Part B

The Botswana Economy in 2003 and Theme Chapter

Bank of Botswana

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Chapter 1

The Botswana Economy in 2003

1. Output, Employment and Prices

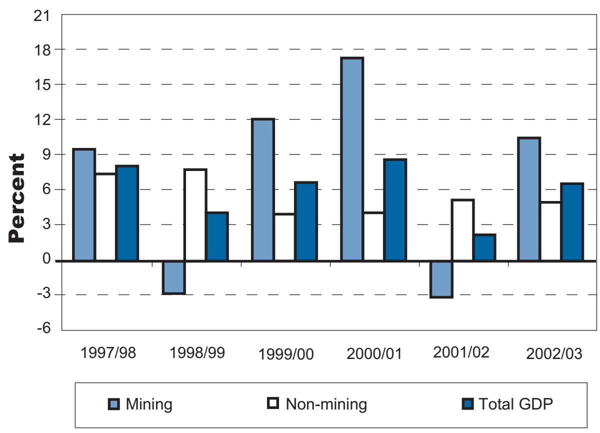
(a) National Income Accounts

1.1 Real gross domestic product (GDP) grew by 6.7 percent in 2002/03[1], a substantial improvement over the revised growth of 2.1 percent in 2001/02[2] and higher than the forecast 5 percent. The higher rate of growth was mainly due to the turnaround in mining sector output growth, which accelerated to 10.4 percent, reversing the 3.1 percent decline in the previous year, and well in excess of the forecast growth of 4.5 percent. Mining output growth was driven by a 10.2 percent increase in diamond production which, in turn, was underpinned by the optimisation of systems and improved operational efficiency in diamond mines, as well as strong demand in the major markets for diamonds, particularly the United States of America (USA). Furthermore, copper/nickel production increased substantially, by 33.1 percent in response to rising metal prices.

1.2 In contrast to the robust growth of mining output, non-mining sector GDP growth slowed marginally to 4.8 percent from a revised 5.1 percent in 2001/02, and was below the 7 percent forecast growth rate, as a result of considerable deceleration in the rates of growth of the trade, construction and several service sectors. Nevertheless, overall growth in the non-mining sector was broad-based, with output expanding in all sectors, albeit only marginally in construction (0.6 percent) and transport (0.9 percent) sectors. Excluding government, output in the non-mining private sector rose by 5.1 percent, compared to the previous year's growth of 4 percent.

1.3 The higher output growth rate for 2002/03 was strongly influenced by the near 100 percent growth of domestic taxes, reflecting higher value added tax (VAT) collections. GDP at factor cost increased by a lower rate of 5.2 percent, while non-mining GDP at factor cost rose by only 2.6 percent and non-mining private sector GDP at factor cost by 2.3 percent.

Chart 1.1 Growth in Real Gross Domestic Product



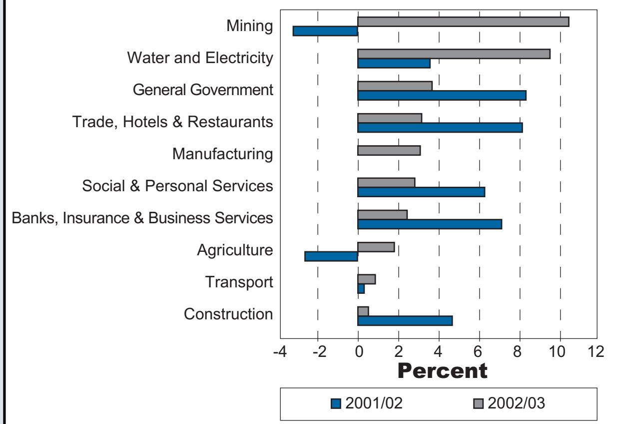
Source: Central Statistics Office

1.4 Turning to the growth of specific economic sectors, value added in the water and electricity sector expanded at a rapid rate of 9.5 percent, compared with 3.7 percent in 2001/02, due mainly to increased water output and, to a lesser extent, electricity production and distribution. In contrast, growth rates of general government, trade, hotels and restaurants, social and personal services and banks, insurance and business services more than halved in 2002/03 compared to the previous year.

1 The national accounts year runs from July each year to June the following year. National accounts data for 2002/03 and 2003/04 are provisional.

2 GDP estimates for 2000/01 and 2001/02 have been revised following the revision of value added for agriculture, manufacturing and transport. Output growth of the transport sector shows the largest drop of 6.7 percentage points in 2001/02 to 0.3 percent, while agriculture and manufacturing show marginal reductions. In 2000/01, agriculture output was 2.6 percentage points higher than the original estimate. Consequently, the overall and non-mining growth rates have also been revised up to 8.5 percent and 4.1 percent, respectively, for 2000/01, and down to 2.1 percent and 5.1 percent, respectively, for 2001/02 .

CHART 1.2 ECONOMIC GROWTH BY SECTOR



Source: Central Statistics Office

1.5 Growth of general government output, which had consistently been above 5 percent since 1995/96, slowed to 3.7 percent from 8.3 percent in 2001/02. This reflected the much slower rate of growth of general government employment, a freeze in civil service salaries during the year, and the slower growth of depreciation that is associated with a lower growth rate of government investment, because of a slowdown in the rate of growth of development spending.

1.6 The trade, hotels and restaurants sector expanded by 3.3 percent, compared to an increase of 8.2 percent in the previous year. The drop was due to the smaller rise of 1.9 percent, compared to 8 percent in 2001/02, in the growth of the trade sub-sector. This reflected a possible competitive squeeze on trade margins and weaker demand due to the public sector salary freeze and restrictive monetary policy. Hotels and restaurants grew at a rapid rate of 13.2 percent, the largest since 1995/96, reflecting enhanced capacity as new hotels and restaurants were established.

1.7 Output of banks, insurance and business services rose by 2.6 percent, against an increase of 7.1 percent a year ago. The lower rate of growth is explained by the poor performance of real estate and other business services that partially offset the healthy growth rates of output of the banks and the insurance industry.

1.8 Manufacturing output increased by 3.1 percent, a significant improvement from zero growth in 2001/02, and a contraction in 2000/01. The 35 percent increase in cattle slaughtered by the BMC and higher production of beverages were the main drivers of the sector's output growth. However, new manufacturing projects, such as those for confectionary and electrical equipment, also contributed to the expansion of output in the sector.

1.9 The rate of growth of agriculture output recovered slightly to 1.9 percent, due to small increases in the livestock population and in the output of other non-arable agriculture activities, following a contraction by 2.6 percent in 2001/02.

1.10 The transport sector grew marginally by 0.9 percent, which was an improvement over the 0.3 percent growth of 2001/02. The modest expansion was supported by strong growth in air traffic on domestic routes and, to a lesser extent, on regional routes, as well as the good performance of the telecommunications sub-sector, which benefited from a substantial increase in the customer base of mobile telephone service providers. However, these were offset by the poor performance of rail and road transport.

1.11 Construction activity slowed considerably in 2002/03 to a ten-year record low growth of 0.6 percent, down from 4.7 percent in 2001/02. This was partly due to the absence of major construction projects as was the case in previous years (large shopping centres, for example), as well as the slowdown in the rate of growth of the government development budget to which construction activity is closely linked.

1.12 GDP by type of expenditure indicates that the rate of growth of gross domestic expenditure declined to 8.9 percent in 2002/03 from 15.3 percent in 2001/02. All major components of domestic expenditure contributed to the slowdown. Private consumption expenditure growth was nearly stagnant at 0.9 percent, compared with an increase of 4.5 percent in 2001/02, while growth of consumption expenditure of the government was 5.9 percent, down from 13.5 percent. Gross investment grew at a slower rate of 21.5 percent, against 33.3 percent a year ago, although most of this growth was due to accumulation of inventories and the growth of fixed capital formation was relatively low, at 1.5 percent, compared to 6.1 percent in the previous year.

(b) Economic Outlook for 2003/04 and 2004/05

1.13 The 2004 Budget Speech forecast a marginal deceleration in overall output growth to about 5 percent in both 2003/04 and 2004/05. Early indicators for the first half of 2003/04[3] suggest this to be a reasonable forecast. Total GDP is estimated to have increased by 4.5 percent in the first half of 2003/04 compared to the first half of 2002/03. Within this overall growth rate, non-mining GDP grew by 8.5 percent, while mining output contracted by 2.2 percent.

1.14 As the preliminary figures for the first half of 2003/04 indicate, the rapid growth of the mining sector experienced in 2002/03 is unlikely to be sustained. This is because the operating systems in diamond mines are running at optimal levels and systems efficiency has reached levels close to the maximum acceptable standards, implying limited scope for further increases in production through this route. In addition, diamond production is estimated to have declined by 14 percent in the first half of 2003/04, compared to the first half of 2002/03. Annual diamond production for 2003/04 is, therefore, likely to be lower than in the previous year unless production in the second half of the year increases sharply. Adding to the expected slowdown in mining output growth is the decline in copper-nickel and coal production by nearly 30 percent each, as well as reductions of 22 percent and 16 percent in salt and soda ash production, respectively, in the first six months of the year. On the upside, mining output should benefit from the planned expansion of copper output from the Phoenix Mine in 2003/04, while in 2004/05 the coming on stream of the Mupane gold mine should boost output.

(c) Employment

1.15 Formal sector employment is estimated to have risen by 2.6 percent in the year to March 2003, slower than the 3 percent growth recorded in the year to March 2002, and well below the 5 percent forecast growth. The slowdown in employment growth was due to a reduction of 5.5 percent in parastatal sector employment, reversing an increase of 1.9 percent in the previous year, while the rate of employment growth in the private sector slowed to 3.6 percent, from 4.6 percent a year earlier. Excluding mining sector employment, non-mining private sector employment increased by 3.4 percent, compared to 4.6 percent in the twelve months to March 2002.

1.16 A total of 7 131 new jobs were created in the year to March 2003, compared with 8 103 in the previous year, of which more than 77.5 percent were in the private sector, including 70 percent in the non-mining private sector. Almost a quarter of the new jobs were created in the commerce sector[4], followed by 9.6 percent in finance and business services, 7.7 percent in mining, 6.5 percent in community and personal services, 6.4 percent in manufacturing and 5.5 percent in private education.

1.17 Employment growth was most rapid in mining and some service sectors despite lower rates of output expansion in the latter. Community and personal services employment rose by 9 percent, followed by mining (7.4 percent), finance and business services (3.7 percent), commerce (3.1 percent), agriculture (3 percent), general government (2.3 percent) and manufacturing (1.5 percent). Employment grew in the

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3 For the first time the Central Statistics Office has provided provisional bi-annual national accounts data.

4 The sector includes jobs in the wholesale and retail trade, and hotels and restaurants.

construction sector by 0.9 percent and in the transport and communications sector by 0.4 percent, while in the water and electricity sector it fell by 0.6 percent.

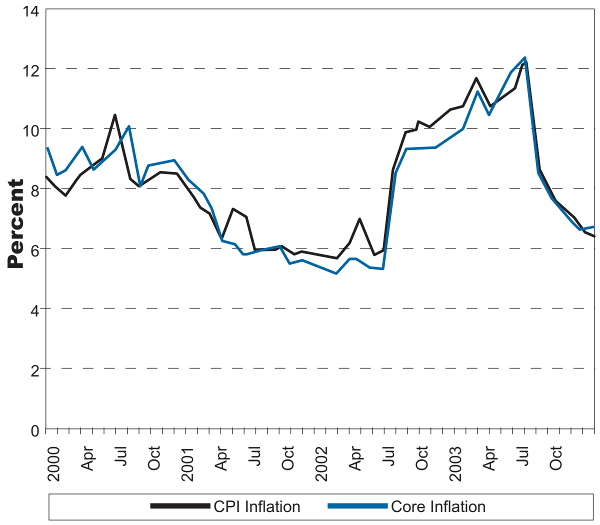
1.18 There are no official forecasts for employment performance in 2003/04 and 2004/05. However, in view of the reasonable growth expected from the non-mining sector, a moderate increase in employment is likely in 2003/04.[5] Nevertheless, more rapid employment growth is necessary if unemployment is to be reduced from the rate of nearly 20 percent recorded in the 2001 Census.

(d) Inflation

1.19 Global inflation remained low and stable in 2003, reflecting a decline in energy and food prices as well as low consumer and business confidence, attributable to a sequence of adverse shocks during the year including the war in Iraq and the outbreak of severe acute respiratory syndrome (SARS). In South Africa, inflation slowed in 2003, largely as a result of the appreciation of the rand as well as the lower rates of increase in prices of food, transport and housing, reaching the mid-point of the South African Reserve Bank's target range of 3–6 percent. Domestically, demand pressures on inflation were low, as indicated by the moderate rates of growth in commercial bank credit to the private sector, which was partly due to the restrictive monetary policy stance maintained throughout the year, along with the absence of public sector salary increases. The slower growth rate of Government expenditure also contributed to the moderation of demand pressures.

1.20 After rising sharply through the latter months of 2002 following the introduction of VAT in July of that year, annual inflation rose further in the first half of 2003, peaking at 12.2 percent in June. Thereafter, it slowed considerably as the effect of VAT fell away, and was 6.4 percent in December 2003, close to the upper end of the inflation objective of 4–6 percent and much lower than 10.6 percent at the end of 2002. Discounting the impact of VAT on inflation, which the Bank had estimated at 4–6 percent, inflation was only marginally above the upper end of the inflation objective for most of 2003.

CHART 1.3 BOTSWANA INFLATION



Source: Central Statistics Office and Bank of Botswana

1.21 The overall inflation trend in 2003 reflected broad-based increases in annual rates of price change for most categories of goods and services in the first half of the year, which slowed considerably in the second half. In addition to the continued impact of value added tax (VAT) on inflation in the first half of 2003, there were increases in various administered prices including fuel, telephone tariffs and water rates as well as public sector housing rentals, which contributed to inflation peaking at 12.2 percent in June. The decline in annual inflation towards the end of 2003 particularly reflects the very low level of monthly inflation during the second half of the year. Indeed, there is a sharp contrast between inflation developments in the two halves of 2003. In the first six months of the year, prices rose by 5.3 percent, or 10.9 percent at an annual rate. In the second half of the year, however, prices rose by 1 percent, equivalent to an annual rate of only 2 percent.

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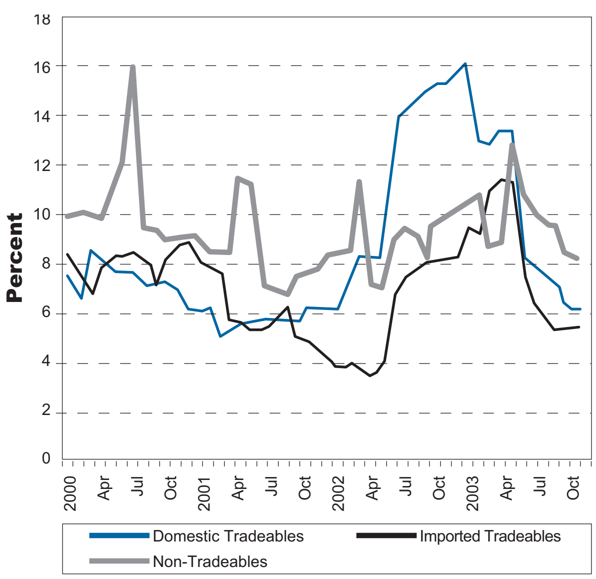
5 These employment figures exclude employment in the informal sector and small businesses.

1.22 The Bank's measure of core inflation[6] closely tracked headline inflation during 2003, mainly reflecting the absence of extreme price changes in any of the categories of goods and services in the CPI basket. Consequently, core inflation also rose during the first half of the year from 9.9 percent in January to 12.3 percent in June, before trending downwards in the second half of the year, and ended the year at 6.7 percent, marginally above the headline inflation rate of 6.4 percent.

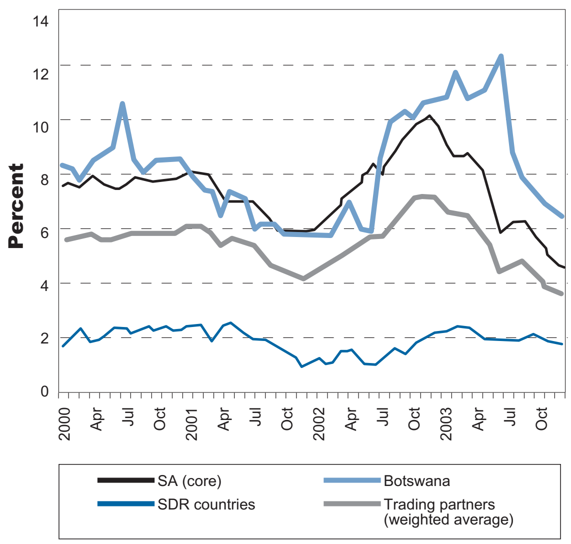
1.23 Price movements by tradeability also showed the same trend. The annual rate of change in the cost of tradeables slowed to 5.7 percent in December 2003 from 12 percent in June 2003 and 10.6 percent in December 2002. This reflected, among other factors, the decrease in inflation in South Africa as the rand appreciated during the year and the falling away of the effect of VAT on the inflation calculation. Within tradeables, inflation for imported tradeables decelerated to 5.5 percent in December 2003 from 11.3 percent in June 2003 and 8.2 percent in December 2002, while inflation for domestic tradeables fell to 6.1 percent from 13.3 percent in June 2003 and 15.2 percent in December 2002. For non-tradeables, the annual price change eased to 8.2 percent in December 2003 from 12.7 percent in June 2003 and 9.8 percent in December 2002.

CHART 1.4 CPI INFLATION BY TRADEABILITY



Source: Central Statistics Office

CHART 1.5 INTERNATIONAL INFLATION



Source: Central Statistics Office, Reuters and Bank of Botswana

(e) Inflation Outlook

1.24 Although it is anticipated that the world economy will grow at a faster rate in 2004, the main impetus to expansion being the improvement in consumer and business spending as geopolitical risks stabilise, global inflation is expected to remain low allowing monetary policy in the major economies to continue to be accommodative. Global inflation is forecast to remain steady at around 2.1 percent in 2004. In South Africa, inflation is forecast to remain below the upper boundary of the inflation target. The main pressures are likely to be strong domestic demand in response to the 5 percent reduction in the repo rate in 2003 and growth in personal disposable income. Although the appreciation of the rand contributed to the decline in the South African inflation in 2003, its future performance is difficult to predict. Oil prices are likely to remain stable given the outlook for political stability in the Middle East and continuing output policy review by the Organisation of Petroleum Exporting Countries

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

(OPEC). Given this background, the impact of external price developments on domestic inflation in 2004 is expected to continue to be benign although there is uncertainty with respect to the value of the rand, a depreciation of which may lead to an increase in inflation regionally.

1.25 Domestic demand, as indicated by growth rates for commercial bank credit and Government expenditure was considerably lower in 2003. In 2004, however, the increase in civil servants' salaries and the possible follow-up increases for the wider economy are likely to stimulate credit growth for the household sector. Meanwhile, the 7.5 percent exchange rate devaluation in February 2004 may in due course result in higher import prices and cost-push pressures throughout the economy, while moderate increases in administered prices are also expected.

2. Public Finance

(a) Budgetary Performance, 2002/03 and 2003/04

(i) Final 2002/03 Budget

2.1 The final budget outcome for 2002/03 was better than expected, with the budget deficit much lower than both in the revised and original budgets.[7] Total revenue for the year amounted to P14 311 million, while total expenditure was P15 710 million, resulting in a budget deficit of P1 399 million, which was 36.9 percent lower than the revised estimate of P2 216 million and 13.6 percent below the original budget estimate of P1 619 million. The improvement was due mainly to the reduced growth rate of overall expenditure which, in turn, was accounted for by a fall of 19 percent in development outlays compared to the original budget estimate and a 6.7 percent drop against the revised estimate, while recurrent expenditure declined by 0.5 percent and 3 percent, respectively.

(ii) Revised 2003/04 Budget

2.2 Following two successive years of large deficits, the Government implemented a variety of measures to achieve a balanced budget in the 2003/04 fiscal year.

2.3 As announced in the 2004 Budget Speech, the revised budget for 2003/04 is in approximate balance, due to both expenditure control and the adoption of additional revenue measures. Among the new revenue generating measures are the sale of the Public Debt Service Fund (PDSF) loan portfolio, and the drawing of dividends from profitable public enterprises.[8] Revenue collections from 'other property income', which includes dividends from public enterprises, is projected to increase by 43.7 percent, while the sale of Government shares worth P630 million in Anglo American Corporation are expected to boost revenue from 'sale of property' significantly.[9] These revenue increases partially offset the sharp reductions in mineral revenue (17.4 percent), non-mineral income taxes (11.8 percent) and VAT collections (25.2 percent). Total revenue is expected to amount to P16 182 million in 2003/04, a reduction of 7.7 percent on the original estimate of P17 539 million.

2.4 Overall Government expenditure for 2003/04 is expected to amount to P16 207 milion, a 6.5 percent reduction over the original estimate. The reduction reflects slower growth of recurrent and development spending of 9.4 percent, compared to 15.8 percent in 2002/03, following discretionary cuts of recurrent expenditure by 5 percent and development spending by 10 percent. The devaluation of the Pula in February

7 The annual Budget Speeches contain data for the budget covering three years, i.e., budget proposals for the coming year, the revised estimates for the current financial year and the final outturn for the previous year.

8 These are the Botswana Development Corporation (P31.4 million), Botswana Telecommunications Corporation (P23.4 million), Water Utilities Corporation (P20.2 million), Botswana Building Society (P6 million), Botswana Power Corporation (P139 million), National Development Bank (P18.7 million), Botswana Telecommunications Authority (P130 million), Air Botswana (P2.5 million) and Botswana Housing Corporation (P9.4 million).

9 There may well be further beneficial spin-offs from the payment of dividends by public enterprises, such as reducing the stock of Bank of Botswana Certificates held by public enterprises and the interest payable thereon.

2004 is not expected to affect the expenditure outcome because of the strict cash limits set.

2.5 The revised projected budget balance for 2003/04 is a small deficit of about P24 million. However, the final 2003/04 budget outcome will critically depend on the success of measures taken to boost revenue and reduce spending as well as exchange rate developments in the last quarter of the financial year. While a balanced budget is now projected for the 2003/04 financial year, this has been largely achieved through asset sales. These measures help to achieve the immediate objective of a balanced budget, but are unlikely to be sustainable on a continuous basis going forward.

(b) 2004/05 Budget: Theme and Programmes

2.6 The theme for the 2004 Budget Speech is ‘Improving Economic Performance: A Vehicle for Sustainable and Diversified Development’. The choice of the theme is in recognition of the importance of improved economic performance in achieving the objectives of NDP 9, Vision 2016 and the United Nation’s Millennium Goals. A number of practical steps that will be taken to improve economic performance are described below.

2.7 *Productivity Improvement* – Implementation of the Performance Management System (PMS) in the public sector, specifically the introduction in 2004 of performance management contracts for senior staff and performance based reward system for the rest of the public sector, as well as the decentralisation and computerisation of the personnel management system.

2.8 *Health and Education* – Continued training of health care personnel in order to improve health care service delivery, while health care infrastructure is improved through the upgrading of hospitals, as well as the amendment and introduction of legal instruments aimed at protecting public health. With respect to education, Government has taken over the running of Community Junior Secondary Schools to ensure uniform standards of education throughout the country; established the Tertiary Education Council in 2003 to guide the development of tertiary education; and is intending to expand the University of Botswana and proceed with the detailed planning for a second university.

TABLE 1.1 GOVERNMENT BUDGET: 2002/03 – 2004/05 (P MILLION)

	2002/03			2003/04		2004/05
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	15 411.4	14 426.1	14 311.0	17 538.9	16 182.2	18 208.9
Mineral	8 492.0	7 039.9	7 502.7	8 140.0	6 721.0	8 070.4
Non-mineral	6 919.4	7 386.2	6 808.4	9 398.9	9 461.2	10 138.5
Expenditure	17 030.5	16 642.3	15 710.1	17 333.0	16 206.7	18 140.1
Recurrent	11 642.4	11 939.6	11 581.1	13 318.8	13 258.0	14 570.5
Of which:						
Salaries[1]	3 884.2	3 903.1	3 946.5	4 132.4	3 941.2	4 775.6
Development	5 187.0	4 501.6	4 200.2	4 431.3	4 000.0	3 610.0
Other[2]	201.1	201.1	–71.2	–417.1	–1 051.3	–40.4
Balance	–1 619.1	–2 216.2	–1 399.1	205.9	–24.4	68.8

1. Wages, Salaries and related staff costs
2. Includes FAP grants and net lending

Source: Financial Statements, Tables and Estimates of the Consolidated Development Fund Revenues 2004/05, MFDP.

2.9 *Privatisation* – The privatisation of public enterprises is expected to accelerate following the release of the Privatisation Master Plan (PMP). Most public enterprises were profitable in 2002/03.

2.10 *Financial Market Development* – Steps will be taken to develop and improve the functioning of capital markets. These will include listing government bonds on the Botswana Stock Exchange, the sale of the PDSF loan portfolio to the private sector, and consideration of the feasibility of establishing a financial services regulatory authority to regulate and oversee non-bank financial institutions. Recent financial sector reforms include the adoption in March 2003 of anti-money laundering regulations and further automation of the national payments system.

2.11 *International Relations* – Botswana will continue to pursue increased integration with the international economy through existing and future trade agreements and arrangements, such as the South African Customs Union Agreement (SACUA), the Southern African Development Community (SADC) Trade Protocol, the Africa Growth and Opportunity Act (AGOA) and the Cotonou Agreement, as a way of exposing local producers to international market pressures and competition and permitting the achievement of economies of scale not possible in the small domestic market.

2.12 *Monetary and Exchange Rate Policies* – In its pursuit of the objectives of low inflation, maintenance of positive real interest rates and international competitiveness, monetary policy effectively contributes to the broader national objective of improving economic performance and achieving sustainable and diversified growth. Together with the exchange rate policy, it aims at maintaining a stable and competitive real effective exchange rate, which is necessary for achieving diversified growth.

2.13 *Public Procurement and Asset Disposal Board (PPADB)* – Given its main objective of enhancing the operational efficiency of the public procurement system, major institutional developments took place during 2003 aimed at ensuring that this objective is achieved. Among these were the establishment of:

- an Advisory Committee (AC) which advises the Ministry of Finance and Development Planning of any weaknesses in the operations of the Board;
- an Independent Complaints Review Committee, which reviews the Board's decisions subject to challenge by stakeholders, e.g., contractors and procuring entities; and
- Ministerial and District Tender Committees intended to ensure that speedy decisions are made.

2.14 *Citizen Entrepreneurial Development Agency* – New developments since the 2003 Budget Speech include the launching of the Venture Capital Fund in late 2003; the take-over from Government of the monitoring of Financial Assistance Policy (FAP) small-scale projects; and planning for the new Credit Guarantee Scheme (CGS). The revised guidelines for the CGS provide for:

- an upper loan limit of P2 million, up from P250 000 in the earlier scheme, to support development of small and medium enterprises;
- a guarantee cover to the participating banks of 75 percent, up from 60 percent, of the net loss;
- a reduced maximum interest rate of prime plus 2 percentage points;
- participating banks provide the funds and appraise projects;
- collateral or security required by banks is subject to negotiation between lender and borrower.

2.15 *Information and Communications Technology* – In order to extend access to ICT to rural communities, the Government will continue to expand telecommunication services through the Nteletsa 1 and Nteletsa 2 projects.

2.16 *Promotion of Trade and Investment* – The Industrial Development Act is being reviewed with the intention of simplifying industrial licensing system in order to enable the speedy issuance of licenses.

(c) 2004/05 Budget Estimates

(i) Revenue

2.17 Total revenue for 2004/05 is forecast at P18 209 million, up 12.5 percent over the revised estimate for 2003/04. Mineral revenue is expected to increase by 20.1 percent, due largely to the expected gradual depreciation of the Pula against the US dollar, and the impact of the recent Pula devaluation; while customs and excise revenue is expected to rise by 45.6 percent. Increases are also expected from non-mineral income taxes (14.3 percent), and VAT collections (20 percent).

(ii) Expenditure

2.18 Total expenditure and net lending for 2004/05 is expected to grow by 11.9 percent over the revised estimates for 2003/04 to reach P18 140 million, a sharp rise compared to the 3.2 percent growth in the previous year. Expenditure figures, however, include the proceeds from the sale of the PDSF loan book in 2003/04 as negative spending; when this is excluded, the increase in expenditure slows to about 9 percent in 2003/04 and 5 percent in 2004/05, compared to 16 percent in 2002/03. Government spending growth has thus been on a downward trend and, if sustained, should contribute to the achievement of the monetary policy objective of price stability.

2.19 With revenue slightly higher than expenditure, the budget has a small surplus of P69 million. As expected, the balancing of the budget is contingent on the prudent management of financial resources and efficient collection of revenue. The Minister of Finance and Development Planning indicated in his 2004 Budget Speech that should actual revenue collected fall short of the expected revenue receipts during the course of the year, development expenditure could be reduced further. This prospect could have a dampening effect on inflation (as competition for resources from the government is reduced) and on the growth of the construction and manufacturing sectors due to the construction sector's dependence on government custom and its use of manufactured inputs, and also due to the reliance of the manufacturing sector on the Government as a direct customer.

(iii) Fiscal Legislation

2.20 The 2004 Budget Speech contains no increases in basic tax rates. However, revenue pressures have necessitated amendments to the Income Tax Act to address long-standing anomalies, the effect of which will be to enhance equity, reduce opportunities for abuse of the tax system and improve tax compliance and administration. These are expected to bring in additional revenue of P50 million a year. A summary of these proposals follows:

- Farming losses that can be offset against non-farming income will be limited to 50 percent of non-farming income, as opposed to allowing all such losses to be offset against other income.

- The factor used in calculating the taxable value of housing benefits for rated properties will be raised to 10 percent from 6 percent, and for non-rated properties to 8 percent from 5 percent, in order to align taxation of these benefits with international practice, where the full market value of the property is used.

- The current 50 percent discount allowed for capital gains realised on sale of shares in a private company will be reduced to 25 percent, while only Botswana resident companies will benefit from the tax exemption of capital gains from sale of shares in public companies.

- The annual allowance for saloon cars and station wagons will be raised to P175 000 from P100 000, while disposal losses on sale of these vehicles cannot be claimed alongside the annual allowance. For businesses that lease or rent these vehicles the rules for claiming deductions in respect of leasing and renting will be changed to ensure that the tax effects are the same whether a business buys, rents or leases such vehicles. Companies in the business of renting and leasing cars will not be affected.

- Income from commercial aspects of non-governmental organisations, which is currently exempt from tax, will be subject to tax and such entities required to file income tax returns unless they can satisfy the Commissioner of Taxes that their income from activities of a business nature and capital gains are applied for public benefit purposes.

- All companies will henceforth be required to file tax returns and pay tax due within four months of the end of their financial year.

- Self-employed persons with multiple income sources will now be required to make two half-yearly payments, the first during the tax year and the second soon after the end of the tax year.

- The condition imposed on International Financial Services Centre companies, obliging them only to do business with non-residents, will be relaxed to allow them to deal with related companies which are part of their group operations and resident in Botswana.

- The limit on construction expenditure per dwelling unit that businesses can claim for the provision of housing to their workers will be raised to P25 000 from the current P5 000.

- Payments by any local telecommunications company in settlement of international telephone traffic fees, such as those regularly made by the Botswana Telecommunications Corporation, will be exempt from withholding tax.

- All payments to non-resident entertainers, regardless of who receives the payments or how they are made, will be subject to the 10 percent withholding tax provided for in the law.

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

(a) Exchange Rates

3.1 During 2003 the Pula appreciated in nominal terms against major international currencies on the back of the significant appreciation of the rand and the weakening of the US dollar.

3.2 The strengthening of the rand was attributable to a combination of factors, including strong commodity prices and the apparent renewed interest by international investors in the South African economy. On the other hand, the weakening of the US dollar was mainly due to the increase in the budget and current account deficits in the US and continued risk of terror attacks which have eroded the dollar's role as a 'safe haven' during times of uncertainty. Given the link to the rand through the currency basket, the Pula appreciated by 13.3 percent against the SDR, which included a 23.1 percent appreciation against the US dollar, but depreciated by 5.9 percent against the rand during 2003 (Table 1.2).

3.3 Botswana's exchange rate policy is guided by the need to maintain competitiveness in its trading partner countries' markets. In order to achieve this objective, exchange rate policy aims to keep the nominal effective exchange rate (NEER) of the Pula stable by pegging the value of the Pula to a basket of currencies comprising the South African rand and the SDR in proportions that reflect Botswana's international trade and financial relations. For most of 2003, this objective was achieved, as the NEER was

TABLE 1.2 NOMINAL AND REAL PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES

Nominal Exchange Rates (Foreign Currency per Pula)			
As at end of	**2002**	**2003**	**Percentage Change**
SA rand	1.5801	1.4875	–5.9
US dollar	0.1829	0.2251	23.1
Pound Sterling	0.1140	0.1265	11.0
Japanese yen	21.68	24.06	11.0
SDR	0.1356	0.1536	13.3
Euro	0.1745	0.1791	2.6
Nominal Effective Exchange Rate	**101.3**	**101.7**	**0.4**
(Index, Nov. 1996 = 100)			

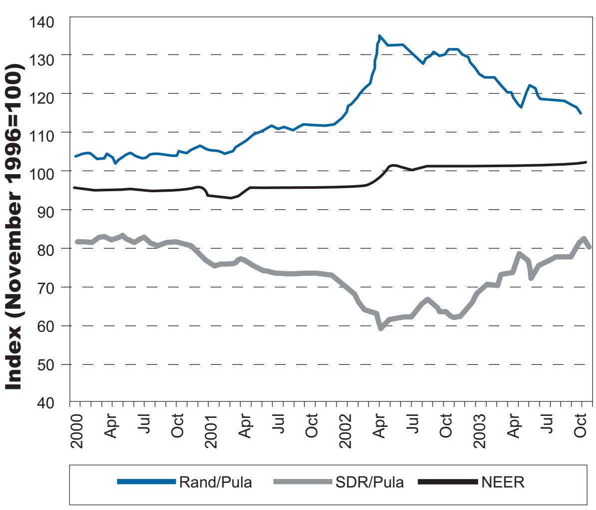
Real Pula Exchange Rate Indices (November 1996=100)			
SA rand[1]	124.4	119.2	–4.2
SA rand[2]	130.5	130.3	–0.2
US dollar	91.1	117.1	28.5
SDR	99.9	118.3	18.4
Real Effective[1] Exchange Rate	**114.8**	**118.4**	**3.1**

1. Calculated using South African core inflation. Core inflation is the all items of consumer price inflation excluding mortgage interest costs and prices of various volatile food items.
2. Calculated using South African headline inflation.

Source: Bank of Botswana.

relatively stable, appreciating marginally by 0.4 percent as the impact of the Pula appreciation against the SDR was offset by the local currency's depreciation against the rand (Chart 1.6). However, the broader macroeconomic policy framework also includes monetary policy to promote competitiveness by maintaining Botswana inflation at levels no higher than the weighted average of the inflation rates of major trading partners. Therefore, in broad terms, the overall level of competitiveness can be defined in terms of the real effective exchange rate (REER), which adjusts the NEER by relative prices in Botswana and its major trading partners. In Charts 1.6, 1.7 and 1.8, an appreciation of the Pula is denoted by a rise in the index and a depreciation by a decline in the index.

CHART 1.6 NEER AND NOMINAL EXCHANGE RATE INDICES AGAINST SELECTED CURRENCIES

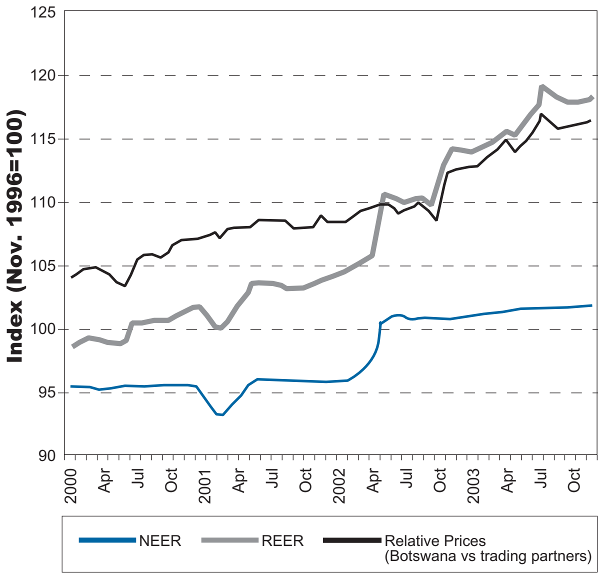


Source: Bank of Botswana

3.4 During 2003, competitiveness was further eroded given that the real effective exchange rate (REER) appreciated by 3.1 percent, following a 3.7 percent appreciation in 2002. As the NEER was virtually unchanged, the appreciation of the REER was due to higher inflation in Botswana than in trading partner countries which was, in turn, largely due to the rapid decline in inflation in South Africa.

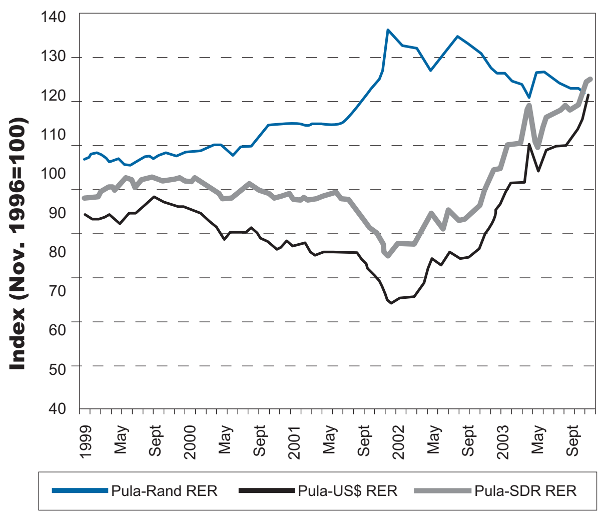
Trading partner inflation at the end of 2003 was 3.5 percent, as compared to inflation of 6.4 percent in Botswana (Chart 1.7). Against individual currencies, the Pula weakened in real terms by 4.2 percent (using core inflation) against the South African rand but appreciated by 18.5 percent against the SDR; the Pula registered a 28.5 percent strengthening against the US dollar (Chart 1.8).

CHART 1.7 NOMINAL AND REAL EFFECTIVE EXCHANGE RATES AND RELATIVE PRICES



Source: Bank of Botswana

CHART 1.8 REAL EXCHANGE RATE (RER) INDICES AGAINST SELECTED CURRENCIES



Source: Bank of Botswana

(b) Overview of the Balance of Payments

3.5 Prior to 2002, Botswana's balance of payments account was heavily influenced by the external indebtedness of the BCL copper/nickel mining operation to its shareholders. In particular, debt service payments were generally forgone by external shareholders, in light of the company's cashflow difficulties; in balance of payments terms, this was classified as imputed inflows of foreign investment. This approach was adopted again in the provisional balance of payments estimates for 2002. However, in late 2002, there was change of ownership of BCL, following the decision by Anglo American to sell all of its copper mining interests in Botswana to Lion Ore. This transaction entailed payment of accrued debt service obligations as well as transfer of BCL's liabilities to Anglo American to the Botswana Government. As a result of this arrangement, there were significant changes to the balance of payments estimates for 2002 in both the current and financial accounts as well as the international investment position (IIP). In future years, BCL's indebtedness will no longer have such a distortionary effect on the balance of payments, since these debts are now classified as domestic liabilities.

3.6 In 2003, as was the case in 2002, there was a substantial fall in foreign exchange reserves largely reflecting continuing valuation losses due, primarily, to the appreciation of the Pula. There was an improvement in the overall balance of payments, however, with a surplus estimated at P797 million, P461 million higher than the P336 million recorded in 2002. The current account surplus is estimated at P3 703 million, while the financial account showed a net outflow of P3 475 million, continuing a trend of negative financial account balances that started in 1998.

(i) *Trade Account*

3.7 Preliminary estimates show a 19 percent decline in the merchandise trade balance, from P4 276 million in 2002 to P3 449 million in 2003. Exports decreased by 3 percent to P14 184 million from

TABLE 1.3 BALANCE OF PAYMENTS: 1999 – 2003 (P MILLION)

	1999	2000	2001	2002*	2003#
Current Account Balance, of which	2 859	2 782	3 689	1 078	3 703
Visible Trade Balance	3 629	4 603	4 346	4 280	3 449
Services Balance	-721	-1 136	-1 010	-127	174
Income Balance	-1 213	-1 792	-801	-4 418	-1 455
Net Current Transfers	1 164	1 108	1 153	1 344	1 535
Financial Account Balance	-1 127	-1 021	-2 976	-1 375	-3 475
Capital Account Balance	95	194	34	99	111
Net Errors and Omissions	2	-15	278	533	457
Overall Balance	1 829	1 941	1 024	336	797

Source: Bank of Botswana * Revised # Provisional

P14 672 million in 2002. Although the international diamond market remained buoyant[10], the value of Botswana diamond exports declined by 6.1 percent due to the appreciation of the Pula against the US dollar, the currency in which diamonds are priced and sold. There was a 44.0 percent increase in copper and nickel exports during 2003, in response to strong demand for nickel, which led to a 40 percent rise in the metal price from the cyclical low in 2001, while copper prices rose by an average of 10 percent. However, soda ash exports declined by 14.3 percent as competition from other suppliers to the South African market intensified due to the strength of the rand, and hence the Pula, against the US dollar. The 6.8 percent fall in beef exports was explained by a further outbreak of foot and mouth disease in the northwest of Botswana, in January 2003, together with adverse effects of the severe drought conditions that extended into 2003, which reduced the quantity and quality of production.

3.8 Provisional estimates indicate that imports rose to P10 735 million, an increase of 3 percent from P10 392 million in 2002.[11]

TABLE 1.4 EXPORTS: 2002–2003 (P MILLION)

	2002	2003	Percentage Change
Total Exports	14 672	14 184	-3.0
of which:			
Diamonds	12 474	11 707	–6.1
Copper-Nickel	482	695	44.0
Beef	279	260	–6.8
Soda Ash	268	230	–14.3

Source: Bank of Botswana, based on data from De Beers Botswana, BCL, Botswana Ash, BMC and Schachter and Namdar.

(ii) Current Account

3.9 The current account surplus of P3 703 million in 2003 was P2 625 million more than the revised estimate of P1 078 million for 2002. The lower surplus in 2002 was a result of a large deficit on the income account (–P4 418 million). This in turn was mainly the result of the financial restructuring and change of ownership of BCL, following which repayments of accumulated debt service obligations (both principal and interest) led to large imputed outflows of investment income. In addition, earnings on external reserves declined, due to combined effects of the poor performance of equity markets and the appreciation of the Pula.

3.10 There was an estimated surplus of P174 million on the services account in 2003, which

10 Reports by De Beers, the company through which all Botswana diamonds are marketed, indicates that the company's profits rose by 10 percent.

11 These figures are very approximate, as they were estimated from actual data covering part of the year only.

contrasted with a P127 million deficit in 2002. The estimated surplus in 2003 resulted from the apparently slow nominal growth of imports, which have a direct impact on services through associated transport costs[12], and reverses the historical trend of deficits.

3.11 The current transfers account, which is dominated by Southern African Customs Union (SACU) transactions, continued to show a surplus of P1 535 million in 2003, P191 million more than P1 344 million in 2002.

(iii) Capital and Financial Accounts

3.12 Modest surpluses on the capital account continued in 2003. However, the financial account, which covers transactions relating to equity, debt and other financial instruments, recorded a large net outflow of P3 475 million, continuing a trend evident since 1998. The large net outflows were mainly due to offshore investments by the rapidly growing pension funds, particularly following the establishment of the Public Officers Pension Fund in 2001. In 2002, however, despite these large outflows of portfolio investment, the deficit on the financial account was much lower than in both 2001 and 2003 due to large imputed inflows relating to the restructuring of BCL debt. The 'other investment' category of the financial account, which is made up of transactions with respect to loans, trade credits, currency and deposits and SACU transactions showed a net outflow of P797 million in 2003, due mainly to movements in bank deposits. Further details of the capital and financial accounts are provided in Table 6.1 in the Statistical Section.

(iv) Foreign Exchange Reserves

3.13 The level of foreign exchange reserves was P23.7 billion as at the end of December 2003, a 20.7 percent decline from P29.9 billion in December 2002, largely reflecting the appreciation of the Pula against the major international currencies during the course of the year. In US dollar and SDR terms, the reserves declined by 2.5 percent and 10.2 percent, respectively. The decrease in the foreign exchange reserves in foreign currency terms was driven by capital outflows related to overseas investment of the Public Officers Pension Fund and by the poor performance of equity markets.

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

(i) International Investment Position

3.14 Comprehensive data on stocks of external financial assets and liabilities are available up to the end of 2002, with preliminary estimates for 2003.[13] Based on the preliminary estimates for 2003, Botswana's total foreign assets declined by P1 867 million during the year from P41 736 million at the end of 2002. The decline was a result of the P6 209 million fall in the foreign exchange reserves which was , however, partly offset by the substantial increase in financial assets abroad, due mainly to the offshore portfolio investments of Public Officers Pension Fund.

3.15 Foreign liabilities increased by P1 125 million, from P10 865 million in 2002 to P11 990 million in 2003. The bulk of the increase (P442 million) was due to public and private loan obligations.

(ii) Industry and Country Classification of Investment

3.16 Tables 1.5 and 1.6 show Botswana's stock of

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12 This account covers a wide range of services including transportation as well as insurance and other professional services. The reported, but as yet not satisfactorily explained, turnaround in the services account indicates possible deficiencies in data collection for an area of the economy that has been developing very rapidly.

13 The 2003 data were derived by adding flows to the previous year's stocks, i.e., valuation changes are not included. (This is with the exception of foreign exchange reserves and portfolio investment assets, where preliminary data, including valuation changes, are available up to December 2003 in the case of reserves. The portfolio investment assets were estimated using actual data up to September 2003.)

TABLE 1.5 LEVEL OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY (P MILLION AS AT 31 DECEMBER 2002)

	Foreign Direct Investment			Other Investment			
Industry	**Equity**	**Non Equity**	**Total**	**Equity**	**Non equity**	**Total**	**Total Investment**
Mining	3 557	2 058	5 615	34	1 743	1 777	7 392
Manufacturing	116	164	280	…	…	…	280
Finance	648	155	803	21	178	199	1 002
Retail and Wholesale	709	47	756	…	101	101	857
Electricity, Gas and Water	19	…	19	…	225	225	244
Real Estate and Business Services	101	3	104	2	76	78	182
Transport, Storage and Communication	49	106	155	…	51	51	206
Construction	4	9	13	…	4	4	17
Hospitality	124	5	129	…	…	…	129
Public Administration	…	…	…	…	2 443	2 443	2 443
Other	1	…	1	…	1	1	2
Total	**5 329**	**2 547**	**7 876**	**57**	**4 823**	**4 880**	**12 755**

Source: Bank of Botswana

TABLE 1.6 LEVEL OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY (P MILLION AS AT 31 DECEMBER 2002)

	Foreign Direct Investment			Other Investment			
Country	**Equity**	**Non Equity**	**Total**	**Equity**	**Non equity**	**Total**	**Total Investment**
N America and Central America	**37**	**3**	**40**	**…**	**…**	**…**	**40**
United states of America	32	…	32	…	…	…	32
Europe	**3 899**	**152**	**4 051**	**2**	**422**	**424**	**4 475**
of which							
United Kingdom	484	129	613	…	60	60	673
Netherlands	16	5	21	…	…	…	21
Germany	…	…	…	…	181	181	181
Luxembourg	3 313	…	3 313	…	43	43	3 356
Other Europe	86	9	95	2	55	57	152
Asia Pacific	**98**	**9**	**107**	**20**	**724**	**744**	**851**
Africa	**1 205**	**2 383**	**3 588**	**35**	**2 008**	**2 043**	**5 631**
South Africa	1 077	2 383	3 460	35	1 928	1 963	5 423
Middle East	**22**	**…**	**22**	**…**	**57**	**57**	**79**
Other	**68**	**…**	**68**	**…**	**1 611**	**1 611**	**1 679**
Total	**5 329**	**2 547**	**7 876**	**57**	**4 823**	**4 879**	**12 755**

Source: Bank of Botswana

foreign liabilities at the end of 2002 classified by industry and by country, respectively.

3.17 As noted earlier, BCL's foreign direct investment (FDI) liabilities declined in 2002, resulting in a reduction of the dominance of the mining industry in total FDI. By the end of 2002, the share of mining had declined to 71.3 percent of total FDI from 81 percent in 2001, while the proportion for the financial sector increased from 7 percent to 10.2 percent, making it the second largest recipient of FDI after mining. The recent increase in distribution outlets in the wholesale and retail sector was reflected in an increase in the proportion of FDI in this sector to 9.6 percent in 2002 from 6.2 percent in 2001.

3.18 As at the end of 2002, the bulk of FDI (51.4 percent) was from Europe, overtaking South Africa as the major source. The turnaround in the respective shares of FDI was again mainly explained by the transactions related to BCL. Though still large, South Africa's share of total FDI liabilities fell to 43.9 percent from 60.1 percent in the previous year.

3.19 The Government's international borrowing continued to dominate the 'other investment' category, accounting for 50.1 percent of these liabilities in 2002. The mining industry accounted for a further 36.4 percent of this category.

4. Money and Capital Markets

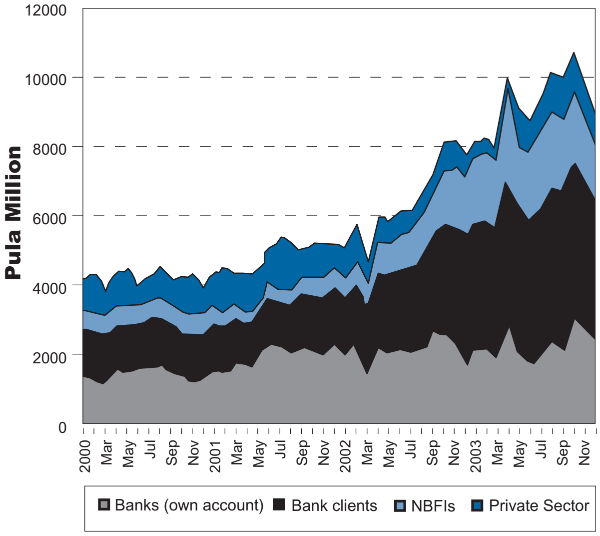
(a) Monetary Policy and Liquidity Management

4.1 The principal objective of monetary policy in Botswana is to promote and maintain monetary stability through achieving a sustainable, low and predictable level of inflation thus contributing to the broader national objective of achieving sustainable and diversified economic growth. Attaining sustainable, low and stable inflation will, among others, facilitate the maintenance of international competitiveness. In 2003, the Bank maintained the inflation objective range of 4–6 percent as specified in the 2003 Monetary Policy Statement. The desired inflation range reflected an assessment of forecast inflation for trading partner countries and was considered suitable to maintain external competitiveness as well as influence inflation expectations downwards.

4.2 Although inflation was high in the first half of 2003 following the introduction of VAT in July 2002, it declined significantly during the second half, reflecting the decline in demand-driven inflationary pressures and the falling away of VAT from the inflation calculation. Moreover, the downward trend in the growth rate of credit continued throughout the year and was largely consistent with the inflation objective. Although the annual increase in Government spending was somewhat higher than rates that would be consistent with the inflation objective being pursued, it still implied a better balance between fiscal and monetary policies. Therefore, as credit growth slowed and inflation declined and the global outlook remained supportive of continuing low inflation abroad, the Bank took the opportunity to reduce the Bank Rate twice, by 50 basis points in October and another 50 basis points in December, to 14.25 percent, thus reversing increases of similar magnitude in October and November 2002.

4.3 The Bank undertook open market operations to sterilise increases in liquidity arising, for the most part, from the ongoing funding by the Government of the Public Officers Pension Fund. Funds were also attracted to Bank of Botswana Certificates (BoBCs) by relatively high rates compared to alternative financial investments and external markets. However, growth in BoBCs slowed towards the end of 2003 largely due to shifting of funds to bonds and external investments. Overall, outstanding BoBCs rose year-on-year by 14 percent to P8 870.5 million in December 2003, from P7 782.6 million at the end of 2002, a slower rate of increase compared to 49.1 percent in 2002. Most of the increase in BoBCs was in holdings by the non-bank private sector and commercial banks,

CHART 1.9 OUTSTANDING BANK OF BOTSWANA CERTIFICATES (BoBCs)



Source: Bank of Botswana

which rose by 45 percent and 28.9 percent, respectively. Holdings by commercial banks' clients increased by 6.1 percent, and were 42.4 percent of the total BoBCs, while those held by other financial institutions increased by 4.6 percent.

4.4 There was active secondary market trading in BoBCs in 2003 as the value of certificates traded increased by 69 percent to P8 814 million, although the market continued to be dominated by trade with the Bank of Botswana, which accounted for 76 percent of the value of transactions. The value of BoBCs traded in the secondary market between the Bank and counterparties was P6 742 million, 47.5 percent higher than P4 572 million traded in 2002. However, there was a significant improvement in trading among counterparties compared to the previous years as the value of transactions among counterparties rose sharply to P2 072 million in 2003 from P630 million in 2002.

4.5 Government bonds worth P2.5 billion were issued in 2003, with maturities of 2 years, 5 years and 12 years, and yields at auction of 13 percent, 12.65 percent and 11.5 percent, respectively. Secondary market activity amounted to P408 million for the whole of 2003 and, at the end of December 2003, the yield curve was downward sloping and rates on the bonds had fallen, an indication that the market expected the decrease

TABLE 1.7 STRUCTURE OF BANK OF BOTSWANA CERTIFICATE HOLDINGS

	P Million		Percentage	Share of total (percent)	
	2002	2003	Change	2002	2003
Commercial Banks	1 776	2 289	28.9	22.8	25.8
Banks' Clients	3 544	3 759	6.1	45.5	42.4
Other Financial Institutions	1 849	1 934	4.6	23.8	21.8
Other Institutions	614	890	45.0	7.9	10.0
Total	7 783	8 871	14.0	–	–

Source: Bank of Botswana

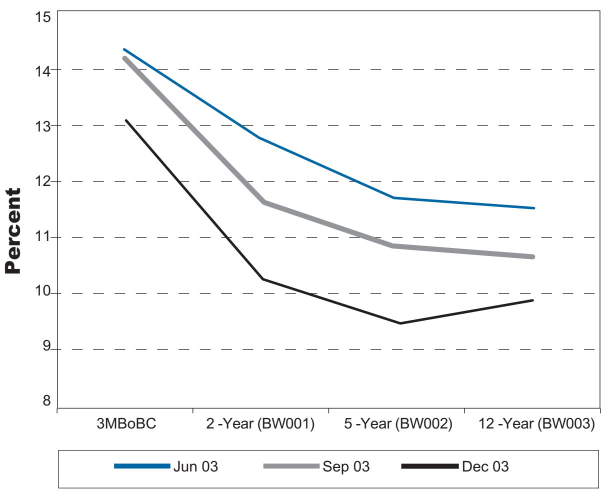
TABLE 1.8 YIELD TO MATURITY ON BoBCs AND GOVERNMENT BONDS (PERCENT)

Instrument	End March	End June	End September	End December
3-Month BoBCs at auction date	14.31	14.27	14.15	13.04
BW001 (2-year)	-	12.75	11.60	10.25
BW002 (5-year)	12.65	11.65	10.85	9.50
BW003 (12-year)	-	11.50	10.65	9.90

Source: Bank of Botswana

in inflation to continue. This was the first-ever issue of bonds by the Government of Botswana, and was primarily intended to support capital market development given that the Government has no immediate need for the funds.

CHART 1.10 YIELD TO MATURITY ON BOBCS AND GOVERNMENT BONDS



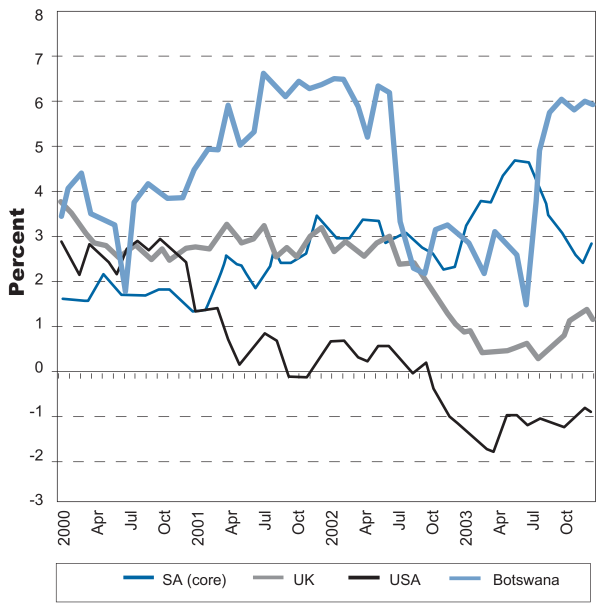
Source: Bank of Botswana

(b) Interest Rates

4.6 Short-term nominal interest rates were relatively stable during the first nine months of 2003, but fell in the last three months of the year following the decrease in the Bank Rate to 14.25 percent from 15.25 percent. The nominal three-month BoBC mid-rate fluctuated in a range of 12.74 percent and 14.01 percent between January and December 2003, with lower rates towards the end of the year due to the easing of monetary policy and market expectations of further interest rate cuts. Commercial banks reduced the cost of borrowing by cutting their prime lending rates to 15.75 percent in December 2003 from 16.75 percent in January, while the average 88-day deposit rate fell to 9.5 percent from 10.15 percent over the same period. The spread between lending rates and deposit rates declined marginally, as the deposits rates generally fell by fewer basis points than the prime lending rate.

4.7 Real money market rates were relatively low during the first half of 2003 as a result of the increase in inflation, but rose sharply in the second half of the year as inflation declined. Therefore, despite the decrease in the Bank Rate, the real three-month BoBC rate increased to 6 percent in December 2003 from 2.9 percent in January and 1.5 percent in June. As at the end of the year, the real commercial bank prime lending rate was 8.8 percent, and real interest rates in Botswana remained higher than comparable rates in South Africa, UK and USA.

CHART 1.11 REAL INTEREST RATES: INTERNATIONAL COMPARISONS



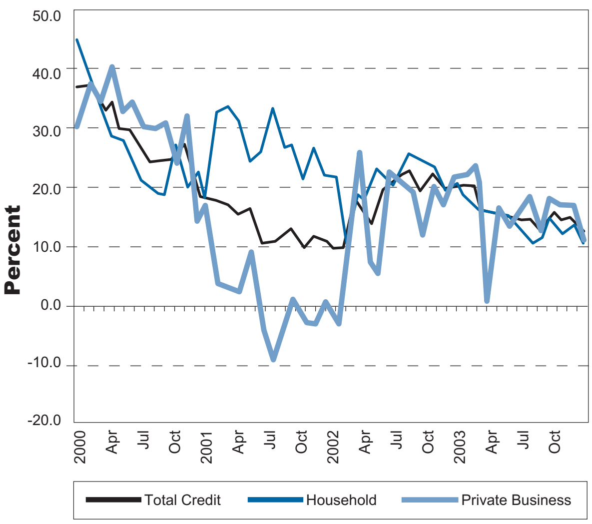
Source: Bank of Botswana

(c) Banking System

(i) Domestic Credit

4.8 The annual rate of growth of commercial bank credit was 10 percent in December 2003, considerably lower than 21.3 percent in December 2002. Both business and household borrowing increased at lower annual rates compared to 2002. The slowdown in the rate of credit growth in 2003 reflected a number of factors, including the restrictive monetary policy maintained throughout the year, and the absence of salary increase for civil servants, which restricted growth in personal incomes and, therefore, access to higher levels of credit for households. At 10 percent in December 2003, the rate of credit expansion was below the range of 12 – 14 percent considered by the Bank to be consistent with its desired inflation objective.

CHART 1.12 ANNUAL GROWTH RATES OF CREDIT



Source: Bank of Botswana

(ii) Monetary Aggregates

4.9 Money supply (M4) grew year-on-year by 13.8 percent in 2003 compared to 23.9 percent in 2002. The main influence on monetary growth during the year was the expansionary effect of the 36.4 percent reduction in Government deposits at the Bank of Botswana and the 12 percent rise in private sector credit, which outweighed the contractionary impact of the 19.5 percent fall in net foreign assets. The major contributing factors to the decline in Government deposits and net foreign assets were unrealised currency revaluation losses on foreign exchange reserves and externalisation of part of the pension funds. By component, the increase in M4 was reflected in a 9.6 percent increase in non-bank holdings of Bank of Botswana Certificates (BoBCs), and a faster rate of increase in call, savings, notice and time deposits, which rose by 23.9 percent in 2003 compared to a contraction of 1.7 percent in 2002. Demand deposits increased at a slower rate of 10.2 percent compared to 25.5 percent during the same period. The value of foreign currency deposits declined by 1.3 percent in 2003 due to the continued appreciation of the Pula against major international currencies, compared to a 22.3 percent contraction in 2002. Currency outside banks grew by 13.4 percent in 2003 reversing a decline of 2.4 percent in 2002.

(iii) Bank of Botswana

4.10 Total assets/liabilities of the Bank of Botswana decreased further by 20.3 percent to P24 009.3 million in 2003, following a fall of 27 percent in 2002. The decline in the balance sheet was mainly attributable to the 35.7 percent decrease in Government deposits at the Bank of Botswana due to the transfer of funds to the Public Officers Pension Fund, unrealised currency revaluation losses and foreign exchange outflows. The currency revaluation losses arising from the appreciation of the Pula, and foreign exchange outflows as well as the poor performance of the international financial markets resulted in a 20 percent decline in foreign exchange reserves. The long-term investment portfolio, the Pula Fund, decreased by 21.4 percent during the year while the Liquidity Portfolio fell by 19.5 percent.

(iv) Commercial Banks

4.11 Total assets of commercial banks grew year-on-year by 15.9 percent in 2003, to P12 963 million, compared to the much lower growth rate of 1.7 percent in 2002. Contributory factors to the increase in total assets were a 9.5 percent expansion of outstanding loans and advances and a 14.3 percent rise in balances due from foreign banks.

4.12 On the liabilities side, total deposits (i.e., excluding Government deposits) at commercial banks increased by 16.8 percent in 2003 to P10 426 million, contrasting with a decrease of 2.7 percent in 2002. Of the deposits, 14.4 percent was held in foreign currency accounts compared to 17.1 percent in 2002. Commercial banks' capital and reserves increased considerably, by 22.1 percent to P1 346 million in 2003 compared to a 5.8 percent rise in 2002.

(v) Merchant Banks

4.13 Total assets/liabilities of the two merchant banks, Investec Bank and ABC, increased by 26 percent during 2003, to P1 066 million, compared to an increase of 30.1 percent in 2002. Most of the growth in assets was due to a sharp increase of 43.6 percent in loans and advances, to P504 million, raising their share of total loans and advances of the consolidated banking sector to 7 percent. The merchant banks' holdings of BoBCs increased by 35.4 percent in 2003 compared to 50.5 percent in 2002. With respect to liabilities, total deposits increased by 21.6 percent, mostly held in notice and time accounts.

(d) Non-Bank Financial Institutions

4.14 The Botswana Building Society (BBS) increased its total assets/liabilities by 5.8 percent in the first six months of 2003 compared to a 7.9 percent growth in 2002. Mortgage lending rose by 12.5 percent, to P403 million, higher than the 7.2 percent increase in 2002. The Botswana Development Corporation (BDC) expanded its assets by 9 percent in the six months to June 2003, to P1 146 million compared to a growth of 42 percent in 2002.

4.15 The Botswana Stock Exchange had a sluggish year during 2003. The domestic company index declined during the first two quarters of the year and only rebounded during the third and fourth quarters. The share index of the domestic component rose to 2 499, barely changed from 2 497 in December 2002. Growth in market capitalisation was also slow, expanding by 0.4 percent to P9 438 million from P9 403 million the previous year. The foreign companies index, however, rose by 13.5 percent, compared to a sharp decline of 27 percent in 2002. Nevertheless, trading improved over the previous year. A total of 77.4 million shares valued at P400 million were traded during 2003, slightly higher than the P345 million traded in 2002.

4.16 The number of domestic companies listed on the Botswana Stock Exchange (BSE) remained at 17 in 2003, while the number of foreign companies declined to five. Companies in the venture capital market remained at three with Turnstar and Afritourism Limited listed on the domestic venture board and Gallery Gold on the foreign board. In the bond market, the total number of bonds listed was unchanged at six, with maturities ranging from 5 years to 12 years. Customisation of the registry system of Government bonds was completed in December 2003 in preparation for listing on the BSE once the relevant listing regulations are finalised. There was only one commercial paper in the market, issued by Botswana Telecommunications Corporation.

(e) Credit Rating

4.17 After a review of Botswana's creditworthiness in 2003, Moody's Investors Service and Standard and Poor's maintained the same ratings as in 2002 and 2001. Moody's rated the long-term foreign currency debt at A2, Prime–1 (P-1) for short-term foreign currency debt and A1 for domestic currency debt. Standard and Poor's reaffirmed an A+ and A-1, respectively, for long- and short-term local currency ratings as well as A- and A-1 for long- and short-term foreign currency ratings. The ratings reflected the country's well-managed mineral economy, long record of political stability and the Government's commitment to restore a balanced budget. However, the ratings remain constrained by the challenges posed by the HIV/AIDS epidemic and slow progress towards economic diversification. There was also more general concern about the deteriorating fiscal position with an indication that the ratings risked being revised downwards if this was not addressed.

(f) Other Financial Sector Developments

4.18 The financial sector continued to be sound throughout the year with a liquid, well capitalised, prudently managed and profitable banking industry. Progress was made towards the reform and modernisation of the National Payments System (NPS) to bring it in line with international best practice and to comply with the Bank for International Settlements' (BIS) Core Principles for Systemically Important Payments Systems. The Bank of Botswana, with technical assistance from the International Monetary Fund (IMF), undertook a review of other laws and legislation that could affect the safety and efficiency of the NPS.

4.19 Since the inception of the International Financial Services Centre (IFSC) project in 1999, seven companies had applied for and been issued with either banking licences or Exemption Certificates as at December 2003. In addition, a cumulative total of 20 companies have been approved by the IFSC Certification Committee during 2003 compared to 13 at the end of 2002. Of these, only one banking licence was issued, to Kingdom Bank Africa Limited, to provide offshore banking services to non-residents.

4.20 The Letlole National Savings Certificates scheme recorded encouraging sales during the year, in response to the Bank's marketing efforts. The total value of certificates purchased and issued amounted to P1.9 million as at the end of November 2003 compared to P1.7 million the same period in 2002.

4.21 The banks continued to invest in up-to-date infrastructure in an effort to improve their efficiency and customer service. The infrastructure introduced included internet banking and refurbishing of premises. In addition, the contribution of the Banking Adjudicator, appointed by banks in 2001 to mediate disputes between them and their customers, was showing positive results. In order to counter money laundering in financial institutions, anti-money laundering regulations were issued during 2003.

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Chapter 2

Competition, Efficiency and Productivity in the Banking Sector

1. Introduction

1.1 The banking sector plays a pivotal role in the economy, acting as an intermediary between savers and borrowers. At the macroeconomic level this promotes efficiency in resource allocation, as funds are pooled and channelled from surplus to deficit sectors. Individually, businesses and consumers benefit from the provision of various banking services, such as saving and borrowing facilities, and from the key role played by the banks in the functioning of the national payments system, especially as the economy moves away from cash-based transactions.

1.2 The size and scope of the banking sector varies across economies, but typically comprises a variety of institutions competing for customers through price and product range. Such competition helps promote efficiency and the best allocation of resources, for the simple reason that customers will prefer to use banks that provide services best suited to their needs. As they compete, banks must also cooperate to ensure the smooth operation of the financial system. Moreover, given the key position of the financial sector in the economy, this will be within a framework of prudential supervision, by the central bank or some other supervisory authority, that might restrict competition in some respects. Because of the role of cooperation as well as competition, there is often concern that banks may place too little emphasis on competing to provide the best possible services to their customers. This can take place in a situation where financial institutions are few, as this may restrict consumer choice. It is part of the role of the supervisory authorities to ensure that an appropriate balance is maintained between competition, cooperation and regulation.

1.3 The lack of competition in banking can take different forms and manifests itself in many different ways. A frequent concern is that banks make excessively high profits. Such concerns may be legitimate, in particular when accompanied by a perception among customers that the services that they are offered do not provide value for money. On the other hand, banks should not be condemned simply because they are highly profitable. Banks are businesses and their primary objective, like any business, is to make a profit. Bank profits can also be a sign of both efficient operations and the underlying stability of the financial system more widely.

1.4 Banking competition, efficiency and profitability are ongoing concerns in Botswana, which, given its small size, appears to some observers to be an ideal environment for non-competitive practices to flourish. While these issues were discussed briefly in the ***2001 Annual Report***, it was recognised then that a more detailed analysis was warranted before strong conclusions could be drawn about the health or otherwise of banking in Botswana. The theme topic for the ***2003 Annual Report*** is, therefore, 'Competition, Efficiency and Productivity in the Banking Sector'.

1.5 This theme is meant to address issues that have become matters of particular importance to the public which, rightly, believes it deserves access to banking services that are affordable and of high quality. An additional concern is the need for Botswana to participate effectively in the international economy, which requires a financial sector that is both efficient and compliant with international standards. However, while the aim of this chapter is to cover the issues in some detail, it is the case that the issues of competitiveness, efficiency and stability in banking are highly complex and not easily amenable to the simple answers that are often demanded.

1.6 The chapter is organised as follows. Section 2 reviews the general arguments in favour of promoting competition between private businesses to support the efficient allocation of resources. This includes a discussion of insights from economic theory and how these relate to the banking sector. Section 3 examines how these arguments might apply to the banking sector in Botswana with a view to gaining some understanding of the extent to which it has or has not become more competitive in recent years. This Section also makes comparisons with other studies of banking, both in Botswana and internationally. Section 4 looks in more detail at the issue of profitability and productivity in Botswana banks, while Section 5 examines regulatory aspects and, in particular, how regulation and supervision of the banking sector can help foster the goals of promoting both competition and stability. Section 6 concludes the chapter.

2. Competition Issues in Banking

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices… But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies, much less to render them necessary. (Adam Smith, 1776).[1]

2.1 It is commonly believed that banking in Botswana is characterised by lack of competition and even collusive behaviour among the banks. High rates of profitability and bank charges are taken as support for this view.[2] However, closer inspection, using insights from economic theory that point to differing forms of behaviour according to varying market structures, suggests a more complex story. By any measure, banking in Botswana is highly concentrated, with only five commercial banks[3] operating in the country. This does not automatically mean an absence of effective competition, however. Indeed, some actions by the banks, while not always immediately popular with the public, often reflect a response to pressures arising from an increasingly competitive environment.

2.2 The provision of banking services is very much under public scrutiny not only in Botswana but also elsewhere. The legitimate expectation of high standards demands value for money and raises questions of appropriate regulation. Whether such regulation, which is necessary to ensure the stability of the banking system, is compatible with encouraging competition also needs to be considered. Detailed reviews of competition issues have been undertaken in other countries. Recent examples include the 'Cruickshank Report' on banking in the UK published in 2000[4] while, in 2001, the South African Competition Commission produced a study on the banking industry in that country.[5] Both studies indicated that commercial banking in their respective countries was characterised by excessive concentration to the possible detriment of competition. Both studies will be used as points of reference in this review of the issues in Botswana.

(a) The Benefits and Drawbacks of Competition

2.3 For most economists, a purely competitive market economy is the best way to allocate scarce resources and, ultimately, to serve the

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1 *An Inquiry into the Nature and Causes of the Wealth of Nations, 1776.*

2 A review published in 2003 by BIDPA on bank charges is an example of this sort of analysis. (See *Cost of Banking in Botswana: 2001–02* Botswana Institute for Development Policy Analysis, January 2003.)

3 Commercial banks offer a full range of banking services, but are particularly distinguished from other financial institutions by the provision of retail banking services such as current accounts, cheque books and ATM facilities, and their participation in the payments clearing system.

4 *Competition in Banking: A Report to the Chancellor of the Exchequer,* HMSO, London.

5 *Industry Overview and Database of the South African Banking Industry,* South African Competition Commission.

interests of consumers. Product prices are determined by market forces and, when there is sufficient competition in the market, these prices reflect the cost of production including a reasonable return on investment. Producers in a competitive environment do not make excessive profits, for if consumers are not prepared to pay market-determined prices, production ceases and resources are used elsewhere. Pure competition also ensures that innovations, both in production techniques and the products themselves are introduced as soon as it is feasible as producers battle to get an advantage over their rivals, again to the benefit of consumers. Critics often say such a reliance on market forces is 'chaotic' and driven by greed. But for its supporters these are advantages, as under such a system it is clearly in the interests of producers to seek to satisfy consumer demands for the simple reason that they would otherwise go out of business. Certainly, compared to the alternative of planned economic development, the operation of competitive markets has proved remarkably effective.

2.4 Theory of course may not always be fully realised in practice. Notably, if the link between prices and the cost of production is weakened then the benefits to consumers may be greatly reduced. There are two principal sources of such 'market failure'. One is where individual producers (or possibly consumers) have sufficient 'market power' to unduly influence the operation of market forces to their benefit at the expense of other producers or clients. Most notably there is the concern that such producers may use this power to make excess profits and/ or provide goods and services inefficiently, to the clear detriment of consumers.

2.5 The second source of breakdown is where the prices of the inputs to production are somehow distorted, and do not properly reflect all costs. For example, producers may contribute to environmental degradation by ignoring the true costs of their activities. For banking, this would involve individual banks not taking proper account of the extent to which their actions might undermine the stability of the banking system as a whole, with the potential for causing harm to the economy more widely. It is often argued that in such cases, where private costs differ greatly from overall economic costs, some form of state intervention or regulation is necessary. In the banking sector, the need to ensure financial stability is one of the primary reasons for prudential regulation of the industry. Such regulation may reduce competition by imposing rules that restrict the entry of new banks into the industry, and enable existing banks to make higher profits for longer than would be the case if competition from new entrants was not restricted.

2.6 Determining the appropriate trade-off between regulation and competition is a key element of designing an effective regulatory framework, and is discussed further in Section 5. In principle, however, the appropriate balance is reached when there is a stable banking system characterised by healthy profits, effective regulation and supervision, and an environment that encourages competition between banks.

(b) Different Forms of Competition/ Market Behaviour

2.7 The stylised models often used by economists to analyse different market structures aim at identifying likely forms of behaviour by market participants and its consequences, particularly as it affects the welfare of consumers. Some of these models are briefly reviewed here. The aim is not to provide an exhaustive discussion, but to highlight salient points that may help cast light on the conditions that prevail in the banking sector and, most importantly, to focus on behaviour that could be associated with more or less competitive conditions.

(i) Perfect Competition

2.8 The benchmark model is that of *perfect competition*. This assumes large numbers of producers and consumers and no constraints ('barriers to entry') on additional producers entering or leaving the market. All producers sell identical products and knowledge of market conditions is freely available. The overall interaction of sellers and buyers determines the amount to be supplied and the price to be charged. Realising that they have no power to influence market conditions, individual producers are 'price takers', accepting the price as determined by the interaction of demand and supply and producing up to the point where additional output at that price would not be profitable. Any producers who cannot produce profitably at this price will leave the market, while large profits will attract new producers, causing the price to fall until only 'normal' profits[6] are made. Because of their lack of market power there is an absence of direct rivalry among participating firms. Nor do firms engage in forms of *non-price competition*, such as advertising, as consumers are already fully knowledgeable about the product. A further consequence is that when firms produce more than one product there is no possibility for *cross-subsidisation* (i.e., when the profits made from one product are used to cover losses elsewhere) between product lines.

2.9 The model is useful, not because it is realistic but in establishing the conditions under which the full benefits of competition will be realised. For instance, if a market is characterised by a large number of buyers and sellers, there are minimal barriers to entry and knowledge about the products is easily available, then it may be reasonable to conclude that such a market is likely to be highly competitive.

2.10 Clearly, however, there are ways in which actual market conditions could differ from this ideal. If there is scope for greater efficiency in large-scale production (so-called *economies of scale*) it will be natural for producers to merge operations and, while the gains in efficiency should also benefit consumers, there will be more scope for market power to emerge. Similarly, if entry into the industry is controlled by regulation, existing producers are shielded from the full impact of competition and may be able to exploit opportunities to make abnormal profits. Acquiring information can in practice be costly, and the operation of the market may be crucially affected by asymmetries in the information available to consumers and producers. Finally, if producers can find ways to differentiate their products from others, then their potential leverage over consumers will be increased, as consumers become more dependant on particular producers both for the supply of and information relating to products.

(ii) Monopoly

2.11 At the other extreme end is *monopoly*. Here there is a single producer who, when faced with no competition, can decide the price at which to sell. A monopoly supplier has an opportunity to make abnormal profits through restrictions on supply that keep the price well above the costs of production. In theory, a monopolist would seek to fully exploit this profit opportunity but may not always do so in practice. Unlike the case of perfect competition where inefficient producers will be driven from the market, a monopolist may squander profit-making opportunities. Profits may be eroded by production inefficiencies and, while higher profits provide resources to undertake research and development to improve products and production techniques, there may be little incentive to do so, as the monopolist already has full control over the market. For the same reason, there is little incentive for the monopolist to advertise or promote its products. Monopoly profits can also be used to cross-subsidise the production of other products, thus potentially gaining the supplier an unfair advantage in other markets.

2.12 A monopoly may exist due to government regulation, a firm's control of key inputs or production technologies, or if entry is made difficult by the need for heavy investment and large-scale production to be efficient. Without

[6] A normal profit is the level of profit that is just sufficient for producers to continue providing goods and services in a market. What this means in practice will vary from market to market, in particular according to the risks associated with the operations.

these, any monopolistic behaviour (e.g., abnormal profits and/or production inefficiencies) will provide an incentive for potential entrants to challenge the incumbent supplier, a situation described as a 'contestable' market. The model of contestable markets, which focuses on potential competition rather than the number of actual suppliers, may be of particular relevance to small markets. In such situations, the number of suppliers may typically tend to be small, but if measures are taken to increase the contestability of the market, effective competition can result. In practice, many monopolies are short lived as barriers to entry are often eroded by advances in product quality and design and production technologies. If a monopoly is long lasting, it is often a natural monopoly[7] or due to laws and regulations that prevent new entrants.

(iii) Oligopoly

2.13 In between the two extremes of perfect competition and monopoly are various forms of imperfect competition. The one discussed briefly here is the market structure called *oligopoly*, where there is a small number of large suppliers, each with some degree of market power.[8] The most important feature of oligopoly, distinct from both perfect competition and monopoly, is that the suppliers see each other as direct rivals whose actions impact on each other. Market behaviour in such conditions is difficult to model, since the results of such modelling are especially sensitive to the assumptions used. However, two general points which are relevant to the issues under discussion can be made.

2.14 First, oligopolists have incentives to *both collude and compete* with each other. On the one hand, if they act together in a coordinated fashion then they can jointly maximise profits to the same extent that is available to a monopolist. The adverse effects of such collusion to consumers has been clearly recognised for a long time, as indicated in the quotation at the start of this Section. For this reason, in many countries, explicit collusive practices by producers are illegal.

2.15 At the same time, however, there is always the incentive for individual suppliers to renege on collusive arrangements in order to grab a greater share of the profits for themselves. This may lead to intense competition between rivals which, in the short term at least, may actually erode profits. To avoid this, producers may enter into more formal arrangements known as cartels with the explicit aim of managing supply. The Organisation of Petroleum Exporting Countries (OPEC) is possibly the most well-known recent example of such an arrangement, the history of which is itself full of examples of members reneging on agreements, amply demonstrating the practical difficulties in maintaining collusive arrangements of this kind.

2.16 The market determines which of the two tendencies, to collude or compete, dominates. Collusion will tend to come to the fore where agreements between suppliers are easier to reach and enforce. This may occur when there are only a small number of participants in a small market. Collusion may be further encouraged in situations where substantial cooperation between the suppliers is necessary for the smooth functioning of the market; as such cooperation may be used to disguise collusive behaviour. At the same time, it is easy to overemphasise the likelihood of collusion. While many industries around the world are oligopolistic, many oligopolies are highly competitive.[9] Indeed, competitive oligopolies are the source of a great

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7 A natural monopoly exists when it does not make economic sense to have more than one producer. Examples include some public utilities.

8 There may be many producers in an oligopolistic market but only a small number are large enough to determine market prices.

9 Examples include the global motor industry and the airline industry. In fact, the airline industry is a good example of many of the issues discussed here. It is highly competitive, in parts. Where it is not competitive, it is largely due to government regulation acting as a barrier to entry and competition. And it is a classic contestable market; with the availability of aircraft leasing, entry is made easier by reducing the need for large-scale initial investment.

deal of the product and process innovations that improve efficiency and ultimately drive economic growth. Where this is not the case it is often due to government intervention and regulation.

2.17 The other major feature of oligopoly, and again at variance with the other two models, is that where rivals do compete this is likely to feature various forms of non-price competition as firms attempt to use some of their profits to strengthen their market position. In particular, there will be a strong incentive to focus on product differentiation. Compared to a monopolist which faces no rivals, there will be more incentives for product innovation and advertising. The extent and form of competition will also be influenced by the independent knowledge that consumers have about the market and the extent of barriers to entry. As with a monopoly, the market power of oligopolists is greatly reduced if the market is easily contestable by potential new entrants.

(iv) Structural Features of the Banking Sector

2.18 The following sections highlight salient features that might be typically expected to characterise the banking sector. Comparing these with the models reviewed above helps provide an indication of the extent to which competition may or may not be expected to prevail within the sector.

2.19 First, banking is characterised by extensive *economies of scale* for many of its product ranges. Commercial banks typically rely on a large and diversified customer base to meet the varying requirements of depositors and borrowers and to effectively spread risks. It is mainly for this reason that the history of banking is characterised by mergers and takeovers, which moves the market away from the competitive paradigm. To the extent that economies of scale are important, there is a ‘minimum efficient scale’ (MES) that defines the smallest possible size for an efficient and competitive bank; a bank that is below this size will face higher costs than larger banks, and hence will be unable to compete. In a small market, where the MES is large relative to the size of the market, then only a small number of banks will be able to survive. While a small number of banks may be efficient, in terms of minimising unit production costs, they may not be very competitive. At the same time, the extent of potential economies of scale may also be exaggerated with recent research suggesting that there is also a ‘maximum efficient scale’ for banks in large markets. [10]

2.20 Second, while perfect competition requires that information on the market is readily and freely available to all producers and consumers, the role of banks as intermediaries between borrowers and lenders reflects the existence of a significant lack of information. If savers and borrowers were fully aware of lending and borrowing opportunities and their associated risks, there would be little need for financial intermediaries. Moreover, observed features of banks’ behaviour such as credit rationing may result from information asymmetries between banks and their customers, borrowers in particular. In such situations, increases in prices, which are normally interpreted as indications of greater market power, may in fact reflect increased competition and efficiency among banks as ways are found to meet previously unsatisfied demand, and more potential customers are accommodated within the banking system.

2.21 Third, banks are *multi-product* providers. This has several important implications, including:

- *Products are sold jointly.* For instance a current account which has an overdraft is a package of both a payments and borrowing facility. Even when not packaged jointly, once customers have been sold a key product, such as a current account, it may

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10 For instance, the Cruickshank Report into competition in UK banking noted (p.20) that ‘economies of scale in traditional banking are not that high’ and referred to research which concluded that ‘the average cost curve has a relatively flat U-shape’ and that medium size banks, with assets of between USD100 million and USD10 billion were the most efficient.

be more likely that they look to the same bank for additional services. Such joint marketing may be convenient for consumers but it also increases the associated information costs as the price that is attached to each component product is less obvious. Moreover, if the marketing of 'gateway' products such as current accounts effectively binds customers to a particular bank then its market power in other product areas will be increased.

- There may be scope for *cross-subsidisation* of products. In many situations banks have used profits from the intermediation function (mainly interest income) to cover the cost of providing customers with other services. Since such cross-subsidisation is not possible in a fully competitive market, a move towards a greater reliance on fees that are directly related to specific services is a possible sign of increased competition, especially if it is accompanied by a reduction in interest spreads.

- Not only is there a wide range of products, but they are also sold to *separate groups of customers,* that are clearly identifiable, such as business and households. This may encourage market segmentation and even price discrimination (i.e. where essentially the same product is sold on different conditions to different categories of customers). This also means that the balance of market power may vary across different sub-sectors within banking.

2.22 Fourth, notwithstanding the points made above, banking is an industry based on broadly *similar products*: essentially, providing loans to borrowers and deposit facilities to savers with interest rates being the price in both cases, and payments services. At the same time, product differentiation is possible, based on standards of customer service, for example. Competition may then be characterised by activities such as product innovation and advertising.

2.23 Fifth, there is a need for *extensive cooperation* among banks to ensure the operation and soundness of the payments system. Indeed as transactions through the banking system increasingly outweigh the importance of cash payments, the operation of the national payments system is crucially dependent on such cooperation among themselves and with the supervisory authorities. The possibility that such necessary cooperation may also be used as, or perceived to be, a vehicle for collusion has already been noted.

2.24 Finally, the extent of *barriers to entry* will be an important determinant of competition. Most importantly from the policy perspective will be the extent to which sectoral supervision creates such barriers. While any supervisory system is likely to have strict standards that must be met before a bank can be allowed to start operations, the degree to which this stifles competition can differ greatly. For example, if the supervisory body takes a view on whether the market can support a new bank, then those already operating are more insulated from competition compared to a case where the resources and expertise of the applicant are the principal criterion for entry into the market. Because of this, the supervisory framework can have a major impact on the contestability of the market. The lower the entry barriers imposed by regulation, the greater the threat of new entry, and hence the greater the (actual or potential) competitive pressures on incumbents. Other non-regulatory factors that affect barriers to entry include technological developments, which may reduce the need for banks to establish extensive branch networks to attract sufficient customers and, more generally, the MES necessary for operations to be viable. At the same time, existing operators may engage in activities, again including product differentiation and advertising, which effectively raise the barriers to entry and MES for potential new entrants.

2.25 The various considerations outlined above point to the conclusion that banking is an industry that is, to a large extent, oligopolistic in nature. Benefiting from economies of scale, a small number of providers are likely to dominate the provision of mainstream banking services. At the same time, because of the shared need for a smoothly functioning payments system, these providers will have strong incentives to cooperate that could in turn lead to opportunities for collusion. Asymmetric information flows may allow market power to emerge but it may be only temporary and fade over time. As has been emphasised, oligopolists can and do compete, often vigorously and in a variety of ways, and there is no obvious reason why this should not also be the case for banking. The question rather is the degree of competitiveness and, in particular, the extent to which the market and its component parts are effectively contestable, as this may be more important for competition than the number of suppliers. It is from this perspective that the next section looks in more detail at the banking industry in Botswana.

3. Competition in Botswana Banking: An Assessment

(a) Overview of the Structure of the Financial Sector in Botswana

3.1 As at the end of 2003, the private sector banks serving the Botswana market[11] comprised five commercial banks and two merchant banks. In addition, there are Government-owned financial institutions that carry out banking-related functions in areas that are not adequately covered by the private sector.[12] Both the private sector banks and deposit-taking financial parastatals (Botswana Savings Bank and Botswana Building Society) are supervised by the Bank of Botswana. Other components of the Botswana financial sector are the stock exchange and stockbroking firms, insurance companies, a growing number of pension funds and asset management companies, bureaux de change and many micro lenders providing personal loans.[13]

3.2 All the banks are either wholly- or majority-owned subsidiaries of established international banking groups. The newest and smallest of the commercial banks is Bank of Baroda, which opened in 2001 and currently operates a single branch in Gaborone. For many years until the early 1980s, the banking market comprised only two banks, Standard Chartered Bank Botswana Limited (Standard Chartered) and Barclays Bank of Botswana Limited (Barclays), which were both established in 1950. First National Bank Botswana Limited (FNBB) was established in 1991, taking over the operations of Bank of Credit and Commerce Botswana Limited (BCCB), and subsequently acquiring both Zimbank Botswana Limited and Financial Services Company (a Government-owned finance and leasing company). In 1992 Union Bank, a subsidiary of Standard Bank of South Africa, took over ANZ Grindlays and was renamed Stanbic Bank Botswana Limited (Stanbic). The first merchant bank, Investec Botswana (Pty) Limited (Investec), was licensed in 1999 and was subsequently joined by African Banking Corporation (Pty) Limited (ABC) in 2000, which had taken over ulc (Pty) Limited, converting it from a leasing company. In late 2003, Investec was acquired by Stanbic, with the stated intention of an eventual merger of their respective operations.

3.3 This brief overview of the development of the private sector banks illustrates two points. First, since BCCB broke the duopoly of the original

11 This review does not cover the various banking/financial institutions that have been established in Botswana as part of the International Financial Services Centre (IFSC) project since up to this point such institutions are strictly licensed to conduct business outside the Botswana market.

12 The Botswana Savings Bank (BSB) provides depository services for low income earners, particularly in rural areas, making extensive use of the post office network; the Botswana Building Society (BBS) principally makes loans for house buyers; the National Development Bank (NDB), the Botswana Development Corporation (BDC) and, more recently, the Citizen Entrepreneurial Development Agency (CEDA), support business development through loans and, in the case of BDC and CEDA, venture capital.

13 For more detailed information on the structure of the financial system in Botswana, see Bank of Botswana Annual Report 2001.

two banks in 1982, the market has not been static, with several new entrants establishing operations particularly from the early 1990s. Second, where some of these new banks were subsequently absorbed through takeovers, it reflects a pattern of rationalisation based on economies of scale that has been common to the banking sector in many countries.[14]

3.4 The banking sector in Botswana, like in most other countries, is clearly a case of an oligopoly, i.e. a market with only a few suppliers. Indeed, the number of banks is so small that it can be fairly described as a 'tight-knit' oligopoly.[15] While this may be due to the small size of the overall market, this observation alone is enough to raise concerns that there may be a lack of vigorous competition among the banks, even in the absence of explicit collusive behaviour. This perception is strengthened by two other factors.

3.5 First, the fact that all the commercial banks are subsidiaries of larger banking groups means that their operations and policies will be heavily influenced by the standard norms and parameters set by their parent organisations and, as such, may not take full advantage of local conditions, which may constrain their ability to react in a competitive manner to market developments. Second, the banks naturally cooperate in many areas, including developing and maintaining the integrity of the national payments system and countering money laundering. While many of these activities are undoubtedly in the public interest, and in most instances are sanctioned and even encouraged by the authorities, they encourage the perceptions that collusion could also exist. For example, the issuing by the banks of a joint statement in 2002 to counter widespread public criticism that the levels of bank charges were excessively high hardly helped reduce the impression that these fees are set through a process of mutual cooperation.[16]

3.6 The regulatory regime for banking in Botswana, as in most other countries, has consistently been based on the primary need to ensure the overall soundness of the banking system. The principal way to do this is to consider applications for banking licences only if the applicants demonstrate that they have the necessary resources and expertise to operate a viable banking business. However, while still guided by this underlying principle, the emphasis has changed significantly over the years, especially since 1989, when the Government adopted a financial sector development strategy that included, as an explicit objective, promoting competition in banking. Under this approach new applications for banking licences have been more actively welcomed. Unlike in the past, no consideration is now given to whether the market is large enough to sustain the operations of additional banks; instead, the view taken is that if the applicants are properly qualified and are willing to commit their resources, then they should be allowed to do so.[17] In addition, both the existing banks and new applicants are given greater freedom concerning the extent of their branch networks, although the Bank of Botswana still has to give permission for branches to be

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14 Although the number of banks in Botswana may appear to be small, this is not surprising given the small size of the economy and it is not unusual by international standards. In larger countries the number of major banks is also often small. In the UK, despite there being upwards of forty banks operating, as well as numerous building societies, the 'big four' dominate most markets; while in South Africa, the 'big six' account for over 80 percent of total bank assets.

15 Under the terminology used by the Competition Authority of South Africa, a tight-knit oligopoly exists when the largest suppliers control 70 percent of the market. Since in Botswana the total number of suppliers, including merchant banks, is only seven, such a categorisation may be applicable.

16 Similarly, the appointment of a banking Ombudsman to deal with complaints by customers was at the initiative of the commercial banks themselves, and was immediately criticised for being biased in their favour: e.g., that the terms of reference were too restrictive, and the chosen appointee was too close to the banking industry to be sufficiently impartial.

17 This change was formally incorporated in the Banking Act (1995), which dropped the provision in the Financial Institutions Act that the impact on existing financial institutions would be taken into account when assessing banking licence applications.

closed or opened. Such flexibility means that new entrants do not have to establish a nationwide branch network and that existing banks do not have to keep open unprofitable branches. This helps to promote competition, in two ways. First, the initial costs for new market entrants are reduced. Second, a system that insists on banks maintaining unprofitable branches and agencies is inherently anticompetitive since it is based on cross-subsidisation between branches and, to be sustainable, must allow operators to earn excessive profits in other areas. Therefore, from the regulatory point of view at least, the contestability of the market is enhanced. This immediately raises the question as to why there have not been more applications for banking licences in an apparently highly profitable market, and suggests the potential importance of barriers to entry other than those arising from the regulation of banks.

3.7 The customer base for banking in Botswana is small. The population of the country is less than 2 million and viable commercial banking is limited mainly to the urban areas, including the larger villages, which account for about 55 percent of the population. Further, the banks' two customer groups, households and businesses, display different structural characteristics. The large number of households, many of which have low incomes and are likely to be less knowledgeable about banking practices, contrasts with a much smaller number of businesses, some of which may be sufficiently large to have market power *vis-à-vis* the banks. There are, however, also high-income households and small businesses (including those in the informal sector which may operate using household banking facilities). This points to the likelihood of significant market segmentation, with different ranges of products and standards of service across classes of customers. The changing relative importance of the various sub-groups may also influence the picture at the aggregate level. For instance, one development that needs to be taken into account is the increasing importance of households as recipients of bank lending. In 1990 this accounted for 30 percent of the total, but by 2002 it accounted for more than 50 percent. The implications of this will be analysed more closely later in this Section.

3.8 A further distinguishing characteristic of the Botswana banking system is the relatively high penetration of banking services throughout the country. Despite the small and dispersed population, a large majority of the population are users of either the commercial banks or the parastatal deposit-taking institutions. As noted in the 2001 Bank of Botswana Annual Report, the usage of banks grew rapidly during the 1990s, with approximately 430 commercial bank accounts per 1000 adults by 2000, compared to 320 accounts in 1990. A survey carried out in 2003 by Finmark Trust/Finscope[18] among households in both rural and urban areas found that 82 percent of respondents made use of products of the formal banking sector; of this a substantial proportion was accounted for by the BSB while over 50 percent had an account with a commercial bank. The 82 percent penetration of formal banking services in Botswana was much higher than in Lesotho, Namibia and Swaziland, where the proportions were 34 percent, 52 percent and 50 percent, respectively.[19]

3.9 A final feature of the banking structure of note is the macroeconomic context in which it has developed. The disposable income of the population served by the banks has grown rapidly. At the same time, there has been some diversification of the economy away from mining, resulting in the growth of profitable

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18 www.finscope.co.za

19 The numbers cited in this paragraph must be interpreted carefully. The figure of 430 commercial bank accounts for every thousand adults does not mean that 43 percent of adults held bank accounts, as it includes accounts held by non-adults (businesses and children) and some people may hold more than one account. Similarly, the Finscope survey, being based on interviews with household heads, cannot be assumed to apply to the population as a whole. It was also a pilot survey, and the results must be treated on that basis.

lending opportunities within the core business areas for commercial banking. However, the expansion has not been sufficient to absorb all of the liquidity generated in the economy, resulting in a general state of excess liquidity in the banking system over the years. At one time the largest domestic loan portfolio were the loans made by the Government, primarily to parastatals, through the Public Debt Service Fund (PDSF). This combination of an environment that at the same time is both conducive to high profitability and constrained in its development may have had implications for the sector's evolution in terms of standard indicators of competitiveness. For instance, at one time in the mid 1980s when excess liquidity was growing rapidly, the banks on occasion refused to accept interest-bearing deposits or open new accounts.

(b) The Experience of Other Countries

3.10 The two reports referred to in the introduction to Section 2 suggested that there was evidence pointing to insufficient competition in the banking industries in the UK and South Africa. The Cruickshank Report raised issues such as the similarities of pricing and the concentration in the supply of banking services in the UK, and was followed by a more detailed investigation by the UK Competition Commission (UKCC) into the provision of banking services to small- and medium-sized enterprises (SMEs). These reports were very critical of the major UK clearing banks accusing them of monopolistic practices and making excess profits and, to correct the situation, recommended 'behavioural remedies', including forms of price control to cut excess profits (setting interest rates for current accounts, for example). The report on South Africa did not go so far, as it was primarily an exercise in information gathering, but it contained similar findings, regarding high degrees of concentration that might, for example, suggest a lack of effective competition among banks.

3.11 Other analysts have pointed out that although these conclusions may be a sound interpretation according to standard models of competition, such as those reviewed in Section 2, they fail to take into account special features of the banking industry.[20] For instance, critics of the report by the UKCC point to the costs that the banks face in providing services to SMEs. These occur particularly in the early stages when the customer's credibility (especially as a potential debtor) is being established, and may be extensive compared to the size of the loan, which is typically small. Furthermore, to overcome the high information costs of decision-making in lending, banks have developed an approach called 'relationship banking', that emphasises the long-term and multi-product nature of banking arrangements where deviations between price and cost, while possibly substantial in some instances, will tend to even out over time and where it is not surprising that more well-established customers are able to obtain better terms. This approach is viewed as suited to small-firm lending as it helps banks internalise the problems with information asymmetries, monitoring and intermediation risks. At the same time, it demonstrates features that would usually be seen as anti-competitive, such as apparent instances of prices deviating from the underlying cost structure, cross-subsidisation or price discrimination. Not surprisingly, critics of the banks are suspicious of attempts to argue that banking is somehow special compared to other industries, and inclined to view such efforts as special interest lobbying.

3.12 Another feature that emerges from these and other studies is the apparent ignorance among customers about the range and extent of services provided by banks. For instance, the Cruickshank report noted that very few new customers seriously compared banks before choosing where to open an account: 60 percent of new personal current account holders only considered the supplier that was ultimately selected, while less

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20 See, for example, Ashton J. and Keasy K. (2003) 'Lending decision making and the Competition Commission Report on the provision of banking services to small firms', *Journal of Financial Regulation and Compliance* Vol 11. no. 1.

than five percent had considered more than four options. Also, despite frequent complaints about service quality, there is very little switching of accounts between banks: a similar proportion of personal customers (59 percent) were still using their first ever current account, while only 23 percent of SMEs had ever changed banks. Again, such behaviour on the part of consumers is open to a variety of interpretations: lack of account turnover may indicate significant costs to switching banks, and one of the UKCC proposals was to set benchmark standards for the time taken by banks to transfer SME accounts, to reduce the perception that switching accounts is costly. However, it may also reflect strong satisfaction with the service being provided by the bank (for example, relationship banking). Whatever the reason, the extent to which customers demonstrate both a lack of sophistication in choosing service providers and subsequent inertia in changing, competitive pressures will be reduced, especially for the leading industry players with established market shares.

(c) Dimensions of Competitiveness in Botswana Banking

3.13 Competitiveness is not something that can be measured either directly or summarised in a single statistic. Rather, various proxy indicators are used, informed by the analysis of expected characteristics of the various markets derived from the theoretical models. The starting point is typically to examine market *concentration,* as this is directly linked to the number of market participants, which is a key feature for distinguishing between the standard models. This approach is followed here. This is followed by consideration of other 'dimensions' of competitiveness, including profitability (although this is dealt with in more detail in the next Section of this chapter), sources of income and non-price competition.

(i) Market Concentration

3.14 It seems clear that banking sector in Botswana is highly concentrated by any standard. A standard summary measure of market concentration is the Hirshmann-Herfindahl Index (HHI) which varies between one and zero according to whether the market is a monopoly or has many participants.[21] Table 2.1 and the accompanying Chart 2.1 show the HHI for total deposits and credit in Botswana since 1994. In 2003 this stood at 0.25 for both categories. While there may have been some trend decline over the period since 1994 (this is less clear for credit than deposits), this compares to the international benchmark guidelines of the US Federal Trade Commission under which values greater than 0.18 indicate a 'highly concentrated' market. Compared to South Africa and some European countries, the banking sector in Botswana is at the upper end of the range. Figures for some advanced economies in 1994 are shown in Table 2.2 (a). For the same year, the index for Botswana was 0.30 for deposits and 0.27 for credit, and even with subsequent reductions it would still be among the highest. This said, concentration in Botswana is not uniquely high, especially in small and less developed countries where the viable market for commercial banking may be quickly saturated and only accommodate a few banks. For example, the data on bank concentration used in Beck *et al* (2003) [22] includes several cases where the entire market was covered by three or fewer banks (see Table 2.2 (b) for comparative figures for selected African countries).

3.15 Another measure of concentration is the concentration ratio (CR) which looks at the market shares of individual or groups of banks. This can focus on particular features of the market profile that are not clear from the composite index, in particular the extent to which, within a highly concentrated market, one

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21 The HHI is calculated as the sum of squares of individual market shares and ranges between 1 (for monopoly) to 1/n, where n is the number of industry suppliers and each has an equal share. In a competitive system, n is large and 1/n approaches zero.

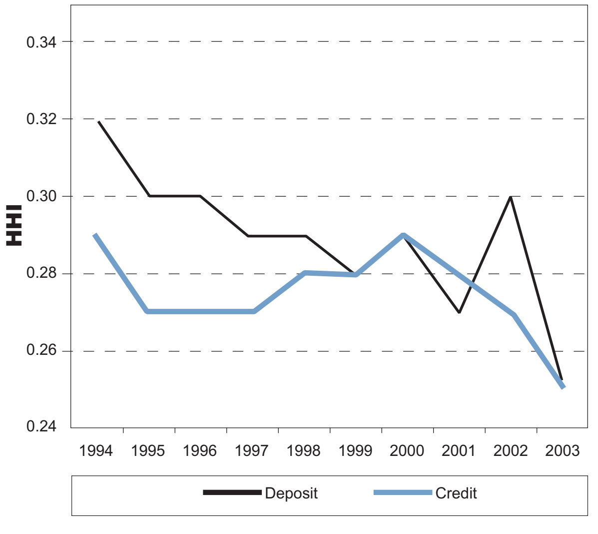
22 Beck, T., Demirguc-Kunt, A. & Levine, R. Bank Concentration and Crises NBER Working Paper 9921, August 2003.

TABLE 2.1 HHI FOR THE BOTSWANA BANKING SECTOR

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
A: Deposits										
Total	0.32	0.30	0.30	0.29	0.29	0.28	0.29	0.27	0.30	0.25
Current Accts	0.37	0.31	0.33	0.34	0.33	0.33	0.33	0.31	0.31	0.30
Households	0.41	0.38	0.37	0.33	0.34	0.35	0.41	0.40	0.34	0.34
Businesses (Resident)	0.31	0.27	0.27	0.27	0.27	0.27	0.27	0.25	0.24	0.24
Non-Fin. Parastatals	0.37	0.30	0.29	0.35	0.34	0.35	0.33	0.26	0.30	0.35
B: Credit										
Total	0.29	0.27	0.27	0.27	0.28	0.28	0.29	0.28	0.27	0.25
Households	0.35	0.32	0.32	0.32	0.33	0.36	0.43	0.38	0.34	0.32
Businesses (Resident)	0.27	0.25	0.26	0.28	0.28	0.28	0.27	0.27	0.25	0.26

Source: Bank of Botswana

CHART 2.1 HHI FOR THE BOTSWANA BANKING SECTOR



Source: Bank of Botswana

or more participants are in a position of particular dominance. This is very relevant to the discussion for Botswana. It was only in 1982 that a third commercial bank (BCCB) entered the market, so it is useful to examine in detail the extent to which the original situation of a duopoly has been eroded. Here it is worth noting, as a point of reference, that under the framework adopted in South Africa a firm is defined to be dominant in a market when its market share exceeds 45 percent, but there is also a presumption of dominance when the share exceeds 35 percent.[23]

3.16 Chart 2.2 shows the cumulative distribution of total deposits of banks in Botswana, with the shares added in declining order (i.e. the bank with the largest share is shown first). This is shown for three years, 1994, 1999, and 2003; also included is the line of equal distribution. The largest three banks (Barclays, Standard Chartered and FNBB) are included individually, with the share of the others (smaller commercial banks and merchant banks) combined. The chart clearly shows a trend of reducing both away from, *and within*, the 'big three' banks as the

[23] Specifically, under the South African Competition Act (1998): A firm is dominant in a market if –
- it has at least 45 percent of that market;
- it has at least 35 percent, but less than 45 percent, of that market, unless it can show that it does not have market power; or
- it has less than 35 percent of that market, but has market power.

In the United States, concerns about market power mean that no single bank can control more that ten percent of deposits.

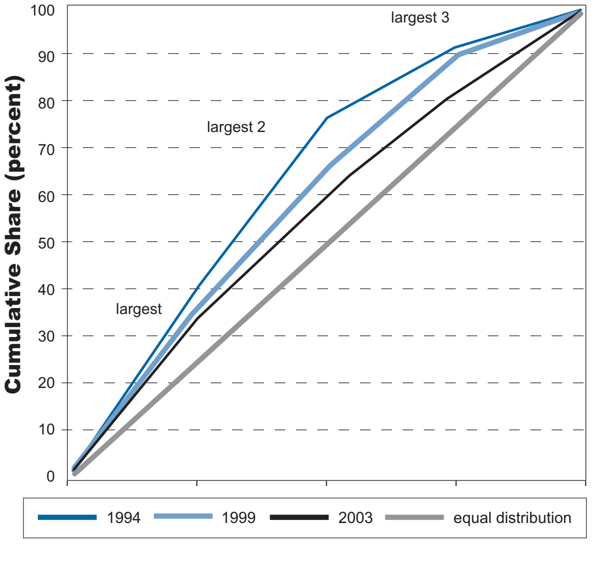
TABLE 2.2 COMPARATIVE INDICATORS OF BANKING CONCENTRATION, SELECTED COUNTRIES

(a) HHI (1994)		(b) Concentration Ratios (Assets of Largest Three Banks, Average 1988–1997)	
Denmark	0.20	Benin	1.00
Finland	0.33	Botswana	0.94
Ireland	0.17	Ivory Coast	0.96
Israel	0.22	Lesotho	1.00
The Netherlands	0.19	Senegal	0.94
New Zealand	0.18	Swaziland	0.95
South Africa	0.16	Tanzania	1.00
Sweden	0.18	Zambia	0.84

Source (a): Industry Overview and Database of South African Banking Industry
Source (b): Beck et al (2003, see footnote 22)

curves are unambiguously flatter at all points on the curve for both 1999 and 2003. Thus, in 1994 the combined CR of the big three (CR3) was 91 percent, of which the original duopoly accounted for 77 percent. By 2003 CR3 had fallen to 83 percent, but the share of the smallest of the trio had increased to 22 percent.

CHART 2.2 DISTRIBUTION OF BANKING DEPOSITS: BIG THREE AND OTHER



Source: Bank of Botswana

3.17 This suggests that equality across the market has been increasing. In turn, this can be seen as an indicator of enhanced competitiveness, both because it points to some reduction in market power among the established banks, and, perhaps more importantly, increased market share for the newer entrants is itself a sign that they have been competing effectively. But while the previous pattern of a duopoly has been substantially eroded, one result has been the emergence of one bank as a clear market leader, with potential to operate from a position of dominance. Of the 16 percent fall in the share of the largest two banks between 1994 and 2003, 11 percent was due to the lower share of Standard Chartered while that of Barclays fell by only five percent. Moreover, the levels of concentration remain very high. In South Africa, in 2000 the largest market share of deposits by a single bank was 22.5 percent, compared to 34.6 percent for Botswana in 2003. In the circumstances, using the HHI to measure the impact of possible merger combinations, there is an indication that the increase in concentration arising from combinations other than among the smaller participants would not be acceptable on the basis of benchmark criteria applied elsewhere.[24] It might, however, be difficult for the local supervisory authority to have a say on such a merger if it results from a merger of parent companies outside the jurisdiction of Botswana.

3.18 Table 2.1 also includes HHI calculations for sub-categories of deposits and credit. While overall concentration remains high, there are interesting differences between various market segments, most importantly, the high degree of concentration in the household category, with averages over the period of 0.37 and 0.34 for deposits and credit respectively. This in turn is driven by the large market share of Barclays, which accounts for over 40 percent of household deposits, i.e. it is close to a position of clear market dominance. One reason for this dominance is that the bank has always maintained a more extensive countrywide branch network as compared to its competitors, which makes it more accessible to many households.[25] In contrast, the extent of concentration for lending to businesses is much less with the newer banks having gained strongly in market share. These divergent trends provide a clear indication of market segmentation where the impact of additional competition has been substantially different in different market segments.

(ii) Profitability

3.19 As well as concentration, competitiveness studies typically look at trends in profitability, since the capacity to make 'excess' profits is the central feature of businesses operating in a less-than-fully competitive environment. However, the identification of such excess profits is not straightforward in practice. What should be considered a normal rate of return varies across industries, countries and time periods, including across the business cycle, and especially according to the differing risks involved. For instance, a market where the risks of failure are high could result in an equilibrium combination of few active participants making high profits and little attempt by others to enter, but when considered against the risks being taken this would not be a case of excess profits. Conversely, other forms of non-competitive behaviour, including inefficiencies and cross-subsidisation, may erode profits; so low profits would not necessarily indicate competition. Partly as a result of such factors, the timescale over which the profits are observed is important. In the short term, large profits may be indications of improved efficiency, or the result of temporarily favourable market conditions and not trend excess profitability. It is generally to be expected that banking profits will vary considerably over the business cycle.

3.20 The trend of increasingly high rates of profitability for Botswana banks since the mid-1990s that is reported in more detail later in this chapter should be interpreted carefully in this context. A feature of the data is the period since 1995 when, after a short-term dip, profitability increased rapidly in subsequent years (see Chart 2.5, Section 4). This could be interpreted as a sign of increased competition, as the lower rates of profit in 1995 reflect, in large part, the impact of major restructuring undertaken by the two established banks in the face of challenges from new market entrants.

3.21 Indeed, this sequence of higher profits arising as the consequence of improved efficiency, resulting from staff reductions and the closure of unprofitable branches (i.e. removing cross subsidisation), is a 'textbook' case of a market characterised by increased competition. It should be acknowledged that the same competitive forces have not subsequently driven profit levels down again; but neither has the market settled down to a comfortable, expanded oligopoly with complacency and inefficiencies returning.

3.22 Profitability must also be viewed in the context of the business cycle. One response of the major clearing banks to the UKCC report on banking services for SMEs was that the survey period of

24 In South Africa, the Competition Commission would probably reject any merger which added 0.05 to the HHI of an already highly concentrated market (see footnote 5). This would be the effect of any merger in Botswana involving one of the largest three banks. (Note that this calculation is purely illustrative and are not intended to indicate policy in Botswana towards mergers).

25 As of the end of 2002 Barclays had nearly twice as many business locations as its nearest rival.

1998–2000 did not include a period of economic recession when profits would normally decline. The relevant point for Botswana is that there has never been a prolonged economic recession.[26] This can at the same time both add to and qualify the impression that profit levels have been excessive. Certainly, any argument that high profitability of Botswana banks reflects high levels of underlying risk has become less plausible in the face of the consistently strong performance of the Botswana economy. At the same time, the relatively small market combined with the concerns that, given limited progress towards diversification from mining, economic growth is now on a slower trend, may act as an effective barrier to entry, especially to international banking groups used to operating on a larger scale. The departure of Investec from the Botswana banking market in 2003 is relevant. The former owners made it clear that the Botswana market, while profitable, was too small to fit well into its broader operations, given its concentration on the niche market of high net worth customers.

(d) Sources of Income

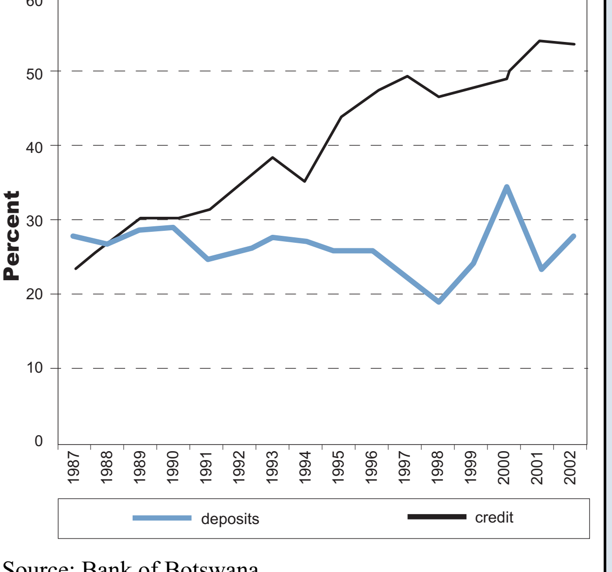
3.23 Banks' various sources of revenue can be divided into two main categories of interest income and non-interest income, the latter mainly comprising fees and commissions. Income sources can also be distinguished according to the type of purchaser, such as households or businesses. Outside the fully competitive market there will be scope for cross-subsidisation between products, and such behaviour is likely in a situation of oligopoly, either reflecting inefficiencies or the strategic manoeuvering of participants as they seek to gain market power at the expense of their rivals. Conversely, any move away from cross-subsidisation may be seen as an indicator of increased competition.

This subsection looks at three particular aspects of the sources of income for banks in Botswana: the importance of lending to households, interest rate spreads and the balance between interest and non-interest sources of income.

(i) Lending to Households

3.24 Chart 2.3 shows a clear trend over the period since the late 1990s where lending to households has increased as a proportion of total borrowing. This reflects a combination of factors. Increased urbanisation has led to easier access for households to banking services. But this does not appear to be the principal explanation, as over the same period, the proportion of household deposits has remained broadly constant. A more important driving force has been the rapid growth of personal incomes (e.g., salaries of civil servants, which are a major influence on wage levels in the economy, rose strongly during the 1990s) and product development across the market spectrum ranging from mortgage finance to credit cards. Together these have combined to make lending to households a 'growth market'. At the same time as household borrowing has been fuelled by rapid income growth, the relatively slow pace

Chart 2.3 Household Share of Commercial Bank Deposits and Credit (Percent)



Source: Bank of Botswana

26 This is not to say that Botswana banks have never faced more difficult trading conditions: economic growth was relatively low, compared to long term trends, in 1992 and 1993, and another cause of the dip in profits in 1995 was the high level of bad debt provisions.

of economic diversification is reflected in the slow growth in lending to businesses. Some borrowing requirements by businesses have been taken care of through Government-funded schemes including, most recently, CEDA. This change in the structure of bank lending must be acknowledged when considering issues of competition and profitability.

(ii) Interest Spreads

3.25 The interest spread in Botswana, that is the difference between lending and deposit rates, had been increasing since the early 1990s[27], and has been taken by some as a clear sign of exploitation of consumers by banks and, by extension, seen as pointing to a lack of serious competition.

3.26 Due to the small size of the Botswana market, banks have been unable to reap the benefits of economies of scale and as such face the high costs of providing service to a sparsely populated country. This could be one reason why local banks have wider spreads compared to other countries. But, beyond this general observation, there is a complex relationship between the interest rate spread and competition.

3.27 The measure of the interest rate spread is itself not straightforward. Banks offer a variety of products to both depositors and borrowers, leading to a range of different interest rates, each of which will reflect different risk and liquidity characteristics. It is no simple matter, therefore, to calculate a representative spread, especially when the product range is developing. For example, average lending rates could be increasing (and, therefore, widening the spread) due to the introduction of products to serve customers in higher risk categories. The growth in such lending has been a characteristic of development in Botswana banking, with the introduction of credit cards by some of the banks being an obvious example, and would seem more likely to have been encouraged by effective competition than its absence. The growing share of households in total borrowing could also have reinforced this trend, as both risks and costs of such lending, which is typically in smaller amounts and often less well secured than business lending, may be higher. At the other end of the spectrum, the banks' prime rate is not a clear reference point, as 'blue chip' borrowers, especially in the corporate market, are able to negotiate even lower rates, with the discount to the prime rate varying according to market conditions.

3.28 The Bank of Botswana reports in its monthly statistical publication a number of deposit interest rates.[28] Only a selection of the different rates are included, and it is not clear which rate(s) should be taken as representative. Many savings accounts rates, sometimes linked to the official Bank Rate, can vary significantly with the level of deposit. Fees (not lower interest rates) may be used to penalise frequent withdrawals.

3.29 Analysis of interest rates and the spread between them should also be set in the context of any changes that have occurred in the monetary policy framework within which these interest rates are set. Much of the observed increase in the spread occurred in the early 1990s, when the Bank of Botswana was switching to a monetary policy framework that increasingly relied on open market operations through the use of Bank of Botswana Certificates (BoBCs), and was explicitly aimed at raising the levels of real interest rates to encourage savings and more productive use of borrowed funds. This may have caused a widening of the spread by some measures as the introduction of BoBCs entailed a major change in the structure of official interest rates and provided the banks with a more tangible market-determined benchmark for risk-free lending compared to the Bank Rate, which for all intents and purposes, is largely symbolic.

3.30 The effect of business conditions should again be acknowledged. As Section 4 addresses this point in more detail, summary measures such as

27 Data on interest rate spreads is presented in Table 2.4.

28 See Table 4.2 in the Statistical Section of this report.

Table 2.3 Ratio of Non-Interest Income to Net Interest Income, 1994–2002

	All	Domestic	Foreign Exchange
1994	49.9	27.7	22.2
1995	53.3	33.6	19.7
1996	57.9	35.3	22.5
1997	54.6	32.0	21.7
1998	60.6	35.8	24.8
1999	52.6	31.2	21.5
2000	53.5	33.9	19.6
2001	56.5	35.0	21.4
2002	57.4	38.0	19.4

Source: Bank of Botswana

the net interest spread, can show significant year-to-year movements due to changes in underlying business conditions.

(iii) Non-Interest Income

3.31 Of concern to some in Botswana is the fact that the cost of banking services is high compared to other countries in the region. This has also been taken as a sign of a lack of competition, with increasing reliance on non-interest income in recent years interpreted as exploitation of the public by the banks through inflated fee increases. This is put in a longer-term perspective by the discussion in Section 4, which shows that between 1993 and 2002, non-interest income contributed an average of 35 percent of banks' total income, a smaller proportion than in the period prior to 1990. As indicated in Table 2.3, there has been a slight upward trend since 1994, as the importance of non-interest income relative to net interest income has increased, due, in large part, to the rise in the domestic component of non-interest income.

3.32 A survey conducted in 2001 for the Bank of Botswana on the quality of banking services in Botswana found that bank charges in Botswana were higher than in South Africa and Mauritius, while the comparison with South Africa in a BIDPA report (see Section 2, footnote 1) also found that charges in Botswana were higher. The concerns of consumers on fees are relevant, especially given the widespread perception that fee increases since the mid-1990s have not been matched by improved service quality (see *Annual Report 2001*).[29] However, the fact that bank charges in Botswana are high by regional standards is not an unexpected finding. Since unit costs of banking service provision are inversely related to both population size and density, banks in Botswana face higher costs on both fronts. Providing a modern banking service in a large country with a small population will inevitably be expensive, and that expense will be reflected in the cost of banking.

3.33 It should also be recognised that a switch towards greater reliance on fee income may reflect both greater underlying competitive pressures and a platform to build further on such a trend. The trend towards more reliance on fee income is in line with that seen in other countries. To some extent this reflects a greater variety of products offered by banks, moving away from the basic intermediation function between depositors and borrowers. But the shift also points to a move towards a more efficient pricing structure, which offers potential key advantages to bank

29 Subsequently, in a press release issued in November 2002, the Bank of Botswana confirmed that it discussed such matters with the commercial banks on a regular basis and that there was a need to develop an appropriate regulatory structure to handle consumer protection issues.

customers. By directly associating fees with specific services, consumers can better determine whether they are receiving value for money and hold the banks accountable. Indeed, the mounting pressure that led banks to reduce some fees in early 2003 in part reflects the greater 'visibility' of income from fees. In addition, while there may still be a considerable degree of cross-subsidisation, fees are generally easier to compare on a like-for-like basis than interest rates, where other conditions attached to loans and deposits will often increase the effective interest rate paid by the borrower or lower the rate received on deposits. In turn, this provides more scope to 'unbundle' the products offered by banks and take advantage of the potential for making savings, including considering the products offered by other banks. There is more incentive and potential for banks to further refine products to match the needs of specific groups of customers, for instance, by offering better quality services to customers who are prepared to pay higher fees.[30]

3.34 There is a need for adequate consumer education on these matters, if the full benefits are to be achieved; for example, customers could be enlightened on the most effective use of the banks' grievance procedures. In this regard, it is encouraging that banks in Botswana have explicitly recognised the need to justify their fee structures to consumers. However, more remains to be done. In particular, the perception which was highlighted in the Finscope survey that accessing banking services is time consuming, unnecessarily complex and restricted to those who are comfortable with modern technology, needs to be overcome as this both restricts the use of banking services and deters customers from shopping outside their 'home' banks.

(e) Non-Price Competition: Product Innovation and Advertising

3.35 Banks in Botswana have continued to widen and refine the range of new services that they offer. Some, such as credit cards, have already been mentioned. Several banks have overhauled their range of products to target specific customer groups, including those frequently perceived as marginalised, such as low-income earners and small business owners. Emphasis has been both on price and in terms of service quality including flexible mortgage facilities, rapid processing of loan applications and more detailed and timely information to help with account management and branch refurbishment. Modern technology, such as internet banking, is being utilised more and more; the high levels of teledensity in the country, especially cell phones (one bank already offers transaction updates through cell phones) means that there is more scope for such technological developments. Indeed, despite continuing concerns about inadequate services, it is easy to forget how radically the provision of banking services in Botswana has been transformed since the late 1980s, when there was not a single ATM facility in the country and virtually all banking business had to be conducted by face-to-face contact in branches. Overall, the quality of banking services has improved considerably. As noted earlier, the process of innovation is an important indicator of the degree of competition, as companies have little incentive to innovate if competition is absent.

3.36 Accompanying this product development, the commercial banks have, to a greater or lesser degree, engaged in intensive advertising. Advertising may help fill the information gap that exists outside the situation of fully competitive markets and, as such, enhance competition through encouraging consumer choice, particularly if promotional activities help bring consumers' attention to new products.

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30 Such differentiation between customers is sometimes seen as unfair. However, offering better services to those who are prepared to pay more is a common feature of many types of business (such as airlines, for example) and there is no reason why banking should be different. Indeed, all customer groups should benefit from such practices as resources can be allocated with greater efficiency, thus making relevant services more readily available for each group. This is not the same as 'price discrimination' where the same product is offered at different prices.

Detailed information is not readily available, but casual observation would suggest that advertising by banks in Botswana has increased in intensity over the years, consistent with the view that there has been some increase in competitive pressures. The dynamic combination of rapid product development and intensive promotion is clearly not consistent with a highly collusive oligopoly, where such activities would undermine the balance of market shares that underpins effective collusion.

3.37 Such advertising has taken various forms, ranging from the promotion of specific products to more general image building, and would seem to be generally beneficial. However, large-scale advertising also has its downside. It is unlikely to be cheap, and one may ask whether consumers benefit more from additional advertising or potentially lower prices. Banks which advertise heavily can benefit from such activities in a variety of ways that are not necessarily in line with their customers' interests. Individually, the enhancement of a supplier's brand 'image' increases market power, potentially making consumers less responsive to lower prices on offer elsewhere. For instance, associating products with other supposed benefits, such as competition prizes, may distract attention from the underlying product price, while brand image advertising is, at least in part, defensive with the aim of deterring customers from looking at options available outside their existing bank. Moreover, as suggested earlier, suppliers may benefit collectively as well, since the need to engage in extensive advertising raises the costs of entering the market and, as such, can act as an effective barrier to entry. As banks increasingly engage in this type of competition, there is an accompanying need to make sure that advertising takes forms that are consistent with consumer interests.

3.38 There is evidence that banks in Botswana are becoming more competitive. This has benefited consumers through a wider range of products and a more transparent pricing structure. Where there is continued concern that fees are not justified by accompanying service levels, over time, and especially as consumers become more knowledgeable, it seems likely that banks will respond further to pressures for improved services. Despite the high levels of profitability and the welcoming attitude by the authorities to applications for banking licences, there have not been many new market entrants. This suggests other barriers to entry, most notably, perhaps, being the size of the market, which, while potentially rewarding, remains small compared to the overall operations of international banks.

4. Banking Profitability, Efficiency and Productivity

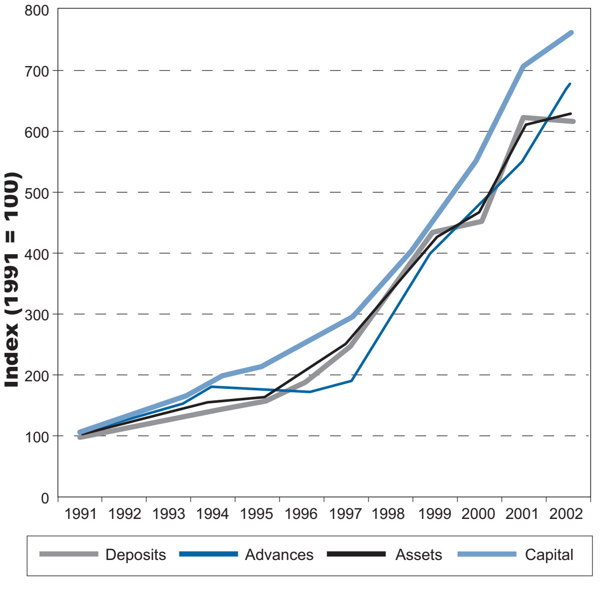
4.1 The previous Sections reviewed competition and profitability trends in the banking sector. In particular, the issues covered dealt with the different forms of market structures and market behaviour of participants, in the context of banking sector policy initiatives directed towards increasing competition as a means of promoting improvements in service quality and efficiency. In this Section, the analysis is extended to review the performance of banks in Botswana since 1993.

4.2 As previously indicated, one of the principal roles that banks perform in an economy is that of financial intermediation. By pooling funds from savers, and using specialised skills for assessing borrowers' capabilities, banks identify investment opportunities for lending funds. Although the ultimate goal of banks is earning profit for their shareholders, it is also important that banks fulfil their intermediation role efficiently, otherwise there would be risk of financial sector instability, which would negatively affect economic activity.

4.3 The review of the bank's performance in this Section will focus on trends in aggregate financial ratios, which are normally used as indicators of profitability and efficiency of banks, as well as productivity trends.

4.4 As noted in Section 3, the number of banks has increased since the early 1990s, partly as a result of a deliberate policy of licensing more banks in order to foster competition as part of the strategy of financial sector development. Since then, commercial banks' activities have expanded rapidly, as reflected in the growth of total banking assets, deposits, advances and capital (Chart 2.4). Although the overall growth trend was upward, there has been some volatility, notably a slowdown in advances growth between 1995 and 1997, and in deposit and asset growth in 2000 and 2002.

CHART 2.4 BANK ACTIVITIES – SELECTED MEASURES



Source: Bank of Botswana

4.5 The expansion in the number of banks was accompanied by an increase in bank branches and other business points (encashment points, ATMs and agencies). These developments provided customers with a convenient way of accessing banking services even beyond the normal operating hours of banks. As at the end of December 2002, there were a total of 65 branches and sub-branches, 12 agencies, 7 encashment points and 123 ATMs across the country. This compares with 45 branches and sub-branches, 61 agencies and 19 encashment points in 1992. It is interesting to consider whether this apparent increase in competition and range of financial services affected the banks' profitability, efficiency and productivity.

(a) Financial Performance Indicators

4.6 The performance indicators covered relate to profitability and efficiency. However, in making international comparisons, it should be borne in mind that performance ratios are affected by market conditions in which the bank operates, including macro-financial policies, prudential regulation and accounting standards, competition and business practices. Thus, 'there are no universal normative standards for what constitutes acceptable earnings performance for a banking institution', (World Bank, 1992[31]) Notwithstanding the limitations of comparing banks' financial ratios across different countries, where possible, an attempt will be made to review the profitability and efficiency of Botswana banks compared to international norms. The financial ratios used in this review are listed in Table 2.4 and cover the period 1993 to 2002.

(i) *Profitability Measures*

4.7 Profitability ratios measure the productivity of resources invested in a firm/bank as well as being an indication of management efficiency in generating returns on capital and assets. The most commonly used measures of profitability are Return on Assets (ROA) and Return on Equity (ROE). The ROA is defined as net income before tax as a percentage of total assets, and measures the capacity of an asset to generate earnings and indicates the effectiveness of management's lending decisions (Bank of Botswana *Annual Report 2001*). The ROE is defined as net income after tax as a percentage of total shareholders equity, and measures how well the bank's equity has been employed.[32]

4.8 During the ten-year period from 1993 to 2002, the banking sector has been consistently profitable. Chart 2.5 indicates that the two ratios

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31 Banking Institutions in Developing Markets, Vol.2, World Bank.

32 Ratios are calculated on the basis of sector-wide data, i.e., from aggregated figures for total income, capital, equity, etc.

have been generally rising steadily over the years, except in 1995 when there was a slight dip. The ROA ratio increased from 2.5 percent in 1993 to 9 percent in 2002 and averaged 4 percent over the ten-year period. The sharp increase in the ratio in 2002 mainly reflected a change in the provisioning methods used by one of the banks, which led to a 59 percent decline in provisions, thus increasing profit. During the same period, the ROE ratio rose from 21.4 percent in 1993 to 44.2 percent in 2002 and averaged 35.1 percent, mainly as a result of the rapid average growth in net income after tax. Overall, these measures show that banks' profitability in Botswana increased over the period, contrary to expectations that as the number of banks rose and competition intensified, profit margins would decline. In general, banking profitability was sustained by relatively low levels of bad and doubtful debts (hence low provisions). In 1993, provisions for bad debts were 3 percent of total advances; they were reduced to 2.2 percent by the end of 2002, and averaged 2.8 percent for the entire 10-year period (see Table 2.4). Hence the quality of assets contributes to the overall profitability of banks, reflecting prudent lending by banks and, more generally, robust economic performance.

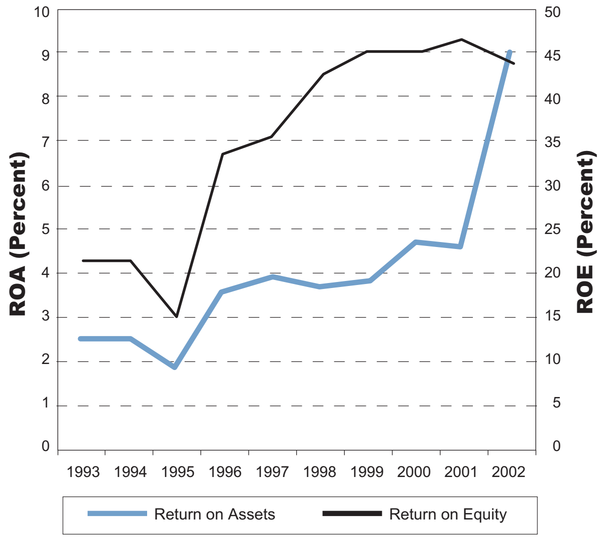
(ii) *Banking Efficiency*

4.9 Efficiency means 'getting any given results with the smallest possible inputs, or getting the maximum possible output from given resources'.[33] Efficiency measures can be divided into operating efficiency and staffing efficiency, which are both aspects of productivity.

(iii) *Operating Efficiency*

4.10 Among the most commonly used measures of operating efficiency are Net Spread (NS) and Net Interest Margin (NIM). NS is the difference between interest earned on advances as a percentage of total advances and interest paid on deposits as a percentage of total interest bearing deposits.[34] This measure of efficiency isolates the effects of interest rates on profits and as a result provides a meaningful understanding of the sources of bank profitability and, therefore, the vulnerability of bank earnings. The second measure of efficiency, NIM, is the difference between interest income and interest expenses expressed as a percentage of average total assets. The NIM identifies the major income generating capacity of the banks, i.e., the ability to use assets to generate income. Table 2.4 and Chart 2.6 show developments in both ratios over the ten-year period to 2002. The NS rose from 1.8 percent in 1993 to 4 percent in 2002, averaging 4.3 percent, while the NIM increased marginally from 6.9 percent in 1993 to 7.4 percent in 2002, and averaged 6.8 percent for the ten-year period. It is notable that while the rising NS indicates the banks' ability to widen the gap between interest rates on advances and deposits, the NIM has remained largely stable. This is most likely the result of the rising share over this period of BoBCs in total assets. As a result, lower-yielding BoBCs have accounted for

CHART 2.5 PROFITABILITY RATIOS



Source: Bank of Botswana

33 Oxford Dictionary of Economics.

34 As calculated here, it excludes BoBCs, which are interest-earning assets but are not advances.

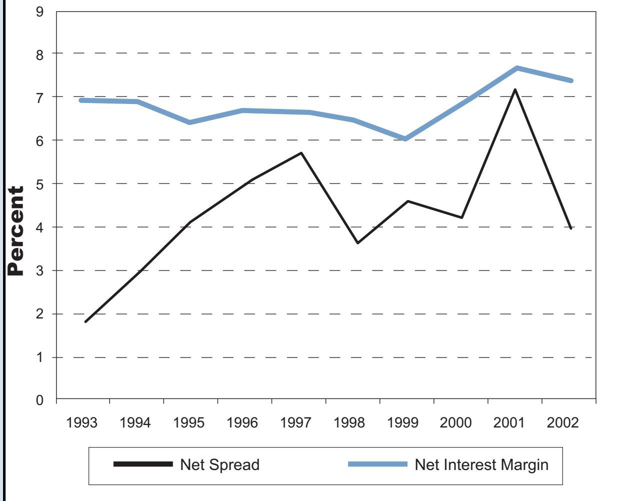
TABLE 2.4 SELECTED KEY PERFORMANCE RATIOS FOR BANKS*

Profitability (Percent)	93	994	995	96	97	98	99	00	001	002	rage
Return on Assets	2.54	2.54	1.85	3.60	3.89	3.73	3.81	4.74	4.60	9.00	4.03
Return on Equity	21.41	21.40	14.77	33.65	35.97	42.42	45.13	45.22	46.68	44.21	35.09
Provisions	2.98	2.96	2.59	2.69	2.86	3.49	3.32	1.82	2.36	2.20	2.73
Efficiency											
(i) Operating Efficiency (Percent)											
Net Spread	1.82	2.95	4.16	5.06	5.72	3.64	4.62	4.19	7.19	3.97	4.33
Net Interest Margin	6.92	6.95	6.46	6.67	6.68	6.52	6.07	6.87	7.68	7.39	6.82
Non Interest Expense/ATA**	5.76	6.33	6.22	5.51	4.82	4.22	4.03	4.47	3.55	4.13	4.90
Net Income/ATA	1.95	1.97	1.46	3.07	3.23	3.34	3.34	3.79	4.23	4.31	3.07
Advances to deposits	74.06	74.99	67.09	57.17	50.01	52.65	59.53	68.64	56.99	68.99	63.01
Average cost of deposits	64.70	65.54	66.84	67.67	72.85	73.90	72.85	67.65	78.73	61.56	69.23
Cost to Income	63.81	66.71	68.00	57.48	51.59	47.31	47.93	47.09	35.94	40.49	52.64
(ii) Staffing Efficiency/Productivity											
Staff cost per Employee (P'000; real)	82.74	81.73	86.55	79.87	76.44	46.24	78.96	57.88	60.10	64.91	71.54
Asset per Employee (P'000; real)	2720.50	2494.98	2672.63	2959.24	3254.54	2513.58	4610.88	2819.37	3188.76	2889.79	3012.43
Return on staff Expense (percent)	83.59	77.41	57.20	133.56	165.46	202.98	222.37	230.65	244.26	400.85	181.83
Net Income per staff (P'000; real)	6916.21	6326.79	4951.12	10667.19	12648.42	9386.09	17558.60	13350.93	14680.03	26018.26	12250.36

* See Box 2.1 for the computation of the ratios. ** Average Total Assets.
Source: Bank of Botswana

an increasing proportion of interest income while interest from higher-yielding advances has fallen (in percentage terms); hence the rise in interest yields on advances, shown in the NS, does not translate into higher interest income as a percentage of assets, in the NIM.

CHART 2.6 OPERATING EFFICIENCY



Source: Bank of Botswana

4.11 The NIM ratios for Botswana banks far exceed those in more developed countries. For example, comparable ratios for major banks in the United States of America (USA), United Kingdom and Canada averaged 3.09 percent, 2.15 percent and 1.97 percent, respectively, between 2000 and 2002. Other countries recorded ratios of similar magnitudes during this period, while Germany and Switzerland recorded ratios below 1 (Table 2.5). This compares with an average of 7.31 for Botswana banks during the same period (Table 2.4). This difference can be attributed to a number of factors specific to Botswana, which include less intense banking competition than in developed countries and different cost structures, market sizes and scope for economies of scale, which are all relevant to the magnitude of the interest spread.

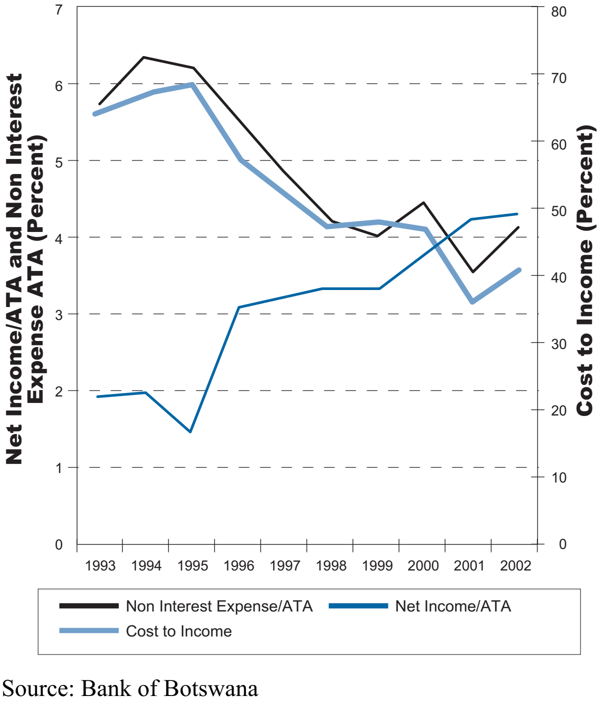
4.12 Other ratios considered in this analysis are Non Interest Expenses to Average Total Assets, Net Income to Average Total Assets and Cost to Income ratios (Chart 2.7(a)). The Non Interest

TABLE 2.5 PROFITABILITY OF MAJOR BANKS (PERCENT OF TOTAL AVERAGE ASSETS)

	Pre-Tax Profits			Provisioning Expenses			Net Interest Margin			Operating Costs		
	2000	2001	2003	2000	2001	2003	2000	2001	2003	2000	2001	2003
United States (USA) (10)	1.86	1.49	1.65	0.56	0.71	0.72	3.07	3.10	3.11	4.45	4.06	3.46
Japan (12)	0.13	-0.93	0.04	0.81	1.36	0.28	1.08	1.14	0.81	1.14	1.20	0.82
Germany (4)	0.53	0.14	0.05	0.17	0.24	0.39	0.83	0.90	0.80	1.62	1.62	1.50
United Kingdom (4)	1.65	1.27	1.11	0.29	0.31	0.36	2.36	2.07	2.02	2.68	2.48	2.40
France (4)	0.85	0.74	0.58	0.17	0.22	0.20	0.93	0.94	1.03	1.94	1.87	1.81
Italy (6)	1.15	0.81	0.48	0.44	0.55	0.67	2.06	2.04	2.16	2.37	2.39	2.61
Canada (6)	1.26	0.92	0.61	0.29	0.41	0.59	1.89	1.95	2.06	2.76	2.84	2.76
Spain (4)	1.33	1.20	0.93	0.35	0.44	0.49	2.65	2.86	2.66	2.63	2.60	2.37
Australia (4)	1.85	1.47	1.49	0.20	0.27	0.26	2.42	2.22	2.16	2.39	2.15	2.29
Switzerland (2)	0.96	0.42	0.08	0.04	0.14	0.21	0.73	0.68	0.84	2.87	2.91	2.47
Sweden (4)	1.16	0.82	0.70	0.06	0.10	0.09	1.60	1.49	1.48	1.72	1.51	1.44

* Figures in parentheses indicate the number of banks included.
Source: BIS 73rd Annual Report.

CHART 2.7(a) EFFICIENCY RATIOS

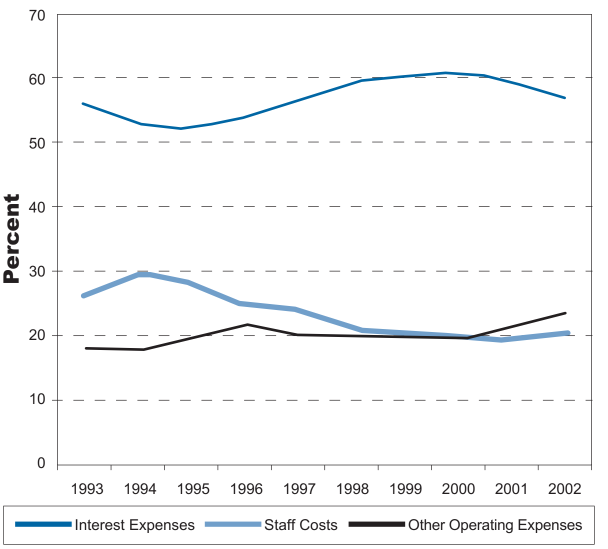


Source: Bank of Botswana

Expenses to Average Total Assets and the Cost to Income ratios have been declining over the period under review, indicating that costs were increasing more slowly than both income and assets, which in turn suggests that banks were able to contain costs and improve efficiency. At the same time, the banks' net income to average total assets has been rising. This indicates that, over time, banks have been able to employ their assets more efficiently and earn relatively more income from a given level of assets.

4.13 Meanwhile, a breakdown of banks' total expenses indicates that, as expected for banking firms, interest expenses accounted for the largest proportion of total expenses. Interest expense accounted for 55.6 percent of total expenses in 1993, rising steadily to a peak of 61 percent in 2000, before falling to 56.6 percent in 2002 (Chart 2.7(b)). On the other hand, for most of the period between 1993 and 2002, staff costs constituted the largest share of non-interest expenses, although their share has been falling over time, partly as a result of restructuring exercises undertaken by the banks in the mid-1990s and the increase in the automation of some banking facilities. Meanwhile, 'other non-interest expenses', which include information technology and marketing costs, have been on an upward trend, and accounted for the largest proportion of non-interest expenses in 2001 and 2002 with 52.5 percent and 53.9 percent, respectively (Chart 2.7(c)).

CHART 2.7(b) COMPOSITION OF BANKS' EXPENSES

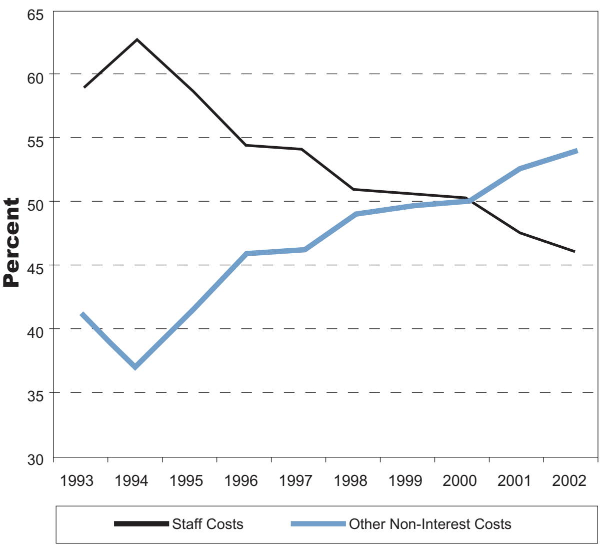


Source: Bank of Botswana

(iv) Staffing Efficiency

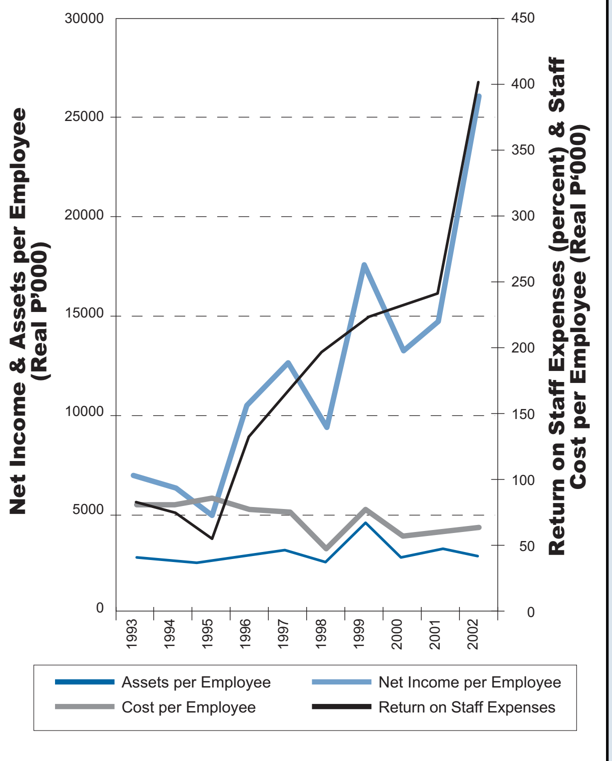
4.14 Employee compensation normally accounts for the largest proportion of non-interest costs to banks (Chart 2.7(c)). Staffing efficiency can be evaluated using ratios such as Net Income per Staff member, Return on Staff Expenses, Asset per Employee and Staff Cost per Employee. As indicated in Table 2.4 and Chart 2.8, banks in Botswana have maintained almost constant rates between the number of staff and salaries and employee benefits on the one hand and between total assets and staff size on the other, as indicated by the Staff Cost Per Employee and Assets Per Employee ratios. The Assets Per Employee ratio has grown only marginally while Staff Cost Per Employee ratio was slightly reduced over the ten-year period. Meanwhile, the Return on Staff Expense and Net Income Per Staff ratios have grown considerably during the same period, which indicates that banks' income has been increasing at a higher rate than the increase in both salaries and employee benefits as well as the number of staff. These are indications of staffing efficiency in the banking sector and possibly the increase in automation.

CHART 2.7(c) COMPOSITION OF BANKS' NON-INTEREST EXPENSES



Source: Bank of Botswana

CHART 2.8 STAFFING EFFICIENCY/PRODUCTIVITY



Source: Bank of Botswana

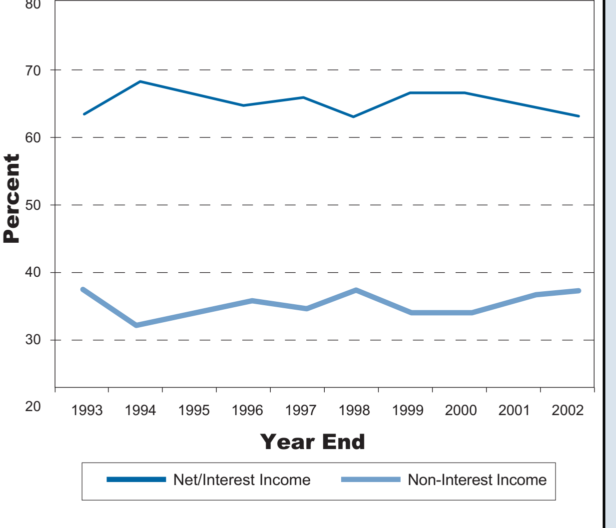
(v) Other Measures of Operating Efficiency

4.15 The operations of commercial banks can be disaggregated into two distinct groups: intermediation and the provision of financial services, such as foreign exchange transactions. Return from intermediation is measured by net interest income, representing the difference between interest earned from extending advances and the interest paid on deposits. On the other hand, return from the provision of financial services, such as foreign exchange, is measured by non-interest income. These measures are discussed below; they are an effort to establish the manner in which market behaviour and competition, which are addressed in Sections 2 and 3, have impacted on them. However, it should be noted that the effects of competition would be expected to be diverse depending on the nature of each particular market. For example, the impact of competition is likely to be more pronounced in the financial services group, where the operations of banks mainly involve products that are largely homogeneous with a clearly identifiable market-determined price. The impact of competition on intermediation may, however, be less pronounced because the operations of commercial banks in this group involve highly differentiated products, e.g., provision of diverse deposit facilities and loan products. Moreover, the market for credit is itself heterogeneous and the return to a bank is not only defined by the interest rate but also by the associated risk.

(b) Financial Services: Non-Interest Income

4.16 Banks provide financial services, from which they earn non-interest income in the form of commissions and fees, as well as intermediation services from which they earn interest income. During the 1980s, non-interest income and net interest accounted for roughly equal shares of commercial banks' total income. However, between 1990 and 1993 the share of non-interest income in total income declined sharply, and since that time net-interest income has accounted for the largest share of total income. Between 1993 and 2002, net-interest income averaged 64.5 percent of total income with the remaining 35.5 percent accounted for by non-interest income (Chart 2.9). Hence there has been a major shift in the relative importance of commercial banks' major income sources during the 1990s as compared to the 1980s. This development has been attributed to the entry of new banks and increased competition between 1990 and 1993, and the breakdown of some of the collusive arrangements that existed with regard to fees and charges during the 1980s.[35] Other explanations for the increased importance of net-interest income since the early 1990s include the growing importance of higher-earning personal (household) loans in banks' advances portfolios, and the generally higher level of interest rates given changes in monetary policy that have taken place since 1989. However, and as noted in Section 3, the declining share of non-interest income has been reversed to some degree since 1994. This increased reliance on non-interest income may reflect a closer alignment of fees and charges with costs, and rising costs due to the provision of enhanced products and services, both in response to competitive pressures.

Chart 2.9 Share of Non-Interest and Net Interest Income in Total Income



Source: Bank of Botswana

(c) Intermediation: Net Interest Income

4.17 Net interest income, which is a measure of the banks return from intermediation, can be used as a proxy for the interest rate spread. A number of factors such as the level of competition, the maturity and risk of loans and the prime rate are important determinants of the interest rate spread. As shown in Chart 2.10, the overall trend

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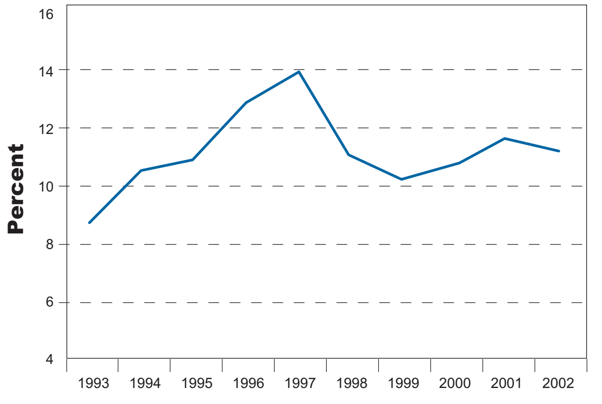
35 See *Bank of Botswana Research Bulletin,* Vol. 12, No.1, September 1994 (p59).

in net-interest income as a percentage of total advances has been upwards. However, the main increase came between 1993 and 1997; since that time the spread has been lower. The latter trend suggests that the interest rate spread was being reduced during the late 1990s and is, therefore, supportive of the findings that the banking sector was becoming less concentrated and more competitive.

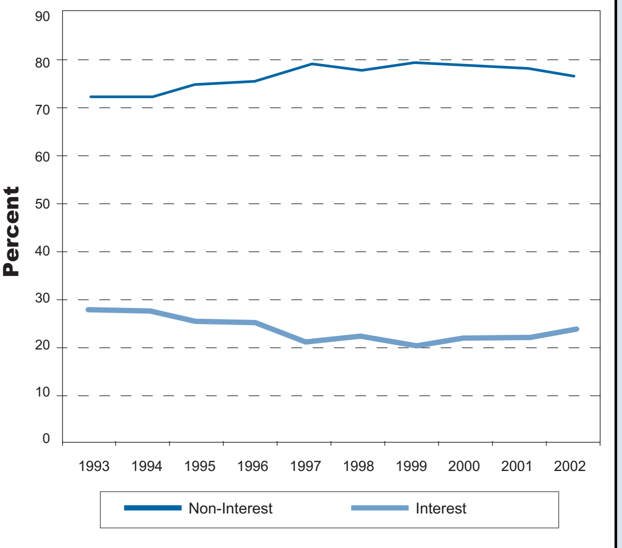
CHART 2.10 NET INTEREST INCOME AS A PERCENTAGE OF ADVANCES BY COMMERCIAL BANKS



Source: Bank of Botswana

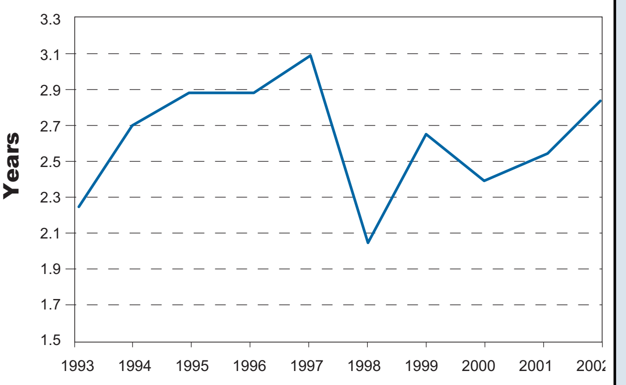
4.18 As explained earlier, the interest rate spread is not only explained by competition; the nature of deposits and the categories of advances and their maturity structures are also important. This is because longer term and large deposits earn relatively high interest rates, as does riskier lending. Chart 2.11 shows that interest-earning deposits account for the largest proportion of total deposits, and that the proportion has generally been increasing over time, especially between 1993 and 1997. The rising share of interest-earning deposits in total deposits may partially explain the rise in the spread between deposit and lending rates (since, to achieve a desired average cost of deposits, the rate of interest paid on interest-bearing deposits will be lower, the higher the proportion of interest-bearing deposits in total deposits). Meanwhile, Chart 2.12 indicates that average maturity has also been increasing, albeit very marginally. The increase in average maturity may also partly explain the increasing spread during the period.

CHART 2.11 RATIO OF INTEREST EARNING AND NON-INTEREST EARNING DEPOSITS TO TOTAL DEPOSITS



Source: Bank of Botswana

CHART 2.12 AVERAGE MATURITY OF BANK LENDING



Source: Bank of Botswana

4.19 The Botswana banking sector has experienced not only a significant increase in the number of participants but also a major technological transformation during the period under review. The expansion in the number of banks has been accompanied by an increase in the number of branches and agencies, business points, encashment points, ATMs, and other facilities as a result of which access to banking services has been made easier than before. The increased number of banks did not, however, erode banking profitability, which has increased over the ten-year period. Rising profitability might be an indication of the fact that the Botswana banking sector is not competitive enough to reduce profitability of individual banks, with profits supported by a combination of factors, including interest margins, which are high by international standards, high levels of efficiency as indicated by the various financial ratios and, generally, the country's sound economic performance.

4.20 The impact of competition on the profitability of banks can be viewed on the basis of two major sources of income for commercial banks, i.e., financial services and intermediation. The shares of interest and non-interest income to total income have changed over time. Prior to the 1990s, non-interest income accounted for the largest proportion of total income; thereafter, net-interest income has become the largest source of the banks' income. The reversal in the role of non-interest and net-interest income signifies that, even though the banks remain profitable, competition has intensified in the banking sector, and this has led to the decline in the contribution of non-interest income to total income.

Box 2.1 Definitions of Financial Ratios in Table 2.4

1. Return on Assets $= \dfrac{\text{Income Before Tax}}{\text{Total Assets}}$

2. Return on Equity $= \dfrac{\text{Net Income After Tax}}{\text{Total Capital}}$

3. Net Spread $= \dfrac{\text{Interest Earned on Advances}}{\text{Total Advances}} * 100 - \dfrac{\text{Interest Paid on Deposits}}{\text{Interest Bearing Deposits}} * 100$

4. Net Interest Margin $= \dfrac{\text{Interest Income - Interest Expense}}{\text{Average Total Assets}}$

5. Cost to Income $= \dfrac{\text{Non Interest Expenses}}{\text{Net Interest Income + Non Interest Income}}$

6. Average Cost of Deposits $= \dfrac{\text{Interest Bearing Deposits}}{\text{Average Total Deposits}}$

7. Staff Cost Per Employee $= \dfrac{\text{Salaries and Employee Benefits (real)}}{\text{Total Number of Staff}}$

8. Assets Per Employee $= \dfrac{\text{Total Assets (real)}}{\text{Total Number of Staff}}$

9. Return on Staff Expenses $= \dfrac{\text{Income Before Tax}}{\text{Salaries and Employee Benefits}}$

10. Net Income Per Staff $= \dfrac{\text{Income Before Tax (real)}}{\text{Total Number of Staff}}$

5. Competition, Efficiency and the Need for Financial Stability – The Case for Regulation and Supervision

5.1 Section 2 discussed and strongly endorsed the case for promoting competition in the banking sector as a means of encouraging efficiency and ultimately satisfying consumer needs. The discussion also recognised that characteristics of the banking sector necessitate a framework of supervision and regulation that could dampen the impact of competitive forces, which raises the question of how to achieve the best trade-off between these two objectives. This is the focus of this Section.

5.2 Addressing this question is, nevertheless, an evolving process. The rapid development of the Botswana banking sector, and the wider financial sector, requires that the regulatory and supervisory framework, as well as the accompanying institutional set-up, are reviewed regularly to ensure that the integrity and efficiency of the system are maintained and strengthened, taking particular account of the changing environment arising from technological developments, globalisation and competition from the broader financial sector. In addition, the framework of financial regulation needs to be coordinated with other objectives, notably consumer protection issues.

(a) The Need for Regulation and Supervision

5.3 Regulation and supervision of the banks is necessary to attain financial stability, characterised by a safe, sound and efficient banking system as well as a payment mechanism that adequately facilitates the transmission of monetary policy. According to Foot (2003)[36] financial stability obtains where, *inter alia*, there is monetary stability, confidence in the operation of key financial institutions and markets and where there are no relative price movements of either real or financial assets which undermine the promotion of monetary stability and desired employment levels. In particular, a stable banking system is characterised by the absence of any adverse effect on the real economy resulting from a bank failure or the risk of a failure. Although the risk of a banking crisis may generally be small, experience shows that where stability is seriously undermined and crises occur, there are large costs to both businesses and individuals with severe negative economy-wide consequences.

5.4 While recognising the negative consequences of banking crises, it is equally important to consider the nature and form of regulation and supervision necessary to safeguard financial stability. The starting point is to understand what makes the banking sector special and, as indicated in Section 2, to examine possible instances of market failure in banking as these will provide the basic justification for any regulatory intervention.

5.5 The unique position of banks derives from their role as deposit takers and, in turn, the use of these deposits as a primary means of payment in the economy, which requires the maintenance of a level of trust between depositors and banks that may not be achievable solely through the operation of market forces. Banking is characterised by information asymmetries, which are most obvious between banks and their customers, few of whom have the capacity (whether time or expertise) to continually monitor and assess the soundness of individual banks. Moreover, because of the use of deposits in making payments, customers must have the necessary level of trust in not only their own bank but also the wider banking sector. An effective regulatory and supervisory framework is, therefore, important to engender confidence in the banking system through an appropriate licensing system, continuous monitoring of performance and soundness of individual banks as well as timely intervention to ensure smooth exit of failed institutions and/or supervising restructurings and mergers. Effectively, given the

36 Foot M. (2003) 'What is Financial Stability and how do we get it?' *The Roy Bridge Memorial Lecture.* April 2003 FSA, UK.

extent of information asymmetry, it makes sense for a supervisory authority to make some of the decisions on behalf of customers, in order to reduce the intense and constantly changing information requirements.

5.6 The protection of retail depositors is one obvious case for some form of regulatory intervention. This is important for banks also, as some form of explicit protection of deposits reduces the risk that otherwise solvent banks will be undermined by a crisis of confidence resulting in large-scale withdrawals of depositors' funds.[37]

5.7 Banks must also have confidence in their dealings with other banks, to ensure both the efficiency of the payments system and that solvent banks are not put at risk by the unexpected failure of others. In addition, banks are frequently exposed to common risks, so any negative shock may undermine their viability simultaneously. In either of these threats, of sequential or parallel bank failures, there is a risk of systemic collapse, which, because of the potentially severe consequences, needs to be guarded against.

5.8 The financial system facilitates the transmission of monetary policy and, therefore, its stability is important for the effectiveness of macroeconomic policy in general.[38] A stable financial system reduces the vulnerability of the economy to crises and ensures that the conduct of macroeconomic policy is not constrained.[39]

37 Commercial banks are vulnerable to such situations as the nature of their business means that there is typically a mismatch between short and medium-term liabilities (deposits) and long-term assets (loans) with the latter difficult to liquidate without incurring serious losses in the event of unexpected large withdrawals by depositors. Such 'runs' on banks can easily spread throughout the banking system. To guard against such runs, banks are normally required to hold a minimum amount of liquid assets to facilitate payments to depositors.

38 For example, as discussed in Lindgren C., Garcia G. and Saal M.I. (1996), *Bank Soundness and Macroeconomic Policy*, International Monetary Fund.

39 Monetary policy is constrained if, for example, an increase in interest rates needed to tighten monetary conditions threatens the health of 'systemically' important financial institutions or markets.

(b) The Limits of Intervention

5.9 While there is a clear justification for regulation of banks, there are strict limits within which this should operate. Most importantly, there is no implication that unprofitable banks should not be allowed to fail. Just as with other businesses, lack of profitability points to an inefficient use of resources to which the appropriate response is usually to allow the business to fail. At the same time, bank failure does not necessarily mean financial instability, especially if depositors funds can be safeguarded, for example, through some form of deposit protection scheme or a take-over/merger, and the financial transactions between the troubled bank and the rest of the banking system can be concluded with minimum disruptions. Moreover, any attempt to achieve a regime of 'zero failure' would inevitably stifle innovation and competition, while a presumption that failed banks will always be rescued will itself encourage risky behaviour that may undermine stability.

5.10 A second limitation relevant to regulation is that banks should be accorded less protection in their dealings with other banks compared to the degree of protection given to their customers, primarily because banks are inherently better equipped to assess financial risks and structure their dealings accordingly, which in turn means that they should accept the good as well as bad consequences of these dealings.[40] The protection of banks against the consequences of a failing bank should focus on cases where the causes of bank failure could not have been reasonably foreseen, where banks have become exposed to a failing bank through payments system participation, or where the likely results are deemed to be so exceptionally severe as to threaten overall financial stability.

5.11 Regulation also needs to be well designed to ensure that the consequences are as intended. It

40 Banks do not typically volunteer to be taxed on transactions that have been highly profitable, so they have no reason to expect to be subsidised on those that result in losses.

has already been noted that guaranteeing banks against failure can encourage risky destabilising behaviour, and that other instances of 'moral hazard' can easily occur. For example, the Cruickshank report argued that the practice of the UK Financial Services Authority (FSA) of giving new market entrants higher minimum capital asset ratios would lead those entrants to concentrate on riskier business in order to earn adequate return on capital.

5.12 The formulation of a regulatory framework is intended to address the causes of underlying market failure rather than regulate against its undesirable consequences. This is important as the possibilities for correcting market failures change over time due to technological developments, and especially as the costs of providing the necessary information to market participants are reduced. For example, the risks of exposures between banks are reduced as real time settlement systems are introduced. More generally, potential users should be made fully aware of the high risk associated with a product, rather than stifle its development through protective regulation.[41] A corollary of this is that regulations should aim to establish a framework for overall risk control and management, and should not be involved in micromanagement where detailed business decisions have to be vetted by regulatory authorities.

(c) Regulation and Competition

5.13 There is extensive literature on the relationship between competition and financial stability, and how this affects the financial services industry, including banks. The literature suggests that there is some trade-off between financial stability and competition among banks, but the significance of this trade-off differs across countries. For example, Carletti and Hartmann (2002) argue that it is hard to draw any strong conclusions because both the theoretical and empirical literature shows that the stability effects of changes in market structures and competition are extremely case-dependent.[42]

5.14 Notwithstanding the on-going debate about whether such a trade-off exists, banking regulation in practice takes forms that restrict competition; for instance, the high standards that typically need to be satisfied in order to acquire a banking licence inevitably curtail competition because regulators, rather than market forces, determine the suitability of prospective participants. Nevertheless, for reasons already explained, this and similar trade-offs are often justifiable. In this context, however, it is worth emphasising the many ways in which competition can support rather than undermine financial stability, and vice versa. For example, if increased competition yields more information to market players, then this helps negate one of the major causes of possible instability, namely, asymmetric information. Similarly, if regulation aims to support the efficacy of the banks' internal governance structures, including ownership and management, then this can also promote enhanced competition. By the same token, regulation that stifles business initiative and self-responsibility can harm both stability and competition.

5.15 Even where there is a necessary trade-off, regulation and supervision should as far as possible take a form that enhances competition, or at least minimises the extent to which competition is reduced. For instance, any regulatory framework that provides in-built advantages to existing market participants should be avoided if possible. As discussed in Section 3, Botswana has moved away from a system where the impact of new entrants on existing banks was a required part of the assessment of banking licence applications. The Cruickshank report raises various instances where the dominance of the 'big four' UK banks

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41 Making customers fully aware of investments where their return is not guaranteed, for example.

42 Carletti, E. and Hartmann, P. (May 2002) 'Competition and Stability: What's Special About Banking?' European Central Bank Working Paper Series. Working Paper No. 146. May 2002.

may raise problems for new entrants including the risk that, by virtue of long-established links to the regulatory establishment, regulatory policy may inadvertently be framed in their interests. To counter this danger, it is important that regulation and supervisory policies are consistent with initiatives to identify areas where new entrants to the sector can bring a diversity of competence and expertise to enhance competition.

5.16 Finally, some regulations may be designed specifically to promote competition, particularly those that improve information flow and, in this context, in Botswana, a Disclosure of Bank Charges Notice was issued requiring banks to disclose as much information as possible on interest rates, fees and bank charges. Such 'truth in lending' requirements enhance competition as they assist consumers of banking services and products to compare costs and make informed choices. Another area where pro-competition regulation may be helpful is in setting guidelines to make it easier for customers to switch banks.

(d) Banking Regulation and Supervision in Botswana

5.17 A well-designed supervision and regulatory framework is only part of wider arrangements that are needed to promote financial stability. Other arrangements include sound and sustainable macroeconomic policies, effective market discipline, procedures for efficient resolution of problems in the financial sector, and mechanisms for providing an appropriate level of systemic protection, including public guarantees or safety net. The different types of financial institutions pose varying types and levels of risks to financial stability and, therefore, the applicable regulation and supervision would depend to a large extent on the structure of the financial sector, particularly the relative importance of the different financial institutions and the linkages between them.

5.18 In line with their unique position in the financial sector, the financial regulatory regime in Botswana focuses primarily on banks. The Bank of Botswana regulates commercial banks under the Banking Act of 1995, which replaced the Financial Institutions Act of 1986. The Ministry of Finance and Development Planning (MFDP), on the other hand, regulates building societies, the National Development Bank and the Botswana Savings Bank under specific pieces of legislation. However, for practical reasons, MFDP has delegated its powers of examination over the statutory banks and the Botswana Building Society to the Bank of Botswana. In addition, Section 53(2) of the Banking Act, 1995 subjects all deposit taking institutions, regardless of the respective legislation under which they were established, to the examination and prudential requirements of the Banking Act.

5.19 MFDP also regulates the insurance business under the Insurance Industry Act, pension funds under the Pensions and Provident Funds Act, and the Botswana Stock Exchange under the Botswana Stock Exchange Act. Following the establishment of the International Financial Services Centre (IFSC) in 1999, the Bank of Botswana was assigned the responsibility to regulate all participants in the IFSC, with the exception of insurance business. In addition, the Bank has responsibility to regulate and supervise foreign exchange dealers and collective investment undertakings; the latter were, until 1999, regulated and supervised by MFDP. The Ministry of Agriculture regulates Credit Unions, while the Ministry of Trade and Industry is responsible for, among others, consumer protection issues in general.

5.20 A proliferation of other types of financial services entities has occurred over the past few years, resulting in several areas of the financial sector that are not regulated. These include micro-lenders, fund/asset managers, financial investment advisers, money transmission services and pawn shops. There is, therefore, a need to reconsider the financial regulatory architecture with a view to ensuring that there are no harmful regulatory or supervisory gaps in the financial system. Provision has been made in NDP 9 for the establishment of a capital markets regulatory authority. The establishment of such a body would help to strengthen the country's financial system regulatory and supervisory capacity.

5.21 The Bank of Botswana, in line with its major role in the maintenance of financial stability in the economy, has established a regulatory regime that adheres to international best practice. The risk capital at market entry and on a continuous basis is regulated to ensure adequate capacity to absorb loan losses; members of the board and senior management are subjected to strict 'fit and proper' requirements; and prudential limits for liquidity requirements, insider lending, credit concentration, investments in subsidiaries, and loan loss provisions are stipulated.

5.22 The supervision of the elements listed above involves regular surveillance in the form of off-site monitoring and risk-focused on-site examinations. The combination of these allows the Bank to form a view, on an on-going basis, regarding the soundness and solvency of individual banks and, more broadly, the stability of the banking system as an assessment of the necessity of any corrective action. In some instances corrective action to maintain stability of the banking system may entail managing the safe exit of a failed bank or its merger with another bank. Although these actions, which are ostensibly aimed at maintaining banking stability, may be construed as reducing competition, there are cases where they enhance competition. For example, when FNBB became established in Botswana through a takeover of BCCB, and later took over Zimbank, it emerged a stronger competitor to the established 'big two' banks, and fragile operators were eliminated from the market.

5.23 Apart from the supervisory and regulatory framework, relatively sound macroeconomic policies and Botswana's free market economy may also be considered as having contributed to the emergence of competitive pressures, without putting a strain on financial stability. It is, generally, the case that poor economic management and performance leads to banking sector fragility through, among others, higher loan default rates and liquidity shortages.

5.24 While banks in Botswana have maintained the traditional banking business of accepting deposits and lending, it has been observed that, internationally, the distinction between banking, insurance and securities market is becoming increasingly blurred. The Banking Act, 1995, allows banks to carry out non-banking business activities that are deemed to facilitate development of the capital and financial markets through setting up of subsidiaries and participation in the securities market. As a result some banks have started engaging in securities dealing, insurance products, micro lending, asset management and leasing, through subsidiaries.

5.25 In the circumstances, a major challenge facing the Bank of Botswana is ensuring that these subsidiary businesses do not endanger the safe, sound and efficient operation of the banking industry. While banks are allowed to carry out non-banking activities through separately incorporated subsidiaries, the banks' regulated activities can be ring-fenced, preventing them from negatively impacting on regulated capital of banks. As a result, it is possible to monitor and prevent double or even multiple leveraging of bank capital. In addition, it is relatively easier to monitor inter-company transactions, which must be conducted at arms length, and assess their possible impact on the banks' operations. However, it is also argued that imposing such fragmented corporate structures is not efficient since they tend to spread management and other resources of the banking group too wide, which can also weaken the core banking institution.

5.26 The developments described above are an indication that banks in Botswana are moving towards becoming financial conglomerates. This scenario may require that the Bank of Botswana consider consolidated supervision to avoid problems such as regulatory arbitrage[43] and double gearing[44] of regulatory capital.

5.27 It is important that the country's financial legislation and the institutional arrangements to implement it do not lag behind financial sector developments. This will minimise exposure to the potentially destabilising effects of the activities of entities that are either totally unregulated or whose level of regulation has not kept pace with their level of sophistication and international best practice. In addition, it has been noted that even in closely regulated industries like banking, some institutions attempt to take advantage of gaps in the regulatory framework by using relatively cheap depositor's funds to set up subsidiaries in unregulated sectors, e.g. money lending and fund/asset management, to take advantage of the absence of regulation in those sub-sectors. It is, therefore, crucial that the country's regulatory and supervisory framework be reviewed on a continuous basis and institutional arrangements strengthened to ensure that stability is maintained in the financial system. In Botswana, the investment by banks in such undertakings is subject to the limitations of Section 17 (10) of the Banking Act, 1995, which requires, among others, that investments in other entities should be approved by the Bank of Botswana, and that in aggregate, they should not exceed 25 percent of a bank's unimpaired capital. If, on the other hand, a bank extends loan funds to such an entity, the loan would have to be at arms length, and be subject to the bank's credit policy and procedures, as well as the legislated prudential requirements.

5.28 While the ultimate objective of financial regulation and supervision is to maintain financial stability in any economy, the appropriate regulatory and supervisory structure design is dependent upon circumstances and preferences and varies across countries. Major considerations include the complexity and sophistication of the institutions that form the financial sector, the size of the economy, cost considerations and skills availability. The current regulatory and supervisory structure in Botswana, comprising a separate regulatory structure for banks and other non-banking institutions that require regulation, is very similar to other structures in the SADC region. Most of them assign the regulation of banks to their respective central banks and that of other financial institutions to Ministries of Finance. South Africa, however, is structured somewhat differently in that the central bank is responsible for banks, while a fully-fledged independent Financial Services Board supervises capital markets and capital market related institutions. In addition, the country has usury legislation setting maximum interest rates that may be levied, and a competition policy to encourage competition.

5.29 Some developed countries, such as the United Kingdom, Republic of Ireland and the Isle of Man, and Australia, have opted for a single regulatory and supervisory authority, separate from the central bank, and this arrangement is being considered by a number of other countries. One supposed advantage of a single regulatory structure, particularly for small developing economies where there is scarcity of resources and a shortage of financial system regulatory skills and expertise, is that optimal use could be made of available resources and skills. A further potential benefit is that consistency in regulatory policy formulation and implementation can be ensured. However, in practice, a single regulatory structure may prove difficult to serve the needs of some countries for reasons listed below.

- Banking supervision has, in terms of

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43 Where a financial institution wholly or in part moves its operations or activities from a tightly regulated environment to a less regulated or unregulated environment.

44 The most common way of double gearing is where a subsidiary bank in need of additional capital issues additional shares to the parent, paid for by loan funds from the bank, and the loan funds are to be repaid by dividends paid by the bank to the parent. Another version is where the bank holding company houses capital of subsidiary banks and juggles it around to ensure that subsidiaries appear to meet capital adequacy standards.

development, reached a level of maturity and sophistication which is far advanced compared to other segments of the financial sector. This means that managing all regulatory procedures under a single regulator may in reality be a highly complex and extended process.

- The culture in banking supervision is largely one of risk aversion, prudence, conservatism and stability. In contrast, for most other formal non-banking institutions, the approach is more varied and characterised by innovation.
- For some non-banking operations, particularly in capital markets, the role of the regulator includes promotional and market development work. This is not the case with regard to supervision of commercial banking.
- Other financial institutions do not have the same systemic risk implications as banks.

5.30 In varying degrees, all these concerns apply to the situation in Botswana, given the structure of the financial sector overall. The potential efficiencies of a single regulator should be acknowledged. However, on balance, the most appropriate regulatory and supervisory framework is judged to be multi-tier, with each tier working with the others through mutual cooperation and backed by a robust legislative framework.

(e) Consumer Protection Issues

5.31 Consumer protection and financial stability are two policy objectives that potentially conflict with one another and, ideally, central banks should focus on financial stability, not consumer protection. However, a policy of regulation that seeks, where possible, to promote effective competition among banks will itself go a long way towards protecting the interests of consumers. Financial system regulatory authorities in free market economies try to address consumer protection issues indirectly by ensuring the existence of well defined and transparent market entry requirements, a level playing field within which institutions conduct their business and wide availability of information to enable consumers to make informed choices.

5.32 At the same time it should be recognised that the specific objective of financial supervision of ensuring financial stability is substantively different from that of protecting consumers from improper actions by other market participants (both suppliers and other consumers). This is most clearly seen by the importance given, in banking supervision, to protecting the interests of depositors while, in contrast, borrowers are left largely to fend for themselves. There are sound reasons for this, in particular because the chronic information asymmetries that affect depositors are less of an impediment for borrowers. Indeed, as indicated in earlier sections, it is the banks as lenders that may have the information disadvantage, not consumers as borrowers. However, it also means that legitimate concerns about consumer protection may not be adequately covered through the supervisory framework; the example of money lending constitutes a clear illustration of this case. From a regulatory point of view, money lending is not considered to pose systemic risk hence there are no prudential grounds for its regulation. Money lending precludes deposit taking[45], as investors lend out their own funds, while in instances where banks invest in money lending entities, their investments and exposures are regulated through existing regulatory limits.

5.33 The most contentious issue with regard to the operation of money lenders is that of price

45 This is different from development oriented micro-finance institutions, which are invariably either funded by donor organisations, and are therefore subject to the strict procedural guidelines and requirements of the donors or by taking deposits, in which case they would be regulated as deposit taking institutions. Examples of these, in the context of Botswana, are Kuru Savings and Loans and Women's Finance House Botswana. Credit Unions would also fall under the category of deposit-taking micro-finance institutions.

setting, which relates to the interest rates charged within the industry. In some other countries, including South Africa, such prices are controlled through usury legislation, although in others, there is no such price control. Other consumer protection issues include debt collection methods. A self-regulatory structure[46] within the wider consumer protection statutory framework would be one possible mechanism for addressing many of the problems associated with the activities of the money lending industry. Whether this should be backed by usury legislation is a contentious issue. Enforcement of usury legislation would add an extra regulatory burden and price control in general is viewed, for good reasons, as being economically inefficient. In the long-term, enhanced consumer education, backed up by statutory information disclosure provisions, is likely to be more beneficial.

5.34 More generally, consumer protection concerns in the financial sector can be more appropriately addressed under a structure that takes care of consumer protection issues in general. Most importantly, there is need to separate consumer protection from supervision of banks so as to avoid any potential conflict of interest that could arise when the two functions are discharged by one entity. Direct consumer protection issues, specifically with respect to banks, almost invariably relate to access to credit and the cost of banking services. These have a direct effect on a bank's profitability, liquidity and ultimately capital position, which also have a bearing on financial stability.

5.35 The main objectives of financial system regulation and supervision are to promote stability of the system and to minimise potential for systemic failure. These are achieved by ensuring that individual institutions are well capitalised, profitable, liquid and well managed. Any action taken by the regulatory authority that may compromise any of the above would not be consistent with its main objectives. As the regulator and supervisor of banks, the Bank of Botswana would be violating the broader public policy objective of market-determined prices if it were to regulate bank prices. Intervention by the Bank of Botswana should be done with the ultimate objective of maintaining financial stability and, to this end, the regulation has been limited to adequate disclosure and simplicity of prices to facilitate transparency and effective market discipline.

5.36 Notwithstanding problems that have been outlined as a threat to financial stability in Botswana, the current regulatory structure has served Botswana well during the development of the financial sector over the past two decades. However, the level of development of the economy and the advent of new financial services, products, business structures and institutions requires that the supervisory framework is kept under regular review. Some institutions may be inadequately regulated while, at the same time, there may be instances whereby the level of regulation that has been applied in the past may no longer necessary. The need to deal effectively with issues of consumer protection is urgent and pressing, but is part of a broader exercise that should be kept strictly separate from that of banking supervision.

6. Conclusion

6.1 Notwithstanding some new entrants in the 1990s, the banking sector in Botswana still comprises only a small number of banks, while the continued rationalisation of the sector through mergers and acquisitions demonstrates the importance of economies of scale, despite the small size of the market. Even for a much larger market, the natural market structure for banking is likely to be one of oligopoly where a few large service providers are dominant in most sectors.

46 The micro-lending sector in Botswana has formed an association, which sets rules for fair conduct by players. However, membership is not compulsory. In other countries, consumer protection legislation mandates the establishment of consumer councils to deal with issues of this nature.

This is more applicable for Botswana, where the small population means that the market can quickly reach saturation.

6.2 Nevertheless, there are clear signs that the market is characterised by intense competition rather than complacency and/or collusion, while the momentum for greater efficiency has been maintained by an environment where the banks can and do compete for market share. Lower levels of market concentration, which are depicted by a variety of measures, are an illustration of this point. The old duopoly has been largely eroded as new entrants have gained a firm foothold in the market, and consumers have benefited from product innovation and more transparent pricing practices, a process that can be expected to continue.

6.3 At the same time, the levels of profitability of banks have remained high, and even increasing. The level of profitability could be considered excessive compared to other markets and may be indicative of insufficient competition. However, the outcome of this analysis is recognition of the complexity involved in determining competitiveness, and it demonstrates that this cannot be easily revealed by simple summary statistics, such as the spread between representative interest rates.

6.4 There are a number of factors that can explain why profits of banks have remained high. To some extent, the high rates of profitability may be attributed to improvements in efficiency in the provision of banking services. While competitive forces may be expected to progressively erode profit rates to some extent, this may take time, and the overall impact may be muted. This is especially the case given the continued growth of the Botswana economy and accompanying expansion of the banking sector that have contributed to a naturally high-profit environment.

6.5 Furthermore, there continue to be some barriers to entry, despite the increasing contestability of the banking market over recent years; one such barrier is the small size of the market. The costs to potential new entrants are likely to be quite high, especially given start up costs and operation expenses that do not vary much in line with market size. These may rise further if the market is close to saturation as the risks that face new entrants will increase. For such reasons, the level of 'normal' profitability for banks in Botswana may inherently be quite high.

6.6 Regulation and supervision of the banking sector may also be a barrier to potential new entrants. The analysis has, however, stressed that not all banking regulations necessarily restrict competition, as in some instances measures can be put in place to support prudential supervision and promote competition; an example of a measure which could be undertaken is enhanced consumer education. It is also clear that the regulatory environment in Botswana has become more competition-friendly. New market participants are actively encouraged provided they possess the requisite resources and expertise to maintain the integrity of the financial system.

6.7 However, at some stage there is a trade-off between competition and financial stability as some regulations are bound to have a restrictive impact on the former. A question arises regarding the optimum balance between a completely unsupervised banking sector and excessive regulation that stifles growth and innovation in the sector. Making the correct judgment on this question is a major policy concern, given the rapid developments in technology and banking structures that can significantly impact on the range and balance of potential risks affecting the banking sector. It is the responsibility of the supervisory authority to continually review its regulatory practices to ensure that the efficiency of banks operating in the country and the potential for competition is not unnecessarily stifled.

6.8 Protection of consumer interests remains an issue. Given the prime responsibility of the banking supervisor to ensure the stability of the banking sector, it should be recognised that there may be times when such interests are not accorded due priority. The position taken here is that, to avoid such potential conflict of interests, consumer protection should be the primary responsibility of a separate body. However, this does not relieve the Bank of Botswana of its responsibility to act, as appropriate, in the interests of bank customers.

6.9 The analysis in this chapter has in many ways raised more questions than it has answered, for which further research is required. Some of this will be undertaken by the Bank of Botswana, but it is equally important that other stakeholders contribute to the research. Banking is of direct relevance to an increasing proportion of the population, hence an efficient and competitive banking sector is important for the development of the economy.