidity establish a benchmark interest rate for commercial banks for short-term riskless investments. At the same time, in contrast to a system of direct controls on interest rates, the structure of banks' lending and deposit interest rates is determined by the market, which then promotes efficient resource allocation. Therefore, additional evidence of the success of monetary policy is the interest rate structure where, in some cases, positive real interest rates have been attained, especially for lending and the higher earning deposit facilities. There is also evidence of effective policy transmission over the long term, shown by the common direction and largely stable margins for the real money market interest rates (Chart 2.2).

3.18 It has been suggested that monetary policy operations have had the effect of increasing interest rates and commercial banks' profitability while, at the same time; there is little evidence that interest rates have had a

**TABLE 2.6: AVERAGE OUTSTANDING STOCK OF BOBCS AND INTEREST COSTS**

Year	Average Outstanding BoBCs (P million)	BoBC Interest Expense (P million)	Interest Expense/Average Outstanding BoBCs (Percent)
2000	4 039	501	12.4
2001	4 748	567	11.9
2002	6 352	749	11.8
2003	9 070	1 182	13.0
2004	9 271	1 123	12.1
2005	11 630	1 296	11.1
2006	13 649	1 589	11.6
2007	16 052	1 839	11.5
2008	17 767	2 062	11.6
2009	16 735	1 623	9.7
2010	18 176	1 229	6.8

Source: Bank of Botswana

significant impact on borrowing and saving decisions. In this regard, the 2007 Financial Sector Assessment Programme (FSAP) suggested that interest rates in Botswana are higher than those prevailing elsewhere in the Southern African Customs Union (SACU) region. However, such comparisons may not be helpful given differences in circumstances from country to country. Table 2.7, shows

pursuit of different monetary objectives between the country and the rest of the SACU countries; this includes insuring that interest rates are positive in real terms. Moreover, although the banks may appear to benefit from being the sole holders of BoBCs, there is scope for the banks to pass on some of the benefit through linked deposit products and offer a commensurate rate of return. To the extent that profits of Botswana banks could be considered to be very high, it is mainly a reflection of the continued insufficient competition in the banking sector which may still be viewed as oligopolistic.<sup>26</sup> This structural problem cannot be addressed by diluting monetary policy formulation. Thus, unwarranted maintenance of low interest rates for purposes of reducing the profitability of banks and/or lowering the cost of monetary operations would act as a disincentive to saving and potentially result in less productive lending. It could also have adverse consequences for both financial sector development and economic performance.

- 3.20 The impact of interest rates on household borrowing and saving decisions was covered in the *Bank of Botswana Annual Report*

**TABLE 2.7: DIFFERENCE BETWEEN LENDING RATES AND DEPOSIT RATES (PERCENT) FOR SELECTED SUB-SAHARAN COUNTRIES**

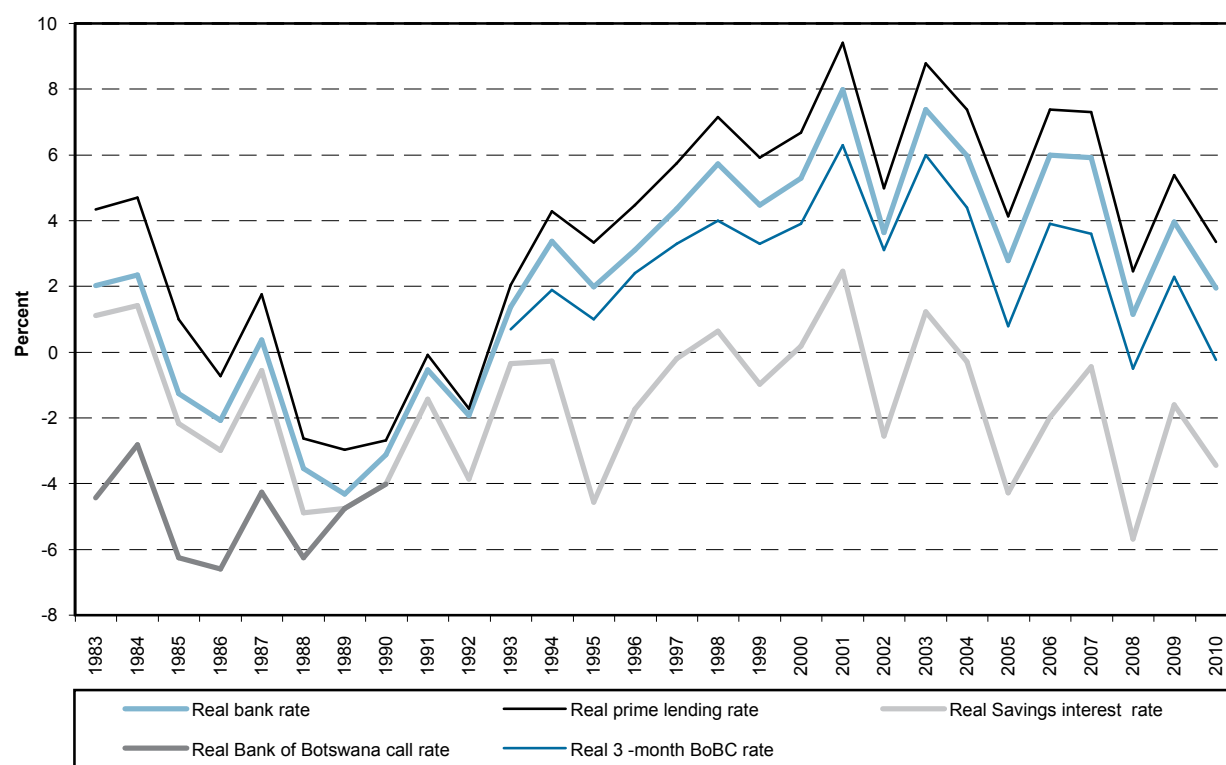
	Botswana	Angola	Kenya	Lesotho	Mauritius	Zambia	Gambia	South Africa
2000	5.57	43.61	13.44	12.50	11.00	17.80	11.50	5.05
2001	5.94	41.58	13.37	11.83	11.00	22.30	11.50	4.23
2002	5.98	58.70	11.99	11.92	11.00	19.70	11.50	5.55
2003	6.26	66.75	10.50	8.75	11.25	16.60	19.50	5.18
2004	5.81	55.94	9.23	8.02	14.25	19.10	14.50	4.97
2005	6.89	41.76	7.44	7.25	13.25	17.33	19.00	4.48
2006	7.79	11.56	9.00	8.66	10.50	11.30	17.00	3.97
2007	7.44	5.49	8.29	8.00	11.51	12.00	14.30	4.00
2008	7.63	3.34	8.43	8.73	10.25	14.03	16.50	3.42
2009	5.71	3.56	8.87	7.73	10.90	15.68	11.50	3.20

Source: International Financial Statistics (IFS), August 2010, International Monetary Fund

the spread between deposit and lending rates for a number of African countries, mainly in Southern Africa.

- 3.19 While Botswana is a member of SACU, it is not part of the Rand Monetary Area (RMA). There is, therefore, greater freedom for the

<sup>26</sup> Using the Herfindahl-Hirschman Index, at 0.21 for 2009, the concentration in the local banking sector remained higher than the 0.18 upper threshold for moderate concentration (see the Bank of Botswana's *Banking Supervision Annual Report, 2009*). This reflects the continuation of a small number of banks which may, in turn, limit competition. However, the index has been on a clearly downward trend in recent years, indicating that this market dominance by a few large banks is steadily declining. Moreover, increased market share of the smaller banks is itself a sign of effective competition.

**CHART 2.2: SELECTED REAL INTEREST RATES**


Source: Bank of Botswana and Commercial Banks

2009. Other than interest rates, there are several factors that influence preferences for saving and borrowing. In particular, large and regular increase in wages and expansion of banking services could contribute to an improvement in access to credit, which may obscure the effect of changes in interest rates. Moreover, in cases where levels of borrowing are maintained in the face of higher interest rates, it implies that, given the same level of disposable income, expenditure on other goods and services is correspondingly reduced, resulting in the desired overall impact on demand.

### *Inflation Performance*

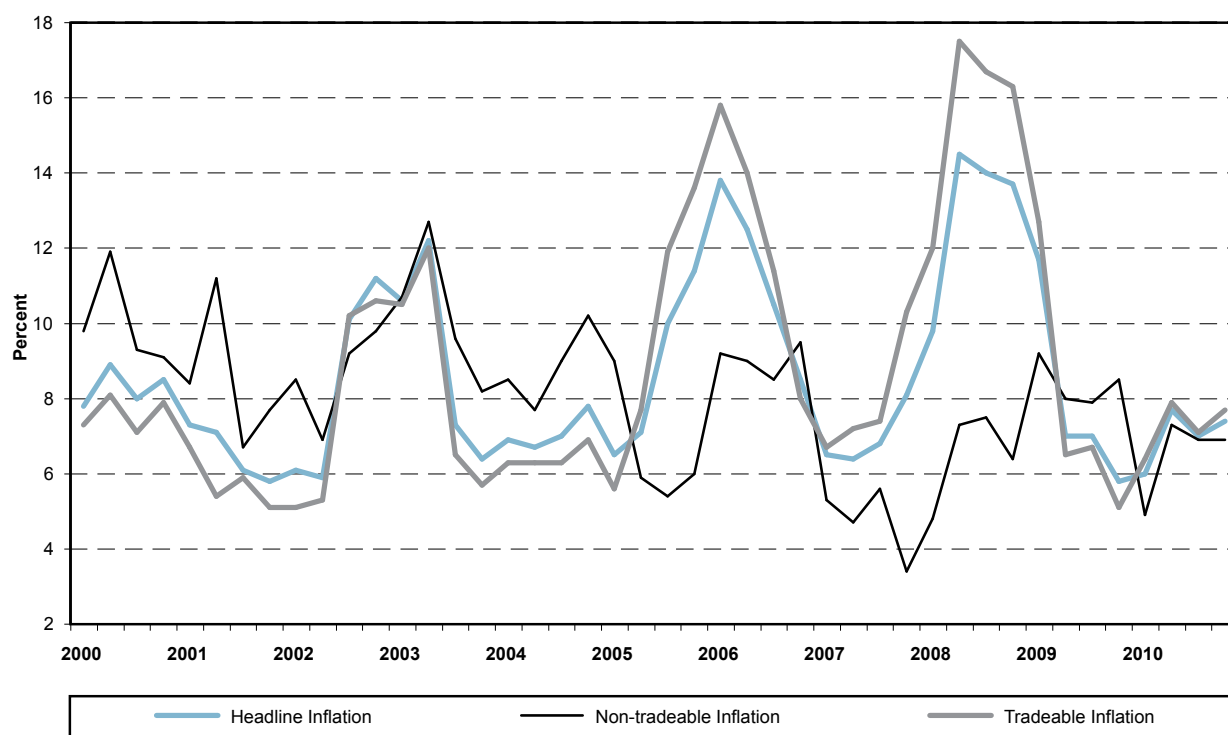
- 3.21 Chart 2.3 (overleaf) shows overall headline consumer price inflation and inflation for tradeable and non-tradeable goods and services. The inflation performance reflects both the monetary policy response and the impact of exogenous and supply side shocks. Monetary policy does not influence all the factors that contribute to inflation, and its major impact is on demand and supply through

capacity expansion derived from spending on investment. From this perspective, special consideration needs to be given to the impact on inflation of the supply-side and transient factors. Hence, in formulating the monetary policy stance, the Bank closely monitors the sources of any changes in inflation and addresses the changes due to domestic demand pressures, rather than those that may be due to transitory factors or supply fluctuations on which monetary policy would have no immediate direct influence.

- 3.22 For Botswana's small, open economy, the main source of supply side shocks is movements in international prices, especially an increase in the cost of imports of food and oil, as was the case in 2007 and 2008. The price increase, together with the related weight in the consumer basket of goods and services that is used to calculate the Consumer Price Index (CPI),<sup>27</sup> resulted in a significant impact of the international price movement on

<sup>27</sup> The combined weight of food and petroleum-related products in the CPI basket is approximately 30 percent.

CHART 2.3: INFLATION-TRADEABILITY ANALYSIS



Source: Central Statistics Office

overall inflation, pushing it well outside of the top end of the 3–6 percent objective range. This development did not signal the failure of monetary policy; in fact, the rate of price increase for other goods and services was more restrained. The monetary policy tightening response, at the time, was not intended to offset the impact of the supply shock, but to limit the extent of second-round effects (i.e., knock-on increases in prices elsewhere) that could have resulted in a prolonged period of inflation. The subsequent return to the inflation objective range, after fuel and food prices had moderated, suggested that monetary policy was broadly successful. This is also supported by the path of non-tradeables inflation which had been more stable and less responsive to external shocks.

- 3.23 Transient factors are price movements that are judged to be one-off and do not have a lasting impact on inflation. Examples of transitory factors include indirect taxes and other levies on consumption, adjustments to the exchange rate and some changes to administered prices (e.g., the reintroduction of secondary

school fees in 2006). Table 2.8 shows several occurrences of one-off price shocks since 2002. When the value added tax (VAT) was increased from 10 percent to 12 percent in April 2010, inflation increased by approximately 1.7 percentage points. Otherwise, the level of inflation would have been within the 3–6 percent objective range for most of 2010. Since, by their nature, the initial impact of transient factors is subsequently reversed, the policy response should not focus on the short-term effect on inflation, but rather the impact on expectations of future inflation. For this reason, the Bank has not always responded to such developments through policy tightening<sup>28</sup> and, given the frequency of transient upward shocks in recent times, headline inflation has frequently been above the objective range.

#### (d) Complementary Measures of Monetary Control

##### 3.24 The chronic excess liquidity in the banking

<sup>28</sup> For example, when VAT was first introduced in July 2002, the Bank of Botswana issued a press release explaining why it would not respond to the resultant increase in inflation by raising interest rates.



**TABLE 2.8: SUPPLY SIDE AND TRANSIENT FACTORS AFFECTING INFLATION, 2002 – 2010**

Year	Sources of Inflationary Pressure	Estimated Impact on Inflation (Percent)
2002	Introduction of VAT, drought conditions in southern Africa, new BTC billing system	4 – 6 (VAT)
2004	7.5 percent Pula devaluation and increase in administered prices	2 (Pula devaluation)
2005	12 percent Pula devaluation and increase in administered fuel prices	3 – 4 (Pula devaluation)
2006	Reintroduction of secondary school fees	1.1
2008	Increase in food prices	1
	Increase in fuel prices	4.4
	Introduction of 30 percent alcohol levy	2.3
2010	VAT increased from 10 percent to 12 percent	1.7
	Increase of alcohol levy to 40 percent	0.8

Source: Bank of Botswana

system and the resultant high cost of monetary policy operations incurred when using market-based policy instruments suggests a need to continually assess the costs and benefits of alternative approaches to monetary control. The alternatives to open market operations and policy signals through changes in the policy interest rate include the use of primary reserve requirements, direct controls on interest rates and the allocation of credit. In weighing the benefits and costs of these alternative methods, consideration is given to the potential impact on financial development and efficiency of intermediation, as well as the need to share the burden (and benefits) of regulating excess liquidity across relevant stakeholders. In particular, the absorption of excess liquidity can include a mix of open market operations and, where appropriate, changes in primary reserve requirements, as well as the development of an enhanced government securities programme that would be above and beyond what is required to fund its own operations.

#### *Government Securities*

- 3.25 The issuance of additional government debt would result in some of the costs arising from excess liquidity being borne directly by the Government; and whether or not this would be beneficial overall would depend on given circumstances. If lending to the government is regarded as more risky than central bank debt, then the total cost of liquidity

absorption could increase. However, this is unlikely to be a major problem in Botswana due to Government's budgetary and overall financial management that is attested by the investment grade sovereign credit ratings. Additionally, there are potential benefits in giving the central bank leeway to focus on price stability without undue concerns about the costs of monetary operations, while the Government is better placed to lead a broader based bond issuance programme that supports capital market development. In this regard, in February 2011, the Government raised its bond issuance from P5 billion to P15 billion, which potentially would over time result in a reduction in funds absorbed through BoBCs. Moreover, this widens the saving channels and sources of income for the general public.

#### *Primary Reserve Requirements*

- 3.26 An extensive use of the primary reserve requirement has significant disadvantages for the development of the money and capital markets, some of which have already been discussed (see paragraph 2.44). In particular, requiring the banks to hold large portions of their assets as non-interest bearing deposits would have negative consequences for banks' own customers (for example, banks refusing to accept interest-earning deposits), thus negating the very clear benefits gained from the introduction of BoBCs.
- 3.27 Moreover, when excess liquidity is not evenly

distributed in the banking sector and, at the same time, the inter-bank market is not functioning smoothly, an increase in reserve requirements may retard the growth of smaller banks with liquidity shortages. Therefore, in circumstances where, to be binding, they need to be maintained at a very high level, reserve requirements could be inimical to financial market development. However, they can serve as an effective monetary control tool where excess liquidity is endemic and, therefore, used to reduce the extent of monetary operations. In this respect, the primary reserve requirement has in recent times, been raised from 3.25 percent to 5 percent in February 2006 and to 6.5 percent in November 2010. Given the extent of excess funds in the banking system and a relatively low advances to deposits ratio, it is not considered that this move signals monetary policy tightening; thus, it would not constrain credit allocation nor necessarily (on its own) result in a higher cost of borrowing.

#### *Direct Controls*

- 3.28 Other forms of direct control, regulation and administrative setting of interest rates and/or limits for credit and its allocation could be a second-best solution where there is a perception of market failure and where there is need to address a financial crisis. Direct regulation is also often appealing to policy makers because there are no apparent direct and immediate operational and fiscal costs to the central bank and the Government. However, the use of direct controls generally results in inefficient resource allocation, while such measures usually become ineffective over time as they are easily circumvented with the development of new financial products and instruments.
- 3.29 Another manifestation of the inefficient use of resources due to direct controls is that time and funds are not devoted to financial development, but to regulatory arbitrage. This results in below-potential financial intermediation, thus a low rate of savings mobilisation and the funding of less productive investments. Reduced intermediation by the

regulated banking sector leads to further loss of monetary control, since monetary policy is mainly transmitted through formal institutions and processes. Therefore, monetary policy objectives are less likely to be attained because of diluted impact of the controls. Moreover, the widespread lifting of capital controls internationally, globalisation of financial markets and innovation surrounding financial instruments and payments methods have rendered the use of direct monetary controls untenable and potentially only suitable for emergency situations. Overall, direct controls are not only distortive, but ineffective in the context of globalisation, integrated markets and innovation.

- 3.30 However, in recognition of the oligopolistic structure of the banking system and relatively low level of financial literacy, the Bank uses moral suasion to influence commercial bank behaviour and consumer response in order to foster appropriate policy transmission. Among others, the Bank uses the regular consultations with the commercial banks to influence proper policy transmission and highlight consumer protection issues. In this regard, since 2009 the Bank has required banks to regularly publish in print media schedules of interest rates for various products in order to promote knowledge of banking products, competition and informed consumer choice. Specific to the interest rate structure and transmission of policy changes, the Bank also now requires banks to publish the interest rate on a three-month deposit, which should not be more than 4 percentage points below the Bank Rate. It is expected that other interest rates would be set commensurately along the maturity spectrum, consistent with an upward sloping yield curve. The Bank was also influential in ensuring the publication of a Code of Banking Practice by the Bankers Association of Botswana which should foster a good relationship and communication between banks and their customers.



**(e) Challenges and Constraints to Monetary Policy Implementation**

3.31 The challenges and constraints to monetary operations include endemic and substantial banking system liquidity and the relatively high costs of liquidity absorption in an environment of weak and fragmented money and capital markets, paucity of financial instruments to support monetary policy and nascent inter-bank markets. Historically, the factors contributing to the accumulation of substantial funds in the banking system in Botswana included large receipts of mineral revenue by mining companies and public finance disbursement practices, while the privatisation of the public sector pension system in 2002 also added significantly to funds in the banking system. In turn, excess liquidity arises because of limited domestic investment opportunities for productive deployment of these funds. As the capital market remains underdeveloped in terms of institutions, instruments and liquidity, a large amount of financial saving is channelled through the banking system. However, several administrative measures have been undertaken to alleviate excess liquidity arising from mining revenue and government disbursement procedures. In particular, the Government's share of Debswana's foreign receipts is paid directly into the Bank of Botswana accounts abroad and the disbursement of Government funds to local authorities and parastatals is effected closer to the actual spending need.

3.32 Prior to the establishment of the Botswana Public Officers' Pension Fund, the rate of increase of outstanding BoBCs averaged approximately 12.6 percent per annum (5 percent after adjusting for inflation) between 1996 and 2001, compared to average nominal GDP growth of 16.9 percent. However, in the subsequent four years, the level of outstanding BoBCs increased by 141 percent, at an average annual nominal rate of 19.5 percent (11 percent in real terms), compared to much lower average annual nominal GDP growth of 10.5 percent. As a result, the share of BoBCs

in Bank of Botswana's liabilities increased from 12.5 percent in 2002 to a peak of 39.4 percent in 2004, before stabilising at around 30 percent (Chart 2.4).

3.33 The growth trend reflects both the initial large transfer of the cumulative pension liabilities and the subsequent regular contributions by the Government and employees. Previously, these funds were effectively sterilised directly by the Bank of Botswana as government deposits. With the transfer to the private sector, the absorption is now undertaken through a less direct route.<sup>29</sup> In terms of investment profile, a larger proportion of the funds are placed offshore as shown in Chart 2.5 (the legislation allows for up to 70 percent to be invested externally).<sup>30</sup> However, for the portion that is in the domestic market, a substantial share is invested in short-term high-yielding BoBC-related products. This reflects a shortage of longer-term domestic investment opportunities that still prevails, despite the increased volume of government and corporate bonds.<sup>31</sup> From this perspective, it is clear that the expansion of domestic productive capacity and infrastructure are not constrained by a shortage of funds.<sup>32</sup> Chart 2.6 shows trends and the relative size of BoBCs and corporate and government bond issues.

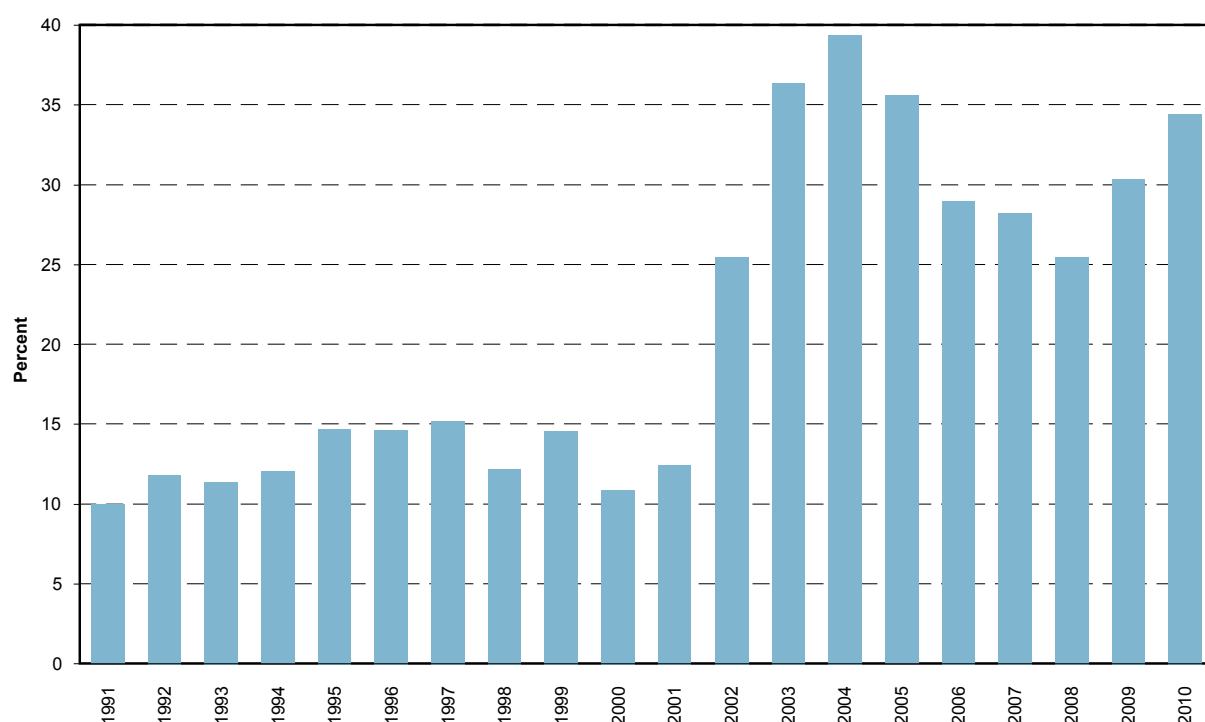
3.34 Apart from the broader structural aspects, it is also possible that inefficient portfolio

<sup>29</sup> An initial amount of P4.9 billion was transferred from the government account at the Bank of Botswana to BPOPF in 2001 and other substantial transfers followed.

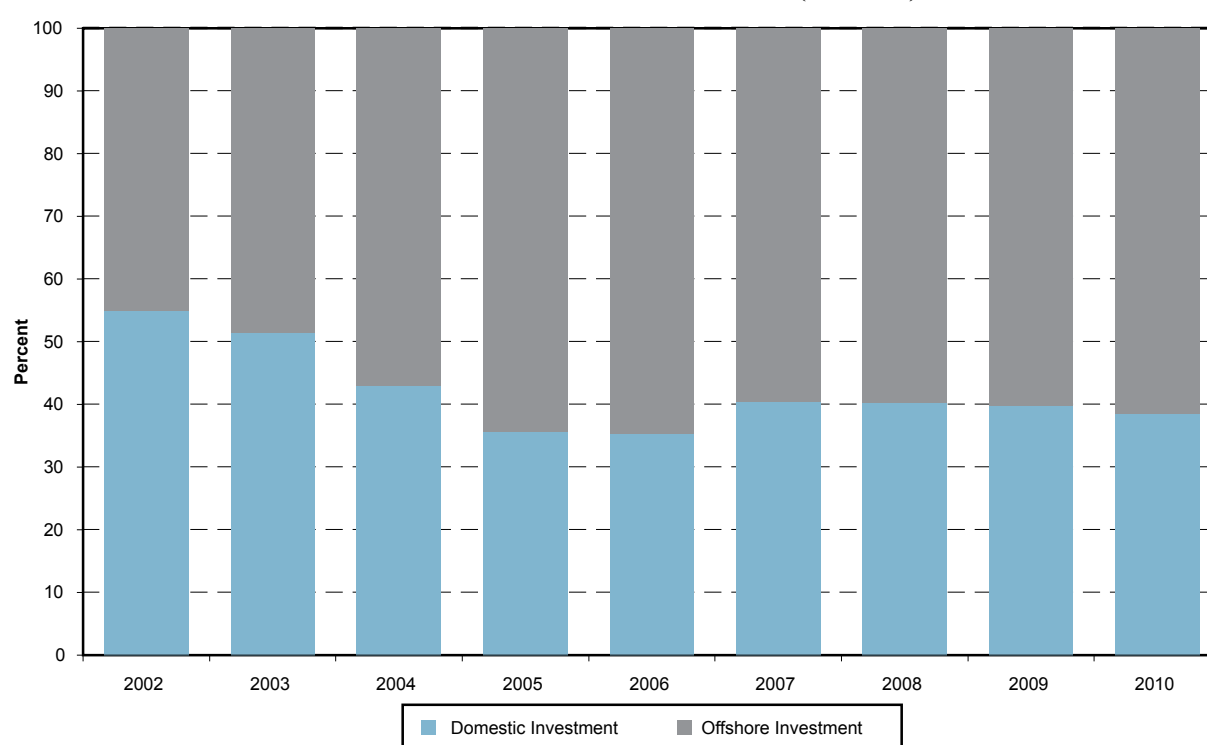
<sup>30</sup> As a prudential measure, pension funds are required to retain at least 30 percent of their assets onshore, much of which is used by banks to purchase BoBCs (Chart 2.5).

<sup>31</sup> After an initial issue of P2.5 billion in 2003, a regular government securities programme of P5 billion was introduced in 2008; this was augmented to P15 billion in February 2011, although it might take longer to have government securities issued up to this level.

<sup>32</sup> It seems unlikely that BoBCs would be a first choice by pension funds and insurance companies, which typically prefer to invest in long-term securities to match the profile of their liabilities. For instance, the Government of Kenya introduced a 25 year treasury bond in 2010 to lengthen the maturity profile of domestic debt and to accommodate the interest of long-term investors (Central Bank of Kenya).

**CHART 2.4: BOBCS/TOTAL BANK OF BOTSWANA LIABILITIES**

Source: Bank of Botswana

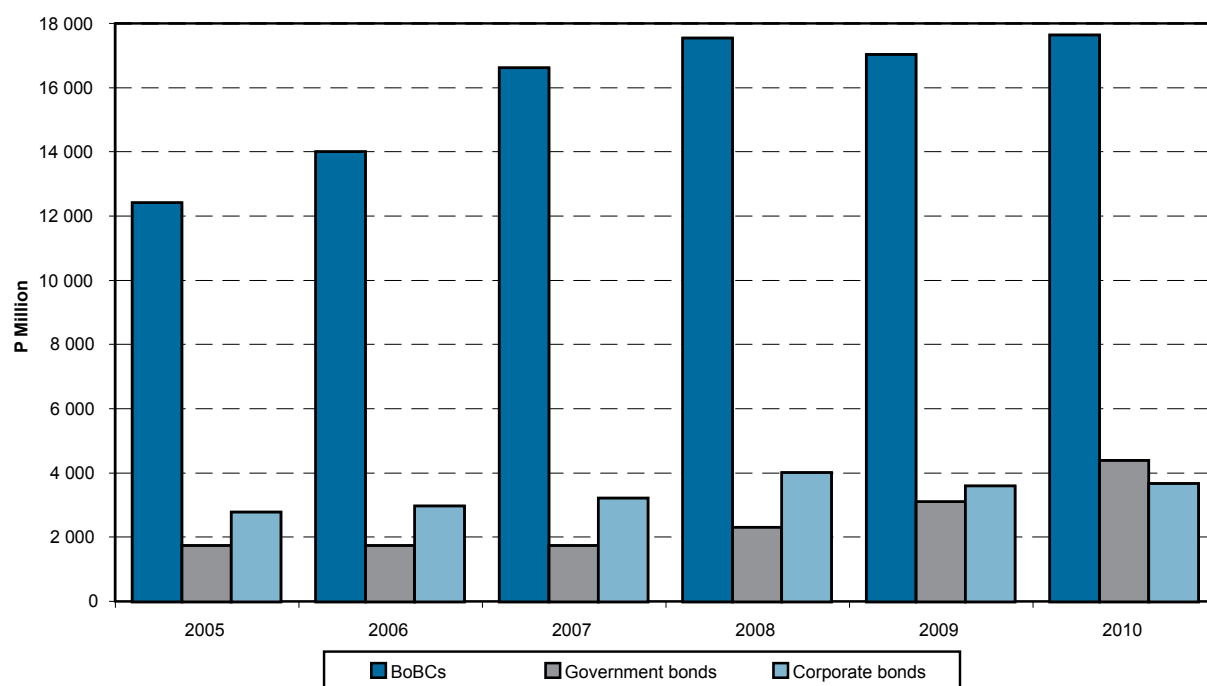
**CHART 2.5: PENSION FUNDS – DOMESTIC AND OFFSHORE PORTFOLIOS (PERCENT)**

Source: Ministry of Finance and Development Planning and Non-Bank Financial Institutions Regulatory Authority

management by investors, banks and their customers could exacerbate the difficulty in regulating excess liquidity. Notably, if large savers at commercial banks hold short-term

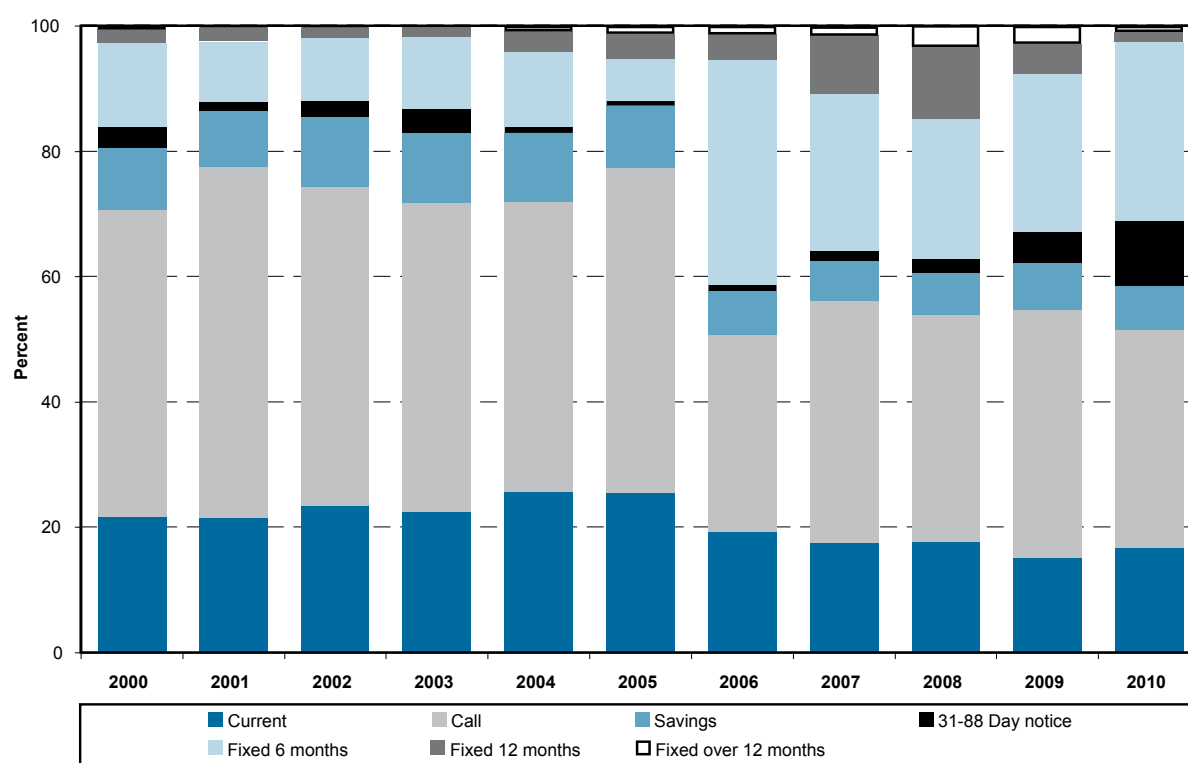
deposits, either because of shortage of long-term investment opportunities or due to sub-optimal cash management practices, banks would, in turn, keep excess reserves in the

CHART 2.6: BONDS AND BoBCs OUTSTANDING



Source: Bank of Botswana and Stockbrokers Botswana Ltd.

CHART 2.7: COMMERCIAL BANKS DEPOSITS – PERCENTAGE DISTRIBUTION



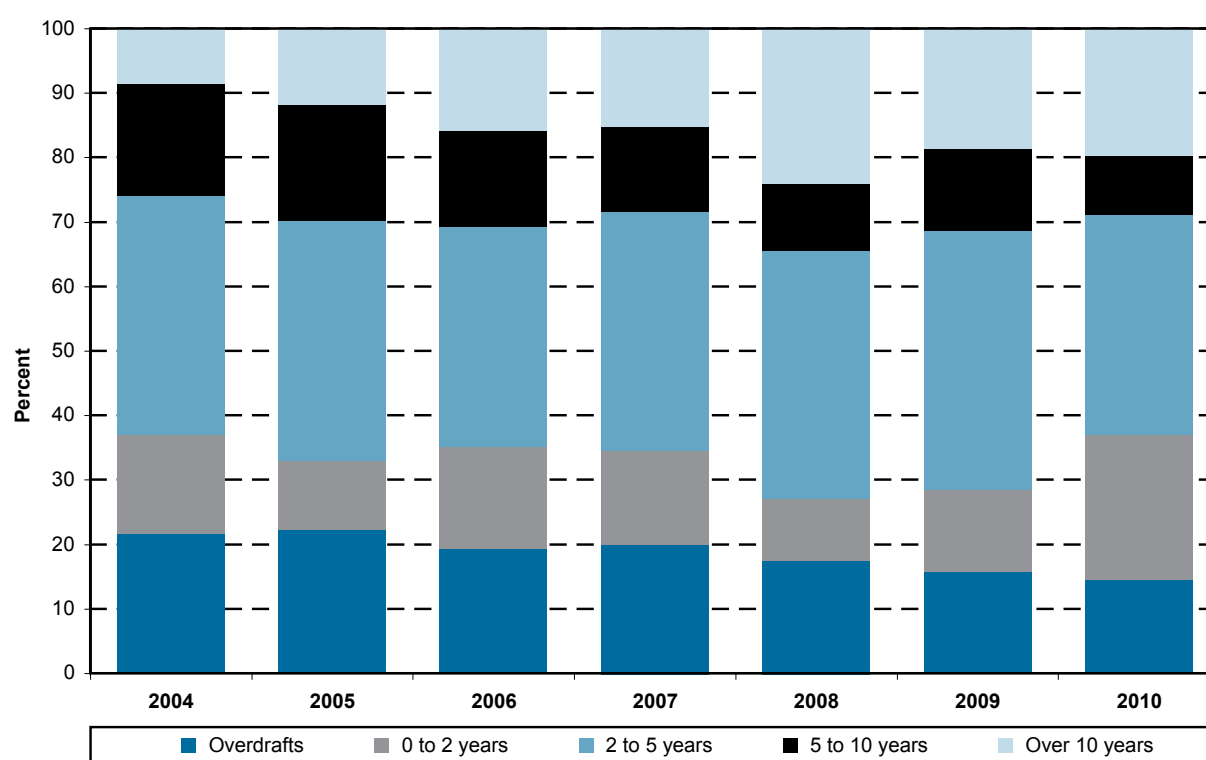
Source: Commercial Banks

most liquid form, including BoBCs.<sup>33</sup> For

instance, government transfers to parastatals

<sup>33</sup> One of the reasons for establishing the Public Debt Service Fund by the Government was that commercial banks were unable to satisfy the long-term financing needs of parastatals due to the short-term

maturity structure of banks' deposits, hence, keeping their lending to shorter term maturities (Bank of Botswana Annual Report 1996).

**CHART 2.8: COMMERCIAL BANKS: LOANS AND ADVANCES BY MATURITY-PERCENTAGE DISTRIBUTION**

Source: Commercial Banks

and local authorities for capital projects ahead of implementation are deposited in short-term commercial bank instruments and, in turn, placed by banks in the more liquid BoBCs (Charts 2.7 and 2.8) consistent with prudent matching of maturities of assets and liabilities. At the retail level, low financial literacy could contribute to widespread holding of current account and savings deposits at commercial banks, even when there are options for long-term saving in higher-earning instruments.

- 3.35 The inter-bank market is considered crucial for the efficient and effective implementation of monetary policy, as it facilitates the transfer of liquidity from surplus to deficit banks. A well-functioning inter-bank market also reduces the role of the central bank in settling inter-bank transactions. Furthermore, high volumes of trading in the inter-bank market can improve the transmission mechanism of monetary policy, from the central bank, through banks and, ultimately, to their customers.<sup>34</sup> However,

the inter-bank market in several countries remains undeveloped due to a combination of easy and cheap access to standing facilities at central banks, uncompetitive behaviour of large banks that do not lend to smaller rivals, uneven distribution of liquidity among banks, lack of high quality securities, weak secondary market trading and fear of payment risks from other banks.<sup>35</sup> Some of these factors are relevant for Botswana. In particular, directives for local exposure limits and assessment of risk criteria may be determined at the head office of branches of international banking groups.<sup>36</sup> Therefore, subsidiaries of foreign banks may be constrained from sourcing funds from other domestic banks through the inter-bank market, due to risk management criterion

Centre for Central Bank Studies, Bank of England.

35 Botswana uses the Real Time Gross Settlement (RTGS) system, which is known as the Botswana Inter-bank Settlement System (BISS).

36 Almost all commercial banks operating in Botswana are subsidiaries of major regional or international banking groups and, therefore, subject to significant external direction.

34 Simon T. Gray and Nick Talbot, "Developing Financial Markets,"

established at its overseas headquarters. The local payments infrastructure may also be considered inadequate and risky due to the absence of an instant collateral transfer facility. The Bank, however, continues to address these challenges through measures to encourage greater volumes of inter-bank trading<sup>37</sup> (Table 2.5) and improvements in the payments and settlement infrastructure and interface of systems to link the inter-bank transfer of funds and the collateral pledged.

- 3.36 Open market operations in Botswana were introduced at a time when the Government did not issue government securities due to persistent budget surpluses. In the circumstances, it was inevitable that open market operations were conducted in the primary market through the issuance of BoBCs, with direct cost implications for the Bank. The government securities issue is relatively small compared to the level of outstanding BoBCs, but is likely to increase significantly following approval of a P15 billion programme. This scenario presents both opportunities and challenges for the operation of monetary policy, notably the need for coordination between the fiscal and monetary authorities with respect to issuance and management of securities. As stated in section 2, the experience from other countries in this regard is varied. In Botswana, the central bank already manages auctions of government bonds and treasury bills; in which case adapting to the increase in government securities should be relatively smooth.
- 3.37 The issues highlighted in this section are also covered in the FSAP of 2007 that was undertaken jointly by the International Monetary Fund and the World Bank. Resulting from this, a Financial Sector Development Strategy (FSDS) is being developed, which, among other issues, will address alleviation

of endemic excess liquidity in the banking system and its impact on monetary policy formulation and associated cost.

#### 4. OPPORTUNITIES FOR IMPROVEMENT IN THE FRAMEWORK AND IMPLEMENTATION OF MONETARY POLICY

##### (a) Relevance of the Current Policy Mix

- 4.1 The 2008 *Annual Report* discussed price stability in the context of a monetary policy framework based on inflation targeting. One of the key issues that emerged relates to the two-pronged policy objective of maintaining international competitiveness of domestically-produced goods and services using the exchange rate, while simultaneously pursuing the goal of price stability. Although not necessarily mutually exclusive (stable prices help reinforce competitiveness, for example), in an environment where inflation is a serious concern, incompatibility between the two objectives can quickly emerge. In particular, while higher interest rates and exchange rate appreciation would help ease inflationary pressures, maintaining stability of the real effective exchange rate (REER) would require depreciation of the nominal exchange rate, which could be inflationary.
- 4.2 Monetary policy autonomy is enhanced by a combination of a floating exchange rate regime and/or capital controls. Conversely, a fixed exchange rate arrangement with free capital movement imposes a constraint on monetary policy independence. Even in the absence of formal controls (Botswana abolished exchange controls in 1999), less developed financial and capital markets represent a *de facto* control on capital flows, given limited options for international flows to respond to changes in domestic interest rates. In addition, the taxes levied on the interest paid to foreign holders of Botswana Government bonds and continuing controls on capital flows by South Africa impose some measure of restriction on

<sup>37</sup> For example, in recent years, the Bank ceased outright secondary market transactions in BoBCs with commercial banks, while the terms on which repos and reverse repos are offered have been made less attractive and the access to the secured lending facility is at a much higher interest rate. The objective of these measures is to make it more attractive for banks to manage their liquidity requirements through the inter-bank market.

capital inflows to Botswana. Therefore, the exchange rate is, to some extent, insulated from pressures that normally arise when capital flows freely. Nevertheless, as efforts to develop the financial sector succeed, capital flows are likely to increase, which could lead to pressures on the exchange rate and may necessitate a review of the policy mix, including the option of greater independence for monetary policy.

4.3 Globally, the delivery of lower inflation through inflation targeting has occurred alongside criticism that a focus on a single goal of price stability diminishes the importance of other macroeconomic goals such as growth and employment creation. A valid response to such criticism is that price stability is conducive to long-term output growth; hence, the focus on controlling inflation complements other objectives of macroeconomic stability and sustainable growth. However, there are lessons to be drawn from the continuing global financial and economic crises. Among the lessons is that the inflation targeting framework potentially does not fully incorporate asset price developments and financial stability issues in both the policy analysis and response.

4.4 Therefore, the issue of price stability versus financial stability currently features prominently in the discussion of the ranking of objectives of central banks. The relevant dimensions are that a singular focus on achieving an inflation target can sometimes lead policy makers to lose sight or ignore important signs of potential instability as reflected in asset price bubbles. In addition, monetary policy action could at times induce financial instability, for instance, when it is used to mitigate the effects of a fall in asset prices while not acting to pre-empt price bubbles. Such asymmetric policy actions risk encouraging problems of moral hazard, resulting in excessive risk taking that, in turn, could lead to financial instability. On the other hand, it is possible that undue consideration for the health of the financial system could constrain a monetary policy response to price developments. It is,

nevertheless, worth emphasising that, while care should be taken that monetary policy is not unduly constrained by concerns over financial sector stability, financial stability remains core to the central bank mandate. Indeed, the recent global financial crisis has sharply brought to the fore the interconnectedness of price stability and financial stability and demonstrated that monetary policy works most effectively in an environment characterised by stability of the financial system.

4.5 Therefore, apart from the exchange rate and monetary policies, financial sector and stability issues enter the policy mix at three levels. First, there is the level of financial sector development and robustness that facilitates the transmission mechanism in terms of efficiency (and moderation of costs) of monetary operations; second, the potential for the financial sector to promote saving channels and productive use of finance; and, third, it is increasingly clear that, regardless of choices regarding ranking, financial stability is an important goal in the broader macroeconomic framework. Therefore, operationally, there is a need for specification of benchmarks/targets, monitoring mechanisms and response triggers to clearly specified indicators as well as clear assignment of institutional responsibility. Overall, financial stability facilitates monetary policy success in stabilising prices and promoting saving, investment and ultimately supporting economic growth.

4.6 Conversely, financial instability is undesirable since it can potentially result in considerable macroeconomic losses by interfering with production, consumption and investment, which could ultimately derail the broader national goals of employment creation, economic growth and development. For the Bank of Botswana, financial stability is clearly central to the Bank's mandate as set out in the Bank of Botswana Act. This requires the Bank to maintain liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system in Botswana.<sup>38</sup>

<sup>38</sup> Bank of Botswana Act, Cap (55:01)



## (b) Financial Stability and Monetary Operations

4.7 Broadly, financial stability can be viewed as an economic situation in which there is no threat of system-wide episodic disruption to the functioning of the financial system and where there is resilience to financial systems stress.<sup>39</sup> In contrast, financial instability is characterised by widespread banking failures, asset-price volatility and deficient market liquidity, which can ultimately lead to a major disruption of the payments and settlement system and erosion of confidence and generalised uncertainty about the value of assets and the ability of financial institutions to meet their obligations.<sup>40</sup>

4.8 The preservation of financial stability requires identification of critical risks and vulnerabilities to the financial system, including credit, market or operational risks, as well as the design of appropriate policy responses. This is done through financial stability analysis, which involves among others, the following:

- (i) an assessment of macroeconomic conditions;
- (ii) determination of soundness of financial institutions and markets;
- (iii) monitoring mechanisms to determine potential key structural vulnerabilities in the financial system, which could expose it to stress in the event of a shock; and
- (iv) formulation of supervisory measures to address deficiencies.

4.9 The process of risk assessment largely entails attempts at enhancing the understanding of the nature and gravity of vulnerabilities in order to improve the prediction of the potential location and possible magnitude of any future significant financial disruption and to help focus attention on monitoring these areas for signals of impending

shocks. Given this knowledge, judgment can be formed on the appropriate scale and design of measures to reduce the probability and mitigate the impact of such events.<sup>41</sup>

### *Costs to Monetary Policy of Financial Instability*

4.10 It is readily apparent that financial instability can seriously impair the conduct of monetary policy, thus adding to its costs and/or diminishing its effectiveness. This is because systemic disruption and distress among financial institutions can impact on the operation of the transmission mechanism through which monetary policy works. In particular, as observed in the recent financial crisis, the impact of interest rate adjustments by central banks on borrowing and lending activities becomes less predictable and effective. This was particularly evident during the “credit crunch”<sup>42</sup> phase of the crisis, where borrowing and lending activity largely came to a halt in wholesale money markets, and where interest rates were at higher levels, bearing little relations to central bank policy rates. Even when the markets had regained a semblance of stability, the established transmission mechanism has remained distorted in many economies, as greater risk aversion by borrowers and/or lenders reduces the capacity of interest rates, even at very low levels, to stimulate economic activity. This situation, sometimes termed a “liquidity trap”, is the principal reason why central banks have resorted to unconventional policy measures, including direct measures to bring about monetary expansion.

### *The Role of Monetary Policy in Supporting Financial Stability*

4.11 It is generally agreed that, in the build up to the global financial crisis, insufficient attention

39 Martin Cihak (2007), ‘Systemic Loss: A Measure of Financial Stability’, Czech Journal of Economics and Finance, 2007, 57 (1–2).

40 Financial Stability Review, South African Reserve Bank, 2010.

41 IMF and the World Bank, *Financial Sector Assessment – A Handbook*, August 2005.

42 A credit crunch is a phenomenon where financial institutions significantly reduce lending owing to increased uncertainty about borrowers’ ability to repay loans.



was paid to signs of emerging financial instability. In essence, an extended period of sustained growth and low inflation (known as the “Great Moderation”) had encouraged the belief that macroeconomic stability in the context of a lightly regulated market economy was sufficient to ensure financial stability. In addition, existing financial soundness indicators proved inadequate in identifying emerging financial imbalances, at a time of rapid innovation in financial products and markets that had loosened the link between bank deposits and lending, while greatly increasing their reliance on wholesale money markets.<sup>43</sup> On this account, there have been suggestions that monetary policy in major economies should have been systematically tighter, despite low and stable inflation, in order to help curb financial imbalances. Nevertheless, this view should be qualified in two important respects which, in turn, cast doubt on the increasingly held view that monetary policy should counter financial instability by ‘leaning against the wind’.<sup>44</sup>

- 4.12 First, the conclusion that signs of emerging instability were ignored is clearest with the benefit of hindsight, although it is plausible to suggest that some of the signals may have been ambiguous. As discussed in detail in Posen (2010),<sup>45</sup> there is strong statistical evidence that only a minority of asset price booms are followed by subsequent busts. This would suggest that, in many cases, leaning systematically against the wind may be harmful overall, with booms often associated with genuine advances in the real economy, including technological

innovation and productivity gains. That said, the fallout from the recent crisis demonstrated the very real negative consequences of a boom-bust cycle and this should be given due weight when considering the appropriate policy response to rising asset prices. Ideally, the implication is that leaning against the wind should be triggered by much more diverse information than asset price movements; but in practice this may not be available in time to guide policy. In this regard, there is a strong argument for reinstatement of monetary indicators in the monetary policy frameworks as leading indicators of nascent financial instability.<sup>46</sup> This would require central banks to supplement their existing forecasting models and procedures, as well as the policy-making process, including potentially reviewing whether the mandate to control inflation should remain the unambiguous primary objective.

- 4.13 Second, even if it can be established that risks of financial instability are increasing, it does not necessarily imply that the best tool to counter this is monetary policy. Reasons for this include:

- (i) the necessary information may not be available sufficiently fast for a timely policy intervention (a lagged policy response may itself be destabilising); and
- (ii) using monetary policy to deflate asset prices may have negative consequences elsewhere in the real economy. This is especially the case during times of market exuberance, when large upward adjustments to interest rates may be necessary to successfully curb asset price increases.

- 4.14 On the basis of these points, it is considered that improved regulatory and supervisory policies are the most appropriate first line of

43 Goodhart, C. A. E. (2010), ‘The Changing Role of Central Banks’, in BIS Working Paper No. 326, November 2010.

44 This refers to situation in which, although price developments in the economy are consistent with the price stability objective of a central bank, monetary policy is tightened, if there are signals for potentially destabilising asset price formation (or bubbles), in order to preclude future instability in the financial markets.

45 *Do we know what we need to know in order to lean against the wind?*, a speech by A. Posen, an External Member of the Monetary Policy Committee, Bank of England and Senior Fellow, Peterson Institute for International Economics, at the Cato Institute’s 28<sup>th</sup> Annual Monetary Conference, Washington Panel on “Is Monetary Policy Responsible for Bubbles?”

46 *In Search of a Robust Monetary Policy Framework*, a Keynote Speech by Stark, J., Member of the Executive Board of the European Central Bank (ECB), at the 6<sup>th</sup> ECB Central Banking Conference “Approaches to Monetary Policy Revisited – Lessons from the Crisis”, Frankfurt am Main, 19 November 2010.

defence against financial instability. However, there are problems with this approach as well. Notably, such policies, which are often the result of protracted discussion, negotiation and compromise, also tend to lag behind innovation-driven financial markets. Overall, monetary policy should, at the very least, avoid situations where it becomes a potential source of volatility, in particular, the risk that an extended period of ultra-loose monetary policy could become a source of future instability in the wake of the financial crisis.

#### *Implications for Botswana*

- 4.15 A consideration of the relevance of these factors for Botswana takes into account the fact that Botswana has a small economy in which the financial sector was largely insulated from the worst effects of the financial crisis which mainly affected the economy through a sharp slowdown in the mining sector. The financial sector remains relatively simple, lacking the complex markets and institutions that contributed significantly to the severity of the global crisis. Notably, the dividing line between banks and non-banks remains clear and none of the domestic financial institutions had significant trading books, including derivatives and similar sophisticated products. Therefore, it appears that much of the global debate about appropriate measures to improve financial stability has limited operational significance in Botswana. For example, the total assets of the commercial banks in Botswana are currently the equivalent of about 50 percent of GDP. This is more comparable to the United Kingdom in 1960 than today where the figure is 470 percent (and 97 percent of this is concentrated in the ten largest UK banks). Thus, it is apparent that problems of institutions that are ‘too big to fail’ are of less relevance to Botswana than in countries where the collapse of a single bank could overwhelm the entire economy.<sup>47</sup> This, of course, is not to say that the consequences of a banking failure in Botswana would not be serious.
- 4.16 From this perspective, therefore, the need to emulate economies with much larger and more complex financial sectors in extensive reforms of regulation and supervision is less clear in the domestic context. This is especially the case given that such changes would clearly involve additional costs to the regulator and regulated institutions alike. In turn, this could have a detrimental impact on links to the real sector, as potentially costly and time consuming adherence to additional regulatory requirements could make banks less responsive to opportunities for productive lending.
- 4.17 Nevertheless, it is important that Botswana draws relevant lessons from the recent financial crisis, as it cannot be presumed that the country is not vulnerable to problems of financial instability. The consequences of the recent economic slowdown for banks could have been much worse if there had been more significant job losses or if the Government had not had the resources to maintain spending programmes, despite falling revenues. In addition, problems of excessive household indebtedness may have been exacerbated by the civil service pay freeze that was introduced in 2008. On the other hand, it is conceivable that asset price bubbles could develop (in property, for example) if effective absorption of excess liquidity was not undertaken.
- 4.18 The implications for the Bank’s decision to enhance its capacity to both monitor and respond to issues related to financial stability remain to be determined. However, it can be anticipated that this can be integrated into the operations of the MPC, which have continued to evolve over a period of several years on the basis of prudence and caution and can be expected to continue to do so. Thus, if it were deemed necessary, it would not be inconsistent with either past practice or the Bank of Botswana’s legislative mandate for policy decisions to factor in the need to ensure continued financial stability.

<sup>47</sup> The recent bailout of the Irish Government was necessitated not by its direct fiscal problems, but by the 2008 decision to provide extensive guarantees to troubled banks.

### (c) Encouraging Opportunities for Savings and Investment

4.19 Monetary policy should be conducted in a manner that is most effective in the context of the current structure of the financial sector so as to maximise net benefits.<sup>48</sup> However, the Bank should also take account of both the continuing evolution of financial institutions and, importantly, the role it can play in encouraging that process in beneficial ways, including those that might help further improve the operation of the transmission mechanism of monetary policy.

4.20 Particularly important in this respect are measures to encourage financial savings, especially by households, where both financial literacy and access to financial services is typically more limited than for businesses. The importance of household savings was considered in detail in the 2009 Bank of Botswana *Annual Report*. The important point to emphasise for purposes of this topic is that improved access and utilisation of relevant savings instruments not only enhances household welfare, it may also increase the effectiveness of monetary policy operations. This argument is illustrated in the following example:

- (i) more competition among financial institutions (banks and non-banks) for household savings may help remove monopolistic distortions that impede the transmission of policy signals. Thus, changes in the policy rate would be reflected more quickly across the full spectrum of interest rates;
- (ii) similarly, improving access to financial services for currently 'unbanked' households (typically the poor and/or those from the rural areas) would bring them into the formal sector where the transmission mechanism both operates

more reliably and can be more easily monitored;

- (iii) increased financial literacy among households should encourage more 'rational' financial management, including their reaction to policy adjustments.

4.21 It should also be recognised that monetary policy itself plays a significant role in the mobilisation of savings as it affects choices with regard to financial instruments and expectations on the future value of savings. This is not just through the level of interest rates where, as discussed in previous section, maintenance of positive real interest rates in Botswana has been an integral part of the policy framework. In addition, a well-designed policy framework that engenders expectations both of price stability and that the authorities will not embark on arbitrary policy actions helps promote an environment that is conducive to financial savings.

4.22 However, at present, additional savings will mainly add to the large volumes of excess liquidity already in the banking system. As was indicated in the previous section, excess liquidity largely reflects limited opportunities for productive lending in the economy, at prevailing monetary conditions. In turn, this is either because such opportunities do not exist or due to the narrow and shallow financial markets resulting in a lack of relevant financial institutions and instruments. However, the suggestion that banks are simply ignoring opportunities for profitable lending seems misplaced. Indeed, it would not be rational for banks to forego the potentially higher return on lending to households and businesses in favour of BoBCs. Thus, in part, the challenge of dealing with excess liquidity could be addressed through continuous exploration of opportunities for productive lending and/or harnessing of these funds through innovative institutions and products. In this regard, one possible platform is the financing of public infrastructure development, especially as the Government is increasingly facing revenue constraints.

<sup>48</sup> For example, the conduct of monetary policy should take cognisance of the need to clearly understand the transmission mechanism in order to improve its efficacy. Also, any monetary policy costs must be justified by greater benefits in terms of economic growth and increased employment.

4.23 It is notable that for any country, apart from conducive macroeconomic policies, the availability and quality of physical infrastructure significantly influences productivity, export competitiveness and ability to attract investment, particularly foreign direct investment (FDI).<sup>49</sup> Therefore, subject to alleviation of constraints of a mismatch between banks' assets and liabilities, given the short-term nature of their deposit liabilities, commercial banks could lend productively in this area. It is also worth noting that, compared to the private sector, the Government typically delivers infrastructure with long delays and at higher costs. Furthermore, in the context of the desire by the Government to charge, where appropriate, economic tariffs to support physical and social infrastructure, it may as well be prudent for the private sector to undertake these activities for increased economic efficiency.

4.24 Various options may be explored for obviating the problem of asset-liability mismatch associated with infrastructure development, such as the variety of forms of Public-Private Partnerships (PPPs), where relevant government guarantees could help bridge the gap. This should be more tractable in the context of Botswana, where, although excess liquidity takes the form of short-term holdings of BoBCs, the apparent mismatch is misleading, as the lion's share of the underlying funds (pension fund onshore assets, for example) should ideally be invested long term.

## 5. CONCLUSION

5.1 This chapter has reviewed various aspects of monetary policy operations from a practical perspective, highlighting the benefits as well as challenges. In this regard, the review includes a discussion of alternative monetary policy frameworks, the associated methods of policy implementation and inevitable trade-offs in terms of resource allocation and benefits. It should be clear, both from the experience in Botswana and other countries

that costs associated with any monetary policy framework may come in different forms. For example, the use of direct controls to set interest rates may have no costs arising from money market operations, and for this reason might have some initial appeal. But the resources committed to enforcing the regulations will be commensurately greater, while the indirect costs in terms of suppressing efficient financial intermediation and financial sector development will also be extensive. For this reason, by now the great majority of countries have largely abandoned such an approach.

5.2 As has been amply demonstrated by the review, monetary policy must be tailored to prevailing economic and institutional circumstances. Notably, in this regard, monetary policy operations must be shaped in the context of the economy in question and, in particular, the financial sector. Key aspects include: the range, depth and sophistication of financial institutions and the extent of borrowing by government, both of which will have an impact on the conduct of money market operations.

5.3 It has further been demonstrated that the challenge of extensive and chronic excess liquidity is not peculiar to Botswana. This characterises many developing economies where the surpluses generated by rapidly growing sectors cannot easily be absorbed domestically, at least not productively. This is especially so in cases when the market for government debt is limited. If this is not absorbed through monetary policy, then the funds would gradually drain from the economy with little benefit in terms of productive investment to support further growth, while creating undesirable pressures on both the balance of payments and domestic inflation. Therefore, the question for policymakers is not *whether* the liquidity should be absorbed, but *how* to do this most effectively.

5.4 That said, it has been emphasised that the monetary authorities should not passively accept the status quo with regard to prevailing conditions that determine the appropriate

<sup>49</sup> By its nature, FDI implies a longer-term commitment than short-term and portfolio investment.



form for monetary policy operations. They should also seek to exert a positive influence on these conditions. For this reason, it is typically appropriate for the central bank to also have a major role in complementary activities related both to regulation and supervision of the financial sector as well as its future development, as these have a critical bearing on the monetary policy transmission mechanism. A financial sector that allocates resources more efficiently, which would help reduce the overhang of chronic excess liquidity, can also be expected to alleviate the costs of monetary policy and enhance the responsiveness to policy signals across the economy.

5.5 Nevertheless, it should be clear that there is no inference that such efficiencies can be achieved directly through monetary policy. However, the conduct of open market operations, if structured appropriately, can support the development of the money market. For this reason, the structure of the Bank of Botswana's market operations, including both the introduction of additional instruments while streamlining others, has been subject to periodic revision since the introduction of BoBCs in 1991. On the other hand, while engendering greater competition in the banking sector will undoubtedly be of benefit to the conduct of monetary policy, it should mainly be achieved through other interventions.

5.6 Similarly, it is important to maintain the distinction between debt management activities undertaken by central government and the use of debt instruments by central banks for monetary policy purposes. Especially in situations of excess liquidity, where, by implication, there is insufficient domestic public debt, the line between the two has tended to become blurred as central banks become primary issuers. However, given the specific requirements of monetary policy (a central bank will have no interest in issuing longer-term debt, or may wish to restrict the range of those eligible to hold its debt, for example) such an arrangement is sub-optimal

for capital market development, as well as potentially inhibiting transparency regarding public sector finances.

5.7 Although often featuring landmark events (the formal adoption of a new monetary policy framework, for example), the development of monetary policy is a process of continuing evolution. This has been amply demonstrated in the historical accounts, both for Botswana and elsewhere. Moreover, this aspect of policy formulation has been vividly underscored by the recent global financial crisis and resulting economic slowdown and policy review. Notably, the crisis has generated introspection on the conduct of monetary policy, which has resulted in governments and central banks undertaking reviews of aspects of their policy frameworks.

5.8 Taking a broad perspective, the way forward in this regard should not be to diminish the importance of price stability (or more precisely, targeting inflation), but to more firmly embed additional objectives in the mandate of central banks, including that of financial stability. Price stability and financial stability are clearly closely related. Without financial stability, price stability is difficult to sustain, as financial instability is likely, in turn, to destabilise the established channels, notably the responsiveness to interest rate adjustments, of the policy transmission mechanism. Similarly, persistently high inflation can pose systemic risks to the financial sector. Nonetheless, they are distinct phenomena, as financial instability can develop under conditions of price stability, while inflation can vary significantly without necessarily leading to financial instability. In most cases, it is neither feasible nor desirable to use a single policy instrument to target more than one objective, and, as discussed in section 4, this also appears to be true with the objectives of price and financial stability. While using monetary policy to "lean against the wind" in support of financial stability may be appropriate in some instances, its widespread use in this manner presents clear operational difficulties, including the adequacy of timely

information necessary to take informed policy decisions.

- 5.9 In conclusion, therefore, monetary policy in Botswana, as conducted by the Bank of Botswana, will continue to be focused on achieving price stability on a sustained basis, through a policy framework that maximises the net benefits. In recognising that some of the direct costs of monetary policy remain extensive, further development of policy and operational arrangements will continue and, from a holistic perspective, will include appropriate interventions to support the continuing development of the financial sector. Initiatives will also be in place to promote public access to financial services. Full account will also be taken of related international developments so far as best practice monetary policy implementation and alignment with the related objective of financial stability are concerned. However, the extent to which such developments are adopted for domestic policy purposes will be solely determined by careful assessment of their relevance.

**ANNEX 2.1: PERFORMANCE INDICATORS FOR BOTSWANA AND SELECTED INFLATION TARGETING COUNTRIES**

	Botswana		South Africa		Brazil		Ghana		Indonesia	
	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation
1990	0.82	11.4	0.01	14.3	0.01	2947.7	0.03	37.3	0.06	9.7
1991	0.92	12.6	0.01	15.6	0.02	477.4	0.08	18.0	0.07	8.5
1992	0.96	16.5	0.01	13.7	0.05	1022.5	0.05	10.1	0.07	9.4
1993	0.98	14.4	0.01	9.9	0.07	1927.4	0.07	25.0	0.07	7.0
1994	1.01	10.6	0.01	8.8	0.06	2075.8	0.10	24.9	0.06	6.2
1995	0.95	10.5	0.02	8.7	0.06	66.0	0.10	59.5	0.06	58.0
1996	1.01	10.1	0.01	7.3	0.07	16.0	0.12	44.4	0.07	20.8
1997	1.16	8.9	0.03	8.6	0.06	6.9	0.08	24.8	0.07	3.8
1998	1.11	6.5	0.03	6.9	0.05	3.2	0.05	19.2	0.22	11.5
1999	1.10	7.8	0.05	5.2	0.06	4.9	0.06	12.5	0.18	11.8
2000	1.22	8.5	0.05	5.4	0.06	7.1	0.05	25.2	0.19	6.8
2001	1.10	6.6	0.06	5.7	0.07	6.8	0.06	32.9	0.19	6.1
2002	0.94	8.0	0.06	9.2	0.08	8.4	0.09	14.8	0.17	10.5
2003	0.63	9.2	0.04	5.8	0.08	14.8	0.17	26.7	0.14	13.1
2004	0.52	7.0	0.05	1.4	0.07	6.6	0.17	12.6	0.12	6.0
2005	0.61	8.6	0.07	3.4	0.06	6.9	0.16	15.1	0.12	9.8
2006	0.67	11.6	0.08	4.7	0.07	4.2	0.16	10.2	0.11	4.8
2007	0.71	7.1	0.09	7.1	0.12	3.6	...	10.7	0.11	9.7
2008	0.62	12.6	0.10	11.5	0.11	5.7	...	16.5	0.09	8.5
2009	0.68	8.1	0.11	7.1	0.14	4.9	...	19.3	0.11	9.4

... Data not yet available

Source: International Monetary Fund, World Economic Outlook Database, October 2010

**ANNEX 2.2: PERFORMANCE INDICATORS FOR BOTSWANA AND SELECTED MONETARY TARGETING COUNTRIES**

	Botswana		Malawi		Tanzania		Zambia		Mexico	
	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation
1990	0.82	11.4	0.08	11.9	0.04	22.6	0.05	109.6	0.03	26.7
1991	0.92	12.6	0.07	8.2	0.04	28.0	0.05	97.7	0.05	22.7
1992	0.96	16.5	0.02	23.2	0.07	21.9	...	165.7	0.05	15.5
1993	0.98	14.4	0.03	22.8	0.04	23.6	0.06	183.3	0.06	9.8
1994	1.01	10.6	0.04	34.7	0.06	37.2	0.08	54.6	0.01	7.0
1995	0.95	10.5	0.07	83.2	0.04	24.0	0.06	34.9	0.05	35.0
1996	1.01	10.1	0.09	37.7	0.06	20.5	0.06	43.1	0.05	34.4
1997	1.16	8.9	0.06	9.1	0.08	15.4	0.07	24.4	0.07	20.6
1998	1.11	6.5	0.15	29.8	0.07	13.2	0.02	24.5	0.07	15.9
1999	1.10	7.8	0.14	44.8	0.08	9.0	0.01	26.8	0.06	16.6
2000	1.22	8.5	0.16	29.6	0.10	4.6	0.08	26.1	0.06	9.5
2001	1.10	6.6	0.13	27.3	0.13	5.2	0.06	21.4	0.08	6.4
2002	0.94	8.0	0.06	17.4	0.15	4.6	0.15	22.2	0.08	5.0
2003	0.63	9.2	0.05	9.6	0.17	4.4	0.06	21.4	0.08	4.6
2004	0.52	7.0	0.04	11.4	0.16	4.1	0.06	18.0	0.08	4.7
2005	0.61	8.6	0.06	15.5	0.14	4.4	0.08	18.3	0.09	4.0
2006	0.67	11.6	0.04	13.9	0.15	7.3	0.06	9.0	0.08	3.6
2007	0.71	7.1	0.06	8.0	0.15	7.0	0.09	10.7	0.08	4.0
2008	0.62	12.6	0.06	8.7	0.13	10.3	0.07	12.5	0.08	5.1
2009	0.68	8.1	0.03	8.4	0.15	12.1	0.13	13.4	0.10	5.3

... Data not yet available.

Source: International Monetary Fund, World Economic Outlook Database, October 2010



**ANNEX 2.3: PERFORMANCE INDICATORS FOR BOTSWANA AND SELECTED EXCHANGE RATE TARGETING COUNTRIES**

	Botswana		Argentina		Saudi Arabia		Singapore		Panama	
	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation	Forex reserves/ GDP	Inflation
1990	0.82	11.4	0.03	2314.0	0.10	2.1	0.72	3.5	0.06	0.8
1991	0.92	12.6	0.03	171.7	0.09	4.6	0.75	3.4	0.09	1.5
1992	0.96	16.5	0.05	24.9	0.05	-0.4	0.79	2.3	0.08	1.8
1993	0.98	14.4	0.06	18.5	0.06	0.8	0.83	2.3	0.08	0.5
1994	1.01	10.6	0.05	4.2	0.05	0.7	0.78	3.1	0.09	1.3
1995	0.95	10.5	0.05	3.4	0.06	5.1	0.76	1.7	0.10	0.9
1996	1.01	10.1	0.07	0.2	0.09	0.9	0.80	1.4	0.09	1.3
1997	1.16	8.9	0.08	0.5	0.10	-0.4	0.76	2.0	0.12	1.3
1998	1.11	6.5	0.08	0.9	0.10	-0.2	0.89	-0.3	0.09	0.6
1999	1.10	7.8	0.10	-1.2	0.11	-1.3	0.94	0.0	0.07	1.3
2000	1.22	8.5	0.10	-0.9	0.11	-1.1	0.93	1.4	0.07	1.5
2001	1.10	6.6	0.06	-1.1	0.11	-1.1	0.98	1.0	0.10	0.3
2002	0.94	8.0	0.11	25.9	0.11	0.2	0.95	-0.4	0.10	1.0
2003	0.63	9.2	0.10	13.4	0.10	0.6	0.96	0.5	0.07	0.6
2004	0.52	7.0	0.11	4.4	0.10	0.4	0.92	1.7	0.04	0.5
2005	0.61	8.6	0.15	9.6	0.49	0.6	0.92	0.5	0.08	2.9
2006	0.67	11.6	0.14	10.9	0.60	2.3	0.89	1.0	0.07	2.5
2007	0.71	7.1	0.15	8.8	0.71	4.1	0.83	2.1	0.09	4.2
2008	0.62	12.6	0.13	8.6	0.86	9.9	0.83	6.6	0.10	8.8
2009	0.68	8.1	0.13	6.3	0.99	5.1	0.94	0.6	0.11	2.4

Source: International Monetary Fund, World Economic Outlook Database, October 2010

