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ECONOMIC REVIEW

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COMMENTARY

Post-election, the focus should turn to NDP11 and much-needed reforms

The last few months have been dominated by the election campaign leading up to the general election on October 24th. Amongst the few economic issues that were prominent in the campaigns of the different parties, the problems of unemployment, poverty and inequality had perhaps the highest profile. There is no real disagreement that these are amongst the most pressing socio-economic issues facing Botswana; however, there is much less agreement on how to successfully address them.

While these issues are crucial and need to be addressed, this must be done in the context of other pressing issues, including dealing with fiscal pressures as government revenues gradually decline in the medium to long term, and the need to restrain fiscal expenditure in order to keep the budget on a sustainable track. None of the parties really came up with a coherent plan for dealing with this, and indeed many of the election promises included unrealistic commitments for ever-greater spending.

Over the past few years, politicians have often stated that certain development projects could not proceed because of recession and adverse economic circumstances affecting the government budget, sometimes with a commitment that said project would proceed once economic circumstances improved. This may be a good way of deflecting pressure for excessive project spending, but it may also generate expectations that cannot be fulfilled.

A second pressing issue is the need to diversify exports and attract more FDI. Again, this was not really addressed in the election campaigns, and indeed all of the parties seemed more concerned with import substitution than promoting exports. In fact, none of the parties took time to adequately address pertinent economic issues, which is most disappointing, especially during the highly publicized pre-election debates.

Now that the election campaign is over, attention will turn to the development and finalisation of two key, closely related strategy and planning documents: the 11th National Development Plan, to run from 2016 to 2022, and the post-Vision 2016 document, which will cover the period of the next two-three NDPs. With the election out of the way, the government will have to ensure that these are completed quickly, but in a way that coherently addresses key economic and social issues.

in this issue ...

COMMENTARY

It will be important to recognise that there are many trade-offs in policymaking. Making rational decisions requires both clarification of objectives and a good understanding of the likely impact of competing policies and projects. Evidence-based policy making is essential if good use is to be made of limited resources, and if sensible decisions are to be made about which projects and programmes are to be financed. However, this is difficult on the basis of Botswana's current capacity to generate and analyse data and statistics. Significantly increased resources need to be provided for statistical and analytical capacity if appropriate policies and projects are to be implemented in NDP11, and subjected to proper monitoring and evaluation.

Of more immediate interest is the forthcoming 2015/16 Budget next February. We have been given a flavour of what the 2015 Budget will say, in the Budget Strategy Paper released in September. The BSP is a good initiative, which helps to keep stakeholders informed and encourage debate. It also helps to put information in the public domain at an earlier stage in the budgeting process, which in turn helps to improve understanding of economic conditions.

From the 2015 BSP, we have learned that the preliminary outturn of the 2013/14 budget was more favourable than originally anticipated, with a fiscal surplus of P3.5 billion (2.8% of GDP). This was mainly due to underspending on the development budget. Clearly there still remains a major problem of implementation capacity and project management – given that many on-going projects are behind schedule, over budget, and only three-quarters of allocated funds for development projects were spent in 2013/14.

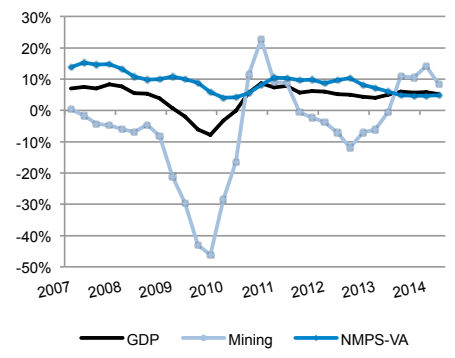
One of the most important elements of the BSP is the introduction of a new Fiscal Rule that commits government, for the first time, to allocate a fixed proportion – 40% is proposed - of mineral revenues to financial savings. In the past, there has been a commitment to invest mineral revenues in various forms of assets, but financial savings have always been a residual. Partly as a result of this, the financial assets accumulated by government over many years were relatively small and quickly depleted during and after the global financial crisis.

The Fiscal Rule is good, in principle, and in many respects is long overdue. However the implications need to be fully understood, in particular that the government will need to run large budget surpluses to finance the proposed savings. There also need to be hard and fast rules regarding drawdowns – the circumstances and conditions under which the accumulated savings be accessed.

Furthermore, government has repeatedly stated its intention to improve the screening and selection of development projects, such that only those yielding positive economic returns will be financed; if this commitment is adhered to – as it should be - some of the projects that are being called for in NDP11 will not pass the test. With the new Fiscal Rule in place, the focus will shift towards saving rather than spending, and as a result there will be less money rather than more for development projects.

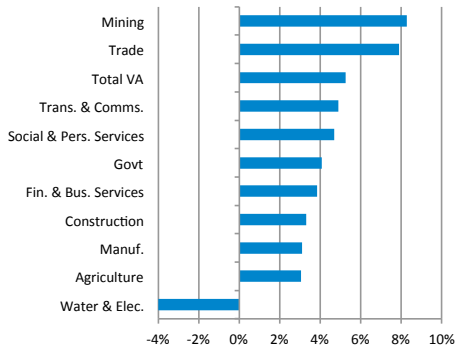
KEY ECONOMIC VARIABLES

Annual GDP Growth



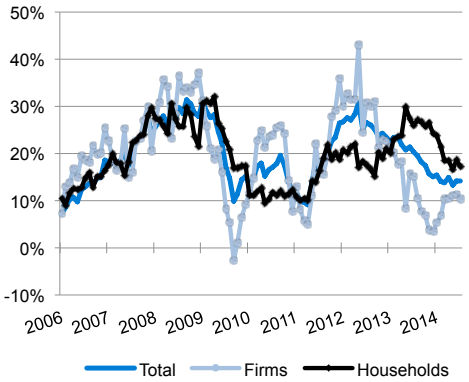
The growth of the economy softened from 5.8% during the year to March 2014 to 5.2% during the year to June 2014. This was largely attributable to the slowing down of mining sector growth from 14.1% to 8.3%, during the same periods. Growth of the non-mining private sector (NMPS) was 4.8% during the year to June 2014, a slight improvement from the 4.7% growth realised during the year to March. However, the NMPS is growing at rates much lower than those recorded in previous years.

Sector GDP Growth



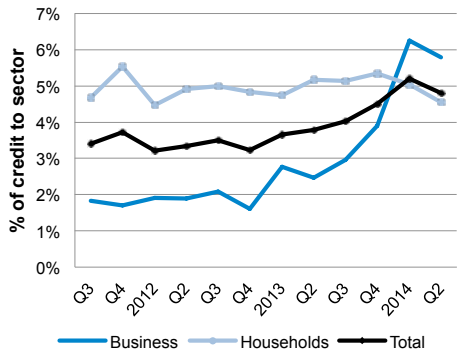
All sectors, except Water and Electricity and Trade, experienced a slowdown during the year to June 2014 compared to growth rates realised during the year to March. The mining sector continued to be fastest growing sector, followed by the services sectors. Besides mining, the other primary and secondary sectors exhibited relatively weak growth.

Annual Credit Growth



Annualised bank credit growth was 14.2% in July 2014 compared to 15.0% in the previous quarter (April 2014) and 20.4% a year earlier (July 2013). The lower growth rates applied to credit to both firms and households. This may be reflective of the banks' reduced capacity to lend due to slow deposit growth and declining liquidity in the banking system.

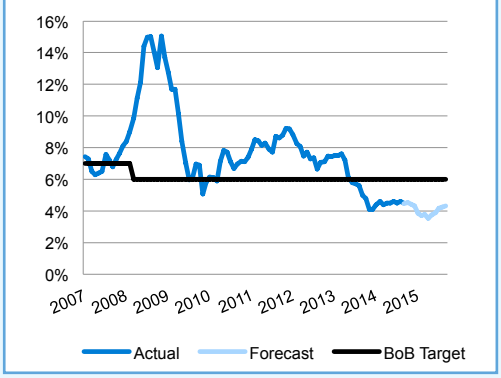
Arrears on Bank lending



Total arrears on outstanding bank credit decreased slightly from 5.2% at the end of Q1 2014 to 4.8% at the end of Q2, due to a decline in arrears on lending to both households and businesses. However it is striking that arrears on credit to firms remains higher than household arrears. This may reflect the decline in the growth rate of the NMPS.

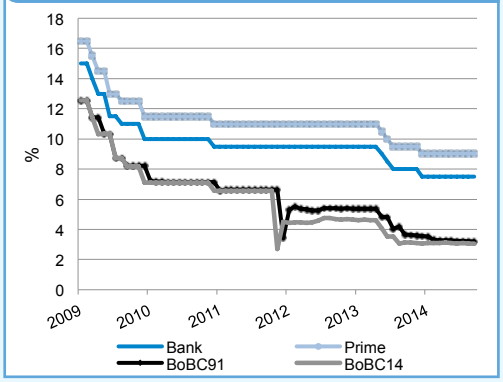
KEY ECONOMIC VARIABLES

Inflation and Forecast



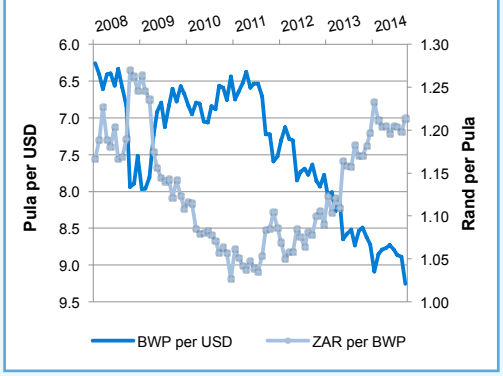
Inflation slightly decreased during Q3, from 4.6% in June to 4.5% in September. This is largely attributable to benign inflationary pressures, both internally and externally. The IMF has adjusted global economic growth forecasts downwards for the years 2014 and 2015, which in turn indicates that global aggregate demand, which drives inflation, will be weak. Inflation is forecast to remain around current levels for the rest of the year, and may dip below 4% in the first half of 2015.

Interest rates



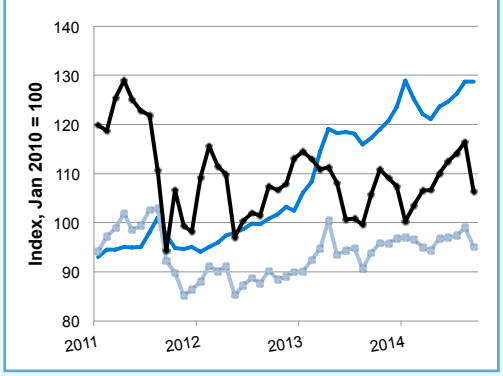
Q3 2014, like the previous two quarters, was characterised by stable interest rates. The Bank of Botswana's Monetary Policy Committee (MPC) has met five times this year, and in all of the meetings the MPC has maintained the bank rate at 7.5%. Consequently, the prime lending, BoBC91-day and BoBC14-day rates have remained fairly constant in the first three quarters of 2014.

Exchange Rates



Q3 2014 saw the Pula depreciate by 5.1% against the US Dollar (USD) to a historical low of P9.23 per USD at the end of the quarter. On the other hand, the Pula continued to appreciate against the South African Rand (ZAR), strengthening by 1.0% during the quarter. The main driver of these changes was ZAR weakness against the USD.

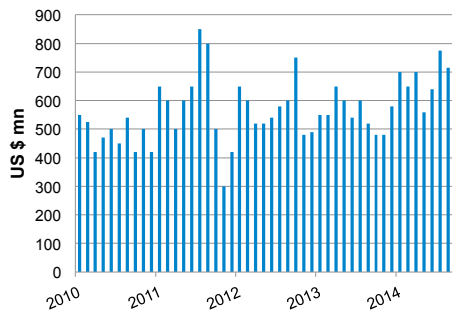
Stock Markets



Q3 2014 saw the BSE DCI gain 3.4% in Pula terms, an improvement on the 2.0% gain in Q2 2014. However, owing to the Pula depreciation against the USD, in USD terms the BSE DCI fell by 1.9% during the quarter. Notwithstanding, the BSE DCI fared better than the MSCI EM index, which lost 5.5% during Q3 2014. G4S, Imara and Letshego stocks were the top 3 gainers of the quarter with each gaining more than 11.0%.

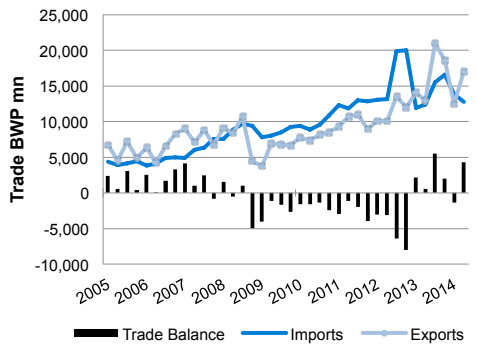
KEY ECONOMIC VARIABLES

Diamond Sales (De Beers)



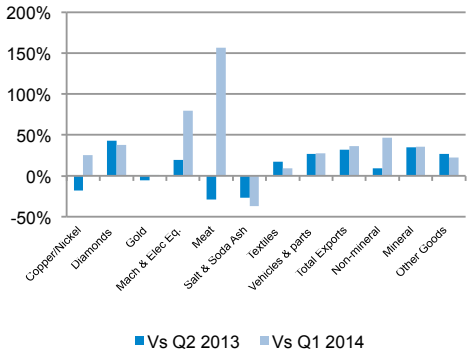
There were only two DTC sights held during the third quarter of 2014, in July and October, as opposed to the three held during the same quarter last year. These two sights grossed an estimated $1,490 mn. Owing to liquidity concerns in the diamond processing/ manufacturing sector, and in turn weak secondary markets for rough diamonds, De Beers maintained fairly stable prices of their boxes during Q3 2014.

Trade



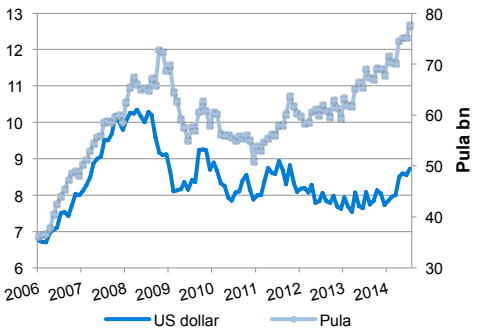
The balance of trade returned to surplus during Q2 2014. This was attributable to the 35.6% increase in exports and an 8.0% decrease in imports. These changes in exports were largely attributable to minerals. Diamonds and copper/nickel exports contributed 85.9% and 4.9% to the increase in exports during the quarter, respectively. On the imports side, diamond imports decreased by 49.7% during Q2 2014, thus dragging imports downwards. It is evident that minerals still dominate the country's trade.

Export Growth (Q2 2014)



The turnaround in the trade balance was a consequence of improvement of exports across most commodities. Only salt and soda ash exports deteriorated during Q2 2014, falling 1.1% compared to Q1 2014. Meat exports skyrocketed 156.7% during Q2 2014. However, these account for only 3.5% of the growth in exports. During Q2 2014 mineral exports grew by 35.5% and ultimately accounted for 90.4% of the growth in total exports.

Foreign Exchange Reserves

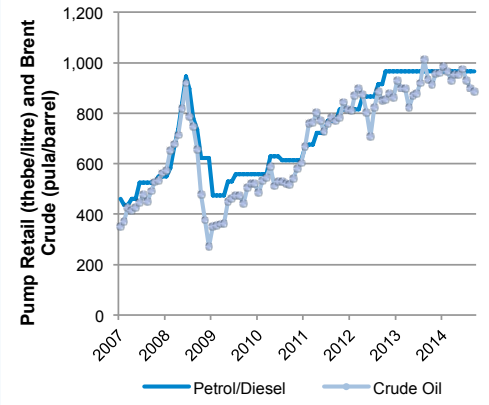


Foreign exchange reserves continued to recover during Q2 2014 and the beginning of Q3 2014, increasing in both Pula and USD terms between March 2014 and July 2014. In Pula terms the foreign reserves increased by 10.8% to P77,654 mn, while increasing by 9.3% in USD terms to 8,736 mn. This is largely driven by the trade surplus the country realised in Q2 2014. This means that in Pula terms the reserves reached their highest ever level, although in USD terms they are still some way below their peak.

Sources: Statistics Botswana, Bank of Botswana, Rappaport Diamond Report, MCSI, Econsult

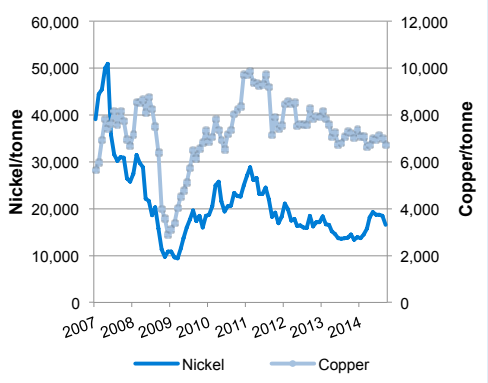
KEY ECONOMIC VARIABLES

Fuel Prices



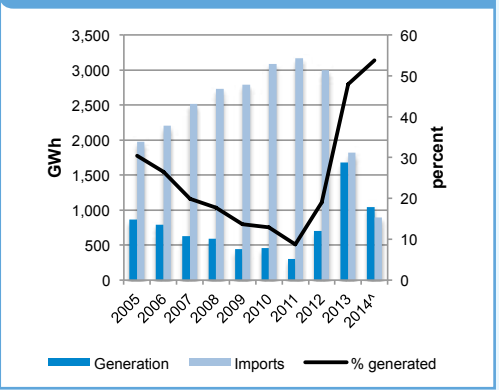
International crude oil prices softened during Q3 2014 to reach the lowest level (of both Pula and USD terms) in the year. This has relieved the pressure on local pump retail prices. These developments would in turn aid the replenishment of the National Petroleum Fund.

Copper & Nickel Prices



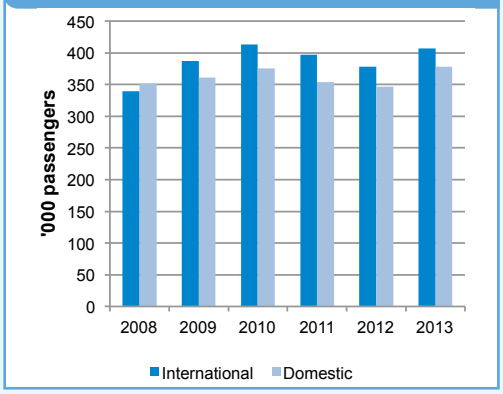
Q3 2014 was characterised by falling commodity prices. This was on the back of price increase in Q2 2014. Nickel and copper fell by 11.8% and 3.1% during Q3 2014, respectively. This was after increasing by 18.9% and 4.8% during Q2 2014, respectively.

Electricity



Prior to the commisioning of Morupule B, Botswana was almost completely dependent upon imported electricity. This situation has changed in 2013 and 2014, with over 50% of power consumed coming from domestic generation in the first half of 2014. The problems resulting from power shortages and load shedding were particularly apparent in 2013, when power consumption fell by more than 5% compared to 2012, with an inevitable impact on economic activity and growth.

Air Passenger Traffic



Air passenger traffic increased by 8.3% in 2013 as compared to 2012, reflecting a 7.5% increase in international passengers and a 9.1% increase in domestic passengers. The increase was welcome, coming as it did after two years of declines.However, data suggests that growth has flattened out in the first half of 2014. Further work is needed to improve the ability of air transport to support tourism and commerce, e.g. expanding capacity at Maun airport, improving the reliability of Air Botswana, and establishing direct international long-haul connections.

Sources: Statistics Botswana, Bank of Botswana, Rappaport Diamond Report, MCSI, Econsult

NEWS HIGHLIGHTS

18th July	SA among SADC nations to initial EU trade pact (Business Day)	The South African Department of Trade and Industry indicated that after a decade of negotiations, a group of SADC countries (including South Africa Namibia, Botswana, Lesotho, Swaziland, Mozambique and Angola) have "initialled" an Economic Partnership Agreement (EPA) with the EU. Moreover the Department asserted that the timing of the agreement is significant as it pre-empts the October 1 deadline imposed by the EU after which Botswana, Namibia and Swaziland would have lost preferential access to the EU market for their exports of beef, fish and sugar, on which their economies depend heavily.
20th July	De Beers Q2 output up 7% to 8.5 million carats (DIB Online)	Anglo American reports that De Beers' diamond production increased 7.0% to 8.515 million carats in the second quarter of 2014 ended June 2014. According to De Beers' parent company, the growth in output is largely due to higher production at the Venetia mine in South Africa following the recovery from the pit flooding in 2013. However, Debswana (the group's largest producer) produced 6.266 mn carats during the second quarter, a 2.0% decline year over year.
22nd July	Survey on local bank charges almost complete (Sunday Standard)	The Banker's Association of Botswana's (BAB) Chief Executive Officer, Mr Oabile Mabusa, revealed that they had commissioned a regional survey on bank charges. He further indicated that the exercise had begun in February and is nearing completion. It would appear that the study was prompted by the Bank of Botswana's decision to impose a two-year moratorium on any upward adjustment of bank charges and fees with effect from January 1 this year.
28th July	Beer consumers shift to 'quarts' as levy bites (Mmegi)	The Managing Director of Kgalagadi Breweries Limited (KBL), Johan De Kok, asserted that the brewer has realised increasingly higher demand for the economical 750ml alcoholic bottles (poPularly known as 'quarts') as consumers feel the effect of the alcohol levy. The retail price for KBL's 340ml canned and bottled beer hovers around P11 while the 'quarts' are sold for an average of P15.
5th August	Parliament passes Retirement Funds Bill (Mmegi)	Parliament last week approved the Retirement Funds Bill of 2014 which will regulate pension funds in Botswana. The Bill will repeal the Pension and Provident Funds Act and replace it with the new Retirement Funds Act.
12th August	Insurance penetration at less than 1% (Mmegi)	The Chief Executive Officer of Old Mutual Botswana, Jack Bekker, indicated that short-term insurance penetration in Botswana is estimated at less than 1.0%, with the average for the continent outside South Africa estimated at below 3.0%. As such, the low insurance penetration coupled with the expected increase in middle class households provides significant opportunities in the industry.
18th August	African Copper expects improved Q2 ore production at Thakadu (Mining Weekly)	During the first quarter of African Copper's 2014/15 financial year (April-March), copper-in-concentrate production fell 12.1% year-on-year to 2 703 tonnes, while volumes processed decreased 6.4% to 169 565 tonnes. The miner indicated that during the three months to the end of June 2014, production continued to be hampered by the previous mining contractor's low levels of waste stripping. However, it further revealed that the new mining contractor, Diesel Power, is set to improve productivity by making inroads to reduce the backlog waste stripping required to expose ore. As such, improved ore production from its Thakadu open-pit copper mine is expected during the second quarter of the 2014/15 financial year.

NEWS HIGHLIGHTS

27th August	Galane secures loan deal with Samsung (Mmegi)	Galane Gold has entered into a secured $5 million (P44 million) loan facility and gold prepayment agreement with Samsung C&T U.K. Limited. Ina statement released to the Botswana Stock Exchange, the company indicated Samsung had agreed, subject to certain conditions, to provide the loan facility to Galane Gold in return for the sale and delivery of Gold by the company's Botswana operating subsidiary, Mupane Gold.Under the agreement, Galane will provide a minimum of 1,607 ounces of gold per month for a period of two years payable by Samsung at a fixed discount rate to the then prevailing spot price upon delivery.
28th August	Daewoo wins bridge project connecting Zambia and Botswana (Korea Bizwire)	Daewoo Engineering & Construction announced that it won a tender for the construction of Kazungula Bridge connecting Zambia and Botswana valued at US$161mn. The construction contractor will build a bridge crossing the Zambezi River running along the border in the project planned by both governments. The groundbreaking is scheduled for next month and the construction is supposed to be completed within four years.
1st September	Slow internet restrains competitiveness (Mmegi)	The Minister of Environment, Wildlife and Tourism, Tshekedi Khama, expressed concern over the slow internet connectivity in the country and its impact on competitiveness. Moreover, the Minister added that Botswana should brand herself as a prestigious business tourism destination through the provision of high quality facilities and services, as this will ensure that the country remains globally relevant and competitive.
1st September	Botswana rough diamond production Is expected to reach 32.2 mn carats in 2020, reveals new report (Digital journal)	Market Research Reports, Inc. has forecast through their report titled "Precious Metals Mining in Botswana to 2020 – a Focus on the Diamond Industry" that Botswana's rough diamond production is expected to reach 25.3 mn carats by 2014 and 32.2 mn carats in 2020.
1st September	Walvis Bay dry port to finally open (Sunday Standard)	The Chief Executive Officer of Botswana Railways (BR), Mr Dominic Ntwayagae, confirmed that starting from the 2nd of September 2014 the company will open its doors to the business community and general public to use its new facility at the Walvis Bay dry port in Namibia.The dry port facility project, which has been leased to BR, cost the Botswana government about P50 million. However, BR is expected to generate between P2 mn and 4 mn annually as profits from the facility.
5th September	Banks profitability plunging (Mmegi)	The profitability of commercial banks weakened for the third successive year in 2013 as pressure on both interest and fee income carved into their bottom-line. According to the Bank of Botswana Annual Banking Supervision Report 2013, key profitability indicators were on down as lower interest rates and reduced Bank of Botswana Certificates (BoBCs) rates negatively impacted on revenues. Return on Equity (ROE) decreased from 31.9% in 2012 to 27.4% in 2013. Return on average total assets (ROAA) fell from 3.2% in 2012 to 3.0% in 2013.
9th September	BPOPF yields to pensioners soften (Mmegi)	The Botswana Public Officers Pension Fund (BPOPF) has declared a 12.3% interest rate for its members for 2014 financial year down from 19.0% last year. This was largely due to market fluctuations.
11th September	Namibia, Botswana to Seek Bids for $15 Billion Rail Study (Bloomberg Businessweek)	Namibia and Botswana will in the next two months ask companies to tender for a feasibility study on the construction of a 1,500-kilometer railway line between the two countries. Namibian National Planning Commission Permanent Secretary, Levi Hungamo, said that the countries want to be ready to invite bids before the end of the year.

NEWS HIGHLIGHTS

19th September	Barclays profits plunge again (Mmegi)	Barclays Bank of Botswana's Profit After Tax (PAT) has tumbled for the third reporting period in a row with management attributing the poor performance to current low interest rates. The bank reported that its profit after tax fell by 35.0% to P123 mn in the six months to June 2014.In its interim financial results for the period ended 30 June 2014, Barclays stated that its loans and advances grew by 17 percent while total income decreased by 6 percent to P608 million. The bank's operating costs increased by 10 percent to P347 million.
19th September	DML halts Botswana underground development on funding issue (Mining Weekly)	Discovery Metals Limited (DML) has placed the development of its Zeta underground mine, at the Boseto copper project, on hold.The miner indicated that a proposed A$25.7mn rights issue, which was announced at the start of September this year, would not proceed, after the company's lenders claimed a breach.The lenders claimed that an updated business plan provided by DML in August, had not been in the correct form, and had been deemed unsatisfactory. The rights issue, under which DML had proposed to undertake a two-for-one renounceable rights issue, priced at A$2c a share, had been aimed at providing funding to allow DML to transition the Boseto project from an open cut to an underground mine.
19th September	China to drive diamond industry growth (Mmegi)	According to the latest Be Beers' Diamond Insight Report, sales of diamond jewellery to Chinese consumers were the fastest growing in the world over the last decade, with a compound annual growth rate of 21.0% from 2003 to 2013. Consequently, the share of polished diamonds sold in jewellery to Chinese consumers grew from about 3.0% in 2003 to just over 13.0% of global demand in 2013.However, the USA is still the largest market for diamonds. The Chinese market is anticipated to drive growth in the diamond industry going forward.
26th September	Spadework for new coal mine at Morupule (Mmegi)	Morupule Coal Mine (MCM) has started preparatory work towards establishment of a new 1 mn tonnes per annum open cast coal mine. This is within its lease area to feed into the envisaged 300MW second phase of Morupule B power plant. The open cast mine, which will be built adjacent to the existing underground operations, is projected to be complete by 2017.

MACROECONOMIC DATA

Key Economic Data

	unit	2011	2012	2013	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3
Annual Economic Growth									
GDP	%	6.2	4.3	5.8	6.0	5.8	*5.8*	5.2	..
Mining	%	-2.3	-7.0	10.6	11.0	10.6	*14.1*	8.3	..
Non-mining private sector	%	9.8	8.2	4.7	4.8	4.7	*4.7*	4.8	..
GDP current prices	*P mn*	105,071	110,763	*124,122*	*31,681*	*31,592*	*32,705*	36,054	..
GDP 2006 prices	*P mn*	70,663	73,712	*77,956*	*19,470*	*20,101*	19,958	20,284	..
Money & Prices									
Inflation	%	9.2	7.4	4.1	5.0	4.1	4.4	4.6	4.5
Prime lending rate	%	11.0	11.0	9.0	9.5	9.0	9.0	9.0	9.0
BoBC 14-day	%	4.5	4.6	3.1	3.2	3.1	3.1	3.1	3.1
Trade & Balance of Payments									
Exports - total goods	*P mn*	*39,996*	*45,723*	*66,491*	*21,005*	18,552	12,479	17,020	..
Exports - diamonds	*P mn*	30,248	36,143	55,443	18,211	15,863	10,348	14,249	..
Imports - total goods	*P mn*	*49,994*	*66,166*	*56,327*	*15,487*	*16,580*	*13,837*	12,730	..
Balance of visible trade	*P mn*	*-9,998*	*-20,443*	*10,164*	*5,518*	*1,972*	*-1,358*	4,290	..
Balance of payments	*P mn*	3,430	-862	1,340	114	-1,621	2,856	..	..
Foreign Exchange									
Exchange rate BWP per USD	*end*	7.524	7.776	8.718	8.532	8.718	8.787	8.787	9.259
Exchange rate ZAR per BWP	*end*	1.086	1.090	1.196	1.170	1.196	1.204	1.205	1.214
FX reserves	*$ mn*	8,082	7,628	7,726	7,842	7,726	7,992	8,547	..
FX reserves	*P mn*	60,271	59,317	67,772	67,024	67,772	70,102	75,174	..
Financial Sector									
Deposits in banks	*P mn*	43,505	47,216	48,512	48,458	48,512	48,778	52,304	..
Bank credit	*P mn*	27,968	34,555	39,763	38,544	39,763	40,928	42,694	..
BSE index		6,970.9	7,510.2	9,053.4	8,594.9	9,053.4	8,955.9	9,133.9	9,440.0
Business Indicators									
Diamond production *(a)*	*'000 cts*	22,903	20,619	23,134	5,541	6,473	5,870	6,364	..
Copper production	*tonnes*	22,319	26,736	41,753	10,999	9,760	7,304	9,925	..
Nickel production	*tonnes*	15,675	17,942	22,848	6,000	5,287	2,715	4,134	..
Business confidence index		54%	47%	45%	45%	..	38%	..	..
No. of companies formed		11,788	16,561	14,190	4,071	3,942	3,616	3,989	4,682
Electricity consumption	*GWh*	3,472	3,703	3,502	922	806	933	1,007	
Crude oil (Brent)	*$/bar*	108.09	110.80	109.95	109.45	109.95	105.95	111.03	94.67
Employment (formal)									
Government		130,196	131,033	..	..	..	..	..	..
Parastatals		16,992	17,484	..	..	..	..	..	..
Private sector		187,986	188,531	..	..	..	..	..	..
Total		335,174	337,045	..	..	..	..	..	..

Govt Budget		2012/13	2013/14 Revised	2014/15 Budget
Revenues	*P mn*	41,658	45,426	50,183
Spending	*P mn*	40,736	45,039	48,857
Balance	*P mn*	922	386	1,326
Public debt & guarantees	*P mn*	29,585	30,922	32,574
Govt deposits at BoB	*P mn*	20,611	..	..
GDP	*P mn*	112,730	*128,502*	136,140
Revenues	*%GDP*	*36.9%*	*35.7%*	*36.9%*
Spending	*%GDP*	*36.1%*	*35.4%*	*35.9%*
Balance	*%GDP*	*0.8%*	*0.3%*	*1.0%*
Public debt & guarantees	*%GDP*	*26.4%*	*24.3%*	*23.9%*
Govt deposits at BoB	*%GDP*	*18.3%*	*24.7%*	..

Sources: Bank of Botswana; MFDP; Statistics Botswana; Department of Mines; Registrar of Companies; Econsult
Notes: (a) 2013 figures include production from Boteti Diamond and Debswana
(b) Numbers in Italics reflect revisions from the previous review

What is changing in the Botswana Banking System?

Introduction

Like it or not, the banking system is central to the way in which almost all economies operate. Banks are important economic actors that shape the economic environment, but also respond to the circumstances of a particular economy. They need to be regulated, in order to protect depositors, ensure financial stability and promote broader financial sector development.

The activities of banks in Botswana, and those of the regulator (the Bank of Botswana) have to a large extent been shaped by one of the main characteristics of the banking system, which is that it has long had excess liquidity – essentially that banks have been awash with cash. In recent years, however, this situation has changed quite dramatically, and this surplus liquidity has largely disappeared. In this article we explore the nature of these changes in the banking system, and explore their likely impact.

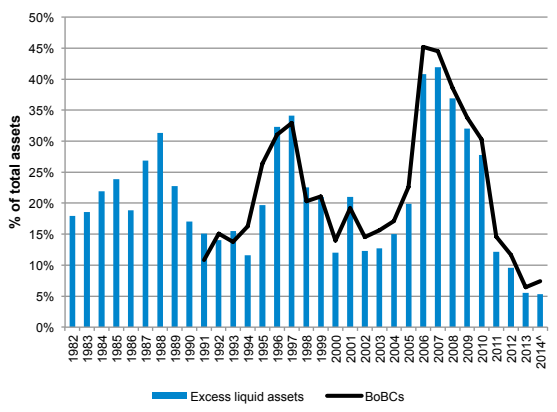
Some Financial History….

Most banks are required by regulators to hold some of their assets in liquid form in order that they can meet operational needs, e.g. for withdrawals. Liquid assets typically include cash, balances with other banks, and securities such as Bank of Botswana Certificates (BoBCs). Excess liquidity means the liquid assets that banks hold over and above what is required by regulation.

The main driver of excess liquidity is the level of deposits in the banking system relative to the level of credit provided through bank loans. Due to faster growth in deposits than lending, Botswana banks have long had excess liquidity; in part this is the macroeconomic counterpart of balance of payment surpluses and the large foreign reserves that have been accumulated as a result.

Excess liquidity can potentially lead to many problems. These include rapid growth in bank lending - perhaps funding unproductive or undesirable borrowing; downward pressure on interest rates – which may not be desirable from a monetary policy perspective; and banks may turn away interest-bearing deposits. To avoid such problems, central banks try and absorb excess liquidity. In Botswana, this has been done through the issuance of BoBCs since 1991, which also provide the BoB with an instrument to influence interest rates.

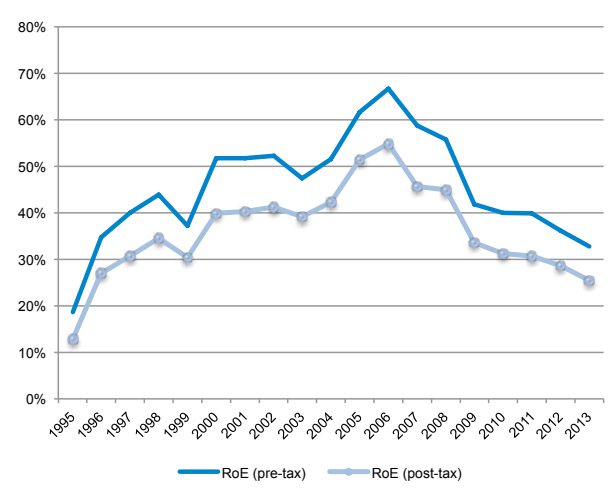
FIGURE 1: Liquid Assets



Source: Bank of Botswana

Over time, BoBCs became a major item on banks' balance sheets, especially after the rules were changed in 2006 to restrict BoBC holdings to licensed banks only. Deposits continued to grow faster than lending, so that the quantum of excess liquidity increased, and BoB had to issue more and more BoBCs. Combined with high interest rates through much of the 1990s and 2000s, the cost of BoBC interest became a major expense for BoB, and BoBC interest receipts became a major source of income for the banks. Because of this, banks were sometimes perceived as reluctant to lend, preferring to reap excessive profits at the expense of BoB, and ultimately of government. Furthermore, because banks did not have to work to bring in deposits, the interest rate paid to depositors was low, making savings unattractive. With so much excess liquidity, the amount of lending that banks could do was not restricted by the availability of deposit funds, but by the availability of profitable lending opportunities.

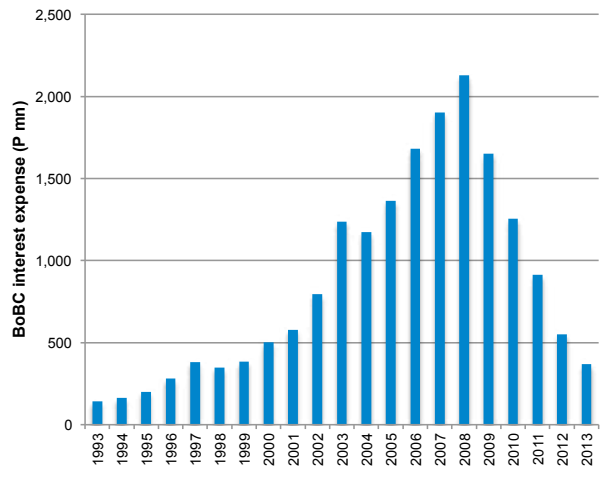
FIGURE 2: Return on Equity



Source: Bank of Botswana, Econsult Botswana

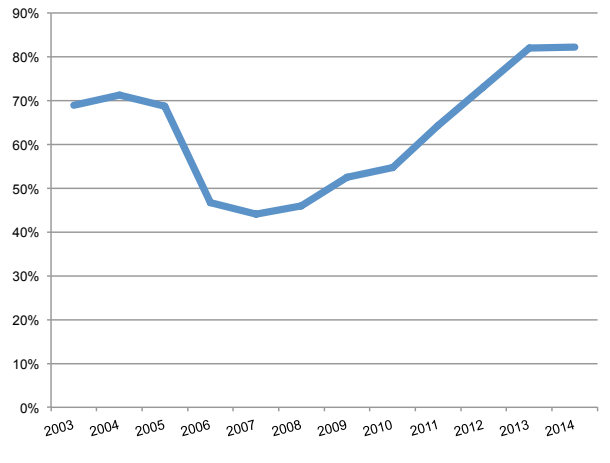
- **Excess liquidity** has dropped sharply, to a minimal level; in contrast to 2006, when excess liquid assets made up 45% of bank assets, by the end of 2013 this had dropped to 6%; as a result, banks hold relatively few BoBCs in excess of regulatory requirements;
- **BoBC issuance** has dropped dramatically, from the peak of P17.5 billion in 2008 to P5.5 billion at the end of 2013; BoB's annual interest expense has fallen from P2,128 million to P369 million over the same period;
- **Bank profitability** has dropped sharply, with the post-tax return on equity falling from 55% in 2006 to 25% in 2013;
- **Banks** are now almost fully lent, and there is an emerging shortage of deposits in the banking system; the loan-to-deposit ratio rose from 47% in 2007 to 82% in 2013.

FIGURE 3: BOBC Expenses



Source: Bank of Botswana

FIGURE 4: Loan Deposit Ratio



Source: Bank of Botswana

Transformation

That was the situation that prevailed in the late 2000s. However, 2008 represented a turning point; in part because of the global financial crisis that began in that year, but also because of other regulatory measures and developments in the financial system since that time. The result is that between 2010 and 2013, the banking environment was completely transformed, and many of the "received wisdoms" that had applied over the previous three decades are now less relevant. The impact of these changes is only slowly being realised. The key changes are as follows:

What has happened?

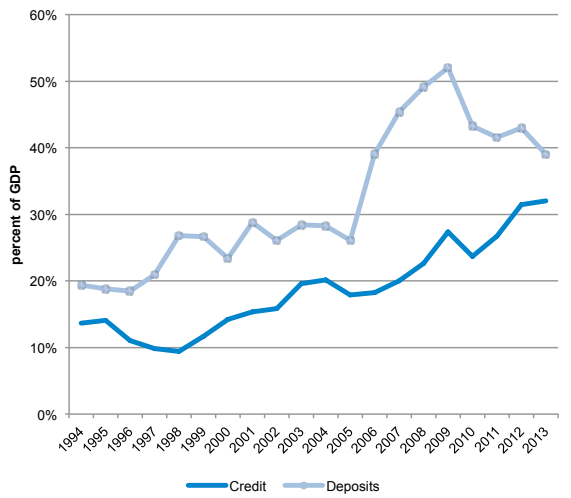
The explanation for these changes lies in a mixture of regulatory and policy changes, macroeconomic developments, and trends in deposits and lending. On the regulatory front, the BoB increased the primary reserve requirement (PRR) – the proportion of deposits that banks must hold in reserve accounts at BoB – from 3.5% to 10% between 2006 and 2011. This meant that a portion of formerly excess liquidity was now moved to reserve accounts, on which BoB does not have to pay interest.

BoB also decided in 2011 to limit BoBC issuance to a maximum of P10 billion, regardless of the level of demand. This restriction on the supply of BoBCs raised the price and hence reduced the interest rate yield that banks earned on them. This led to a cost saving for BoB.

Besides these specific changes in BoBC interest rates, the general level of policy interest rates was reduced steadily from 2008 through to 2013, in response to the global economic crisis, declining economic growth and lower inflation. This led to a reduction in the main policy rate – the Bank Rate – from 15.5% to 7.5% over this period. Combined with a widening of the differential between the Bank Rate and the BoBC rate, this meant that the latter was reduced by almost 10%, from 13.1% to 3.2%, over a similar period.

But perhaps the biggest driver of the reduction in excess liquidity has been contrasting trends with regard to bank deposits and lending. As Figure 5 shows, deposits rose sharply between 2006 and 2009, leading to a major expansion of bank balance sheets. But since 2009, the deposit base of the banking system has contracted, falling from 52% of GDP in 2009 to only 39% in 2013.

FIGURE 5: Banks & GDP



Meanwhile bank lending has been steadily increasing, from 27% to 32% of GDP over the same period. The growth rate of bank lending was faster than the growth rate of deposits every year from 2008 to 2013.

Why have deposits fallen? There are various explanations. Government has been deliberately trying to reduce deposits held in the banking system by public sector entities – notably local authorities and parastatals – and has adjusted budget allocations and disbursement schedules accordingly, for entities holding significant bank balances. However, this is not the whole explanation for sluggish deposit growth, as private companies have also been holding back on deposits. This may reflect adverse business conditions in the non-mining private sector, where some firms have been reporting low growth and weak profits. There may have also been a deposit outflow due to low interest rates in Botswana. Given that Botswana has no exchange controls, firms can choose where to hold surplus cash. As Botswana interest rates have declined relative to South Africa, for instance, firms may have decided to hold deposits outside of the country. This contrasts with the situation in the 2000s, when relatively high interest rates in Botswana most likely caused an inflow of liquidity.

What next?

As a result of these changes, the banking sector is moving into uncharted territory. The loan to deposit ratio is close to its highest ever level. Some banks are finding that their ability to lend is being constrained by the availability of deposits. Banks are competing to bring in deposits, which is pushing up deposit interest rates. There is some evidence that this in in turn having an effect on bank lending, with banks becoming more selective in granting credit, and increasing the cost. Certainly, for this and other reasons, the growth rate of credit has been steadily declining.

If the trend of declining liquidity continues, various changes can be expected. As is already happening, interest rates may rise independently of any change in monetary policy rates. The changing liquidity environment also changes the impact of certain policy or regu-

latory measures. For instance, when the PRR was increased, the BoB noted that "normally, an increase in the primary reserve requirement implies monetary policy tightening. However, in this instance, the increase is unlikely to constrain the supply of credit, as, in essence the funds mopped up through BoBCs are excess to what is required for productive lending" (2011 Monetary Policy Statement Mid-term Review). But, as excess liquidity diminishes, the high PRR becomes akin to a monetary policy tightening, because it contributes to a reduction in the funds available for lending. Hence it may be time to reduce the PRR to make it consistent with the general, more accommodating, monetary policy stance.

Similarly, the role of the BoB in the money market may also change. As noted above, in an environment of excess liquidity, one role of the central bank is to absorb excess liquidity. But it is more common for banking systems to be short of liquidity, in which case the role of the central bank is to provide liquidity to the money market. If this occurs in Botswana, it will in turn have implications for the way in which monetary policy is implemented, and the interest rates that are used to signify changes in monetary policy.

Conclusion

The decline in excess liquidity has taken the banking system into uncharted territory – at least by Botswana standards – and raised new challenges. One important change is that as bank deposits become scarce, the balance of power will shift in favour of savers and depositors, who should be able to earn higher returns. But this could also lead to a general upward movementin interest rates, which may need to be countered by regulatory action, if considered to be inappropriate from a monetary policy perspective.

Other measures may be necessary to encourage more deposit inflows into the banking system as a whole, rather than just competition between banks to reshuffle existing deposits. This could include encouraging deposits from non-residents, or stimulating the transfer of resident deposits from foreign currency accounts (FCAs) – which account for around 15% of total deposits - to Pula accounts. Higher deposit rates would help to encourage inflows of liquidity from outside of the country. Another possibility would be to place some government deposits with the banks, rather than the BoB.

The issuance of BoBCs may decline further, and could end up being held by banks simply to meet liquid asset requirements rather than excess liquidity. If so the BoB's role at the margin would change from absorbing liquidity to providing liquidity to the banking system. In many respects this reflects the end of the era of an economy driven by mineral-led surpluses, to a more normalised economy.

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