ANNUAL REPORT 2017

BANK OF BOTSWANA

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ANNUAL REPORT

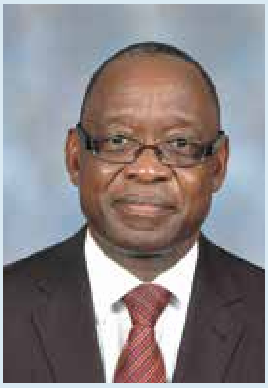
2017

Board Members
(as at year-end 2017)

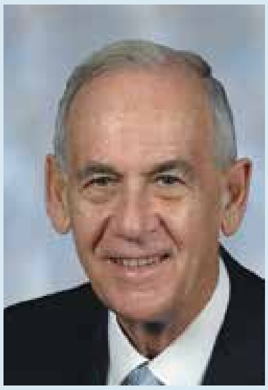
Moses D Pelaelo
Governor
(Chairman)

Solomon M Sekwakwa*

Gordon K Cunliffe



Dr Joel Sentsho



Robert N Matthews

Dr Malebogo Bakwena

Daphne K Briscoe

Bernard M Ditlhabi

Victoria T Lekoma

** Permanent Secretary, Ministry of Finance and Economic Development*

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** Permanent Secretary, Ministry of Finance and Economic Development*

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Statutory Report on the Operations and Financial Statements of the Bank - 2017

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Figures, Charts and Tables

TABLES

Abbreviations Used in the Report

AACB	-	Association of African Central Banks
AC	-	Audit Committee
AfDB	-	African Development Bank
AML	-	Anti-Money Laundering
BACH	-	Botswana Automated Clearing House
BBS	-	Botswana Building Society
BDC	-	Botswana Development Corporation
BDF	-	Botswana Defence Force
BEDIA	-	Botswana Export Development and Investment Authority
BFS	-	Botswana Financial Statistics
BIS	-	Bank for International Settlements
BISS	-	Botswana Inter-bank Settlement System
BITC	-	Botswana Investment and Trade Centre
BNM	-	Bank Negara Malaysia
BoBCs	-	Bank of Botswana Certificates
BPOPF	-	Botswana Public Officers Pension Fund
BSB	-	Botswana Savings Bank
BSE	-	Botswana Stock Exchange
BTCL	-	Botswana Telecommunications Corporation Limited
BURS	-	Botswana Unified Revenue Service
CBK	-	Central Bank of Kenya
CCBG	-	Committee of Central Bank Governors
CEDA	-	Citizen Entrepreneurial Development Agency
CFT	-	Combating of the Financing of Terrorism
CRT	-	Credit Risk Transfer
CSD	-	Central Securities Depository
CTO	-	Central Transport Organisation
DBGSS	-	De Beers Global Sightholder Sales
DFIs	-	Development Finance Institutions
DvP	-	Delivery versus Payment
e-KYC	-	Electronic-KYC
EFT	-	Electronic Funds Transfer
EPS	-	Electronic Payment Services
ESAAMLG	-	Eastern and Southern Africa Anti-Money Laundering Group
FATF	-	Financial Action Task Force
FCA	-	Foreign Currency Account
FCI	-	Foreign Company Index
FDI	-	Foreign Direct Investment
FIA	-	Financial Intelligence Agency

FMIs	-	Financial Market Infrastructures
FSAP	-	Financial Sector Assessment Programme
FSB	-	Financial Stability Board
FSD	-	Financial Stability Division
FSDS	-	Financial Sector Development Strategy
FSOCs	-	Financial Stability Oversight Councils
G-SIFIs	-	Global Systemically Important Financial Institutions
GDP	-	Gross Domestic Product
GIA	-	Government Investment Account
GSMA	-	Global System Mobile Association
HHI	-	Hirschman-Herfindahl Index
ICT	-	Information and Communications Technology
IFC	-	International Finance Corporation
IFRS	-	International Financial Reporting Standards
IFSC	-	International Financial Services Centre
IIP	-	International Investment Position
IMF	-	International Monetary Fund
ISPAAD	-	Integrated Support Programme for Arable Agricultural Development
KBAL	-	Kingdom Bank Africa Limited
KYC	-	Know Your Customer
LIMID	-	Livestock Management and Infrastructure Development
MAP	-	Making Access Possible
MEFMI	-	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MFED	-	Ministry of Finance and Economic Development
MITI	-	Ministry of Investment, Trade and Industry
MNOs	-	Mobile Network Operators
MOU	-	Memorandum of Understanding
MPC	-	Monetary Policy Committee
NBFIs	-	Non-Bank Financial Institutions
NBFIRA	-	Non-Bank Financial Institutions Regulatory Authority
NDB	-	National Development Bank
NDP	-	National Development Plan
NEER	-	Nominal Effective Exchange Rate
NIM	-	Net Interest Margin
NPS	-	National Payments System
OMO	-	Open Market Operations
PDSF	-	Public Debt Service Fund
PEEPA	-	Public Enterprises, Evaluation and Privatisation Agency
PPADB	-	Public Procurement and Asset Disposal Board
PPP	-	Public Private Partnership
RBI	-	Reserve Bank of India
REER	-	Real Effective Exchange Rate

REMCO	-	Remuneration Committee
RMCI	-	Real Money Conditions Index
RTGS	-	Real Time Gross Settlement
SACCOS	-	Savings and Credit Cooperatives
SACU	-	Southern African Customs Union
SADC	-	Southern African Development Community
SDGs	-	Sustainable Development Goals
SDR	-	Special Drawing Rights
SEZ	-	Special Economic Zones
SIPS	-	Systematically Important Payments Systems
SIRESS	-	SADC Integrated Regional Settlement System
SMME	-	Small Micro and Medium-sized Enterprises
SWFs	-	Sovereign Wealth Funds
UIDAI	-	Unique Identification Authority of India
UK	-	United Kingdom
UMICs	-	Upper Middle-Income Countries
UNDP	-	United Nations Development Programme
USA	-	United States of America
USD	-	United States Dollar
VAT	-	Value Added Tax
WEO	-	World Economic Outlook

Part A

Statutory Report on Operations and Financial Statements of the Bank for 2017

Bank of Botswana

Senior Management as at December 31, 2017

Deputy Governors

Dr Kealeboga S Masalila

Andrew M Motsomi

General Managers

Ewetse T Rakhudu

Richard H Nlebesi

Heads of Department

Ralesedi E Somolekae
Human Resources

Daniel N Loeto
Finance

Julius Ghanie
Information Technology

Dr Tshokologo A Kganetsano
Research and Financial Stability

Dr Lesedi Senatla
Banking Supervision

Matthew Wright
Financial Markets

GOVERNOR'S FOREWORD

The 2017 *Annual Report* is published in accordance with Section 68(1) of the Bank of Botswana Act (CAP 55:01). The *Report* provides a summary of the operations and audited financial statements of the Bank for the year ended December 31, 2017.

The *Report* also covers the key functions and responsibilities, and outlines the accountability framework for the Bank's performance. These functions and responsibilities include, inter alia, conduct of monetary policy; maintaining financial stability; implementation of the exchange rate policy; the design and issuance of currency; foreign exchange reserves management; regulation and supervision of banks; oversight of the payments systems; provision of banking and settlement services to Government, commercial banks and other financial institutions; economic research; policy advice to Government; and production and publication of monetary and financial statistics.

The *Annual Report* contains an economic review theme topic focussing on *Financial Sector Development, Inclusive and Sustainable Economic Growth*. The review evaluates financial sector development and prospects for further improvement and the potential for meaningful and durable contribution to inclusive economic growth. In this regard, the theme chapter examines the relationship between financial sector development and economic growth; analyses the evolution of the financial sector in Botswana; and outlines cross-country experiences which could, potentially, inform Botswana's policy reform agenda. Furthermore, the theme chapter addresses financial resource mobilisation in terms of the determinants and policy initiatives in Botswana and, also, the scope for broadening the sources of resource and/or resource mobilisation as part of financial sector development.

The Bank was successful in implementing the 2017 work programme and, in general, achieved its policy objectives for the year, notwithstanding challenges in the domestic and external environment, dominated by uncertainty and risks. Nonetheless, the recovery in global economic activity gained momentum in 2017 with growth of 3.7 percent relative to 3.2 percent in 2016 and performance was broad-based across regions and sectors. In advanced economies, growth in output improved, reflecting stronger global demand and trade, sustained by increasing investment especially in advanced economies.

Global growth was supported by strengthening demand, favourable financial conditions, improving labour markets, increasing commodity prices, as well as the resurgence in world trade. In emerging market economies, output expansion was led by robust economic performance in China and India. Furthermore, notwithstanding some uncertainty about the magnitude and likely impact, as well as re-emergence of inward-looking policies, it is expected that tax policy changes in the United States of America (USA) and the related fiscal stimulus will raise growth in the USA, with possible positive spill-overs for trading partners in 2018, while the euro area recovery continued to gain traction.

For Botswana, all economic sectors, except mining, recorded positive growth. Non-mining output growth weakened in the twelve months to September 2017 compared to the corresponding period in 2016. Nevertheless, overall economic expansion was constrained, in the main, by a contraction in mining production. Inflation was restrained by modest growth in personal incomes, the moderate increase in bank credit, the resultant subdued domestic demand and benign global and trading partner inflation. Inflation in Botswana has been either within or slightly below the medium-term objective range since June 2013. For 2017, inflation was within the 3 – 6 percent and close to the lower bound of the medium-term objective range, breaching the lower bound only once in November 2017. The average inflation for the twelve-months to December 2017 was 3.3 percent.

Monetary policy was conducted against the background of below-trend economic activity (a non-inflationary output gap) and a positive medium-term inflation outlook, which provided scope for an accommodative monetary policy stance in support of stronger output growth. Accordingly, the Bank Rate was reduced by 50 basis points to 5 percent in October 2017. Monetary policy implementation entailed the use of Bank of Botswana Certificates (BoBCs) to mop up excess liquidity and to maintain interest rates that are consistent with the monetary policy stance. In this regard, the relaxation on the amount of BoBCs used to mop excess liquidity helped to alleviate downward pressure on short-term interest rates and remedy the misalignment of market interest rates with the policy stance. The decision to broaden acceptable collateral to access the Bank's overnight credit facility to include the whole maturity spectrum of government securities enabled the banks to manage liquidity more efficiently and, also, address the apparent distortion in policy transmission.

For 2017, the Bank's implementation of the exchange rate policy entailed a 0.26 percent upward annual rate of crawl to stabilise the real effective exchange rate (REER), given that domestic inflation was projected to be around the lower end of the medium-term objective range and lower than average inflation forecast for the trading partner countries. The Pula basket weights were changed from 50-50 to 45 percent and 55 percent for the South African rand and the Special Drawing Rights (SDR),[1] respectively. Meanwhile, the REER appreciated by 0.35 percent in the twelve months to December 2017, due to the upward rate of crawl implemented during 2017 and the positive inflation differential between Botswana and trading partner countries.

The banking industry was sound, prudently managed, solvent, liquid and profitable. All licensed banks met the minimum prudential requirements as set out in the Banking Act (CAP 46:04) and Banking Regulations. The banking sector's financial position increased by 3.5 percent, from P80.6 billion in December 2016 to P83.5 billion as at December 31, 2017. The industry's total deposits increased by 1.8 percent from P62.4 billion in 2016 to P63.6 billion in 2017, compared to an increase of 5.6 percent in loans and advances from P51.3 billion in 2016 to P54.2 billion in 2017. Even so, annual credit growth declined from 6.2 percent in 2016 to 5.6 percent in 2017, reflecting the slower rate of increase in mortgage lending and early repayment of loans by some statutory corporations.

National and international payments were carried out efficiently through various platforms, including the Botswana Automated Clearing House (BACH). The Bank continued to embrace improvements in the payments and settlement landscape as driven by developments in information and communications technology, competition and customer requirements. At the same time, the Bank implemented related security and risk mitigation measures to avert any possible cyber-attacks, fraud and misuse of payments systems.

Both Moody's Investors Service and S&P Global Ratings retained Botswana's investment grade credit ratings of A2 and A-, respectively. The ratings affirmed the Government's strong financial position as underpinned by well-established prudent macroeconomic policies, the net external creditor position, low public debt and a well-managed economy. The rating agencies also recognised the existence of robust institutional frameworks that facilitate prudent policymaking and continuing political stability. However, both rating agencies reiterated the concerns about the country's narrow economic base, specifically heavy reliance on the diamond industry and the slow pace of economic diversification.

With regard to the financial condition and performance, the Bank's total assets declined by P3.3 billion to P74.3 billion in December 2017 (P77.6 billion in December 2016), of which P73.7 billion was foreign exchange reserves (a decline from P76.8 billion in December 2016). In United States dollar terms, the level of reserves increased by 4.2 percent from USD7.2 to USD7.5 billion, while the SDR amount remained unchanged at SDR5.3 billion. At this level, the reserves were equivalent to 18 months of import cover of goods and services. The decrease in foreign exchange reserves in Pula terms reflects the net foreign exchange outflows and net foreign currency revaluation losses, mainly arising from the appreciation of the Pula against the US dollar.

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1 The SDR is the IMF's unit of account, comprising the US dollar, euro, Japanese yen, British pound and the Chinese renminbi (also known as the yuan).

The Bank's net income for the year was P739.5 million, compared to P1.4 billion in 2016. The distributable net income for 2017 was, however, P1.9 billion (P3.6 billion in 2016), after the transfer of P1.1 billion from the Currency Revaluation Reserve to cover the non-distributable currency revaluation losses of the same amount.

The focus on skills development, through appropriate short- and long-term training programmes, and staff welfare improvement was maintained with a view to sustaining the Bank's operational and leadership capability and productivity.

In fulfilment of its statutory obligations, the Bank's *Annual Report* and *Banking Supervision Annual Report* for 2016 were submitted to the Minister of Finance and Economic Development on March 31 and June 30, 2017, respectively. The Bank also continued to publish the monthly *Botswana Financial Statistics,* the *biannual Business Expectations Survey* and the *Research Bulletin*. The Bank initiated a comprehensive review of the Bank of Botswana Act, with a view to modernising the law, better specification and ranking of primary objectives as well as institutional arrangements for effective discharge of the Bank's mandate.

External stakeholder relations were maintained during the year, and this included economic briefings, consultations with relevant international bodies and institutions, such as the Association of African Central Banks, Committee of SADC Central Bank Governors, International Monetary Fund, World Bank, Bank for International Settlements and Financial Stability Board Regional Consultative Group.

The management and staff owe a debt of gratitude to the Board for the guidance and support in implementing the 2017 work programme. It is hoped that stakeholders will find the 2017 *Annual Report* informative.

Moses D Pelaelo
GOVERNOR

Statutory Report on the Operations and Financial Statements of the Bank - 2017

The Bank's Mission and Objectives

The primary objective of the Bank, as stipulated in Section 4(1) of the Bank of Botswana Act (CAP 55:01), is to promote and maintain monetary stability, an efficient payments mechanism and the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system, and, in so far as it would be consistent with the monetary stability objective, to foster monetary, credit and financial conditions conducive to the orderly, balanced and sustainable economic development of the country. Based on this primary statutory responsibility, the Bank's functions and responsibilities can be grouped under the following categories.

(a) monetary policy – an essential focus of monetary policy is to preserve the purchasing power of currency by keeping the rate of inflation low and stable. Monetary stability contributes to a sound and stable macroeconomic environment conducive for sustainable economic growth;

(b) open market operations – the Bank engages in open market operations and, through weekly auctions of BoBCs and overnight credit facilities to banks, has the ability to influence monetary conditions and market interest rates to be aligned to the policy stance as well as foster orderly and efficient functioning of the financial system;

(c) macroprudential supervision – financial sector vulnerability assessment and performance monitoring are carried out to help inform policy and adopt appropriate measures to respond to any financial sector imbalances and, therefore, maintenance of financial stability;

(d) banking regulation and supervision – banks are regulated and supervised to foster operational safety and soundness;

(e) issuance of currency (banknotes and coin) – currency management ensures adequate supply of high quality banknotes and coin to facilitate transactions and economic activity, including adherence to stringent standards in design and production to mitigate against possible counterfeiting;

(f) central banking, payments and settlement services – the Bank provides banking services to the Government, commercial banks and selected public institutions. Facilitation and maintenance of integrity of payments systems enables the flow of payments and efficient settlement. Moreover, oversight and regulation entrenches confidence in the payments and settlement system and mitigates systemic risks;

(g) implementation of exchange rate policy – the Bank also implements the exchange rate policy, the objective of which is to promote and maintain competitiveness of domestic firms and contribute to overall macroeconomic stability;

(h) management of official foreign exchange reserves and making foreign payments on behalf of Government – the Bank manages the country's foreign exchange reserves as an agent of Government. The management of foreign exchange reserves enables the country to meet international financial obligations. The investment guidelines ensure that the reserves are managed prudently to ensure safety, liquidity and return within acceptable risk parameters; and

(i) economic analysis and policy advice – the Bank provides advice to Government on macroeconomic and financial policy matters. Furthermore, the Bank collects and disseminates statistics, especially those relating to monetary, financial and international transactions.

In an endeavour to achieve its mission and objectives, the Bank utilises various strategies, activities and supportive infrastructure as indicated in Figure 1.

Figure 1: Mission, Objectives, Strategies and Supportive Structures

Supportive Infrastructure

- Governance Structures: Board and Management Committees
- Strategic Planning, Capacity Building and Staff Welfare
- Assurance: Risk Management, Internal Audit, Security and Business Continuity Planning
- Operating Platforms: Information Technology Systems and Physical Infrastructure and Facilities
- Accountability, Stakeholder Feedback and Communication

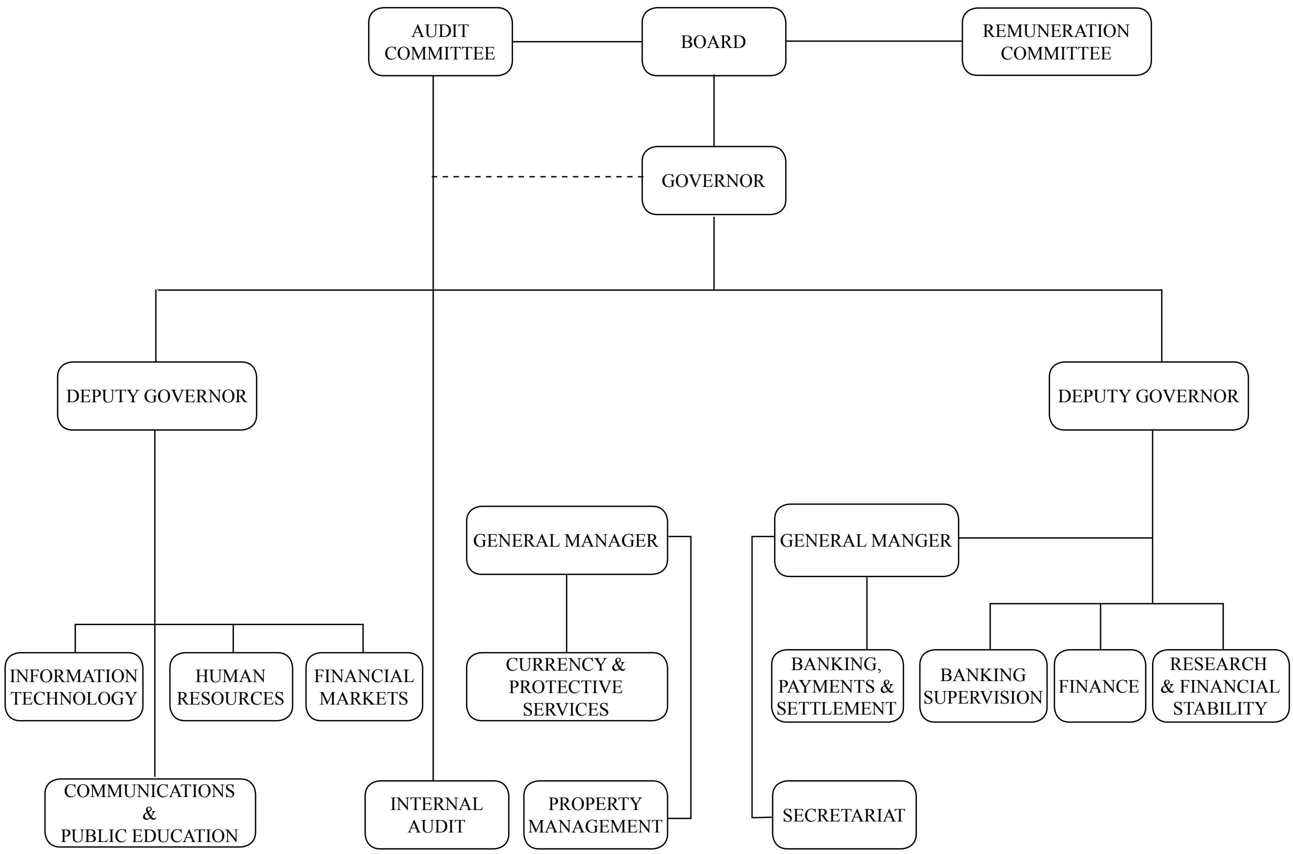
Mission, Objectives and Functions	Instruments and Activities
Monetary Stability and Operations	Bank Rate, Open Market Operations, Exchange Rate Management, Primary Reserve Requirement, Policy Focused Research and Inflation Modelling and Forecasting
Financial Stability	Macro-Prudential Policy, Surveillance and Monitoring
Sound Banking System	Banking Regulation, Licensing, Supervision and Enforcement Action
Efficient Payments System	Banking, Payments System, Regulation and Oversight, Clearing and Settlement Systems
Issuance of Quality Banknotes and Coin	Currency Design and Management, including Quality of Currency in Circulation
Banker for Government, Banks and Selected Institutions	Maintenance of Customer Accounts and Credit Facility or Lender of Last Resort
Foreign Exchange Reserves Management	Investment and Foreign Exchange Dealing
Economic Analysis and Policy Advice to Government	High-Level Bank Representation, Direct Advice, Joint Committees, Research and other Publication, Public Education on Banking and Financial Matters

GOVERNANCE, MANAGEMENT AND ORGANISATIONAL STRUCTURE OF THE BANK

The Bank's functions and key responsibilities, its organisation and how it is held accountable for its performance are as described below:

The Board is at the apex of the governance structure of the Bank and it is chaired by the Governor, who is also the Chief Executive Officer of the Bank. The Governor oversees eight departments and four divisions, supported by two Deputy Governors and two General Managers (Figure 2). The governance structure fosters coordination and synergy between policy-oriented activities and support functions, including human resource management and training, adoption of efficiency-enhancing technology, risk, safety and security management, while maintaining a culture of professionalism, good conduct, staff discipline and adherence to institutional values across all functions of the Bank.

FIGURE 2: ORGANISATION STRUCTURE AS AT DECEMBER 31, 2017



Source: Bank of Botswana

Board Functions, Membership and Appointments

The Board oversees and guides the Bank's general strategic direction, policy formulation and operations in accordance with the Bank of Botswana Act and Bye-Laws. It comprises nine members, two of whom are ex-officio members, the Governor and Permanent Secretary of the Ministry of Finance and Economic Development (MFED). The other seven members are appointed by the Minister of Finance and Economic Development in their individual capacity, two of whom may be public officers. The Governor and the two Deputy Governors are appointed by the President. The two Deputy Governors are not Board members.

The Board had two committees in 2017: the Audit Committee (AC) and the Remuneration Committee (REMCO), chaired by non-executive Board members. The Audit and Remuneration Committees considered issues pertaining to their respective mandates and made recommendations to the Board. The Board is required to meet at least once a quarter, although in practice it typically meets six times in a year. In 2017, there were seven Board meetings held (Table 1). The Board approves the Bank's annual budget, monitors the financial and operational performance of the Bank, ensuring that the Bank is well run in accordance with the Bank of Botswana Act and the Bye-Laws. At year-end, the Board had a full complement of nine members following appointment of Mr B M Ditlhabi, and Mesdames D K Briscoe and V T Lekoma in 2017.

Table 1: Board Meetings and Attendance in 2017

Meeting	**BB 1/17 (Feb 17)**	**BB2/17 (Mar 28)**	**BB 3/17 (Jun 16)**	**BB 4/17 (Aug 25)**	**BB 5/17 (Oct 26)**	**BB 6/17 (Oct 27)**	**BB 7/17 (Dec 8)**
M D Pelaelo (Board Chairman)	✓	✓	✓	✓	✓	✓	✓
S Sekwakwa (Ex-officio)	✓	✓	✓	✓	×	×	✓
G K Cunliffe (Chairman AC)	✓	✓	✓	✓	✓	✓	✓
R N Matthews (AC)	✓	✓	✓	×	✓	✓	×
J Sentsho (REMCO)	✓	✓	×	✓	✓	×	×
M Bakwena (Chairman REMCO)	✓	✓	✓	✓	✓	✓	✓
D K Briscoe (REMCO)	NA	NA	✓	✓	✓	✓	×
B M Ditlhabi (REMCO)	NA	NA	NA	NA	NA	NA	✓
V T Lekoma (AC)	NA	NA	NA	NA	NA	NA	✓

Key: ✓ Attended
× Not attended
BB Board Meeting
NA Not yet appointed

Source: Bank of Botswana

Governor

The Governor implements Board decisions and submits the *Annual Report* on the operations and financial performance, including the audited financial statements of the Bank to the Minister of Finance and Economic Development within three months of the end of the financial year, as stipulated in the Bank of Botswana Act. In turn, the Minister is mandated to present the *Annual Report* to Parliament within 30 days, following receipt of the *Report* from the Bank. *The Banking Supervision Annual Report* is submitted to the Minister by the end of June each year. The Governor represents the Bank at relevant local, regional and international fora, and is the Governor for Botswana on the non-executive Board of Governors of the International Monetary Fund (IMF).

Executive Committee

The Executive Committee comprises Deputy Governors, General Managers and Heads of Department and is chaired by the Governor. Senior advisors may be co-opted as members. The Committee has the collective responsibility for advising the Governor on day-to-day administration, including policy formulation, risk and financial management as well as overall governance of the Bank. It meets once a week to monitor, coordinate and review the implementation of the Bank's work programme.

Departments and Divisions

The Bank has eight departments, four of which are policy departments that fulfil the Bank's core mandates, while four departments provide auxiliary support and corporate services. The Research and Financial Stability Department undertakes data collection, research, macroeconomic analysis, monitors the financial sector and evaluates emerging risks and other developments emanating from the macroeconomic environment. The Department also conducts macro-prudential assessments, and facilitates coordination with other relevant external entities to ensure macroeconomic and financial stability. Furthermore, the Department undertakes macroeconomic forecasting and policy review in support of the Bank's conduct of monetary policy and implementation of the exchange rate policy. Production and dissemination of the Bank's *Annual Report*, monthly *Botswana Financial Statistics* (BFS), the *Research Bulletin, Monetary Policy Statement* and the *Business Expectations Survey* are also responsibilities of the Research and Financial Stability Department.

The Banking Supervision Department licenses, regulates and supervises commercial banks and other financial institutions that fall under the Bank's regulatory and supervisory purview; it also publishes the *Banking Supervision Annual Report*. The Department is responsible for prudential supervision, including investigating unauthorised and illegal deposit-taking activities, improper use of banking names as well as market conduct of financial institutions under its purview, with a view to ensuring fair treatment of customers. The Financial Markets Department manages foreign exchange reserves, foreign exchange dealing, open market operations and other money and capital market activities, which include issuance of government bonds and treasury bills. The provision of banking services to the Government, commercial banks and selected institutions, as well as oversight and regulation of payments and settlement transactions, was carried out by the Banking, Payments and Settlement Department. The Department is also responsible for operating the Bank's Real Time Gross Settlement System, known as the Botswana Interbank Settlement System (BISS) and overseeing the Botswana Automated Clearing House (BACH) system owned and operated by banks.

The Finance Department is responsible for accounting and reporting on the Bank's financial activities, including production of monthly and annual financial statements of the Bank, in accordance with the Bank of Botswana Act (CAP 55:01) and International Financial Reporting Standards (IFRS). The Department also coordinates strategic planning, formulation and implementation of risk management and business continuity management. The Human Resources Department is responsible for staff recruitment, training, remuneration and welfare, while the Information Technology Department ensures that the Bank's information technology systems and infrastructure are robust and effective in meeting the needs of the Bank. The Currency and Protective Services Department had responsibility for procurement, management, custody and issuance of the national currency, as well as ensuring the safety of Bank staff, information and property.

The Secretariat serves the Board and Executive Committee and discharges related support functions. It is also responsible for the library, registry, records management and protocol services. Other support services are undertaken through the specialised activities of three divisions: Internal Audit, Communications and Public Education, and Property Management. The Internal Audit Division ensures that the Bank's operations are sound and comply with established financial and operational controls as well as governance structures in line with the Bank of Botswana Act, Audit Committee Charter and international best practice. The Communications and Public Education Division coordinates communications activities in relation to media and effective transmission of information on the Bank's mandate, policies and practices to stakeholders in a timely, efficient and effective manner. The Division also coordinates the Bank's Public Education Programme and policies with the aim of promoting financial and economic literacy and improving public understanding of the Bank's role in economic development of the country. The Property Management Division undertakes procurement, custody and maintenance of immovable and movable assets, including the Bank's related equipment.

Review of the Bank's Main Activities in 2017

Monetary Policy, Money and Capital Market Activities and Exchange Rate Policy

Monetary Policy

The Bank conducts monetary policy primarily through setting of the policy rate (Bank Rate), open market operations and setting primary reserve requirements. While the Bank may use prudential regulations and moral suasion, the primary instrument to manage liquidity and influence short-term deposit and lending interest rates in the economy is Bank of Botswana Certificates (BoBCs).

In 2017, monetary policy was conducted against the background of below-trend economic activity (a non-inflationary output gap) and a positive medium–term inflation outlook. These developments provided scope for an accommodative monetary policy stance in support of stronger output growth. Thus the Bank Rate was reduced by 0.5 of a percentage point from 5.5 percent to 5 percent in October 2017. In line with this rate cut, the prime lending rate of commercial banks decreased from 7 percent in 2016 to 6.5 percent in 2017. The nominal 3-month (88-day) deposit interest rate of commercial banks decreased from 2.03 percent in December 2016 to 1.10 percent at the end of 2017. Meanwhile, inflation was mostly within the Bank's 3 – 6 percent objective range and closer to the lower end of the objective range throughout the year due to modest growth in personal incomes, the moderate increase in credit and the resultant subdued domestic demand and low foreign inflation that resulted in benign pressure on domestic inflation.

In an endeavour to enhance communication of macroeconomic policy and add to its communication tools, effective February 2017, the Bank introduced press briefings after each meeting of the Monetary Policy Committee to announce the policy decision and related background information that formed the basis for the policy decision. In addition, the Bank pre-announced, for the first time, the schedule of MPC meetings for the year. These improvements in transparency and communication are important in helping to anchor inflation expectations and foster policy predictability.

Money and Capital Markets

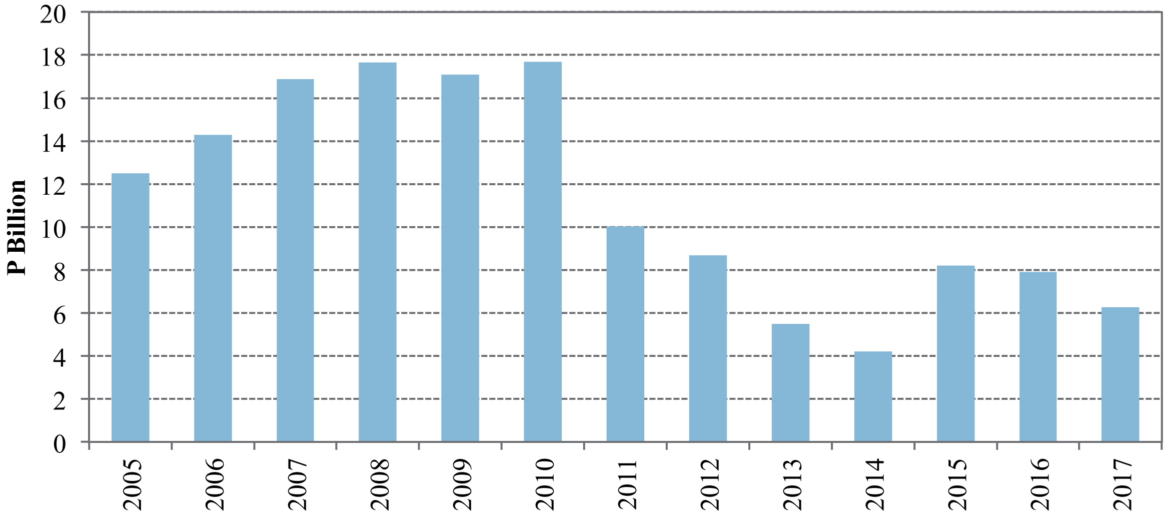
Monetary policy was implemented through Open Market Operations (OMO) to absorb excess liquidity to ensure levels of interest rates that were consistent with the policy stance. In that regard, the Bank introduced measures to improve market efficiency and effectiveness of monetary operations, in particular to better align market interest rates to the policy stance. Two of the key measures were the relaxation on the amount of BoBCs used to mop up excess liquidity, which helped to alleviate downward pressure on short-term interest rates and correct the misalignment with the policy stance. In addition, the range of securities eligible for use by commercial banks as collateral when accessing the Bank's credit facility were broadened to include all government securities, regardless of maturity and Pula denominated bonds issued by the International Finance Corporation in the Botswana market. Commercial banks were, therefore, able to manage liquid assets more efficiently, with less reliance on BoBCs for collateral purposes. In turn, this would potentially reduce the cost of monetary policy implementation. The outstanding value of BoBCs decreased from P7.9 billion at the end of 2016 to P6.3 billion in December 2017 (Chart 1). Repurchase Agreements (repos) and reverse repos were used during the year to manage liquidity between auctions, and P54 million worth of reverse repos was outstanding at the end of 2017 compared to P1.3 billion in December 2016. There were no outstanding repos as at the end of 2017 (Table 2).

TABLE 2: MONEY MARKET 2016 - 2017

	End-2016			End-2017		
	Outstanding balances[2] (P Billion)	Interest rate (Percent)[1] Nominal	Real	Outstanding balances[2] (P Billion)	Interest rate (Percent)[1] Nominal	Real
6-month Treasury Bills[1,3]	1.0	1.00	-1.94	0.87	1.34	-1.80
14-day BoBCs[1]	3.9	0.84	-2.10	2.9	1.47	-1.68
91-day BoBCs[1]	4.0	1.01	-1.93	3.4	1.48	-1.67
Reverse repos	1.3	1.00	-1.94	0.054	1.00	-2.13
Repos	0	5.00	1.94	0	4.50	1.26
88-day deposits for commercial banks	2.1	2.03	-0.94	3.0	1.10	-2.03
Prime rate		7.00	3.88		6.50	3.20

1. Stop-out yield is used for Treasury Bills, while the weighted average yield is used for both the 14-day and 91-day BoBC yields.
2. Book value
3 Original date to maturity
Source: Bank of Botswana

CHART 1: BANK OF BOTSWANA CERTIFICATES 2005 - 2017



Source: Bank of Botswana

Following the measures that were implemented to improve on the efficiency and effectiveness of monetary operations, the 14-day BoBC weighted average yield increased from 0.84 percent in December 2016 to 1.45 percent in December 2017, while the yield on the 91-day BoBC increased from 1.01 percent to 1.41 percent in the same period. In line with the Bank's commitment to encouraging savings, commercial banks continued to offer and advertise the 91-day deposit facility or equivalent deposit product which pays an interest rate that, at a minimum, is the prevailing Bank Rate less 3.5 percentage points,[2] with higher interest rates for longer-dated deposits.

The P15 billion Government Bond Programme remains in place, with a focus on the development of the capital market, as well as providing an alternative source of government funding. Outstanding bonds of various maturities and Treasury Bills increased from P9.3 billion at the end of 2016 to P10.2 billion in December 2017 (Table 3). Primary Dealers and their customers held P3.9 billion (37.7 percent) and P6.3 billion (62.1 percent), respectively, of the government securities outstanding at the end of 2017, while, the Bank held P20 million (0.2 percent) of the total outstanding securities for possible repo transactions.

Table 3: Government Bonds and Treasury Bills 2016 – 2017

Bond Code[4]	End 2016			End 2017		
		Market Yields[3] (Percent)			Market Yields[3] (Percent)	
	Outstanding (P Million)[1,2]	Yield	Real	Outstanding (P Million)[1,2]	Yield	Real
6-month Treasury Bills	1 000	1.00	-1.94	870	1.34	-1.80
BW010 (14/03/2017)	718	2.40	-0.58	-	-	-
BW005 (12/09/2018)	1 808	3.02	0.02	2 008	1.88	-1.28
BW008 (08/09/2020)	1 564	4.05	1.02	2 047	3.63	0.42
BW013 (07/06/2023)	-	-	-	250	3.81	0.59
BW007 (10/03/2025)	1 629	4.59	1.54	1 897	4.26	1.03
BW011 (10/09/2031)	1 653	5.19	2.13	1 803	4.98	1.72
BW012 (13/06/2040)	886	5.44	2.37	1 328	5.20	1.94
	9 258			**10 203**		

1. Where outstanding values differ for the same bond code between the two years, it means the bond was reopened for issuing an additional amount.
2. Book value.
3. Indicative yields.
4. Maturity dates are in parentheses.

Source: Bank of Botswana

Exchange Rate Policy

The Bank is responsible for implementing the exchange rate policy. In accordance with the Bank of Botswana Act (CAP 55:01), the framework for the determination of the external value of the Pula is set by His Excellency, the President, on recommendation by the Minister of Finance and Economic Development, after consultation with the Bank. The Bank implemented a 0.26 percent upward rate of crawl of the nominal effective exchange rate (NEER) during 2017, as projected inflation was close to the lower end of the Bank's medium-term objective range and lower than the expected average inflation for trading partner countries. The Pula basket weights were changed from 50 percent each to 45 percent and 55 percent for the South African rand and the SDR, respectively. In the twelve months to December 2017, the trade-weighted NEER of the Pula appreciated by 0.26 percent, consistent with the rate of crawl of the Pula exchange rate. Meanwhile, the REER appreciated

[2] Given the Bank Rate of 5 percent, the minimum deposit interest rate was 1.5 percent for the 91-day and equivalent deposit facilities.

modestly by 0.35 percent in the twelve months to December 2017, due to the upward rate of crawl implemented during 2017 and the small positive inflation differential between Botswana and trading partner countries. A virtually stable REER implies maintenance of competitiveness (by this measure) of domestic producers of tradable goods and services. Nevertheless, it should be noted that the exchange rate alone is not sufficient to ensure sustainable competitiveness of local producers. The attainment of durable competitiveness of domestic producers is mainly through a sustained improvement in productivity, which also contributes to lower inflation. Even then, the enhanced transparency engendered by the disclosure of Pula exchange rate parameters helps to reduce uncertainty surrounding exchange rate policy and enriches information used in making financial and investment decisions by economic agents.

Supervision and Regulation of Banks and Bureaux de Change

During 2017, the Bank continued to monitor the performance of banks through a system of monthly and quarterly returns, risk-based supervision, on-site examinations, regular consultative meetings with each bank and trilateral meetings with banks and their external auditors. The biannual meetings of the Banking Committee facilitate discussion of industry-wide matters. The banking sector was adequately capitalised, profitable and liquid as at December 31, 2017. The industry's compliance with the regulatory and prudential requirements was satisfactory (Table 4). However, the banking sector's asset quality deteriorated. The ratio of non-performing loans to gross loans and advances increased from 4.9 percent in 2016 to 5.3 percent in 2017. The deterioration in asset quality was against the background of closure of some mining operations in the country, rationalisation by some parastatals resulting in loss of employment and defaults by some companies in the diamond industry.

Most banks reported higher levels of profit compared to the previous year. On the other hand, three banks registered losses for the year ending December 31, 2017. The banking sector's balance sheet increased by 3.5 percent from P80.6 billion in December 2016 to P83.5 billion as at December 31, 2017. The industry's total deposits increased by 1.8 percent from P62.4 billion in 2016 to P63.6 billion in 2017, compared to an increase of 5.6 percent in loans and advances from P51.3 billion in 2016 to P54.2 billion in 2017. As a result, the financial intermediation ratio[3] increased marginally from 0.82 in 2016 to 0.85 in 2017. All banks were adequately capitalised, liquid and complied with the minimum prudential and statutory capital and liquidity requirements. Nevertheless, losses recorded by some banks would, in the absence of additional capital injection, reduce capital adequacy ratios as losses are deducted from Tier I capital. In addition to the prudential supervisory role, the Bank monitored business conduct to ensure that banks treat their customers in a fair, professional and transparent manner.

[3] The financial intermediation ratio is calculated as total loans and advances divided by total deposits. It is a measure of the degree of financial intermediation of an economy.

Table 4: Financial Soundness Indicators and Range of Prudential Standards for Licensed Banks (2014 - 2017)

Prudential and Financial Indicators	Prudential Standard (Percent)	Range of Indicators for Local Banks (Percent)			
		2014	2015	2016	2017
Capital Adequacy	≥15	16.1 – 23.1	16.4 – 31.0	16.3 – 35.9	15.2 – 36.6
Liquid Asset Ratio	≥10	10.5 – 19.6	2.9 – 28.6	13.5 – 46.3	12.2 – 35.1
Profitability (Return on Assets)	Positive	0.2 – 3.8	(1.0) – 2.7	(1.9) – 2.5	(3.6) – 2.9
Profitability (Return on Equity)	Positive	2.1 – 27.7	(6.4) – 21.4	(10.5) – 20.4	(29.1) – 22.1
Asset Quality (Non-Performing Loans/Total Loans)	≤2.5	0.6 – 11.8	0.6 – 8.4	0.8 – 8.5	1.3 – 10.0
Intermediation (Advances/ Deposits)	50 - 80	68.7 – 94.9	51.1 – 104.6	58.3 – 91.3	65.3 – 137.9

1. Numbers in parentheses are negative.
2. Figures as at December 31, 2017

Source: Bank of Botswana

The liquidation of the defunct Kingdom Bank Africa Limited (KBAL) and the subsequent litigation instituted by one of its major creditors against the Bank of Botswana for alleged negligence in the performance of statutory duties were ongoing as at December 31, 2017.

Abandoned funds continued to be administered in accordance with Section 39 of the Banking Act (CAP 46.04). As at December 31, 2017, the total abandoned funds balance was P10.6 million, up from P6.9 million as at December 31, 2016. During the year, an amount of P2.9 million was claimed, while P445 962 was transferred to the Guardian Fund.[4]

During 2017, a total of four new bureaux de change were licensed, while two bureaux de change licences were revoked. The total number of operating bureaux de change was 61 as at December 31, 2017.

The Bank carried out full scope on-site prudential and Anti-Money Laundering and Combating of the Financing of Terrorism (AML/CFT) examinations at selected banks in 2017. Consequently, where necessary, remedial and corrective supervisory actions are being implemented by the concerned banks. In addition, the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) made an assessment of Botswana's anti-money laundering and combating of terrorism framework in 2017. Following the evaluation, Botswana was requested to enhance its legal and regulatory framework for combating money laundering and the financing of terrorism. In this regard, there is ongoing comprehensive review and modernisation of the Banking Act and the Bank of Botswana Act to address the needs of the evolving regulatory environment. However, there are specific amendments to the Banking Act being processed to address immediate requirements relating to facilitating reporting of suspicious transactions solely to the Financial Intelligence Agency and allowing authorised law enforcement agencies access to bank customer accounts.

[4] The Guardian Fund is administered under the Administration of Estate Act (CAP 31.01). It is under the custody of the Master of the High Court and was created to hold and administer funds whose rightful owners could not be located immediately.

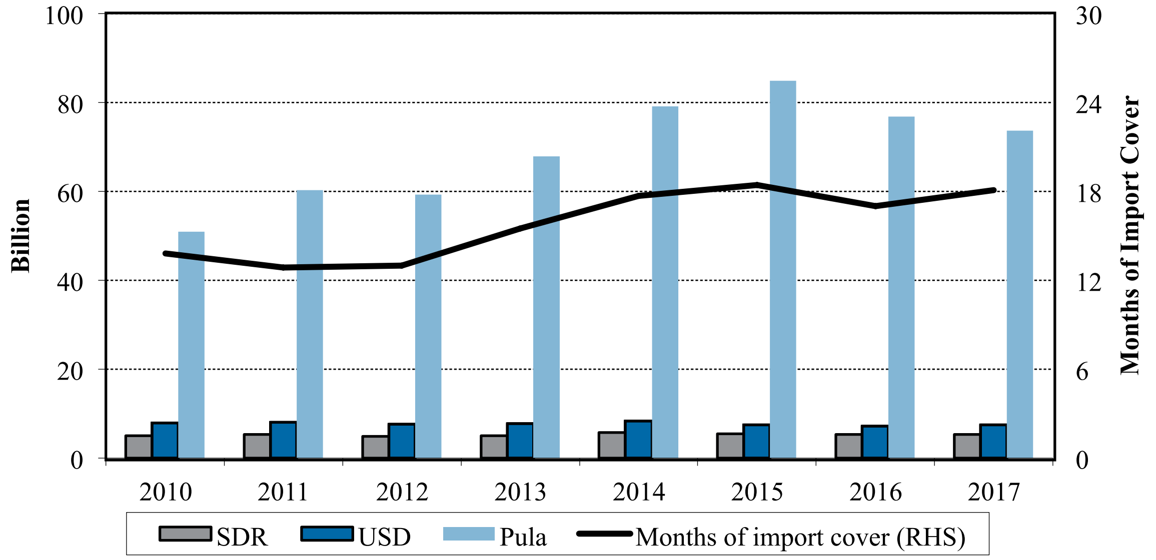
Foreign Exchange Reserves Management

At the end of December 2017, foreign exchange reserves amounted to P73.7 billion, a decrease of 4 percent from P76.8 billion in 2016 (Chart 2). This was equivalent to 18 months of import cover[5] of goods and services. In US dollar terms, the level of reserves increased by 4.2 percent from USD7.2 to USD7.5 billion, while the SDR amount remained unchanged at SDR5.3 billion. The decrease in foreign exchange reserves in Pula terms reflects the net foreign exchange outflows and net foreign currency revaluation losses, mainly arising from appreciation of the Pula against the US dollar.

The official foreign exchange reserves are managed by the Bank in accordance with Board-approved investment policies and guidelines underpinned by the key objectives of safety, liquidity and return within well-defined risk parameters. The foreign exchange reserves, tranched into two portfolios, the liquidity portfolio and the long-term investment portfolio (Pula Fund), are managed prudently using a diversified pool of high quality financial instruments traded in deep and liquid international markets. In addition to its staff, the Bank uses selected international fund managers to manage the foreign exchange reserves and, also, employs the services of a reputable, well-rated global custodian to safeguard the reserve assets.

In October 2017, the Board approved revised Reserves Management Policies while delegating the review and approval of the detailed Investment Guidelines to the Bank's Investment Committee, which is chaired by the Governor and comprises senior management of the Bank. The new policies will be implemented during 2018, providing a broad framework for the management of the foreign exchange reserves for the next five years, including the updated strategic asset allocation framework in recognition of the continually changing market environment. Sovereign wealth funds, reserve managers and other fund managers are increasingly diversifying their portfolios into less traditional assets across an array of markets and risk factors, in order to generate higher returns, while continuing to keep risk within acceptable bounds. This has become more increasingly relevant given the low and, in some cases even negative, yields that continue to prevail in more developed markets. Under the new guidelines, a wider range of markets will be eligible for investment through either bonds or equity while maintaining the focus on high quality investment-grade assets. At the same time, a small new tranche for selective investment in higher-yielding assets will be introduced. Overall, however, the Bank maintained its broad investment policy objectives of safety, liquidity and return.

CHART 2: LEVEL OF FOREIGN EXCHANGE RESERVES



Source: Bank of Botswana

[5] The calculation of import cover excludes imports of rough diamonds as these are mainly for re-export.

Currency Operations

The Bank continued to monitor the supply and quantity of banknotes and coin in circulation, withdrawing from circulation and destroying soiled and damaged currency, replacing it with banknotes and coin of high, acceptable standard, in accordance with the Bank's Clean Banknote Policy. The Bank was also involved with the Botswana Police Service and other law enforcement agencies in developing strategies to address banknote counterfeiting.

During 2017, the Bank embarked on the design of a new polymer P10 banknote, which was subsequently launched in February 2018. Polymer banknotes generally last longer than the conventional cotton-based banknotes, are not easy to counterfeit and are more resistant to dirt and moisture. The P10 polymer banknote would be the first of its kind in Botswana.

The annual rate of growth of banknotes in circulation increased from 6.2 percent in 2016 to 10 percent in 2017. Notably, the rate of increase in net issuance of the P20 banknote denomination increased from 5.1 percent in 2016 to 18.6 percent in 2017, while for the P10 banknotes, the rate of increase fell from 6.5 percent to 1.3 percent in the same period. The increase in the net issuance of P20 banknotes during the period under review was largely driven by the need to compensate for the reduced demand for both the P50 and P10 banknotes. The P200 denomination continued to have the highest share of total issuance (quantity) of banknotes at 29.6 percent in 2017. The net issuance of all coin denominations increased by 5.4 percent in 2017, less than the increase of 6 percent in 2016. The relatively low net issuance in 2017 was attributable to sufficiency of coin issued into the market and the fact that coin is exchanged at commercial banks and not ordinarily returned to the Bank of Botswana.

Banking Operations, Payments and Settlement

The Bank continued to discharge the oversight function of monitoring the National Payments System (NPS) operators, participants and service providers to ensure safety and efficiency of the NPS. In this regard, key Financial Market Infrastructures (FMIs), such as the BISS, BACH and Central Securities Depository (CSD), remained stable. Emphasis is on the application of internationally prescribed operating standards for FMIs, for effective management and mitigation of risk and fostering resilience of the FMIs. In that regard, an oversight inspection of the BISS was conducted in October 2017. The preliminary findings indicated that the BISS is largely in compliance with the relevant international standards for Principles of Financial Market Infrastructures (PFMIs).

The National Payments System landscape continued to evolve, as evidenced by an increase in participants and new payment methods associated with information and communications technology developments. These necessitated a close monitoring of the operations and provision of oversight in respect of Systemically Important Payment Systems (SIPS) licensed by the Bank to provide payments and financial services. Consistent with the oversight responsibilities, the Bank continued to foster and monitor these developments, while promoting measures aimed at mitigating related risks such as cybercrime, money laundering, fraud and counterfeiting of the national currency.

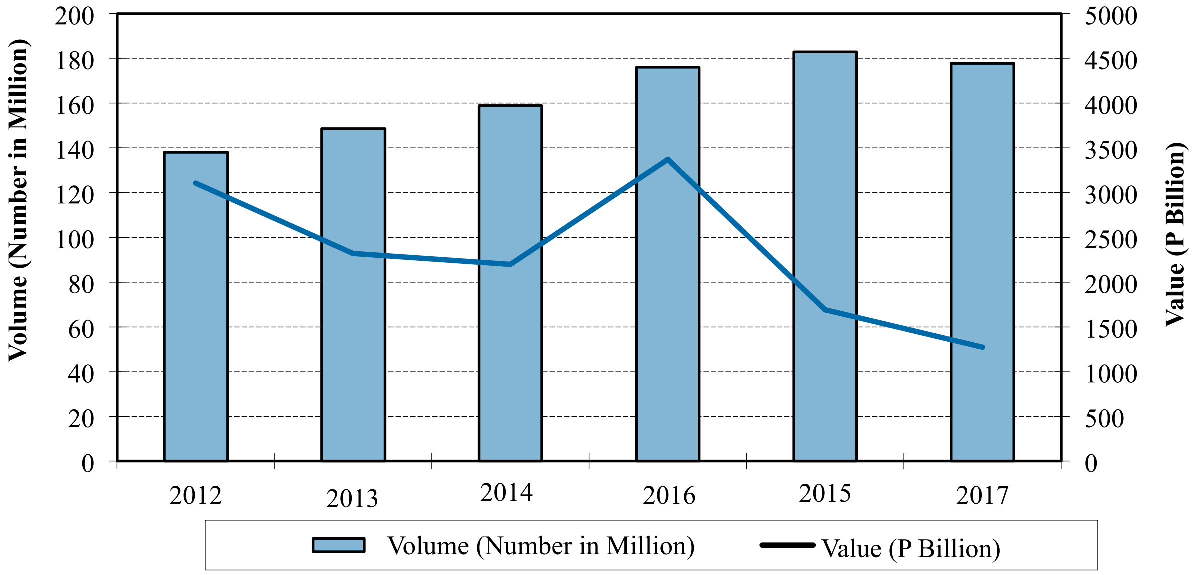
In executing its role as a final settlement provider, the Bank provided settlement services to the banking industry in a secure, robust and efficient manner in real time through the BISS. The Bank also has a mandate to support initiatives that promote electronic payments and improve efficiency. To this extent, the Bank played a major role in ensuring successful adoption of the web-based Customs Management System by the Botswana Unified Revenue Service (BURS) in 2017. A new referencing algorithm was developed in the BISS to cater for settlement of BURS customs duty transactions.

The Electronic Payment Services (EPS) Regulations were submitted to the Ministry of Finance and Economic Development for possible adoption, legal drafting and promulgation. The aim of the Regulations is to provide a regulatory framework for the provision and usage of electronic payment services in Botswana and to promote an enabling environment for innovation in financial services delivery channels without compromising the integrity, safety and efficiency of payment systems.

The number of Botswana banks that participate in SADC Integrated Regional Exchange Settlement System (SIRESS) increased to two, namely, First National Bank of Botswana Limited and Stanbic Bank Botswana Limited, which went live in October 2016 and September 2017, respectively. SIRESS enables commercial banks to discharge cross-border payments obligations within SADC with certainty and speed, at low risk and reasonable cost. The business community and the public doing business and transacting within SADC can use this alternative platform to avoid higher costs and delays associated with conventional correspondent banking payment methods. SIRESS was launched in July 2013 to facilitate regional cross border transactions and lower transaction costs. It is considered an important milestone towards regional trade facilitation and economic integration.

Transactions processed through the BISS and the electronic clearing house (electronic funds transfer (EFT) decreased in value and volume terms during 2017 (Charts 3 - 5).[6] Cheque transactions declined, while EFT transactions through the automated clearing house increased by 8.4 percent in volume terms, but declined slightly by 0.4 percent in value terms (Charts 4 and 5).

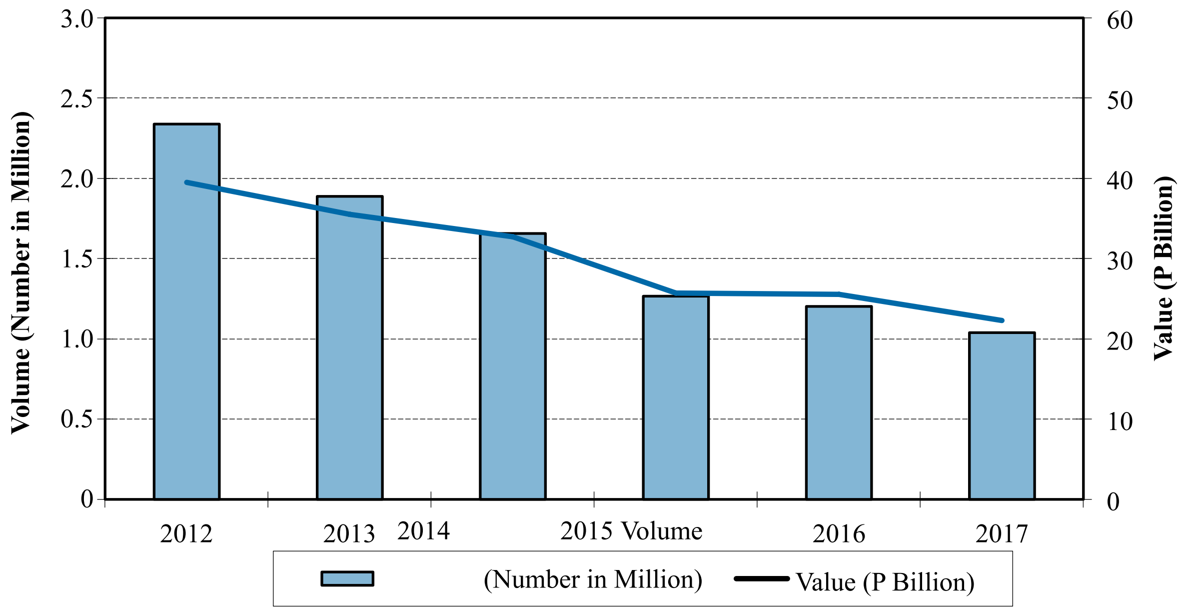
CHART 3: BOTSWANA INTERBANK SETTLEMENT SYSTEM (BISS) TRANSACTIONS (2012 - 2017)



Source: Bank of Botswana

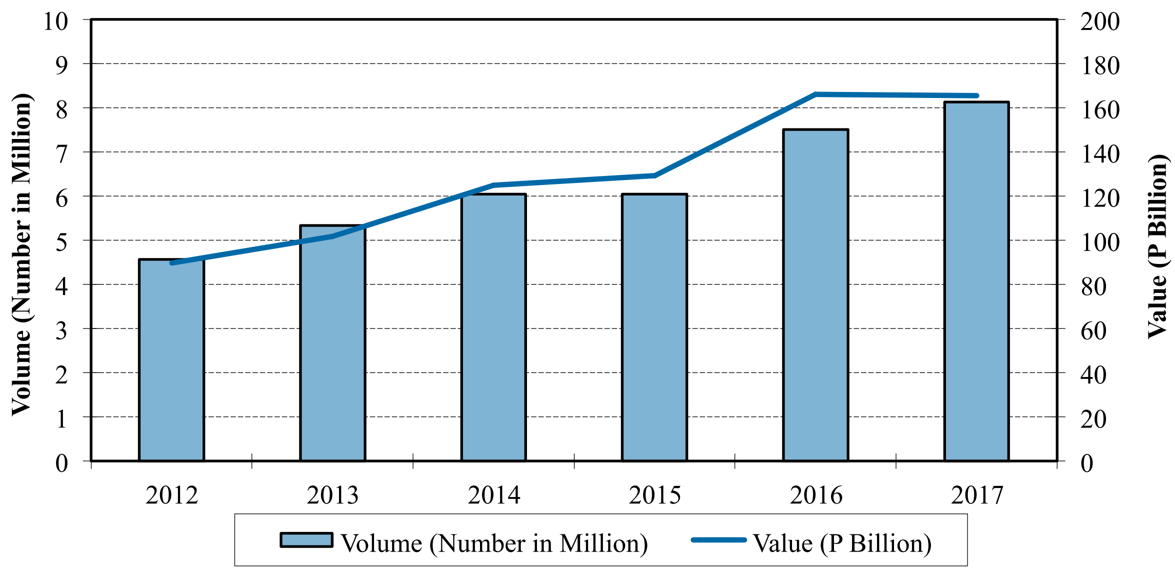
[6] The decline was due to the adjustment of the BISS values to exclude BACH Net Settlement Instructions and cancelled payments.

CHART 4: ELECTRONIC CLEARING HOUSE - CHEQUE PROCESSING (2012 - 2017)



Source: Bank of Botswana

CHART 5: ELECTRONIC CLEARING HOUSE - ELECTRONIC FUNDS TRANSFERS (2012 - 2017)



Source: Bank of Botswana

Information Technology

The Bank's computing and information systems continue to be upgraded in line with innovation and technological advancements and in order to meet evolving functional and strategy requirements, while also allowing for effective connectivity. Cyber-crime and international regulatory compliance pose major challenges for the global financial industry. Therefore, the Bank allocates the requisite resources towards upgrading information technology systems to ensure security, and safeguard and retain the integrity and functionality of mission-critical systems, as well as to achieve operational efficiency.

Human Resources, Staff Welfare and Staff Pension Fund

Human Resources and Staff Welfare

As at December 31, 2017, the Bank's Staff Establishment was 590, the same as at December 31, 2016. The vacancy rate stood at 5.8 percent, down from 8.5 percent in 2016 and 9.4 percent in 2015. Thirty-one (31) staff joined the Bank, while fifteen (15) terminated employment. The Bank continued to place emphasis on staff development and, in this regard, a number of staff members benefited from both short- and long-term training. As at the end of the year, there were eight Staff members on long-term training. The Bank has established and accommodates staff committees and clubs to coordinate staff welfare activities, including health and wellness, and participation in sports.

Staff Pension Fund

The Bank of Botswana Defined Contribution Staff Pension Fund declared an investment return of 9.45 percent and 8.89 percent for active and deferred members, respectively, for the year ended September 30, 2017. This marks an improvement on the 2016 declared return of 7.5 percent and 6.94 percent for the active and deferred members, respectively.

External Relations and Communication

The collaboration with stakeholders on different issues of mutual interest and for purposes of coordination was maintained through membership and participation in inter-institution committees, working groups, task forces, and technical fora during 2017.

External Relations

The Bank participated in relevant regional and international meetings, as well as consultation, surveillance and technical assistance missions to Botswana. In this regard, the Bank took part in meetings and conferences organised by the Bank for International Settlements, World Bank and International Monetary Fund. At a regional level, the Bank participated in meetings organised by the Southern African Customs Union (SACU), SADC Committee of Central Bank Governors (CCBG), Association of African Central Banks (AACB) and the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI). The Bank also participated in the Financial Stability Board (FSB) Regional Consultative Group, which the Governor co-chairs with the South African Reserve Bank Governor, Mr Lesetja Kganyago, for a two-year period effective 2017.

In addition, the Bank hosted Moody's Investors Service (Moody's) and S&P Global Ratings sovereign credit rating agencies. Moody's reviewed and reaffirmed, for 2017, Botswana's credit rating of A2 for foreign and domestic bonds (stable outlook), while S&P reaffirmed the ratings of "A-" for long-term bonds and "A-2" for short-term bonds in domestic and foreign currency denominated borrowing and revised the outlook from negative to stable.

Publications, Communications and Public Education

The Bank submitted the 2016 *Annual Report* on the Bank's operations and financial statements and the *2016 Banking Supervision Annual Report* in accordance with statutory requirements to the Minister of Finance and Economic Development on March 31, 2017 and June 30, 2017, respectively. The 2017 Monetary Policy Statement (and Mid-Term Review), monthly *Botswana Financial Statistics, bi-annual Botswana Expectations Survey* and the *Research Bulletin* were also published, while the Bank's website provided timely access to data, publications, press releases and policies of the Bank.

Governance and Accountability

In fulfilment of accountability and transparency principles of governance and in the implementation of the public outreach programme, the Bank conducted economic briefings following the publication of the *2016 Annual Repor*t. Among key stakeholders briefed were the Cabinet, heads and representatives of diplomatic missions, heads of public and private sector institutions, senior government officials and the media. Furthermore, following the promulgation of the National Whistleblowing Act, the Board approved the Bank's Whistleblowing Policy Guidelines, which are intended to further enhance the Bank's governance structures, to allow staff to anonymously report any acts of impropriety without undue concern about potential victimisation and/or infringement on the Bank's Oath of Secrecy.

Annual Financial Statements

2017

Bank of Botswana

CONTENTS

Statement of Responsibility of the Board and Approval of the Annual Financial Statements

The members of the Board are responsible for the preparation and fair presentation of the annual financial statements of the Bank, comprising the Statement of Financial Position at December 31, 2017, Statement of Profit or Loss and Other Comprehensive Income, Statement of Distribution, Statement of Cash Flows and Statement of Changes in Shareholder's Funds for the year then ended, and the notes to the financial statements.

These financial statements include a summary of significant accounting policies and other explanatory notes, in accordance with International Financial Reporting Standards, and in the manner required by the Bank of Botswana Act (CAP 55:01).

The Board members are also responsible for such internal control as the members determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and for maintaining adequate accounting records and an effective system of risk management.

The Board members have made an assessment of the ability of the Bank to continue as a going concern and have no reason to believe that the Bank will not be a going concern in the year ahead.

The independent external auditor is responsible for reporting on whether the annual financial statements are fairly presented in accordance with the applicable financial reporting framework.

Approval of Annual Financial Statements

The annual financial statements of the Bank, as identified in the first paragraph, were approved by the Board on March 26, 2018 and signed on behalf of the Board by:

Moses D Pelaelo
Governor

Gordon K Cunliffe
Board Member and Chairman
(Audit and Risk Committee)

KPMG, Chartered Accountants
Audit
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Fairgrounds Office Park
PO Box 1519, Gaborone, Botswana
Telephone +267 391 2400
Fax +267 397 5281
Web http://www.kpmg.com/

Independent Auditor's Report
To the Members of the Board of the Bank of Botswana

Opinion
We have audited the financial statements of the Bank of Botswana ("the Bank"), which comprise the statement of financial position as at December 31, 2017, the statements of profit or loss and other comprehensive income, distribution, cash flows and changes in shareholder's funds for the year then ended and notes to the financial statements, which include a summary of significant accounting policies, as set out on pages 6 to 40.

In our opinion, the financial statements give a true and fair view of the financial position of the Bank of Botswana as at December 31, 2017 and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards, and in the manner required by the Bank of Botswana Act (CAP 55:01).

Basis for Opinion
We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Bank in accordance with the International Ethics Standards Board for Accountant's Code of Ethics for Professional Accountants (IESBA Code) and we have fulfilled our other ethical responsibilities in accordance with the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information
Members of the Board are responsible for the other information. The other information comprises the rest of the information contained in the annual report, but does not include the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and we do not express an audit opinion or any form of assurance conclusion thereon.

KPMG

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Those Charged with Governance for the Financial Statements

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

In preparing the financial statements, members of the Board are responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the members of the Board either intend to liquidate the Bank or to cease operations, or have no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.

KPMG

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the members of the Board.

- Conclude on the appropriateness of the members of the Board's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Bank to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with the members of the Board regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the members of the Board with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

KPMG
Certified Auditors
Practicing member: AG Devlin 19960060
March 26, 2018
Gaborone

STATEMENT OF FINANCIAL POSITION
As at December 31, 2017

	Notes	2017 P'000	2016 P'000
ASSETS			
Foreign Assets			
Liquidity Portfolio	1.1	16 353 257	21 211 469
Pula Fund	1.2	55 998 024	54 145 500
International Monetary Fund (IMF)			
Reserve Tranche	2.1	388 855	585 663
Holdings of Special Drawing Rights	2.2	931 310	839 790
General Subsidy Account	2.3	21 295	21 845
Total Foreign Assets		73 692 741	76 804 267
Domestic Assets			
Property and Equipment	3	407 820	395 771
Government of Botswana Bond	4	21 741	22 901
Other Assets	5	208 378	370 395
Total Domestic Assets		637 939	789 067
TOTAL ASSETS		74 330 680	77 593 334
LIABILITIES AND SHAREHOLDER'S FUNDS			
Foreign Liabilities			
Allocation of IMF Special Drawing Rights	6	804 336	825 107
Liabilities to Government (IMF Reserve Tranche)	7	-	86 615
Total Foreign Liabilities		804 336	911 722
Domestic Liabilities			
Notes and Coin in Circulation	8	3 136 545	2 858 135
Bank of Botswana Certificates	9	6 277 908	7 918 371
Reverse Repurchase Agreements	9.1	54 001	1 302 879
Deposits	10	5 730 000	6 307 357
Dividend to Government	11	1 042 198	2 205 952
Other Liabilities	12	197 191	352 439
Total Domestic Liabilities		16 437 843	20 945 133
Total Liabilities		17 242 179	21 856 855
Shareholder's Funds			
Paid-up Capital	14	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		30 778 873	29 109 428
Currency Revaluation Reserve		19 170 357	20 455 967
Market Revaluation Reserve		5 514 271	4 546 084
General Reserve	15	1 600 000	1 600 000
Total Shareholder's Funds		57 088 501	55 736 479
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		74 330 680	77 593 334
FOREIGN ASSETS IN US DOLLARS (000)[1]		7 501 921	7 188 879
FOREIGN ASSETS IN SDR[2] (000)		5 261 662	5 345 577

[1] United States dollar/Pula – 0.1018 (2016: 0.0936)
[2] SDR/Pula – 0.0714 (2016: 0.0696)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
For the year ended December 31, 2017

	Notes	2017 P'000	2016 P'000
INCOME			
Interest – Foreign exchange reserves	16	1 166 293	1 190 868
Dividends – Foreign exchange reserves	17	451 649	520 137
Interest – Government of Botswana bond		2 000	2 003
Net realised fair value gains on disposal of securities	18	1 037 027	2 505 803
Net realised currency gains	19	-	3 617 572
Net unrealised fair value gains	21	-	50 586
Profit on foreign exchange deals		29 347	37 830
Other income		12 588	11 978
		2 698 904	7 936 777
EXPENSES			
Interest expense	22	100 602	92 536
Administration costs		552 378	497 815
Depreciation expense	3	28 008	26 231
Net realised currency losses	19	12 009	-
Net unrealised currency losses	20	1 255 595	5 916 948
Net unrealised fair value losses	21	10 781	-
		1 959 373	6 533 530
NET INCOME		739 531	1 403 247
OTHER COMPREHENSIVE INCOME			
Items that may be reclassified subsequently to profit or loss			
Net unrealised currency losses on non-monetary "available-for-sale" financial instruments		(668 436)	(3 401 924)
Net unrealised fair value gains/(losses) on "available-for-sale" financial instruments		2 107 688	(1 514 801)
		1 439 252	(4 916 725)
TOTAL COMPREHENSIVE INCOME/(LOSS)		2 178 783	(3 513 478)

STATEMENT OF DITRIBUTION
For the year ended December 31, 2017

	Note	2017 P'000	2016 P'000
TOTAL COMPREHENSIVE INCOME/(LOSS)		2 178 783	(3 513 478)
Net unrealised currency losses on non-monetary "available-for-sale" financial instruments		668 436	3 401 924
Net unrealised fair value (gains)/losses on "available-for-sale" financial instruments		(2 107 688)	1 514 801
NET INCOME		739 531	1 403 247
TRANSFER FROM CURRENCY REVALUATION RESERVE	23	1 131 458	2 240 738
NET INCOME TO GOVERNMENT		1 870 989	3 643 985
TRANSFER TO GOVERNMENT INVESTMENT ACCOUNT		(297 791)	(802 033)
DIVIDEND		(708 000)	(848 000)
RESIDUAL NET INCOME	11	(865 198)	(1 993 952)

STATEMENT OF CASH FLOWS
For the year ended December 31, 2017

	Notes	2017 P'000	2016 P'000
OPERATING ACTIVITIES			
Cash (used in)/generated from operations	26	(1 562 462)	4 242 428
INVESTING ACTIVITIES			
Net withdrawals from foreign exchange reserves		3 313 094	578 992
Interest received from Government of Botswana bond		2 000	2 003
Proceeds from disposal of property and equipment		731	1 030
Purchase of property and equipment	3	(41 258)	(19 879)
NET CASH GENERATED FROM INVESTING ACTIVITIES		3 274 567	562 146
FINANCING ACTIVITIES			
Dividend to Government	11	(2 736 952)	(1 037 782)
Government investments/(withdrawals)		746 437	(3 917 092)
NET CASH USED IN FINANCING ACTIVITIES		(1 990 515)	(4 954 874)
NET INCREASE IN CURRENCY IN CIRCULATION		(278 410)	(150 300)
CURRENCY IN CIRCULATION AT BEGINNING OF THE YEAR		(2 858 135)	(2 707 835)
CURRENCY IN CIRCULATION AT YEAR END		(3 136 545)	(2 858 135)

STATEMENTS OF CHANGES IN SHAREHOLDER'S FUNDS
For the year ended December 31, 2017

	Paid-up Capital P'000	Currency Revolution Reserve P'000	Market Revolution Reserve P'000	General Reserve P'000	Government Investment Account P'000	Accumulated Profit P'000	Total P'000
BALANCE AT JANUARY 1, 2016	25 000	23 911 754	4 967 305	1 600 000	35 504 942	-	66 009 001
Total profit and other comprehensive income	-	(3 401 924)	(1 514 801)	-	-	1 403 247	(3 513 478)
Net unrealised currency losses on non-monetary "available for sale" financial instruments	-	(3 401 924)	-	-	-	-	(3 401 924)
Net unrealised fair value losses on "available for sale" financial instruments	-	-	(1 514 801)	-	-	-	(1 514 801)
Net income	-	-	-	-	--	1 403 247	1 403 247
Transfers (to)/from Government Investment Account:	-	2 186 875	1 093 580	-	(6 395 514)	(802 033)	(3 917 092)
Net unrealised fair value losses	-	-	1 093 580	-	(1 093 580)	-	-
Net unrealised currency losses	-	2 186 875	-	-	(2 186 875)	-	-
Excess of Government's share of net income from Pula Fund over dividend	-	-	-		802 033	(802 033)	-
Government withdrawals	-	-	-	-	(3 917 092)	-	(3 917 092)
Transfer to Currency Revaluation Reserve	-	(2 240 738)	-	-		2 240 738	-
Dividend to Government	-	-	-	-	-	(848 000)	(848 000)
Residual net income	-	-	-	-	-	(1 993 952)	(1 993 952)
BALANCE AT DECEMBER 31, 2016	25 000	20 455 967	4 546 084	1 600 000	29 109 428	-	55 736 479
Total profit and other comprehensive income	-	(668 436)	2 107 688	-	-	739 531	2 178 783
Net unrealised currency losses on non-monetary "available for sale" financial instruments	-	(668 436)	-	-	-	-	(668 436)
Net unrealised fair value gains on "available for sale" financial instruments	-	-	2 107 688	-	-	-	2 107 688
Net income	-	-	-	-	-	739 531	739 531
Transfers (to)/from Government Investment Account:	-	514 284	(1 139 501)	-	1 669 445	(297 791)	746 437
Net unrealised fair value gains	-	-	(1 139 501)	-	1 139 501	-	-
Net unrealised currency losses	-	514 284	-	-	(514 284)	-	-
Excess of Government's share of net income from Pula Fund over dividend	-	-	-	-	297 791	(297 791)	-
Government Investments	-	-	-	-	746 437	-	746 437
Transfer from Currency Revaluation Reserve	-	(1 131 458)	-	-	-	1 131 458	-
Dividend to Government	-	-	-	-	-	(708 000)	(708 000)
Residual net income	-	-	-	-	-	(865 198)	(865 198)
BALANCE AT DECEMBER 31, 2017	25 000	19 170 357	5 514 271	1 600 000	30 778 873	-	57 088 501

SIGNIFICANT ACCOUNTING POLICIES
For the year ended December 31, 2017

REPORTING ENTITY

The Bank of Botswana ("the Bank") is the central bank of Botswana established by the Bank of Botswana Act (CAP 55:01). The address of the Bank's registered office is 17938 Khama Crescent, Gaborone. These financial statements apply to the financial year ended December 31, 2017. The Government of Botswana is the Bank's sole shareholder.

BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

Statement of Compliance

The principal accounting policies applied in the preparation of the financial statements are stated below. These policies have been consistently applied to all the years presented and comply with International Financial Reporting Standards in all material respects.

The Financial Statements were authorised for issue by the Board on March 26, 2018.

Basis of Measurement

The financial statements are prepared on a historical cost basis, modified by fair value accounting for available-for-sale financial assets, all derivative contracts, financial assets and liabilities that are held at fair value.

Functional and Presentation Currency

The financial statements are presented in Pula, which is the Bank's functional currency. Except as otherwise indicated, financial information presented in Pula has been rounded to the nearest thousand.

ADOPTION OF REVISED STANDARDS AND INTERPRETATIONS

As at the date of finalisation of the financial statements, the following standards were relevant to the Bank's operations and available for adoption.

Standard	Effective for annual period beginning on or after
Disclosure Initiative (Amendments to IAS 7) The amendments provide for disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flow and non-cash changes. This includes providing a reconciliation between the opening and closing balances for liabilities arising from financing activities. The amendments did not have any impact on the Bank's financial statements due to the nature of the Bank's financing activites.	January 1, 2017

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

STANDARDS AND INTERPRETATIONS IN ISSUE NOT YET ADOPTED

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

Standard	Effective for annual period beginning on or after
IFRS 15 – Revenue from Contracts with Customers The standard, issued in May 2014, replaces IAS 18 Revenue and other revenue standards. It contains a single model that applies to contracts with customers and two approaches to recognising revenue at a point in time or over time. The model features a contract-based five step analysis of transactions to determine whether, how much and when revenue is recognised. The standard is not expected to have a significant impact on the Bank's financial statements due to the nature of revenue transactions.	January 1, 2018
IFRIC 22 - Foreign Currency Transactions and Advance Considerations When foreign currency consideration is paid or received in advance of the item it relates to, which may be an asset, an expense or income, IAS 21 - The Effects of Changes in Foreign Exchange Rates, is not clear on how to determine the transaction date for translating the related item. This has resulted in diversity in practice regarding the exchange rate used to translate the related item. IFRIC 22 clarifies that the transaction date is the date on which the company initially recognises the prepayment or deferred income arising from the advance consideration. For transactions involving multiple payments or receipts, each payment or receipt gives rise to a separate transaction date. The Bank is assessing the impact on the financial statements resulting from the application of IFRIC 22.	January 1, 2018
IFRS 16 - Leases (Replacement of IAS 17) IFRS 16 supersedes IAS 17 Leases, and it sets out principles for recognition, measurement, presentation and disclosure of leases. It provides a single lessee accounting model requiring lessees to recognise assets and liabilities for all leases unless the lease term is twelve months or less; or the underlying asset has a low value. Lessors will continue to classify leases as operating or finance leases. The Bank is assessing the impact on the financial statements resulting from the application of IFRS 16.	January 1, 2019

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

STANDARDS AND INTERPRETATIONS IN ISSUE NOT YET ADOPTED (Cont'd)

IFRS 9 - Financial Instruments (Replacement of IAS 39)
IFRS 9, published in July 2014, replaces IAS 39 Financial Instruments: Recognition and Measurement. IFRS 9 sets out the requirements for recognition and measurement of financial assets, financial liabilities, and some contracts to buy and sell non-financial assets. Financial assets and liabilities are to be classified and measured based on the entity's business model on which they are held, and the characteristics of their contractual cash flows. IFRS 9 includes revised guidelines on the classification and measurement of financial instruments, including a new expected credit loss model for calculating impairment on financial assets and the new hedge accounting requirements.

In October 2017, the IASB issued Prepayment Features with Negative Compensation (Amendments to IFRS 9). The amendments are effective for annual periods beginning on or after January 1, 2019, with early adoption permitted. Under the current IFRS 9 requirements, the Solely Payments of Principal and Interest (SPPI) condition is not met if the lender has to make a settlement payment in the event of termination by the borrower (also referred to as early repayment gain). The amendment clarifies how an entity would classify and measure a debt instrument if the borrower was permitted to prepay the instrument at an amount less than the unpaid principal and interest owed. Such a prepayment amount is often described as including 'negative compensation'. Under the amendments, the sign of the prepayment amount is not relevant. The calculation of this compensation payment must be the same for both the case of an early repayment penalty and the case of an early repayment gain. This amendment is not expected to have a significant impact on the Bank.

The Bank will apply IFRS 9 as issued in July 2014 effective January 1, 2018 and will early adopt the amendments to IFRS 9 (Prepayment Features with Negative Compensation) on the same date. Based on the assessments undertaken to date, the revised classification and measurement requirements on the adoption of IFRS 9 are expected to have a significant impact on financial statements of the Bank. However, the impairment requirements and the related amendments to IFRS 9 are not expected to have a significant impact.

The Bank has a taskforce with representation from all relevant functional areas. The taskforce is responsible for the robustness of models, data accuracy, and other process and system impacts as a result of IFRS 9. The parallel run of IFRS 9 and IAS 39 impairment models will commence in June 2018 which will include model, process and output validation, testing, calibration and analysis.

Classification – Financial Assets
The classification of financial assets by the Bank entails assessment of the objective of the business model in which a financial asset is held at a portfolio level as this best reflects the way the business is managed, which includes:

- the stated policies and objectives of the portfolio and the operation of those policies in practice, including whether management's strategy focuses on earning contractual revenue, maintaining a particular earnings profile, or realising cash flows through the sale of assets;
- how the portfolio is evaluated and reported to the Board;
- the risks that affect the performance of the business model (and the financial assets held within the business model) and how those risks are managed;
- how managers of the funds are compensated, e.g. whether compensation is based on the fair value of the assets managed or the contractual cash flows collected; and
- the frequency, volume and timing of sales in prior periods, the reasons for such sales and expectations about the future sales activity. However, information about sales activity is not considered in isolation, but as part of an overall assessment of how the Bank's stated objectives for managing the financial assets is achieved and how cash flows are realised.

The preliminary assessment of how the standard will affect the classification and measurement of assets held as at January 1, 2018 is as follows:

- trading assets and derivative assets held for risk management, which are classified as held-for trading and measured at Fair Value Through Profit or Loss (FVTPL) under IAS 39, will be measured at FVTPL under IFRS 9;
- loans and advances that are classified as loans and receivables and measured at amortised cost under IAS 39 will, in general, be measured at amortised cost under IFRS 9;
- held-to-maturity investment securities measured at amortised cost under IAS 39 will, in general, be measured at amortised cost under IFRS 9;
- fixed income instruments that are classified as available-for-sale under IAS 39 may, under IFRS 9, be measured at amortised cost, Fair Value Through Other Comprehensive Income (FVOCI) or FVTPL, depending on particular circumstances;

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

STANDARDS AND INTERPRETATIONS IN ISSUE NOT YET ADOPTED (Cont'd)

IFRS 9 - Financial Instruments (Replacement of IAS 39) (Cont'd)

- investment securities that are designated at FVTPL under IAS 39 will in general continue to be measured at FVTPL under IFRS 9;
- the equity investment securities that are classified as available-for-sale under IAS 39 will be measured at FVTPL under IFRS 9; and
- financial assets that are held for trading and those that are managed and whose performance is evaluated on a fair value basis will be measured at fair value through profit or loss because they are neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets.

The Bank is yet to finalise the estimation of the impact on equity of the changes in classification and measurement. The actual impact of adopting IFRS 9 on January 1, 2018 may change because the Bank is refining and finalising its models for expected credit loss calculations and the new accounting policies, assumptions, judgements and estimation techniques employed are subject to change until the Bank finalises its first financial statements from the date of initial application.

Impairment
IFRS 9 replaces the 'incurred loss' model in IAS 39 with a forward-looking 'expected credit loss' model. This will require considerable judgement over how changes in economic factors affect Expected Credit Loss (ECLs), which will be determined on a probability-weighted basis.

The new impairment model applies to financial assets that are debt instruments not measured at fair value through profit or loss. Under IFRS 9, no impairment loss is recognised on equity investments.

IFRS 9 requires a loss allowance to be recognised at an amount equal to either 12-month ECL or lifetime ECLs. Lifetime ECLs are the ECLs that result from all possible default events over the expected life of a financial instrument, whereas 12-month ECLs are the portion of ECLs that results from default events that are possible within 12 months after the reporting date. The Bank will recognise loss allowances at an amount equivalent to lifetime ECLs except in the following cases, for which the amount to be recognised will be 12-month ECLs:

- fixed income instruments that are determined to have low credit risk at the reporting date. The Bank considers a security to have low credit risk when its credit rating falls within the globally understood definition of 'investment-grade' and
- other financial instruments for which credit risk has not increased significantly since initial recognition.

Classification – Financial Liabilities
IFRS 9 largely retains the existing requirements in IAS 39 for the classification of financial liabilities. However, under IAS 39, all fair value changes of financial liabilities designated as at FVTPL are recognised in profit or loss, whereas under IFRS 9 these fair value changes will generally be presented as follows:

- the amount of the change in the fair value that is attributable to changes in credit risk of the liability will be presented in Other Comprehensive Income (OCI); and
- the remaining amount of the change in the fair value will be presented in profit or loss.

The Bank has designated fixed income instruments issued as at FVTPL when it holds related derivatives at FVTPL and designation eliminates or significantly reduces an accounting mismatch that would otherwise arise. In 2017, there were no changes in the fair value attributable to changes in the credit risk under IAS 39. On adoption of IFRS 9, any such change in fair value will be recognised in OCI, although the amount recognised in OCI each year will be variable. The cumulative amount recognised in OCI will be nil if the designated liabilities are repaid at maturity.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

FINANCIAL INSTRUMENTS

General
Financial instruments carried on the Statement of Financial Position include all assets and liabilities, including derivative instruments, but exclude property and equipment and other assets (prepayments, VAT receivables, sundry receivables and sundry receipts).

Fair Value Measurement
"Fair value" is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or the most advantageous market to which the Bank has access at that date. The fair value of a liability reflects its non-performance risk.

The Bank measures the fair value of a financial instrument using the quoted price in an active market for that particular instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

When quoted prices in an active market are not available, the Bank uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The chosen valuation technique incorporates all of the factors that market participants would take into account in pricing a transaction.

Financial Assets
Financial assets are initially measured at fair value plus, in the case of financial assets not measured at fair value through profit or loss, incremental direct transaction costs and subsequently accounted for depending on their classification as either loans and receivables, held to maturity, fair value through profit and loss or available-for-sale.

Loans and Receivables
Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. These arise when the Bank provides a service directly to a counterparty. Loans and receivables (as well as prepayments, advances to banks and staff advances) are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at amortised cost using the effective interest method less any identified impairment losses at the end of each reporting period.

Financial Assets at Fair Value through Profit or Loss
Financial assets are classified as fair value through profit or loss when the financial asset is held for trading. The Bank holds short-term investments as held for trading.

A financial asset is classified as held for trading if it is acquired principally for the purpose of selling it in the short-term or if so designated by management. Financial assets at fair value through profit or loss are stated at fair value, with any realised and unrealised gains and losses arising from changes in the fair value of financial assets recognised in profit or loss in the year in which they arise.

Short-term Investments (Liquidity Portfolio)
The Bank has designated the Liquidity Portfolio as a fund in which money market instruments and bonds are invested to facilitate payments for regular transactions. Securities invested in this portfolio are measured "at fair value through profit or loss" and are classified as held for trading. They are initially recognised at fair value and are subsequently remeasured at fair value based on bid prices. All related realised and unrealised gains and losses are recognised in profit or loss.

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

The realised and unrealised gains and losses recognised in profit or loss exclude interest and dividend income. Derivatives are classified as held for trading.

Available-For-Sale
Available-for-sale assets are non-derivative financial assets that are designated as available-for-sale or are not classified as another category of financial instruments. Available-for-sale instruments are intended to be held for long periods of time but may be sold in the normal course of business of the Bank.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

FINANCIAL INSTRUMENTS (Cont'd)

Long-term Investments (Pula Fund)
This is a long-term fund intended to generate returns and maintain the purchasing power of reserves, and is invested in foreign financial instruments. These investments, which may be sold in response to needs for liquidity, changes in interest rates, exchange rates, etc., are classified as "available-for-sale", except for derivatives. These securities are initially recognised at fair value (which includes transaction costs) and are subsequently remeasured at fair value, based on bid prices.

All realised currency gains/losses are recognised in profit or loss. Unrealised currency gains/losses on monetary items are also recognised in profit or loss. The unrealised currency gains/losses on non-monetary items are recognised in other comprehensive income. However, in line with the Bank policy, all currency gains/losses for this Fund are not distributable and are, therefore, appropriated to the Currency Revaluation Reserve.

Realised fair value changes are recognised in profit or loss. Unrealised fair value changes are recognised in other comprehensive income. Unrealised gains and losses arising from fair value changes of the instruments classified as "available-for-sale" are non-distributable as per the Bank's policy and are allocated to the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated fair value or impairment adjustments are included in profit or loss as gains or losses from investment securities.

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

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

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

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

Derivative Instruments
The Bank uses a variety of derivative instruments to manage its exposure to interest rate and foreign exchange risks. These include interest rate futures, foreign exchange forward contracts, cross-currency swaps and options.

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

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

Financial Liabilities
All the Bank's financial liabilities are classified as other financial liabilities at amortised cost. Financial liabilities are initially recognised at fair value and subsequently measured at amortised cost using the effective interest method.

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

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

FINANCIAL INSTRUMENTS (Cont'd)

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

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

Bank of Botswana Certificates
As one of the primary tools for maintaining monetary stability in the economy, the Bank of Botswana issues its own paper, Bank of Botswana Certificates (BoBCs), to absorb excess liquidity in the market and thereby influence short term interest rates. BoBCs are issued at a discount to counterparties. They are classified as "other financial liabilities".

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

CREDIT FACILITY

Under the Credit Facility, the Bank provides emergency and intermittent funding to solvent banks, intended to bridge intra-day and overnight liquidity shortages. The advances are secured by all Government of Botswana bonds of any maturity, International Finance Corporation Pula denominated note listed on the Botswana Stock Exchange, Bank of Botswana Certificates (BoBCs) and any other eligible Government guaranteed securities, valued at fair value prices on the date of the transaction. Only high quality, marketable and freely transferable paper with a minimum amount of risk is acceptable as collateral at the discretion of the Bank. A margin/haircut is applied to mitigate risk. The Bank has the right to call for additional collateral, should the value of the security decline during the tenure of the facility. Interest earned on the advances is credited to profit or loss, while advances outstanding as at the Statement of Financial Position date are recorded under "other assets".

SECURITIES LENDING PROGRAMME

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

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

The Bank records income from lending securities as it accrues.

REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

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

The term of a repurchase agreement and reverse repurchase agreement can vary from overnight to 91 days, depending on the liquidity conditions in the domestic market.

Interest earned by the Bank on repurchase agreements and interest paid by the Bank on reverse repurchase agreements is recognised in profit or loss.

OFFSETTING FINANCIAL INSTRUMENTS

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

(a) there is a legally enforceable right to set off; and
(b) there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

FINANCIAL INSTRUMENTS (Cont'd)

FOREIGN CURRENCIES

All transactions denominated in foreign currencies are translated to Pula at the mid exchange rate at the transaction date. All assets and liabilities denominated in foreign currencies are translated to Pula using mid rates of exchange at the close of the financial year. Foreign currency differences arising on translation are recognised in profit or loss, except for unrealised exchange differences arising on translation of non-monetary "available-for-sale" financial instruments, which are recognised in other comprehensive income. However, all gains and losses relating to disposals whose proceeds are reinvested in foreign assets, and all the unrealised gains/losses arising on financial instruments are not considered distributable in terms of Bank policy; they are appropriated to the Currency Revaluation Reserve.

NON-FINANCIAL ASSETS, LIABILITIES AND RECOGNITION OF PROVISIONS

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

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

Liabilities and Provisions
The Bank recognises liabilities (including provisions) when:

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

INCOME AND EXPENSE RECOGNITION

Interest income on all assets is calculated using the effective interest method and is recognised in profit or loss. The 'effective interest rate' is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or financial liability to the carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates future cash flows considering all contractual terms of the financial instrument, but not future credit losses. The calculation of the effective interest rate includes transaction costs that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the statement of profit or loss and other comprehensive income include:

(a) interest on financial assets and financial liabilities measured at amortised cost calculated on an effective interest basis; and
(b) interest on available-for-sale investment securities calculated on an effective interest rate basis.

Dividends on available-for-sale equity instruments are recognised in profit or loss when the right to receive payment is established. Usually, this is the ex-dividend date for quoted equities.

GENERAL RESERVE

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

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

CURRENCY REVALUATION RESERVE

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

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

MARKET REVALUATION RESERVE

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

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

GOVERNMENT INVESTMENT ACCOUNT

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

PROPERTY AND EQUIPMENT

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

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

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

Any impairment loss is recognised immediately in profit or loss.

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

If significant parts of an item of property or equipment have different useful lives, they are accounted for as separate items (major components) of property and equipment.

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

The annual depreciation rates used are as follows:

	Percent
Buildings	2.5 – 6
Other Assets	
Furniture, fixtures and equipment	5 – 25
Computer hardware	25
Computer software	20
Motor vehicles	5 - 25

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2017

PROPERTY AND EQUIPMENT (Cont'd)

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

Capital works in progress comprise costs directly attributable to the construction of an asset. Assets remain in capital works in progress until they have become available for use or commissioned, whichever is the earlier date. At that time, these assets are transferred to the appropriate class of property and equipment as additions and depreciated.

Subsequent expenditure is capitalised only when it is probable that the future economic benefits of the expenditure will flow to the Bank. Ongoing repairs and maintenance are expensed as incurred.

RETIREMENT BENEFITS

Pension benefits are provided for employees through the Bank of Botswana Defined Contribution Staff Pension Fund, in accordance with the Retirement Funds Act, 2014. The contribution per pensionable employee is at the rate of 21.5 percent of pensionable salary, which comprises 16 percent and 1.5 percent payable by the Bank as its contribution to the Fund and for administration costs of the Fund, respectively, and a 4 percent contribution by each pensionable employee. Other than the contributions made, the Bank has no commitments or obligations to this Fund. Obligations for contributions to the pension fund are recognised in profit or loss in the periods during which services are rendered by employees.

SHORT-TERM EMPLOYEE BENEFITS

Short-term employee benefits obligations are measured on an undiscounted basis and are expensed as the related service is provided.

FINANCE LEASES

Assets held by the Bank under leases that transfer to the Bank substantially all of the risks and rewards of ownership are classified as finance leases. The leased asset is initially measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Assets held under other leases are classified as operating leases and are not recognised in the Bank's statement of financial position.

RELATED PARTY TRANSACTIONS

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

SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

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

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS
For the year ended December 31, 2017

	2017 P'000	2016 P'000
1. FOREIGN EXCHANGE RESERVES		
1.1 Liquidity Portfolio		
Bonds: held for trading	8 965 032	8 520 683
Amounts due from Pula Fund	807 985	931 761
Short-term deposits	6 580 240	11 759 025
	16 353 257	21 211 469
1.2 Pula Fund		
Equities: available-for-sale	22 574 949	20 576 760
Bonds: available-for-sale	32 496 355	32 424 379
Derivative instruments: assets (Note 13)	(8 457)	-
Amounts due to Liquidity Portfolio	(807 985)	(931 761)
Derivative instruments: liabilities (Note 13)	19 332	-
Short-term deposits	1 723 830	2 076 122
	55 998 024	54 145 500
(a) **Statement of Financial Position**		
Capital Employed		
Government	30 278 873	28 692 442
Bank of Botswana	25 719 151	25 453 058
	55 998 024	54 145 500
Employment of Capital		
Investments	55 998 024	54 145 500
Investments expressed in US dollars ('000)[3]	5 700 599	5 068 019
Investments expressed in SDR ('000)[4]	3 998 259	3 768 527
(b) **Statement of Profit or Loss and Other Comprehensive Income**		
Income		
Interest and dividends	1 149 914	1 255 091
Realised currency revaluation gains	378 575	2 877 949
Unrealised currency revaluation losses	(1 049 444)	(3 856 189)
Realised fair value gains	1 164 395	2 616 808
Sundry income	13 640	174
	1 657 080	2 893 833
Expenses		
Administration charges	(160 074)	(157 957)
	(160 074)	(157 957)
Net income	1 497 006	2 735 876
Other Comprehensive Income/(Loss)		
Items that may be reclassified subsequently to profit or loss		
Net unrealised currency losses on non-monetary "available-for-sale" financial instruments	(668 436)	(3 401 924)
Net unrealised fair value gains/(losses) on "available-for-sale" financial instruments	2 108 848	(1 513 966)
Other comprehensive income/(loss)	1 440 412	(4 915 890)
Total comprehensive income/(loss)	2 937 418	(2 180 014)

[3] United States dollar/Pula – 0.1018 (2016: 0.0936)
[4] SDR/Pula – 0.0714 (2016: 0.0696)

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

	2017	2016
	P'000	**P'000**

2. **INTERNATIONAL MONETARY FUND (IMF)**

2.1 **Reserve Tranche**

This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is the membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holding of Pula by the IMF, which initially was equal to 75 percent of the quota, has changed from time to time as a result of the use of the Pula by the IMF in lending to member countries.

	2017 P'000	2016 P'000
Quota SDR 197 200 000; (2016: SDR 197 200 000)	2 761 905	2 833 333
Less: IMF Holdings of Pula	(2 373 050)	(2 247 670)
Reserve Position in IMF	388 855	585 663

The IMF Holdings of Pula are represented by the Non-Interest Bearing Note of P1 477 900 684 (2016: P1 477 900 684) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in the current account held at the Bank (included in other deposits in Note 10).

2.2 **Holdings of Special Drawing Rights**

	2017 P'000	2016 P'000
The balance on the account represents the value of Special Drawing Rights (SDR) allocated and purchased less utilisation to date.	931 310	839 790

2.3 **General Subsidy Account**

	2017 P'000	2016 P'000
Face value (SDR 1 520 000)	21 289	21 839
Interest	6	6
	21 295	21 845

This is an investment with the International Monetary Fund, the purpose of which is to augment the resources of the Poverty Reduction and Growth Trust Fund. The term of investment agreement of August 22, 2017 has been extended to August 30, 2022.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

3. **PROPERTY AND EQUIPMENT**	**Freehold Land**	**Leasehold Land**	**Buildings**	**Capital Works in Progress**	**Other Assets**	**Total**
	P'000	**P'000**	**P'000**	**P'000**	**P'000**	**P'000**
Cost - December 31, 2017						
Balance at the beginning of the year	2 065	4 932	403 391	194	207 149	617 731
Additions	-	-	-	24 912	16 346	41 258
Disposals	-	-	(40)	-	(8 330)	(8 370)
Transfers from WIP	-	-	803	(1 705)	902	-
Balance at year-end	2 065	4 932	404 154	23 401	216 067	650 619
Accumulated Depreciation						
Balance at the beginning of the year	-	-	96 464	-	125 496	221 960
Charge for the year	-	-	10 828	-	17 180	28 008
Disposals	-	-	(13)	-	(7 156)	(7 169)
Balance at year-end	-	-	107 279	-	135 520	242 799
Net book value at December 31, 2017	2 065	4 932	296 875	23 401	80 547	407 820
Cost - December 31, 2016						
Balance at the beginning of the year	2 065	3 083	400 428	11 062	192 924	609 562
Additions	-	-	-	9 310	10 569	19 879
Disposals	-	-	-	-	(11 710)	(11 710)
Transfers from WIP	-	1 849	2 963	(20 178)	15 366	-
Balance at year-end	2 065	4 932	403 391	194	207 149	617 731
Accumulated Depreciation						
Balance at the beginning of the year	-	-	85 818	-	119 974	205 792
Charge for the year	-	-	10 646	-	15 585	26 231
Disposals	-	-	-	-	(10 063)	(10 063)
Balance at year-end	-	-	96 464	-	125 496	221 960
Net book value at December 31, 2016	2 065	4 932	306 927	194	81 653	395 771

Valuation of Properties
Freehold and leasehold land and buildings were valued by an independent professional property valuer in December 2016 at an open market value of P852 005 000 (2014: P770 940 000).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

	2017 P'000	2016 P'000
4. GOVERNMENT OF BOTSWANA BOND		
Government Bond BW005, maturing on September 12, 2018, bearing interest at the rate of 10 percent, receivable semi-annually in arrears:		
Fair value	21 128	22 288
Interest accrued	613	613
	21 741	22 901
5. OTHER ASSETS		
Staff loans and advances	66 125	59 334
Prepayments	3 472	3 363
Donor funds – Government projects	126 711	303 095
Other	12 070	4 603
	208 378	370 395
6. ALLOCATION OF IMF SPECIAL DRAWING RIGHTS		
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.	804 336	825 107
7. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)		
This balance represents the Bank's liability to the Government in respect of the Reserve Tranche position in the IMF (Note 2.1).	-	86 615
8. NOTES AND COIN IN CIRCULATION		
Notes	2 981 032	2 709 457
Coin	155 513	148 678
	3 136 545	2 858 135

Notes and coin in circulation held by the Bank as cash in hand at the end of the financial year have been netted off against the liability for notes and coin in circulation to reflect the net liability to the public.

	2017 P'000	2016 P'000
9. BANK OF BOTSWANA CERTIFICATES		
Face value	6 281 000	7 919 900
Unmatured discount	(3 092)	(1 529)
Carrying amount	6 277 908	7 918 371

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

	2017 P'000	2016 P'000
9.1 REVERSE REPURCHASE AGREEMENTS		
Fair value	54 001	1 302 879

The reverse repurchase agreements matured on January 3, 2018 (2016: January 4, 2017).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

	2017 P'000	2016 P'000
10. DEPOSITS		
Government	1 084 943	1 084 419
Bankers - current accounts	253 291	1 064 061
- statutory reserve accounts	2 693 180	2 556 716
Other	1 698 586	1 602 161
	5 730 000	6 307 357

These deposits are various current accounts of Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free, except for the statutory reserve requirement, which is also interest free, but not repayable on demand.

	2017 P'000	2016 P'000
11. DIVIDEND TO GOVERNMENT		
Balance due at the beginning of the year	2 205 952	401 782
Dividend to Government from Pula Fund	708 000	848 000
Paid during the year	(2 736 952)	(1 037 782)
Residual net income	865 198	1 993 952
Balance due at the end of the year	1 042 198	2 205 952

The final instalment of the pre-set dividend of P177 000 000 and the residual net income of P865 198 000 unpaid as at December 31, 2017 has been provided for in accordance with Section 6 of the Bank of Botswana Act (CAP 55:01); which requires that all profits of the Bank be distributed to the shareholder, the Government.

	2017 P'000	2016 P'000
12. OTHER LIABILITIES		
Accounts payable	10 055	8 844
Donor funds – Government projects	126 711	303 095
Other payables and accruals	60 425	40 500
	197 191	352 439

13. CATEGORIES OF FINANCIAL INSTRUMENTS

13.1 Financial Assets

	2017 P'000	2016 P'000
Held for trading		
Bonds	8 965 032	8 520 683
Derivative instruments (Note 1.2)	(8 457)	-
	8 956 575	8 520 683
Available-for-sale		
Bonds	32 496 355	32 424 379
Equities	22 574 949	20 576 760
Government bonds	21 741	22 901
	55 093 045	53 024 040
Loans and Receivables		
IMF Reserves	1 341 460	1 447 298
Staff loans and advances	66 125	59 334
Short-term deposits	8 304 070	13 835 147
Total Financial Assets	73 761 275	76 886 502

The above is disclosed in the Statement of Financial Position as follows:

	2017 P'000	2016 P'000
Total Foreign Assets	73 692 741	76 804 267
Add: Derivative instruments (liabilities) (Note 1.2)	(19 332)	-
Government of Botswana bonds	21 741	22 901
Other Assets - staff loans and advances (Note 5)	66 125	59 334
	73 761 275	76 886 502

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

	2017 P'000	2016 P'000
13. CATEGORIES OF FINANCIAL INSTRUMENTS (Cont'd)		
13.2 Financial Liabilities		
Held for trading		
Derivative instruments (Note 1.2)	(19 332)	-
Other Financial Liabilities - at amortised cost		
Bank of Botswana Certificates	6 277 908	7 918 371
Reverse Repurchase Agreements	54 001	1 302 879
Allocation of SDR (IMF)	804 336	825 107
Liabilities to Government (IMF)	-	86 615
Deposits	5 730 000	6 307 357
Dividend to Government	1 042 198	2 205 952
Other liabilities	197 191	352 439
	14 086 302	18 998 720

13.3 Derivative Instruments

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

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

		Asset 2017 (P'000)	Liabilities 2017 (P'000)	Notional Amount 2017 (P'000)	Assets 2016 (P'000)	Liabilities 2016 (P'000)	Notional Amount 2016 (P'000)
Fixed Income Futures	-Buy	(9 158)	-	190 291	-	-	-
	-Sell	-	20 306	(363 027)	-	-	-
Other Options	-Buy	(10)	-	20	-	-	-
	-Sell	-	4	(14)	-	-	-
Swaps	-Buy	711	-	643	-	-	-
	-Sell	-	(978)	(1 872)	-	-	-
		(8 457)	19 332	(173 959)	-	-	-

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

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

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

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

	2017 P'000	2016 P'000
14. PAID-UP CAPITAL		
Authorised and Paid-up Capital	25 000	25 000

The capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act (CAP 55:01). The Bank is not subject to any externally imposed capital requirements. Therefore, capital is not actively managed. Management considers the Paid-up Capital and the General Reserve to be capital.

	2017 P'000	2016 P'000
15. GENERAL RESERVE		
In the opinion of the Board, the General Reserve, taken together with other reserves which the Bank maintains, is sufficient to ensure the sustainability of future operations of the Bank.	1 600 000	1 600 000
16. INTEREST – FOREIGN EXCHANGE RESERVES		
Liquidity Portfolio		
Short-term deposits: loans and receivables	294 801	258 978
Bonds: held for trading	157 050	196 215
IMF Reserves: loans and receivables	2 537	548
Pula Fund		
Short-term deposits: loans and receivables	34 301	20 402
Bonds: available-for-sale	677 604	714 725
	1 166 293	1 190 868
17. DIVIDENDS – FOREIGN EXCHANGE RESERVES		
Pula Fund		
Equities: available-for-sale	451 649	520 137
18. NET REALISED FAIR VALUE GAINS ON DISPOSAL OF SECURITIES		
Liquidity Portfolio		
Bond: held for trading	(127 367)	(111 006)
Pula Fund		
Derivative instrument: held for trading	2 724	-
Bonds: available-for-sale	(38 537)	370 634
Equities: available-for-sale	1 200 207	2 246 175
	1 037 027	2 505 803

Included above are net fair value gains of P1 161 670 000 (2016: P2 616 809 000), which have been reclassified from equity to profit or loss on disposal of investments classified as available-for-sale.

	2017 P'000	2016 P'000
19. NET REALISED CURRENCY (LOSSES)/GAINS		
Liquidity Portfolio		
Short-term deposits: loans and receivables	(453 208)	(235 670)
Bonds: held for trading	62 624	975 293
Pula Fund		
Derivative instruments: held for trading	(2 472)	-
Short-term deposits: loans and receivables	(19 040)	(29 106)
Bonds: available-for-sale	264 292	1 116 741
Equities: available-for-sale	135 795	1 790 314
	(12 009)	3 617 572

Included above are net currency gains of P400 087 000 (2016: P2 907 055 000) which have been reclassified from equity to profit or loss on disposal of investments classified as available-for-sale.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

	2017 P'000	2016 P'000
20. NET UNREALISED CURRENCY LOSSES		
Liquidity Portfolio		
Short-term deposits: loans and receivables	60 282	(269 305)
Bonds: held for trading	(265 445)	(1 796 189)
IMF reserves: loans and receivables	(988)	4 734
Pula Fund		
Short-term deposits: loans and receivables	(37 949)	(25 398)
Bonds: available-for-sale	(1 021 822)	(3 830 790)
Derivative instruments: held for trading	10 327	-
	(1 255 595)	(5 916 948)
21. NET UNREALISED FAIR VALUE (LOSSES)/GAINS		
Liquidity Portfolio		
Bonds: held for trading	(11 329)	50 586
Pula Fund		
Derivative instruments: held for trading	548	-
	(10 781)	50 586
22. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	87 995	75 057
Reverse Repurchase Agreements	12 607	17 479
	100 602	92 536
23. NET CURRENCY REVALUATION LOSSES RETAINED IN PROFIT OR LOSS		
Total net realised (losses)/gains (Note 19)	(12 009)	3 617 572
Total net unrealised losses (Note 20)	(1 255 595)	(5 916 948)
Total net currency revaluation losses	(1 267 604)	(2 299 376)
Appropriated to Currency Revaluation Reserve:		
Net realised currency gains reinvested in foreign assets	(124 137)	(3 676 210)
Net unrealised currency losses (Note 20)	1 255 595	5 916 948
Transfer from Currency Revaluation Reserve	1 131 458	2 240 738
Net currency revaluation losses retained in profit or loss	(136 146)	(58 638)

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

The Bank's contribution to the Bank of Botswana Defined Contribution Staff Pension Fund for the year ended December 31, 2017 is P29 501 000 (2016: P27 388 000).

25. STATEMENT OF CASH FLOWS

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

	2017 P'000	2016 P'000
26. CASH GENERATED FROM OPERATIONS		
Net income for the year adjusted for:	739 531	1 403 247
Net realised and unrealised exchange losses	1 131 458	2 240 738
Depreciation expense	28 008	26 231
Loss on disposal of Property and Equipment	469	612
Interest: Government of Botswana bond	(2 000)	(2 003)
	1 897 466	3 668 825
Adjustments for movements in:		
Deposits: banks and other	(577 882)	1 043 807
Deposits: Government	525	196 178
Bank of Botswana Certificates	(1 640 462)	(271 551)
Reverse Repurchase Agreements	(1 248 878)	(369 970)
Other assets	162 017	(247 791)
Other liabilities	(155 248)	222 930
Cash (used in)/generated from operations	(1 562 462)	4 242 428
27. CAPITAL COMMITMENTS		
Approved and contracted for	142 814	4 937
Approved, but not contracted for	13 820	58 235
	156 634	63 172

These capital commitments will be funded from internal resources.

28. COLLATERAL

(a) Credit Facility
There were no open positions as at December 31, 2017 (2016: Nil) under the Credit Facility accounted for as "Advances to banks".

(b) Securities Lending Programme
Under the Bank's Securities Lending Programme, the Bank has lent securities with a fair value of P9.7 billion (2016: P9.3 billion). The Bank has accepted securities with a fair value of P10.2 billion (2016: P9.7billion) as collateral for the securities lent under this programme.

29. GOVERNMENT OF BOTSWANA BONDS AND TREASURY BILLS

In accordance with Sections 56 and 57 of the Bank of Botswana Act (CAP 55:01), the Bank acts as agent of the Government for the issuance and management of the Government Bonds and Treasury Bills. An analysis of the bonds and treasury bills issued during the financial year ended December 31, 2017 is provided below:

Government of Botswana Bonds and Treasury Bills issued during the year 2017

Bond/ Treasury Bill	Date of Issue	Date of Maturity	Interest Rate Percent (per annum)	Nominal Value (P' 000)	Discount /Premium (P' 000)	Net Proceeds (P' 000)	Interest Paid (P' 000)	Interest Accrued (P' 000)
BW005	Mar 8, June 7, Sept 6, 2017	Sept 12, 2018	10	200 000	20 089	220 089	7 500	6 133
BW007	Mar 8, June 7, Sept/Dec 6, 2017	Mar 10, 2025	8	268 000	62 590	330 590	2 720	6 693
BW008	Mar 8, June 7, Sept/Dec 6, 2017	Sept 8, 2020	7.75	483 000	57 026	540 026	12 904	11 892
BW011	Sept 6, 2017	Sept 10, 2031	7.75	150 000	37 945	187 945	-	3 629
BW012	Mar 8, June 7, Sept/Dec 6, 2017	June 13, 2040	6	442 000	39 214	481 214	13 260	1 384
BW013	Dec 6, 2017	June 6, 2023	4.5	250 000	7 364	257 364	-	799
BW060917	Mar 8, 2017	Sept 6, 2017	-	770 000	(5 713)	764 287	5 713	-
BW061217	June 7, 2017	Dec 6, 2017	-	500 000	(3 590)	496 410	3 590	-
BW070318	Sept 6, 2017	Mar 7, 2018	-	500 000	(3 500)	496 500	-	2 250
BW060618	Dec 6, 2017	June 6, 2018	-	370 000	(2 590)	367 410	-	370
TOTAL				**3 933 000**	**208 835**	**4 141 835**	**45 687**	**33 150**

(a) Net proceeds realised from the issue of the bonds of P4 141 835 000 (2016: P4 165 823 000) were invested in the Government Investment Account. The nominal value of holdings of total outstanding Government bonds and treasury bills as at December 31, 2017, was P10 203 000 000 (2016: P9 258 000 000). The nominal value of redemptions during the year to December 31,2017 was P2 988 000 000 million (2016: P1 840 000 000).

(b) Interest is payable on all interest earning bonds on a semi-annual basis in arrears. During the year to December 31, 2017, total interest payments of P692 312 150 were made (2016: P573 119 400) and were funded from the Government's current account maintained with the Bank.

(c) Government bonds and treasury bills are liabilities of Government; and are, therefore, not accounted for in the Statement of Financial Position of the Bank.

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

30. **RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Cont'd)**

Risk Management Governance Structure
The Bank's risk management governance structure is broadly as follows:

(a) Board

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

(b) Investment Committee

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

(c) Financial Markets Department

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

(d) External Fund Managers and Custody

External fund managers are engaged to complement the Bank's reserve management activity. The Bank uses the services of a custodian which provides custodial services for the Bank's assets.

(e) Segregation of Duties

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

Tranching of Foreign Exchange Reserves – Liquidity Portfolio and Pula Fund
The Bank of Botswana Act (CAP 55:01) requires the Bank to maintain a primary international reserve, that is, the Liquidity Portfolio, while Section 34 provides for the establishment and maintenance of a long-term investment fund, the Pula Fund. In compliance with the statutory requirements, a major feature of the foreign exchange reserves management strategy is, therefore, to allocate a certain level of reserves to the Liquidity Portfolio, with the remaining amount invested in the Pula Fund.

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

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

There are no equities in the Liquidity Portfolio. Investment instruments include government bonds, government guaranteed bonds supranational bonds of eligible investment grade currencies and eligible money market instruments.

Types of Risk Exposure
The Bank's investment guidelines cover basic types of risk exposures, namely, market risk (currency risk, interest rate risk and equity price risk), credit risk and liquidity risk. These types of risk apply to the foreign assets and liabilities.

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Cont'd)

(a) Currency Risk

The foreign exchange reserves are invested in currencies that are freely convertible, less susceptible to frequent and sharp exchange rate fluctuations and are used in well developed financial markets. The Bank's policy is to invest only in currencies with high ratings assigned by Moody's Investors Service and Standard and Poor's. Through a diversified currency allocation relative to an SDR weighted benchmark, the Bank ensures that the purchasing power of the foreign exchange reserves is preserved. In terms of the investment guidelines, a maximum deviation from the neutral level (using the SDR weights as a benchmark) for USD and EUR of 10 percentage points is permitted, while a deviation of up to 5 percentage points on all other currencies is permitted. At the end of 2017, the Bank's total exposure to SDR and related currencies was P70.3 billion (2016: P72.1 billion). The Bank is also exposed to SDR currency risk on net IMF balances amounting to P537 123 000 (2016: P535 575 000).

(b) Interest Rate Risk

Interest rate risk is the possible loss in the value of a fixed income asset resulting from an unexpected and adverse movement in interest rates and a consequent change in price. Interest rate risk is measured by modified duration, which measures the sensitivity of the price of a bond to changes in interest rates expressed in years. The Bank benchmarks the interest rate risk for the Pula Fund (fixed income assets) to reflect the long-term nature of the portfolio, with emphasis on higher return. The higher interest rate risk is generally compensated by higher returns expected from longer maturity bonds. The modified duration benchmark will vary over time, as changing market conditions and index weights impact the global modified duration of the index. At the end of 2017, the average modified duration of the fixed income portion of the Pula Fund was 7.5 years (2016: 7.6 years). As the Liquidity Portfolio gives priority to liquidity over return, given the constant need to provide foreign exchange to finance international transaction payments, from the Bank's perspective, this portfolio is exposed to minimum interest rate risk. At the end of 2017, the Liquidity Portfolio's average modified duration was 1.9 years (2016: 2.3 years).

(c) Equity Price Risk

Equity price risk is the risk that the value of equities decrease as a result of changes in the level of equity indices and diminution of value of individual stocks. The geographic allocation of equity exposure follows generally the market capitalisation among the major markets. The investment guidelines stipulate the holding levels of equities. Holdings of more than 5 percent in one company are not permitted. A reasonable spread among the industry sectors is maintained in the portfolio. There are no investments in private placements or unquoted stocks. At the end of 2017, the equity portion of the Pula Fund was P22.6 billion (2016: P20.6 billion).

Market Risk Sensitivity Analysis

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

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

30. **RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Cont'd)**

December 31, 2017

Risk Variable		Adverse market change		Beneficial market change	
		Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income[5] (P'000)	Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income[3] (P '000)
Interest Rate Risk		Increase in yields by 50 basis points	(1 326 500)	Decrease in yields by 50 basis points	1 326 500
Currency Risk	SDR currencies	Strengthening of the Pula by 1 percent	(716 311)	Weakening of the Pula by 1 percent	716 311
	South African rand	Strengthening of the Pula by 1 percent	(20 617)	Weakening of the Pula by 1 Percent	20 617
Equity Risk	Global Equities	Decline in global equity prices by 5 percent	(1 128 747)	Increase in global equity prices by 5 percent	1 128 747

December 31, 2016

Risk Variable		Adverse market change		Beneficial market change	
		Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income (P'000)	Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income[3] (P '000)
Interest Rate Risk		Increase in yields by 50 basis points	(1 354 941)	Decrease in yields by 50 basis points	1 354 941
Currency Risk	SDR currencies	Strengthening of the Pula by 1 percent	(735 712)	Weakening of the Pula by 1 percent	735 712
	South African rand	Strengthening of the Pula by 1 percent	(32 331)	Weakening of the Pula by 1 Percent	32 331
Equity Risk	Global Equities	Decline in global equity prices by 5 percent	(1 028 838)	Increase in global equity prices by 5 percent	1 028 838

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

(d) Credit risk

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

Consistent with the investment policies and guidelines, the Bank disinvests whenever the rating of an instrument falls below investment grade. In cases where the new lower rating necessitates a lower exposure, holdings are reduced to ensure that the new limit is not exceeded.

[5] The effects are expected to have the same impact on shareholder's funds.

30. **RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Cont'd)**

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

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

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

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

	Notes	2017 P'000	2016 P'000
Financial Assets			
Liquidity Portfolio			
Bonds: held for trading	1.1	8 965 032	8 520 683
Short-term deposits: loans and receivables		7 388 225	12 690 786
Pula Fund			
Bonds: available-for-sale	1.2	32 496 355	32 424 379
Derivative instruments: held for trading		(8 457)	-
Short-term deposits: loans and receivables		915 845	1 144 361
International Monetary Fund- loans and receivables			
Reserve tranche	2.1	388 855	585 663
Holdings of Special Drawing Rights	2.2	931 310	839 790
General Subsidy Account	2.3	21 295	21 845
Government of Botswana bond: available-for-sale	4	21 741	22 901
Other Assets- staff loans and advances: loans and receivables	5	66 125	59 334
Total		51 186 326	56 309 742
Analysis of Credit Exposure by class:			
Measured at fair value			
Bonds		41 461 387	40 945 062
Derivatives		(8 457)	-
Government of Botswana bond		21 741	22 901
Measured at amortised cost			
IMF Reserves		1 341 460	1 447 298
Staff advances		66 125	59 334
Short-term deposits: loans and receivables		8 304 070	13 835 147
Total		51 186 326	56 309 742

While some financial instruments are recorded at fair value, the amounts shown above represent the current credit risk exposure, but not the maximum risk exposure that could arise in future as a result of changes in values. The Tables below reflect the credit exposure based on the fair value of the assets with counterparties as at December 31, 2017.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

30. **RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Cont'd)**

Credit Exposure on Bonds

Moodys/S&P Rating	Government (P'000)	Corporate (P'000)	2017 Total (P'000)	2016 Total (P'000)
AAA	26 214 981	82 106	26 297 087	26 891 937
AA+	1 218 053	34 265	1 252 318	3 780 181
AA	7 560 798	139 041	7 699 839	5 106 000
A+	3 116 372	89 796	3 206 168	3 540 810
A	348 172	15 079	363 251	-
Other[6]	2 400 463	242 261	2 642 724	1 626 134
	40 858 839	602 548	41 461 387	40 945 062

Credit Exposure to Banks (Short-term deposits)

Fitch Rating	2017 (P'000)	2016 (P'000)
AAA[7]	3 032 728	4 455 047
AA[7]	317 492	52 744
A[7]	200 642	45 962
a+5	6 020	636 691
a1	276 232	581 460
a5	299 530	494 797
aa2	-	157 074
aa-1	196 598	605 866
aa-2	442 399	2 083 912
aa-5	1 255 460	1 332 500
a-5	435 481	983 511
a-1	98 320	-
BB+	1 582 259	-
BBB-[7]	-	1 740 863
Bbb5/bbb+5	160 909	664 720
	8 304 070	13 835 147

Credit Exposure on Securities Lending Programme

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

(e) Instrument Risk

Sovereign Bonds

In accordance with the investment policies and guidelines, the Bank invests in eligible instruments that are direct obligations or obligations explicitly guaranteed by governments or local governments of 13 selected sovereign countries that are highly rated by Standard and Poor's and Moody's Investors Service. Exposure limits are assigned to the specific sovereign countries in accordance with the ratings assigned by the credit rating agencies.

Corporate Bonds

The Bank invests in a small proportion of corporate bonds rated A1 or higher, with the issuer being incorporated and tax resident in a country whose sovereign debt is eligible for investment by the Bank. A reasonable geographical spread of issuers is maintained.

[6] Other includes investments rated below A -, but still remain within the acceptable investment grade s as per the investment guidelines.

[7] Included in AAA , AA+, AA, A and BB+ are deposits held with central banks .

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Cont'd)

(f) Liquidity risk

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

Financial Liabilities at Undiscounted Cash Flows

The table below summarises the maturity profile of the Bank's financial liabilities as at December 31, 2017, based on contractual undiscounted repayment obligations.

December 31, 2017	Less than 3 months (P'000)	3-12 months (P'000)	1-5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	6 281 000	-	-	-	6 281 000
Reverse Repurchase Agreements	54 001	-	-	-	54 001
Deposits	5 730 000	-	-	-	5 730 000
Allocation of SDR - IMF	-	-	-	804 336	804 336
Dividend to Government	1 042 198	-	-	-	1 042 198
Other Liabilities	197 191	-	-	-	197 191
	13 304 390	-	-	804 336	14 108 726

December 31, 2016	Less than 3 months (P'000)	3-12 months (P'000)	1-5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	7 919 900	-	-	-	7 919 900
Reverse Repurchase Agreements	1 302 879	-	-	-	1 302 879
Deposits	6 307 357	-	-	-	6 307 357
Allocation of SDR - IMF	-	-	-	825 107	825 107
Liabilities to Government - IMF	-	-	-	86 615	86 615
Dividend to Government	2 205 952	-	-	-	2 205 952
Other Liabilities	352 439	-	-	-	352 439
	18 088 527			911 722	19 000 249

(g) Operational Risk

Operational risk is the risk of financial or reputational loss arising from systems failure, human error, fraud or external events. To mitigate this risk, the Bank has in place, a policy and operational risk framework approved by the Board. The risk management and planning function within the Finance Department focuses primarily on coordinating management of operational risks and it ensures that there is a bank-wide system of identifying, assessing, evaluating and monitoring operational risks including business continuity management. Management and the Board maintain an oversight role for the management of operational risks through the Risk Management Committee and Audit Committee of the Board, respectively.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

31. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value of financial instruments carried at amortised cost
The Board considers that the carrying amounts of financial assets and liabilities recognised in the financial statements at amortised cost approximate their fair values.

For financial instruments that trade infrequently and have little price transparency, fair value is less objective and requires varying degrees of judgement depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risk affecting the specific instrument.

Valuation models and techniques
The fair values of financial assets and financial liabilities with standard terms and conditions and traded on active liquid markets are determined with reference to quoted market prices (includes listed redeemable notes, bills of exchange, debentures and perpetual notes).

The fair values of other financial assets and financial liabilities (excluding derivative instruments) are determined in accordance with generally accepted pricing models and valuation techniques. The fair values are based on net present value, discounted cash flow models and comparison with prices from observable current market transactions and dealer quotes for similar instruments.

The objective of valuation techniques is to arrive at a fair value measurement that reflects the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date.

The Bank uses widely recognised valuation models for determining the fair value of financial instruments, such as interest rates yields, that use only observable market data and require little management judgement and estimation.

The fair value of Government bonds is derived from market quotations. These are prices dealers will be willing to pay for similar instruments.

The Bank uses discounted cash flow analysis to value Bank of Botswana Certificates (BoBCs). The valuation is based on observable market prices, with the yield curve providing the discount factors needed.

The fair values of derivative instruments are calculated using quoted prices. Where such prices are not available, a discounted cash flow analysis is performed using the applicable yield curve for the duration of the instruments for non-optional derivatives, and option pricing models for optional derivatives.

Foreign currency forward contracts are measured using quoted forward exchange rates and yield curves derived from quoted interest rates matching maturities of the contracts. Interest rate swaps are measured at the present value of future cash flows estimated and discounted based on the applicable yield curves derived from quoted interest rates.

Fair values are categorised into different levels in a fair value hierarchy, which reflects the significance of the inputs used in making the measurements.

Level 1 fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices). This category includes instruments valued using: quoted market prices in active markets for similar instruments; quoted prices for identical or similar instruments in markets that are considered less active; or other valuation techniques in which all significant inputs are directly or indirectly observable from market data.

Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

If the inputs used to measure the fair value of an asset or a liability are categorised in different levels of the fair value hierarchy, then the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

31. FAIR VALUE OF FINANCIAL INSTRUMENTS (Cont'd)

Fair Value Measurements recognised in the Statement of Financial Position

The following Table provides an analysis of financial instruments that are measured at fair value, including their levels in the fair value hierarchy.

December 31, 2017	Note	Level 1 P'000	Level 2 P'000	Total P'000
Financial Assets				
Held for trading				
Bonds		8 965 032	-	8 965 032
Derivatives Instruments		-	(8 457)	(8 457)
Available-for-sale				
Bonds		32 496 355	-	32 496 355
Equities		22 574 949	-	22 574 949
Government Bond		-	21 741	21 741
Loans and Receivables		-	9 711 655	9 711 655
		64 036 336	9 724 939	73 761 275
Financial Liabilities				
Held for trading				
Derivatives Instruments		-	(19 332)	(19 332)
Other financial liabilities				
Bank of Botswana Certificates		-	6 277 908	6 277 908
Other liabilities		-	7 827 726	7 827 726
		-	14 086 302	14 086 302

December 31, 2016	Note	Level 1 P'000	Level 2 P'000	Total P'000
Financial Assets				
Held for trading				
Bonds		8 520 683	-	8 520 683
Available-for-sale				
Bonds		32 424 379	-	32 424 379
Equities		20 576 760	-	20 576 760
Government Bond		-	22 901	22 901
Loans and Receivables		-	15 341 779	15 341 779
		61 521 822	15 364 680	76 886 502
Financial Liabilities				
Derivative instruments		-	-	-
Other financial liabilities				
Bank of Botswana Certificates		-	7 918 371	7 918 371
Other liabilities		-	11 080 349	11 080 349
		-	18 998 720	18 998 720

There were no transfers between levels during the year.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

32. RELATED PARTY BALANCES AND TRANSACTIONS

Balances and Transactions with the Government
The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2017, were:

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

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

(c) being the Government agent for government bonds and treasury bills.

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

No charge is made to the Government for provision of these services.

The Bank earned interest on its holding of the Government of Botswana bonds (as described in Note 4) of P2 000 000 (2016: P2 003 000).

Other Related Party Balances and Transactions
(a) Amounts due to related parties.

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

	2017 P'000	2016 P'000
Botswana Savings Bank	51 676	1 557
Botswana Unified Revenue Service	97 851	112 575
Total	149 527	114 132

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

(b) Remuneration of Key Management Personnel

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

Gross emoluments of the key management personnel are:

	2017 P'000	2016 P'000
Non-Executive Board members	135	94
Executive Management		
Salaries, allowances and other short term benefits	13 390	13 057
Post-employment benefits	3 099	5 366
	16 624	18 517

Of the Staff Loans and Advances per Note 5, P1 647 000 (2016 : P1 548 000) are attributable to Executive Management.

33. CONTINGENCIES

The Bank is defending an action instituted by one of the depositors of Kingdom Bank Africa Limited that is now under liquidation. Although liability is not admitted, if the defence against the action is unsuccessful, the claim against the Bank, and legal costs could amount to the equivalent of approximately P30 million.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2017

34. **EVENTS AFTER THE REPORTING DATE**

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

Part B

The Botswana Economy in 2017

Theme Chapter:

Financial Sector Development, Inclusive and Sustainable Economic Growth

Bank of Botswana

CHAPTER 1
THE BOTSWANA ECONOMY IN 2017

1. OUTPUT, EMPLOYMENT AND PRICES

(a) National Income Accounts

Overview

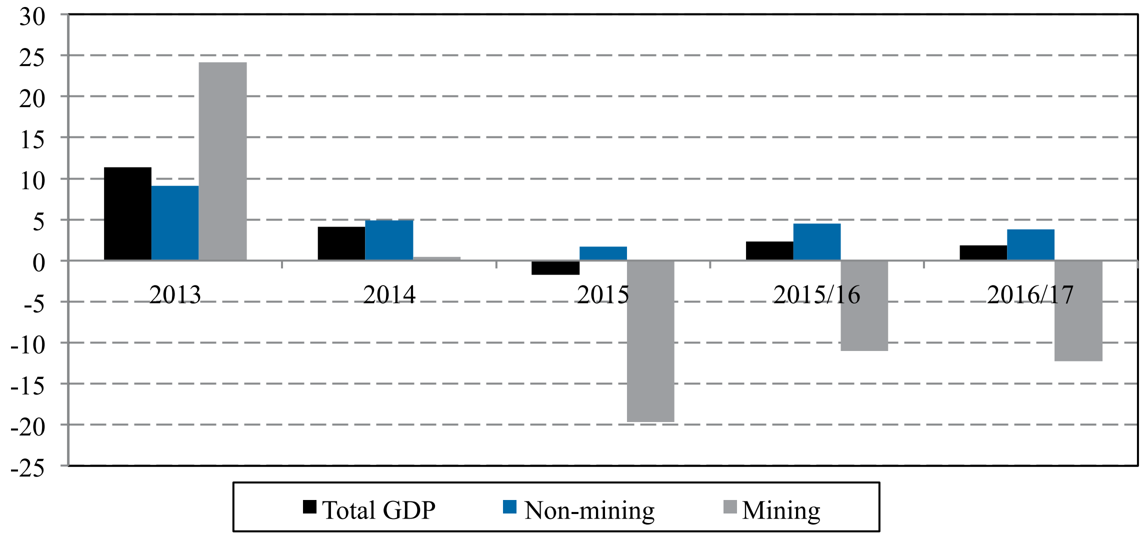
1.1 Real GDP grew by an estimated 1.8 percent in the twelve months to September 2017[7] (Chart 1.1), compared to a faster growth of 2.3 percent in the corresponding period ending in September 2016. The lower increase in output is, in the main, attributed to a contraction in mining output, while growth in non-mining GDP slowed from 4.5 percent to 3.8 percent over the review period. Mining output contracted by 12.3 percent in the year to September 2017 compared to a reduction of 11 percent in the corresponding period ending in September 2016. The decline in the mining GDP mainly stems from the closure of the BCL and Tati Nickel mines in October 2016. The relatively weaker performance of the non-mining GDP was mainly due to a deceleration in output growth for *trade, hotels and restaurants* sector, as a result of lower quality of diamonds sold by De Beers Global Sightholder Sales (DBGSS). Nonetheless, relative to other sectors, the mining sector remains the largest in the economy, with a share of 20.5 percent of GDP[8] in current prices.

Sectoral Performance

1.2 Output for all economic sectors, except *mining,* increased in the twelve-months to September 2017 (Chart 1.2), hence, contributing positively to real GDP growth (Chart 1.3) although, in most cases slightly weaker than in 2015/16.

1.3 The overall contraction in the mining sector was mainly due to the closure of the BCL and Tati Nickel mines in October 2016, which brought copper-nickel production in the country to an end.[9] *Soda ash* and *other mining* also declined by 11.8 percent and 0.3 percent, respectively, in the review period. The notable contraction in *soda*

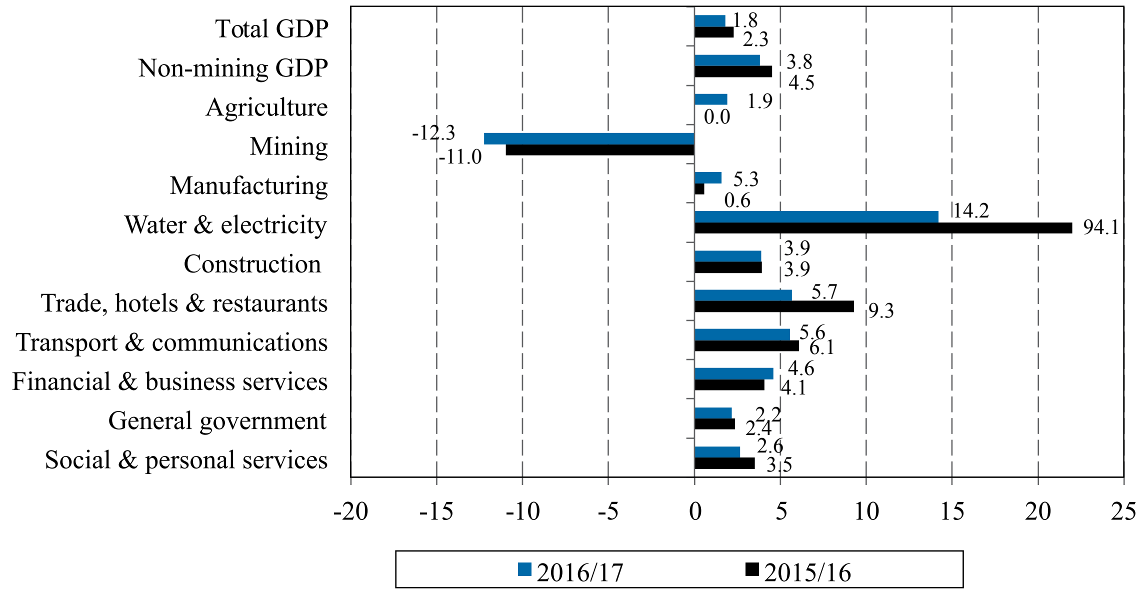
CHART 1.1: REAL GDP GROWTH 2013 - 2016/17 (PERCENT)



1. Data for 2016/17 are for the 12-month period to September 2017.
Source: Statistics Botswana

[7] Estimates for the final quarter of 2017 had not yet been published.
[8] See Statistics 2017, Part C, Table 1.3, in this Report, for the rest of sectoral shares of GDP in current prices.
[9] This was until the Mowana mine, under new ownership, assumed full production in April 2017, following liquidation in 2015.

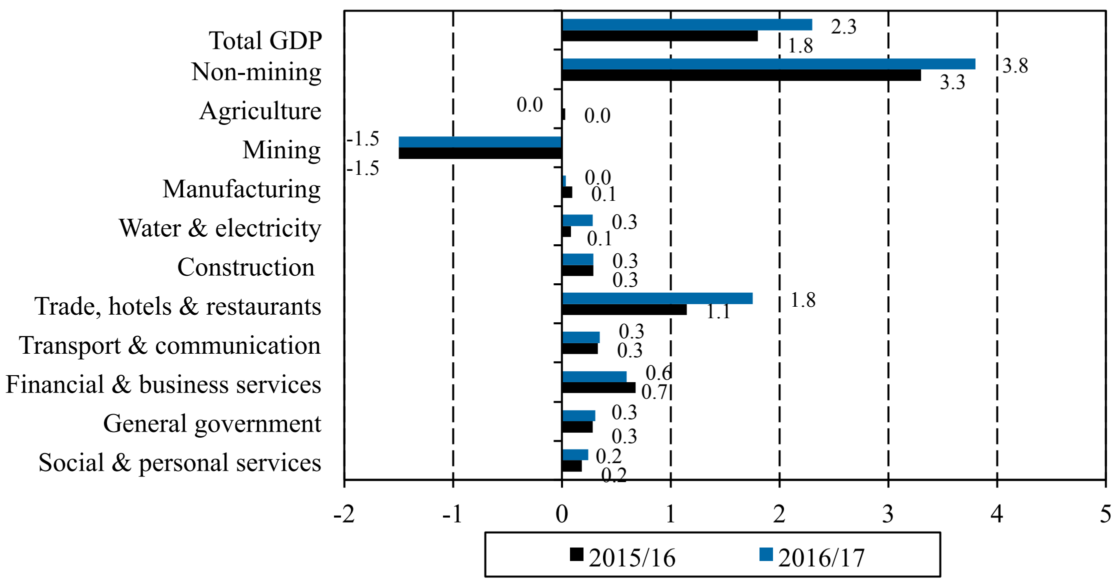
CHART 1.2: REAL GDP GROWTH BY SECTOR (PERCENT)



1. Data are for the 12-months period ending September 2016 and September 2017.

Source: Statistics Botswana

CHART 1.3: CONTRIBUTION TO REAL GDP GROWTH BY SECTOR (PERCENT)[1]



1. Percentage contribution to growth is measured by multiplying the current sector growth by the sector's share of GDP in the previous year.
2. Data for the two periods are for the 12-month period ending September 2016 and 2017.

Source: Statistics Botswana

ash resulted from plant refurbishment during the second quarter of 2017. In contrast, diamond production increased by 13.4 percent in the twelve months to September 2017, compared to a contraction of 8.6 percent in the period ending September 2016. The better performance in the year to September 2017 was due to an increase of 14.2 percent in rough diamonds produced by Debswana, compared to a contraction of 8.3 percent in the corresponding period ending September 2016. However, output from Karowe Mine contracted.[10] Overall, positive growth in diamond output was due to a higher level of Debswana's output, which more than offset the output contraction at other mines. Meanwhile, coal production grew by 18.3 percent in the year to September 2017 compared to a decline of 5.2 percent in the corresponding period ending in September 2016. This growth was attributable to an increase in coal demand for use in domestic electricity generation by the Morupule B power plant.

1.4 Output growth of the *water and electricity* sector slowed from a substantial increase of 94.1 percent in the twelve-month period to September 2016 to 14.2 percent in the year to September 2017. Growth in water and electricity output was mainly attributable to a 14.9 percent rise in the *water* sub-sector on account of the heavy rains experienced at the beginning of 2017.[11] The *electricity* sub-sector grew by 21.2 percent in 2017, due to fewer disruptions in the domestic power generation, leading to relatively stable electricity supply and a reduction in imported electricity.

1.5 Output of *trade, hotels and restaurants* grew by 5.7 percent in the year ending September 2017, down from the 9.3 percent growth in the corresponding period ending September 2016. The lower growth was attributable to a significant decline in output of the *wholesale* sub-sector due to the lower trade margins of the DBGSS resulting from lower quality of diamonds sold in the third quarter of 2017.

1.6 Growth in *transport and communications* sector was 5.6 percent in the twelve-month period to September 2017, lower than the 6.1 percent growth in the corresponding prior year. All sub-sectors registered positive growth in the review period, with the exception of the *Central Transport Organisation (CTO)* and the *railway* sub-sectors. CTO output contracted mainly because of a large cut in internal travel and transport charges, whereas the decrease in the *railway* sub-sector was due to a temporary halt in services of both passenger and goods trains following the damage to the railway line caused by the tropical storm, named Dineo, at the beginning of 2017.

1.7 The *finance and business services* sector expanded by 4.6 percent in the twelve months to September 2017 compared to 4.1 percent in the year ending September 2016. All the sub-sectors grew, led by *business services* (7.6 percent), *real estate* (6.4 percent), *banks* (5.4 percent), *insurance* (3.7 percent), *business prospecting* (3.2 percent) and *owner-occupied dwellings* (1.8 percent).

1.8 Growth in *construction* was 3.9 percent in the twelve-month period ending September 2017, the same as in the corresponding period of the previous year. This growth was partly due to ongoing government construction projects, such as the Boatle-Gaborone dual carriage road, Kazungula and Mohembo bridge construction, major village water infrastructure development, Morupule A power station rehabilitation, Masama West Well Fields, the fibre optic telecommunications network and Economic Stimulus Programme projects, such as the expansion of classrooms in various schools country-wide. Private construction projects, particularly in the Gaborone Central Business District, shopping malls and petrol stations across the country, also contributed to the sectoral expansion.

1.9 *Agriculture* output increased by 1.9 percent in the twelve-months to September 2017, following

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[10] Output at Karowe Mine declined mainly due to failure of the mining contractor to increase its expected operation levels, resulting in lower-than-planned high-value ore volumes. Meanwhile, the company sold the historic 1 109 carat Lesedi La Rona diamond in September 2017 to Graff Diamonds for USD53 million, below the reserve price of USD70 million that had been in place at the Sotheby's auction in 2016, when the diamond failed to sell. Other non-Debswana mines were non-operational; Ghaghoo mine remains under care and maintenance, while Lerala mine ceased production in May 2017 and went into final liquidation in September 2017 (2018 Committee of Supply Speech by the Minister of Mineral Resources, Green Technology and Energy Security).

[11] The *water* sub-sector has a higher weight (70 percent) than *electricity* in the *water and electricity* sector in the twelve-month period to September 2017.

stagnation in the year to September 2016. All sub-sectors in *agriculture* expanded, led by *other agriculture (horticulture)* at 2.7 percent, followed by *crop* and *livestock* production at 2.5 percent each. The improved performance is attributable to satisfactory harvest and livestock production, following good rainfall experienced across the country in the first quarter of 2017. Manufacturing output rose by 1.6 percent in the twelve months to September 2017, due to a growth of 3.4 percent in other manufacturing, owing to increased activity by diamond cutting and polishing companies.

(b) Economic Growth Prospects

1.10 It is estimated that real GDP increased by 4.7 percent in 2017 and is projected to grow by 5.3 percent in 2018, driven largely by the recovery in mining activity. Furthermore, accommodative monetary conditions in the domestic economy, budgeted expansion in government expenditure in the 2018/19 fiscal year, as well as stability in the supply of key inputs, such as water and electricity, are expected to support growth of the non-mining sectors. Global output growth is projected at 3.9 percent in 2018, higher than 3.7 percent in 2017. The positive global outlook is mainly supported by accommodative monetary policy and fiscal expansion in advanced economies. For emerging markets and developing economies, the forecast expansion in output reflects the impact of anticipated rebound in prices of some commodity exports and improved growth in some key export markets. In addition, it is expected that maintenance of fiscal support will be positive for output growth in large economies such as China and India. In South Africa, the growth outlook is improving on account of anticipated higher agricultural output and improvement in investor sentiment and business confidence following the recent political developments in the country.

1.11 Domestically, government revenue continues to be heavily dominated by mineral and customs and excise receipts, which are susceptible to exchange rate and international market fluctuations. In addition, business confidence remains modest, thus a likelihood of constrained investment and contribution of the private sector to economic growth. However, prospective recovery of commodity prices and improved global demand should support performance of the domestic economy.

Table 1.1: Global Growth Estimates and Forecasts 2016 - 2018 (Percent)

	2016	2017	2018 (Projections)
Global	3.2	3.7	3.9
Advanced economies, of which,	1.7	2.3	2.3
USA	1.5	2.3	2.7
Euro area	1.8	2.4	2.2
Japan	0.9	1.8	1.2
Emerging markets, of which,	4.4	4.7	4.9
Sub-Saharan Africa	1.4	2.7	3.3
China	6.7	6.8	6.6
India	7.1	6.7	7.4
South Africa	0.3	0.9	0.9
Botswana[12]	4.3	4.7	5.3

Source: International Monetary Fund, World Economic Outlook, January 2018 update and Ministry of Finance and Economic Development

(c) Employment

1.12 Formal sector employment decreased by 0.8 percent from 344 487 persons in September 2016 to 341 874 persons in September 2017.[13] Employment in the private sector declined by 1.8 percent mainly due to loss of jobs in mining and quarrying (-35.2 percent) and construction (-2.7 percent). The notable job losses in the mining and quarrying industry are mainly attributable to the cessation of operations by BCL and Tati Nickel Mining Company in October 2016, which left close to 5000 employees jobless. However, employment in parastatals, central and local government increased by 1.9 percent, 0.4 percent and 1.2 percent, respectively, over the review period. As shown in Chart 1.4, the broad distribution of employment between the public and private sectors has maintained a relatively stable trend for the past five years, with the private sector accounting for about 60 percent of the formal sector work force.

1.13 The most recent domestic unemployment data, from the 2015/16 Botswana Multi-Topic Household Survey, estimate the national

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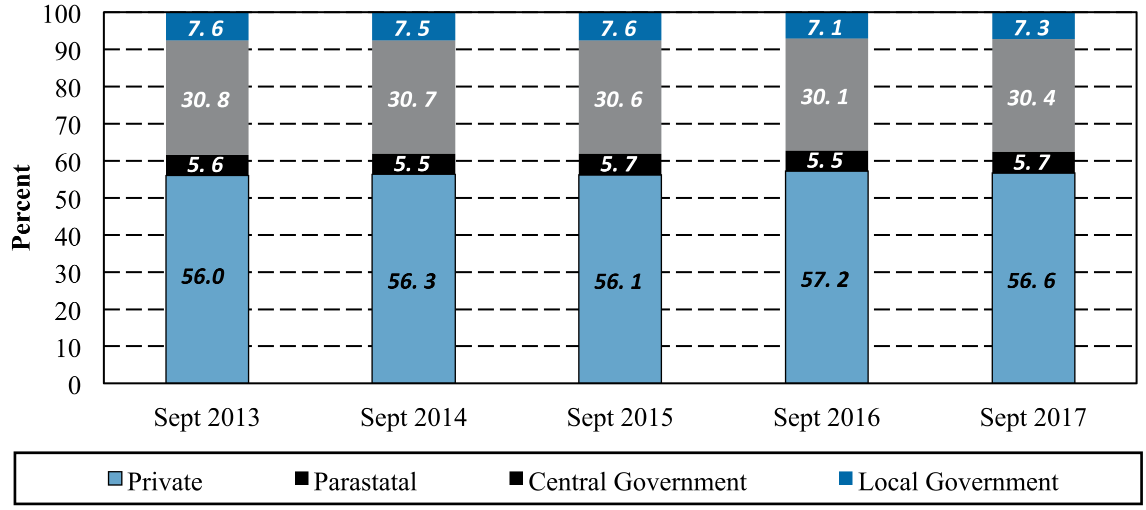
12 Projections for Botswana are sourced from the 2018/19 Budget Strategy Paper.

13 The formal sector employment figures exclude workers engaged in the labour intensive public works programme, Ipelegeng, which is a part of the poverty reduction strategy, as well as employment in the Botswana Defence Force (BDF).

CHART 1.4: SECTOR COMPOSITION OF FORMAL SECTOR EMPLOYMENT (EXCLUDING IPELEGENG)



Source: Statistics Botswana

unemployment rate at 17.7 percent of the labour force.[14] Unemployment rate was higher for women than men (19.1 percent compared to 16.3 percent).

(d) Inflation

1.14 Global inflation was subdued in 2017, mainly due to restrained global demand, slow wage growth and the impact of globalisation and enhanced international trade. However, the increase in commodity prices (especially crude oil prices) contributed to the modest increase in inflation. International oil prices generally increased in 2017. For example, the Brent crude price increased by 20.6 percent between December 2016 and December 2017.[15] The recovery in oil prices was mainly sustained by adherence by some of the large producers to agreed production cuts, while geopolitical tensions also posed risks to supply. Meanwhile, international food prices decreased by 0.3 percent in 2017 compared to an increase of 11 percent in 2016, driven by a decrease in prices of vegetable oils and sugar. Generally, international oil and food prices exerted marginal upward pressure on domestic inflation in 2017.

1.15 With respect to Botswana's trading partner countries, trade-weighted average inflation[16] decreased from 4.2 percent in December 2016 to 3.1 percent in December 2017. For the SDR countries (USA, UK, Japan, Eurozone and China) however, inflation increased slightly from 1.7 percent to 1.8 percent in the same period. Meanwhile, headline inflation in South Africa decreased from 6.8 percent in December 2016 to 4.7 percent in December 2017, and to within the country's target range of 3 – 6 percent since April 2017 (Chart 1.5).

1.16 In Botswana, inflation increased from 3 percent in December 2016 to 3.2 percent in December 2017 and was within the Bank's 3 – 6 percent medium-term objective range (Chart 1.6). The rate of increase in prices was modest for most categories of goods and services. In particular, domestic fuel prices increased by 9.5 percent in December 2017, reflecting the upward adjustment of fuel prices in November and December, compared to the 3.3 percent decrease in December 2016. However, food price inflation decreased from 3.9 percent in

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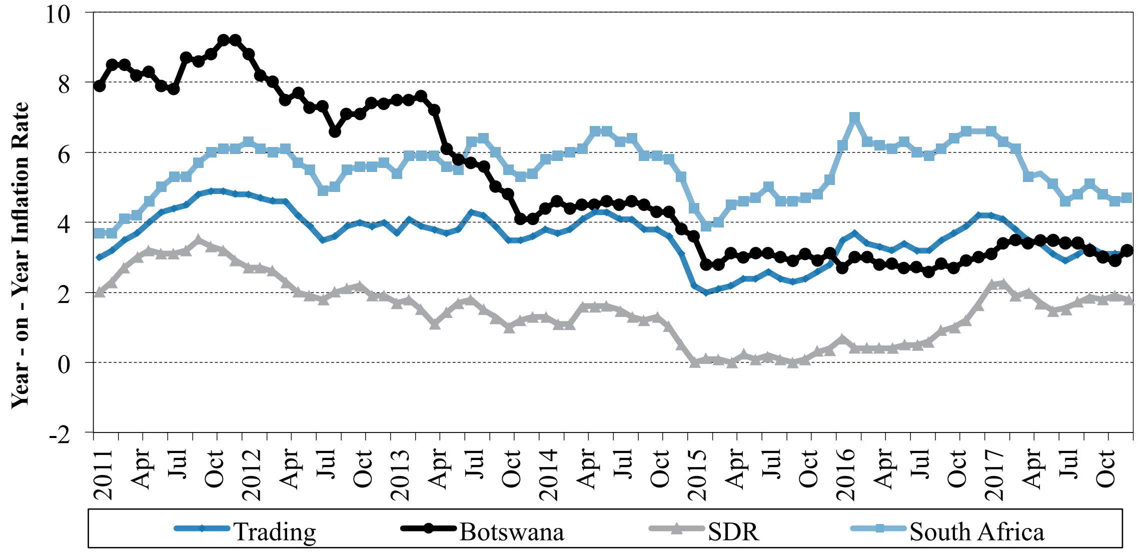
14 This is based on the standard international definitions where the labour force includes all persons aged 15 and above who are working or actively looking for work. It neither takes account of the extent of underemployment within the working age population nor does it include the so-called "discouraged workers", i.e., those who are available for work, but not actively looking for employment

15 Oil prices reached USD70 in January 2018.

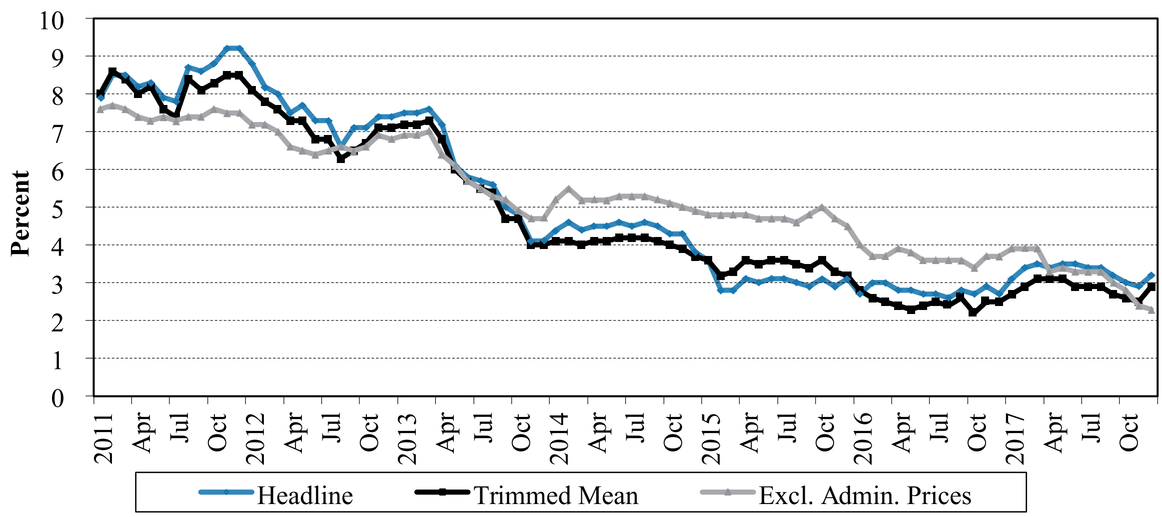
16 Being weighted average inflation of the countries whose currencies comprise the IMF's Special Drawing Rights (SDR) and South African inflation.

CHART 1.5: BOTSWANA AND TRADING PARTNER COUNTRIES' INFLATION (2011 - 2017)



Source: Statistics Botswana, Bank of Botswana and Bloomberg

CHART 1.4: BOTSWANA HEADLINE AND CORE INFLATION (2011 - 2017)



Source: Statistics Botswana

December 2016 to 1.1 percent in December 2017. Regarding core inflation measures, the 16 percent trimmed mean inflation increased from 2.5 percent in December 2016 to 2.9 percent in December 2017, while inflation excluding administered prices decreased from 3.7 percent to 2.3 percent in the same period.

(e) Inflation Outlook

1.17 The global inflation outlook for 2018 remains favourable, although there are indications of emerging upside pressures, mainly from higher oil prices. Global inflation is forecast to increase from 3.1 percent in 2017 to 3.3 percent in 2018. In this environment, it is anticipated that monetary policy will remain accommodative in most economies, complemented by measures aimed at facilitating financial intermediation and fostering the resilience of the financial sector to support economic activity. It is expected that inflation will maintain an upward trend in advanced economies during 2018 as international oil prices increase further and due to inflationary policy bias in the euro area and Japan. For emerging market economies, inflation is expected to increase on account of the rebound in commodity prices and from the continued fiscal support to boost economic activity. For Botswana, given the outlook of restrained growth in personal incomes and the forecast modest impact of higher administered prices, it is projected that inflation will remain within the 3 - 6 percent objective range in the short-to-medium-term. Any substantial upward adjustment in administered prices and government levies and/or taxes, as well as any increase in international food and oil prices beyond current forecasts, present upside risks to the domestic inflation outlook. However, there are downside risks associated with modest global economic activity, technological progress and a possible fall in commodity prices.

2. PUBLIC FINANCE AND THE 2018/19 BUDGET

2.1 The government budget for 2018/19 marks the second year of implementation of National Development Plan (NDP) 11, Vision 2036 (the country's new long-term vision) and the transition to the Sustainable Development Goals (SDGs). The budget was presented against the backdrop of positive global economic prospects. The recovery in the global economy is expected to increase demand for the country's main export, diamonds, as well as improve performance in the non-mining sectors. Despite the positive outlook, a budget deficit is projected for 2018/19 financial year. The projected deficit results from slower growth in revenue and the budgeted increase in spending by various ministries. In seeking to optimise the allocation of resources in line with national priorities, the 2018 Budget Speech focused on three strategic intervention areas of: promoting growth and economic diversification; investing in human capital for building an inclusive society; and maintaining a sustainable fiscal policy. The priorities are consistent and aligned to NDP 11 and the objectives of the SDGs and Vision 2036.

(a) Budget Performance: 2016/17 and 2017/18[17]

2016/17 Budget Outturn

2.2 The budget outturn for the 2016/17 financial year was a surplus of P1.1 billion, compared to the revised estimate of a deficit of P1.1 billion, and a much higher projected deficit of P6 billion in the original budget. The surplus (0.6 percent of GDP) was mainly due to higher revenue and grants, resulting from mineral revenues and the almost P2 billion dividend/residual income from Bank of Botswana compared to the revised budget estimates. The payment from Bank of Botswana reflects net realised fair value gains on disposal of securities which resulted from portfolio rebalancing.[18] Meanwhile, mineral revenue exceeded the revised estimate for the 2016/17 financial year, driven by improved rough diamond demand and prices, hence, an improvement in sales. As a result, total revenue increased by P10 billion (21 percent) to P57.4 billion in 2016/17, compared to the previous year.

2.3 Total expenditure and net lending increased from P54.4 billion in 2015/16 to P56.3 billion in 2016/17, but was slightly below the revised budget estimate of P57 billion, due to underspending of the development budget and reduction in net lending. Of the total spending, recurrent expenditure amounted to P41.2 billion compared to P39.7 billion in the revised budget estimates, representing an increase of 3.8 percent, largely due to overspending in personal emoluments (the bulk of recurrent expenditure), following the 3 percent public sector salaries increment and the creation of new ministries in the 2016/17 financial year. Overspending in grants and subventions also contributed to the increase in recurrent spending. On the other hand, development spending underperformed by 6.9 percent to reach P15.2 billion at the end of the financial year compared to the revised budget estimates figure of P16.3 billion. The underspending in development budget compared to the revised budget estimates is due to project implementation challenges, such as late commencement of projects, procurement inefficiencies and delays in processing payments.

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17 Calculation of percentages are based on figures from tables in this section, and may differ from those calculated from rounded off figures in the text.

18 The Bank conducted a portfolio rebalancing operation (i.e., realigning its foreign exchange reserves portfolios with the stipulated policy weights and exposures) given overall market movements and persistent capital outflows.

Table 1.2: Government Budget 2016/17 – 2018/19 (P Million)

	2016/17			2017/18		2018/19
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	**48 398**	**55 926**	**57 398**	**57 187**	**57 187**	**64 277**
Mineral Revenue	17 033	20 854	22 496	16 334	16 334	24 592
Non-Mineral Revenue	31 365	35 072	34 903	40 853	40 853	39 685
Expenditure	**54 445**	**57 031**	**56 275**	**59 544**	**59 606**	**67 867**
Recurrent Expenditure	39 699	39 663	41 166	43 071	43 091	48 637
Personal Emoluments	18 107	18 107	19 224	21 450	21 451	21 168
Grants & Subventions	10 986	11 100	11 324	12 496	12 496	14 864
Public Debt Interest	736	736	878	903	903	969
Other Charges	9 871	9 720	9 740	8 222	8 242	11 634
Development Expenditure	14 821	16 277	15 161	16 520	16 562	19 306
Net Lending	-76	1 091	-52	-47	-47	-76
Balance	**-6 046**	**-1 106**	**1 124**	**-2 357**	**-2 419**	**-3 589**

Source: Ministry of Finance and Economic Development

2017/18 Revised Budget Estimates

2.4 The revised estimates of the budget for 2017/18 show a deficit of P2.4 billion, which is almost equal to the projected deficit in the original budget. The revised deficit results from a slower growth in revenue alongside additional spending requirements by various ministries.

2.5 Revenue estimates for both revised and original budgets have remained unchanged at P57.2 billion. Meanwhile, the estimate for expenditure and net lending was revised slightly upward, from P59.5 billion to P59.6 billion or 32 percent of GDP (two percentage points above the fiscal rule of 30 percent of GDP). This was mainly due to supplementary funding under the recurrent and development budgets.

(b) The 2018/19 Budget Proposals

2.6 The proposed budget allocation for 2018/19 is mainly informed by the need to promote economic growth, enhance economic diversification efforts and create employment opportunities.

Revenue

2.7 Revenue for 2018/19, including grants, is projected to be P64.3 billion, which is 12.4 percent higher than the revised budget for 2017/18 (Table 1.3). This mainly reflects a projected 50.6 percent increase in mineral revenue from P16.3 billion in 2017/18 to P24.6 billion in 2018/19. This is based on expected positive performance of diamonds exports, underpinned by recovery in the global economy. Minerals remain the largest source of revenue, representing 38.3 percent of the total. Non-mineral income tax revenue is projected to increase by 8.2 percent to P13.4 billion, thus accounting for 20.8 percent of the budgeted revenue. Estimates suggest that VAT collections will remain the same in 2018/19, accounting for 12.6 percent of expected total revenue. In contrast, SACU receipts are forecast to fall from P17.1 billion in 2017/18 to P14.8 billion in 2018/19, due to weaker expected imports and household consumption in the region.

Expenditure

2.8 Total expenditure and net lending for 2018/19 is budgeted at P67.9 billion (33.4 percent of expected GDP), an increase of 13.9 percent from the P59.6 billion in the revised estimates for 2017/18 (Table 1.3). Recurrent expenditure is projected to grow by 12.9 percent, from revised budget of P43.1 billion in 2017/18 to P48.6 billion in 2018/19, accounting for 71.7 percent of total spending and slightly exceeding the expenditure allocation rule of 70 percent and 30 percent between recurrent and development spending. The development spending budget (28.4 percent of total spending) is projected

TABLE 1.3: GOVERNMENT BUDGET 2013/14 – 2018/19

Fiscal Year (FY)	2013/14	2014/15	2015/16	2016/17	2017/18*	2018/19*
GDP, current prices						
(P Million)	131 221	147 920	149 112	174 836	185 931	203 175
Growth rate (percent)	16.9	12.7	0.8	17.3	5.2	7.2
Budget					**Revised Budget**	**Budget**
Revenue & Grants	48 951	55 904	47 420	57 398	57 187	64 277
Recurrent Expenditure	33 220	37 583	40 413	41 166	43 091	48 637
Development Expenditure	8 909	13 072	12 773	15 161	16 562	19 306
Net Lending	-399	-91	1 225	-52	-47	-76
Expenditure & Net Lending	41 730	50 564	54 411	56 275	59 606	67 867
Balance	**7 222**	**5 340**	**-6 991**	**1 124**	**-2 419**	**-3 589**
Share of GDP (percent)						
Revenues & Grants	37.3	37.8	32.0	32.8	30.8	31.6
Recurrent Expenditure	25.3	25.4	27.2	23.5	23.2	23.9
Development Expenditure	6.8	8.8	8.6	8.7	8.9	9.5
Expenditure & Net Lending	31.8	34.2	38.0	32.2	32.1	33.4
Balance	**5.5**	**3.6**	**-4.7**	**0.6**	**-1.3**	**-1.8**

* Projections

Source: Ministry of Finance and Economic Development

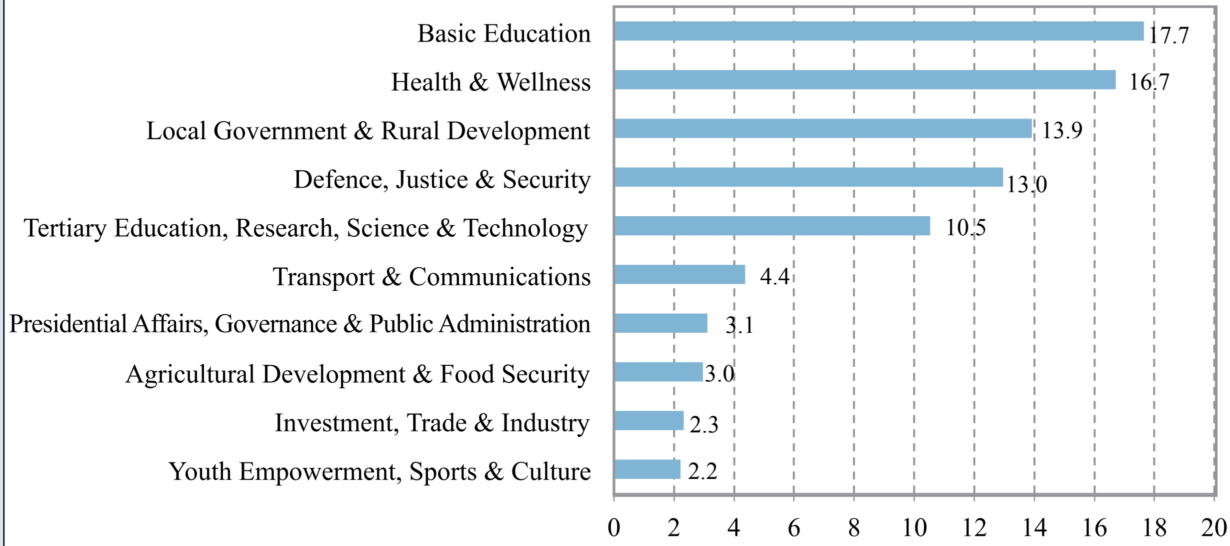
to grow by 16.6 percent from a revised P16.6 billion in 2017/18 to P19.3 billion in 2018/19.

2.9 As a result, a budget deficit of P3.6 billion or 1.8 percent of GDP is forecast for 2018/19, which would be financed by a combination of drawing down of Government savings, as well as domestic and foreign borrowing. The budget outturn retains the fiscal prudence to ensure fiscal sustainability in the medium to long term as balanced against developmental/ infrastructure needs and government operations necessary to support inclusive and sustainable economic activity.

2.10 The bulk of the 2018/19 recurrent spending, P21.2 billion (43.5 percent), is on personal emoluments, which includes wages and salaries as well as pensions and gratuities. The balance (56.5 percent) is allocated to grants and subventions to parastatals and local authorities (P14.9 billion or 30.6 percent), "other charges" (P11.6 billion or 23.9 percent), and interest on public debt (P969.3 million or 1.4 percent). Ministerial allocations are led by Basic Education with a share of 17.7 percent, as reflected in Chart 1.7.

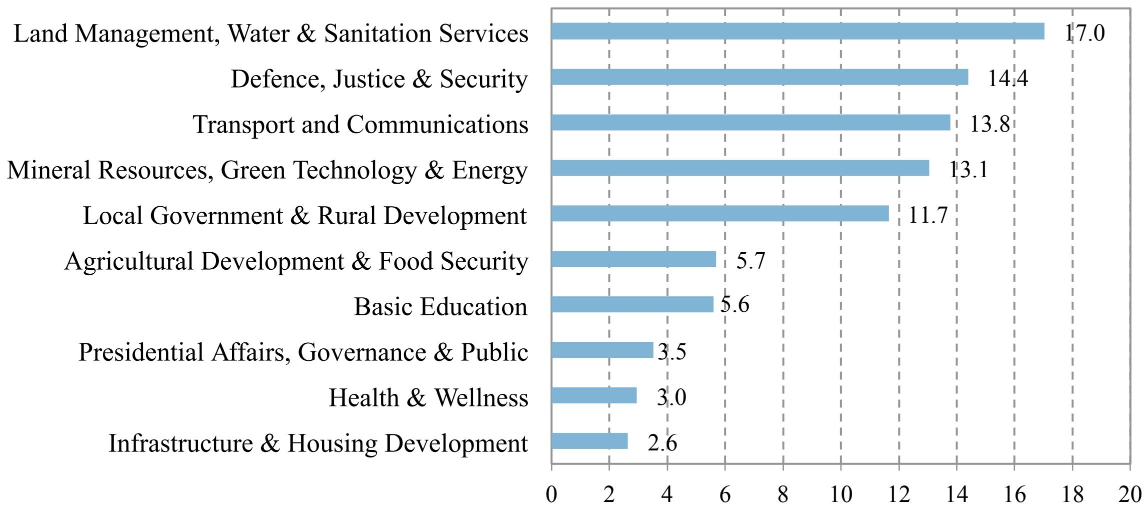
2.11 More than half of the development budget (58.3 percent) was allocated to water, security, electricity and construction-related projects (Chart 1.8). Thus, the largest share of P3.3 billion or 17 percent was allocated to the Ministry of Land Management, Water and Sanitation Services, and includes P2.5 billion for water projects. The Ministry of Defence, Justice and Security received the second largest proportion (14.4 percent), mostly to finance the provision of infrastructure, refurbishment of facilities for the Botswana Police Service and the Department of Prisons and Rehabilitation. The Ministry of Transport and Communications was allocated 13.8 percent of the development budget, followed by the Ministry of Mineral Resources, Green Technology and Energy Security with 13.1 percent. Thus, the development budget is skewed towards infrastructure development and enhanced provision of utilities (for example, electricity and information and communications technology connectivity).

Chart 1.7: Proposed Ministerial Allocation of the Recurrent Budget (Percent)



Source: Ministry of Finance and Economic Development

Chart 1.8: Proposed Ministerial Allocation of the Development Budget (Percent)



Source: Ministry of Finance and Economic Development

Debt Management

2.12 Government and government-guaranteed debt for the 2017/18 fiscal year is projected at P38 billion,[19] of which P28.1 billion is Government's own debt; the balance is government-guaranteed debt (Table 1.4). Total external debt amounts to P23.7 billion or 12.7 percent of GDP, while domestic debt, at 7.7 percent of GDP, amounts to P14.3 billion. Overall, total projected debt as at March 31, 2018, is equivalent to 20.4 percent of forecast GDP and below the statutory ceiling of 40 percent of GDP, with both domestic and external debt each being lower than the 20 percent of GDP limit.[20]

[19] An increase of 3.1 percent compared to the balance outstanding at the end of 2016/17 fiscal year.

[20] Most figures reported for Government debt are taken from Tables VII and VIII of the Financial Statements, Tables and Estimates of the Consolidated and Development Funds Revenues. These may differ in some instances from those included in the Budget in Brief.

TABLE 1.4: GOVERNMENT DEBT AND GUARANTEES 2014/15 – 2018/19 (P MILLION)

Financial Year	2014/15	2015/16	2016/17	2017/18	2018/19
		Actual		Projected	
External					
External Debt	17 981	18 345	16 659	15 962	15 522
External Guarantees	7 160	8 482	7 738	7 738	7 738
Total External Debt	25 141	26 827	24 397	23 700	23 260
Internal					
Internal Debt	7 468	7 817	10 330	12 164	13 143
Internal Guarantees	521	698	2 136	2 136	2 136
Total Internal Debt	7 989	8 515	12 467	14 300	15 279
Grand Total	33 130	35 342	36 864	38 000	38 539
GDP for FY	147 920	149 112	174 836	185 931	203 175
Percent of GDP					
External Debt & Guarantees	17.0	18.0	14.0	12.7	11.4
Internal Debt & Guarantees	5.4	5.7	7.1	7.7	7.5
Total Debt & Guarantees	22.4	23.7	21.1	20.4	19.0

Source: Ministry of Finance and Economic Development

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

(a) Exchange Rates

3.1 The exchange rate policy supports competitiveness of domestic industries in the international and domestic markets, by maintaining a stable real effective exchange rate (REER)[21] of the Pula against a basket of currencies of major trading partner countries. With effect from January 1, 2017, the weights of the Pula basket currencies were changed from 50 percent each to 45 percent and 55 percent for the South African rand and the Special Drawing Rights (SDR), respectively.

3.2 Consistent with the policy objective of maintaining a stable REER of the Pula, an upward rate of crawl of 0.26 percent was implemented to the nominal effective exchange rate (NEER) during 2017 as the projected domestic inflation was close to the lower end of the Bank's medium-term inflation objective and lower than the trading partner countries' forecast average inflation. Consequently, the trade-weighted NEER of the Pula appreciated by 0.26 percent in the twelve months to December 2017. Given the small positive differential between inflation in Botswana and trading partner countries average inflation, the REER appreciated modestly by 0.35 percent in the twelve months to December 2017. A virtually stable REER implies maintenance of competitiveness (by this measure) of domestic producers of tradable goods and services. Nevertheless, it should be noted that the stable exchange rate alone is not sufficient to ensure sustainable competitiveness of local producers. The attainment of durable competitiveness of domestic producers is mainly achieved through a sustained improvement in productivity, which also contributes to lower inflation. Even then, the enhanced transparency engendered by the disclosure of Pula exchange rate parameters helps to reduce uncertainty surrounding exchange rate policy and enriches information

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

Table 1.5: Pula Exchange Rates against Selected Currencies

Nominal Exchange Rates (Foreign Currency per Pula)

Currency (As at end of)	2016	2017	Change (Percent)
SA rand	1.2792	1.2563	-1.8
SDR	0.0699	0.0713	2.0
US dollar	0.0939	0.1013	7.9
British pound	0.0765	0.0753	-1.6
Japanese yen	10.95	11.42	4.3
Euro	0.0891	0.0848	-4.8
Chinese yuan	0.6544	0.6605	0.9
NEER (Sept. 2016 = 100)	100.1	100.4	0.26

Real Pula Exchange Rate Indices[1] (Sept. 2016 = 100)

Currency	December 2016	December 2017	Change (Percent)
SA rand	99.0	95.8	-3.2
SDR	101.5	104.9	3.3
US dollar	97.9	106.8	9.1
British pound	103.2	101.7	-1.4
Japanese yen	112.3	119.7	6.6
Euro	103.7	100.5	-3.1
Chinese yuan	100.3	102.6	2.3
REER	100.2	100.6	0.3

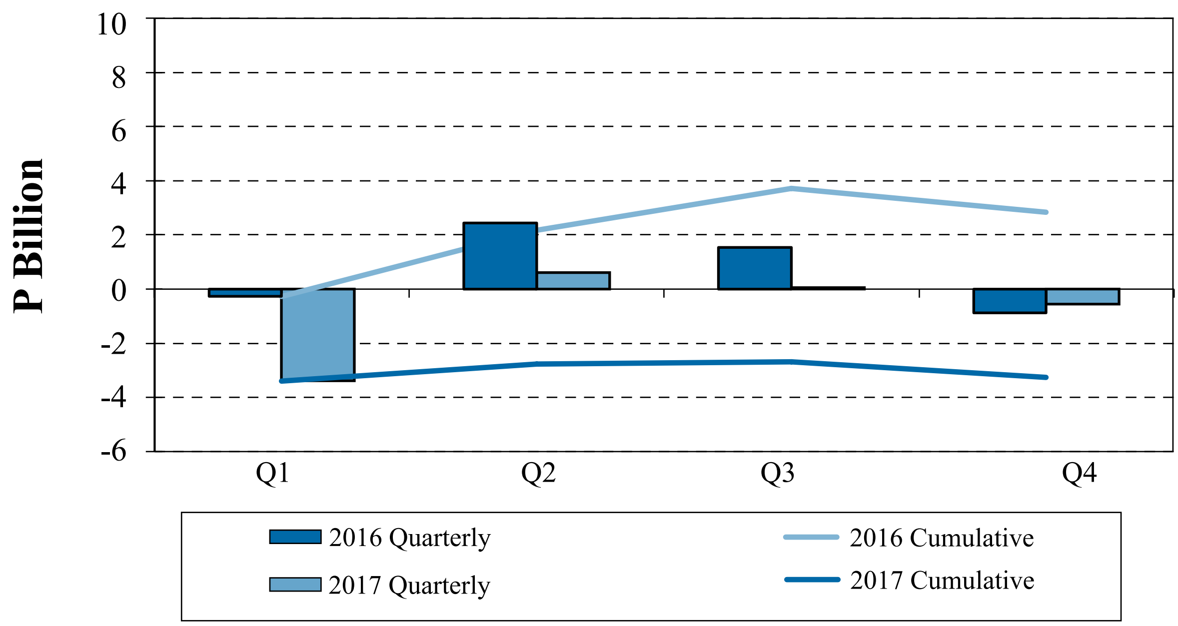
1. All real indices calculated using headline inflation.
Source: Bank of Botswana

used in making financial and investment decisions by economic agents.

(b) Balance of Payments

3.3 The balance of payments was in an overall deficit of P3.3 billion in 2017, compared to a surplus of P2.8 billion in 2016 (Chart 1.9 and Table 1.6). The deficit was mainly attributable to government financial obligations, including: funding of embassies in various countries, payments for imports and external loan repayments, resulting in withdrawals from foreign exchange reserves. To a lesser extent, foreign currency revaluation losses, which resulted from the appreciation of the Pula against the US dollar, also contributed to the overall deficit balance. Within the overall balance, the current account is estimated to have been in a surplus of P22.2 billion in 2017, compared to a surplus of P23.4 billion in the previous year.[22]

Chart 1.9: Quarterly Balance of Payments 2016 - 2017



Source: Bank of Botswana

[22] The balance of payments overall balance is mainly determined by flows from foreign exchange reserves, and due to the fact that not all financial flows associated with DBGSS diamond trade are reflected in the foreign exchange reserves, the two do not always correspond.

Table 1.6: Balance of Payments 2013 - 2017 (P Million)

	2013*	2014*	2015*	2016*	2017#
Current Account	9 549	19 260	8 233	23 389	22 234
Of which:					
Merchandise Trade	-716	6 831	-6 588	16 262	9 622
Services	-1 102	-30	203	895	1 266
Income	-3 152	-3 102	-2 322	- 6 572	-6 003
Net Current Transfers	14 519	15 562	16 940	12 803	17 349
Financial Account	-6 009	-4 763	-3 278	-6 348	-10 141
Capital Account	1	-	2	-	16
Net Errors and Omissions[23]	-2 201	-3 093	-5 013	-14 197	-15 361
Overall Balance	1 340	11 404	-57	2 843	-3 253

* Revised
# Provisional
Source: Bank of Botswana

Table 1.7: Diamond Trade 2015 - 2017 (P Million)

Period	Exports				Imports	Re-Exports
	Rough		Polished	Total		
	Botswana Exports (1)	Total Exports (2)	Exports (3)	(Rough and Polished) (4)=(2)+(3)	(5)	(6)=(2)-(1)
2015	25 809	48 286	4 444	52 730	25 232	22 477
2016	43 647	66 386	4 395	70 781	18 905	22 739
2017:						
Q1	9 563	15 071	1 013	16 084	3 320	5 508
Q2	8 356	12 022	1 224	13 246	3 475	3 665
Q3	9 785	9 731	1 669	11 400	3 015	-54
Q4	8 331	11 978	1 675	13 653	4 035	3 647
Total	**36 035**	**48 802**	**5 581**	**54 383**	**13 845**	**12 767**

Notes:
1. **Botswana Exports** refer to the value of exports of rough diamonds mined by Debswana and sold to DBGSS and Okavango Diamond Company (ODC).
2. **Total Exports:** Represent the value of rough diamonds from Botswana, including re-exports, which should imply that the subtraction of Botswana diamonds from this total approximates the gross value of re-exports. However, due to time lags in data availability, the two sets of data are not fully comparable, especially over short periods.

Source: Bank of Botswana

[23] The exceptionally large net errors and omissions for 2016 and 2017 suggest either an overestimation of the current account or an underestimation of capital outflows from the financial account. Efforts are continuing to address these data gaps

Table 1.8: Total Exports by Destination in 2012 - 2017 (Percent)

Country	2012	2013	2014	2015	2016	2017
United Kingdom	60.2	31.0	0.9	0.8	1.3	0.7
Belgium	4.3	12.0	23.5	19.8	18.9	22.1
India	1.1	2.7	13.7	12.4	15.1	18.6
United Arab Emirates	0.3	1.0	4.2	5.3	9.7	15.5
South Africa	13.1	15.4	13.3	15.6	13.5	9.8
Israel	5.4	5.7	7.7	6.0	6.1	7.4
Hong Kong	0.3	0.7	2.6	1.9	2.5	4.3
Namibia	1.9	11.7	9.8	11.8	11.6	3.4
United States of America	1.2	1.3	2.7	2.5	1.8	2.1
Canada	0	6.3	6.5	6.3	5.0	1.5
Others	12.3	12.2	15.0	17.5	14.6	14.4
Total	100.0	100.0	100.0	100.0	100.0	100.0

Current Account[24]

3.4 The current account surplus of P22.2 billion in 2017 was primarily the result of improved revenue inflow from the Southern African Customs Union (SACU), which increased by 31.5 percent from P12.4 billion in 2016 to P16.3 billion in 2017, as well as the surplus in the merchandise trade account.

Merchandise Trade[25]

3.5 Trends in merchandise trade continue to be driven by diamond trade, mainly from DBGSS, which includes a substantial re-export trade for rough diamonds[26] (Table 1.7). The merchandise trade balance surplus decreased from P16.3 billion in 2016 to P9.6 billion in 2017, reflecting the reduction in diamond trade during the same period. Total diamonds exports constitute 89 percent of total exports, compared to 26.7 percent for total imports in 2017. This follows from the relocation of De Beers' aggregation and sales functions from the United Kingdom to Botswana in 2012 and 2013, respectively. The relocation also shifted the direction of diamond trade significantly, with the major export destination switching from the United Kingdom to Belgium, followed by India, South Africa and Namibia.[27] The majority of these countries received less than 5 percent of Botswana exports prior to 2013. However, they collectively account for an annual average of 50 percent of total diamond exports for the period 2014-2017 (Table 1.8).

3.6 In 2017, total exports declined by 23.5 percent, mostly due to a 23.2 percent reduction in diamond exports from P70.8 billion in 2016 to P54.4 billion. The contraction in diamond exports resulted from a combination of weaker demand and lower rough diamond prices in 2017,[28] particularly in the second half of the year whereby manufacturers sought lower value diamonds. Total exports also weakened as a result of diminished copper and nickel sales following the closure of the BCL and

24 The current account comprises trade in goods and services, the income account and the net current transfers.

25 The trade data used in preparing the balance of payments does not fully match the monthly trade statistics prepared by Statistics Botswana. This is because for some export commodities, the trade statistics data are supplemented by additional information collected directly from exporters.

26 In addition to Botswana, DBGSS aggregates rough diamonds from De Beers' mining operations in Canada, Namibia and South Africa. The value-addition on imported rough diamonds through the aggregation and sales processes is reflected in the trade balance. Some aspects of the statistical treatment of diamond trade flows continue to be reviewed and, as such, published data may be subject to further revision. Imports and exports of other commodities in 2017 should also be treated with caution following adoption of a new statistical system.

27 This is based on the average of exports by destination from 2014 to 2017.

28 De Beers' consolidated average price declined by 13 percent from USD183 per carat in 2016 to USD162 per carat in 2017, resulting in lower rough diamond sales, which are estimated to have fallen by 5 percent to USD5.31 billion during the same period. This low diamond sales stated in this paragraph does not match the statement in paragraph 2.2, for Public Finance accounts due to the different reporting periods (2017 and 2016/2017).

Table 1.9: Merchandise Exports, 2016 – 2017 (P Million)

			Percentage Share		
	2016	2017	2016	2017	Percentage Change
Total Exports	80 260	61 406			-23.5
of which:					
Diamonds	70 781	54 384	88.2	88.6	-23.2
Copper-Nickel	2 631	41	3.3	0.1	-98.4
Beef	931	886	1.2	1.4	-4.9
Soda Ash	939	970	1.2	1.6	3.3
Gold	344	383	0.4	0.6	11.4
Textiles	280	178	0.3	0.3	-36.4
Vehicles	529	571	0.7	0.9	8.0
Other Goods	3 824	3 993	4.8	6.5	4.4

Source: Bank of Botswana

Table 1.10: Merchandise Imports, 2016 – 2017 (P Million)

			Percent Share		
	2016	2017	2016	2017	Percent Change
Total Imports	63 998	51 784			-19.1
of which:					
Diamonds	18 905	13 844	29.5	26.7	-26.8
Fuel	8 649	7 616	13.5	14.7	-11.9
Food	7 478	6 857	11.7	13.2	-8.3
Machinery & Electrical Equipment	9 186	7 070	14.4	13.7	-23.0
Chemicals & Rubber Products	6 559	5 573	10.2	10.8	-15.0
Metals & Metal Products	3 045	2 434	4.8	4.7	-20.1
Textiles & Footwear	2 040	1 657	3.2	3.2	-18.8
Vehicles & Transport Equipment	5 033	4 053	7.9	7.8	-19.5
Other[29]	3 103	2 682	4.8	5.2	-13.6

Source: Bank of Botswana

Tati Nickel mines in October, 2016. Exports of *gold, vehicles* and *soda ash* increased by 11.4 percent, 8 percent and 3.3 percent, respectively (Table 1.9). The increase in gold exports was, amongst others, boosted by the increase in average gold prices from USD 1 248 per ounce in 2016 to USD1 258 per ounce in 2017 and the improved global demand in 2017. Overall, the merchandise trade account was in a surplus of P9.6 billion in 2017, compared to a surplus of P16.3 billion in 2016.

3.7 Imports for 2017 are estimated at P51.8 billion, a decrease of 19.1 percent from P64 billion in 2016 (Table 1.10). The decrease is largely due to a contraction of 26.8 percent in imports of diamonds following weaker global demand, which restricted diamond sales from De Beers diamond producers, which export diamonds to Botswana, including: Canada, Namibia and South Africa. Imports of all other commodities

[29] Other goods include: meat and meat products, hides and skin, copper, plastic and plastic products, etc.

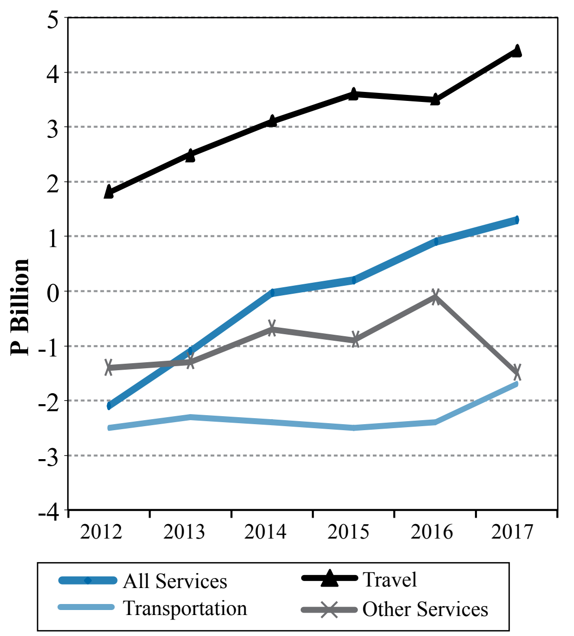
also declined due to the slowdown in growth of output of non-mining sectors, which declined from 4.5 percent to 3.8 percent in the twelve months to September 2017. In addition, imports of machinery and electrical equipment (-23 percent) declined due to advanced stages of implementation of some development projects, for example, the Morupule B power project. The closure of the BCL and Tati copper mines in 2016 also affected importation of fuel (-11.9 percent), which was used for operational processes in the mines. The improvement in crop production, which increased by 4 percent, from P266.7 million in the first nine months of 2016 to P277.5 million in the first nine months of 2017, also resulted in the decline of imports of food by 8.3 percent.

Services

3.8 A surplus of P1.3 billion is estimated in the services account in 2017 compared to P895 million in the previous year (Chart 1.10). Exports of transportation[30] services increased by 46.3 percent, from P361 million in 2016 to P528 million in 2017, mainly from freight, which increased by 42.1 percent from P319.7 million to P454.3 million during the same period. Imports of transportation services declined by 21.4 percent, from P2.8 billion to P2.2 billion during the same period, almost entirely driven by freight from transporting imports of goods. Notwithstanding the increase in exports of transport services, the higher imports of transport services resulted in a deficit of P1.7 billion in overall transport services. Exports of travel services increased by 15.9 percent, from P6.3 billion to P7.3 billion, primarily because of the increase in personal travel, dominated by tourism expenditure, which increased by 6.1 percent from P6.2 billion to P7.2 billion during the period under review. In comparison, imports of travel services also increased by 3.6 percent from P2.8 billion to P2.9 billion, also attributable to personal travel expenditure to other countries. The balance for travel services in 2017 was a surplus of P4.4 billion. Exports of 'other' services declined by 3.4 percent from P2.9 billion in 2016 to P2.8 billion in 2017, compared to an increase in imports of 38.7 percent, from P3.1 billion to P4.3 billion during the same period. 'Other' services is dominated by government, mining, professional and construction services, its balance was a deficit of P1.5 billion.

3.9 The income account is estimated to have recorded a deficit of P6 billion in 2017, lower than the previous year's deficit of P6.6 billion. The credit side of this account is comprised of salaries received from abroad and income earned from foreign investment. The income earned on investment from foreign exchange reserves dominates the account, it decreased by 5.9 percent, from P1.7 billion in 2016 to P1.6 billion in 2017. The debit component of the income account comprises salaries paid abroad and income earned by foreign enterprises operating in Botswana. Dividends and retained earnings[31] are the predominant factors. These are estimated to have decreased by 10.8 percent, from P7.4 billion in 2016 to P6.6 billion in 2017. A greater proportion of this component was dividends paid by Debswana in 2016, which is estimated to have been lower in 2017. The reduction in the deficit of income account resulted from the reduced dividends paid to non-residents.

Chart 1.10: Balance of Trade in Services (2012 - 2017)



Source: Bank of Botswana

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30 Imports and exports of transportation services include: passenger fares; freight (road, sea, air, rail, clearing charges) and 'other' services; (landing fee, aircraft hire, and air charter).

Current Transfers

3.10 Current transfers consist of government and private transfers, the former making up the bulk of this component. In 2017, net current transfers are estimated to have increased by 35.2 percent from P12.8 billion in 2016 to P17.3 billion, reflecting increased SACU receipts. Thus, net government transfers grew by 35 percent from P12 billion to P16.2 billion in the same period. In comparison, net private transfers increased by 37.5 percent from a surplus of P846 million in 2016 to a surplus of P1.1 billion in 2017.

Capital and Financial Accounts

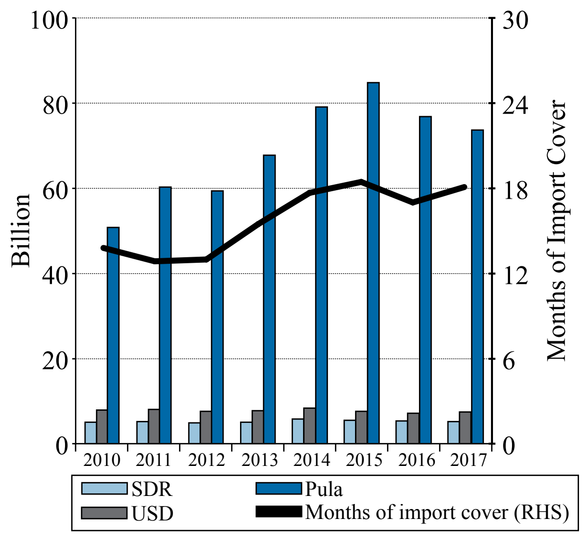
3.11 The capital account records transfers of financial assets by migrants to/from Botswana and, as in previous years, these transfers were insignificant in 2017.

3.12 The financial account, comprising 'direct,' 'portfolio' and 'other' investment,[32] is estimated to have registered a larger net outflow of P10.1 billion in 2017[33] compared to P6.3 billion in 2016. With respect to direct investment, total inflows increased from P1.4 billion in 2016 to P4.1 billion in 2017, mainly due to company loans and trade credits. On the other hand, it is estimated that outflows remained unchanged at P3.4 billion in 2017. The portfolio inflows declined from P358 million in 2016 to P179 million in 2017 due to low foreign investor participation in the domestic capital market. In comparison, portfolio outflows are estimated to have increased from P249 million in 2016 to P6 billion in 2017, mainly due to an increase in offshore investments by pension funds, as performance in the global economy improved. 'Other' investment inflows decreased from P1.8 billion to P1.1 billion, concentrated in the financial sector rather than the non-financial sectors. Meanwhile, outflows of 'other' investment increased from P2.7 billion in 2016 to P3.9 billion in 2017 due to increases in foreign assets in the financial sector (foreign notes held in local vaults and deposits abroad). Flows in 'other' investments, especially for the financial sector, can be volatile due to settlement of payments amongst such entities.

Foreign Exchange Reserves

3.13 The foreign exchange reserves decreased by 4 percent from P76.8 billion in 2016 to P73.7 billion in 2017 (Chart 1.11). In US dollar terms, the level of reserves increased by 4.2 percent from USD7.2 to USD7.5 billion, while the SDR amount remained unchanged at SDR5.3 billion. The decrease in foreign exchange reserves in Pula terms reflects the net foreign exchange outflows and net foreign currency revaluation losses, mainly arising from appreciation of the Pula against the US dollar. The level of reserves in 2017 was equivalent to 18 months of import cover[34] of goods and services.

Chart 1.11: Level of Foreign Exchange Reserves



Source: Bank of Botswana

(c) Balance of Payments Outlook

3.14 In 2018, the current account balance is expected to be in surplus against the background of projected 5.3 percent growth in domestic GDP, which is higher than the estimated GDP growth rate of 4.7 percent in 2017. This is mainly supported by expected improvements in the mining sector as global demand and commodity prices continue to strengthen.

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31 Retained earnings by foreign-owned businesses are an imputed outflow in the income account, matched by an offsetting inflow of foreign direct investment.

32 'Other' investment comprises borrowing from/lending to foreign entities not classified as direct investment and portfolio investment. These include government and non-government loans, currency and deposits, trade credits and 'other' equity.

33 The 2017 position is based on preliminary estimates.

34 The calculation of import cover excludes imports of rough diamonds, as these are for re-export.

The positive outlook is also underpinned by the anticipated good performance of the non-mining sectors, partly in response to government interventions, policies and strategies aimed at diversifying the economy. Among the non-mining sectors envisaged to support the current account balance is the trade, hotels and restaurants sector through increased tourism receipts to boost revenues for travel services. Other sectors include the music industry, in anticipation of promoting receipts for 'other' services, other than 'transportation' and 'travel.' However, given the narrow export base, the economy remains vulnerable to external shocks, especially in the diamond markets, which could undermine the external balance outcome.

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

(i) International Investment Position35

3.15 Preliminary estimates for 2017 indicate that Botswana's net international investment rose slightly by 1.2 percent from P58.4 billion in 2016 to P59.1 billion in 2017, with total foreign assets increasing by 1.1 percent from P143.2 billion to P144.8 billion over the same period, compared to an increase in foreign liabilities from P84.8 billion to P85.7 billion during the same period. By component, the stock of 'portfolio assets' and 'other assets' increased by 6.6 percent and 16.3 percent, respectively, while 'direct investment' declined by 0.4 percent and foreign exchange reserves declined by 4.1 percent in the same period. The increase in 'portfolio investment' and 'other investment' is associated with the increase of pension fund assets and cash deposits abroad, respectively. The decline in 'direct investment' stems from losses registered from investment in foreign equities during initial stages of investments. On the liabilities side, inward direct investment increased by 2.4 percent from P53.7 billion to P55 billion between 2016 and 2017, resulting from foreign investment towards the mining and retail sectors. 'Portfolio investment' declined by 18.7 percent from P962 million to P782 million, while 'other investment' declined by 0.7 percent from P30.1 billion to P29.9 billion in the same period.

(ii) Investment in Botswana by Industry and Country Classification in 2016

3.16 Tables 1.11 and 1.12[36] show the stock of Botswana's foreign liabilities at the end of 2016, classified by industry and country. 'Direct investment' is for foreign enterprises holding at least 10 percent share in resident enterprises and 'other investment' records all other liabilities, including 'portfolio investment.' The retail and wholesale trade and mining sectors have the largest shares of foreign direct investment at 38.9 percent and 30.2 percent, respectively. DBGSS dominates the retail and wholesale trade sector through its global diamond sales operations. Europe is the major source of direct investment in mining, accounting for 64.4 percent, of which 60.7 percent is from United Kingdom, where the DBGSS parent company is located. Africa is also a major source of foreign direct investment at 33.3 percent, of which South Africa accounts for 18.1 percent, most of which is directed to the domestic finance sector.

3.17 *Other investment* is mainly driven by government loans. In 2016, government external debt, classified under 'public administration,' amounted to 55 percent of 'other investment.' This is followed by the electricity, gas and water category at 20 percent, dominated by a loan sourced from China for the Morupule B power project. The finance sector accounted for 17.3 percent of 'other investment.' By region, the largest share of 'other investment' is from Africa, constituting 56.5 percent of the total, with government borrowing from the African Development Bank (AfDB) accounting for 44.3 percent. Asia Pacific constitutes 19.9 percent, followed by 'other regions' with 12.5 percent, which includes loans from multilateral development banks, such as the World Bank, and deposits of non-residents held in local financial institutions. South Africa constitutes 11.6 percent of 'other investment.'

35 There have been revisions to the data to align the IIP with balance of payments flows.

36 These figures are based on the 2016 Balance of Payments Survey conducted by Bank of Botswana. The annual Balance of Payments Survey is conducted with a lag of one year, when consolidation of the annual financial statements for the entities surveyed is complete.

Table 1.11: Level of Foreign Investment in Botswana by Industry 2016 (P Million)

Industry	Direct Investment	Other Investment	Total
Mining	16 204	81	16 285
Manufacturing	4 552	421	4 973
Finance	8 825	5 379	14 204
Retail and wholesale trade	20 899	775	21 674
Electricity, gas and water	0	6 218	6 218
Real estate and business services	464	30	493
Transport, storage and communication	1 439	160	1 599
Construction	545	0	545
Hospitality	358	42	400
Public administration	0	17 082	17 082
Other	403	883	1 286
Total	**53 688**	**31 071**	**84 759**

Source: Bank of Botswana

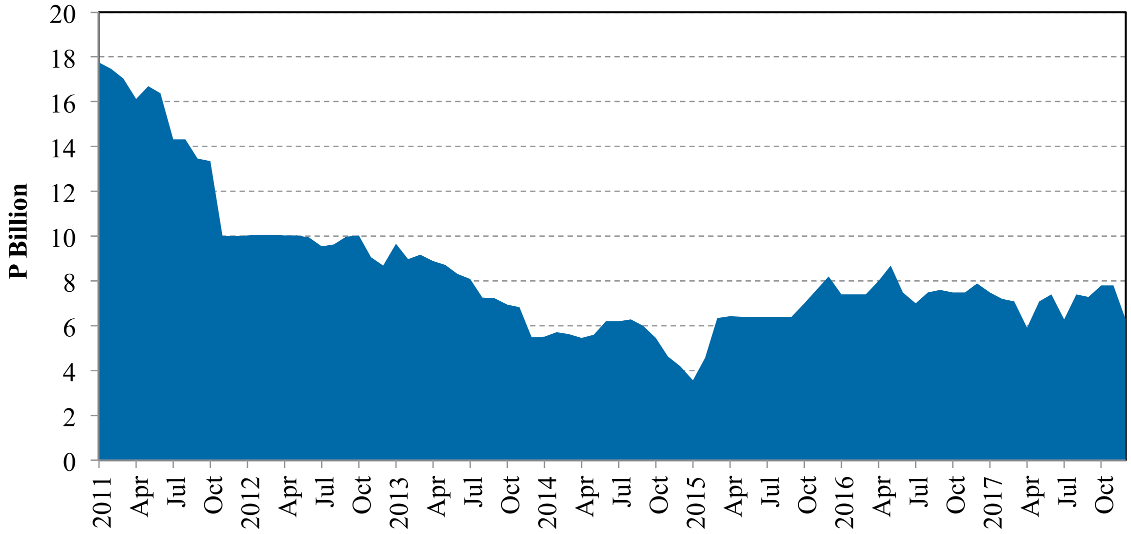
Table 1.12: Level of Foreign Investment in Botswana by Region and Selected Countries 2016 (P Million)

Country	Foreign Direct Investment	Other Investment	Total
North and Central America	244	2 531	2 775
Of which			
United States	104	1 705	1 809
Europe	34 556	929	35 485
Of which			
United Kingdom	32579	579	33 159
Netherlands	453	0	453
Luxembourg	102	4	106
Other Europe	1 422	346	1 768
Asia Pacific	907	6 183	7 090
Africa	17 885	17 549	35 434
Of which			
South Africa	9 737	3 605	13 342
Ivory Coast	0	13 778	13 778
Middle East	79	0	79
Other	17	3 879	3 896
Total	**53 688**	**31 071**	**84 759**

Source: Bank of Botswana

Note: Tables 1.11 and 1.12 display capital inflows by industry and region, broken down into 'Direct Investment' and 'Other Investment'. Data is mainly sourced from the Balance of Payments Annual Survey, which reports data for the year under review. This data should reconcile with table 6.6 in the statistical section in Part C of the Report, but due to limitations in data collection, this was not possible in the past few years. With continued concerted effort to address data challenges, the Bank has, with effect from this Annual Report publication, managed to resolve the data discrepancies.

Chart 1.12: Outstanding Bank of Botswana Certificates



Source: Bank of Botswana

4. Money and Capital Markets

(a) Monetary Policy and Liquidity Management

4.1 The primary objective of the Bank's monetary policy is to achieve price stability, which is defined as a sustainable level of inflation that is within the medium-term objective range of 3 – 6 percent. In addition, policy formulation incorporates the objective of safeguarding the stability of the financial system. A low and predictable level of inflation and a conducive financial environment foster savings mobilisation, productive investment and international competitiveness of domestic producers, thus contributing towards the broader national objective of sustainable economic development.

4.2 The monetary policy framework is forecast based, with a medium-term outlook that primarily guides the Bank's response to projected movements in inflation, while taking account of prospects for economic growth and developments in financial soundness and other indicators relevant for monitoring risks to financial stability. To this end, in assessing the policy stance, the Bank takes into account forecast real monetary conditions[37] in the context of other relevant domestic and international factors[38] as well as their impact on the output gap and, consequently, on inflation. The policy framework recognises the importance of effective communication to foster policy credibility and influence inflation expectations. As such, there is a press release and media briefing after each meeting of the Bank's Monetary Policy Committee (MPC) to announce the policy decision and its rationale.[39] The public is also notified, in advance, of MPC meeting dates for the year.

(b) Interest Rates and Bank of Botswana Certificates

4.3 The conduct of monetary policy entailed open market operations through weekly auctions of BoBCs to absorb excess liquidity in order to achieve market interest rates consistent with the policy stance. The value of outstanding BoBCs was P6.3 billion in December 2017,

37 The real monetary conditions, as measured by the real monetary conditions index (RMCI), indicate the relative looseness or tightness of monetary conditions and gauge the likely effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The RMCI combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

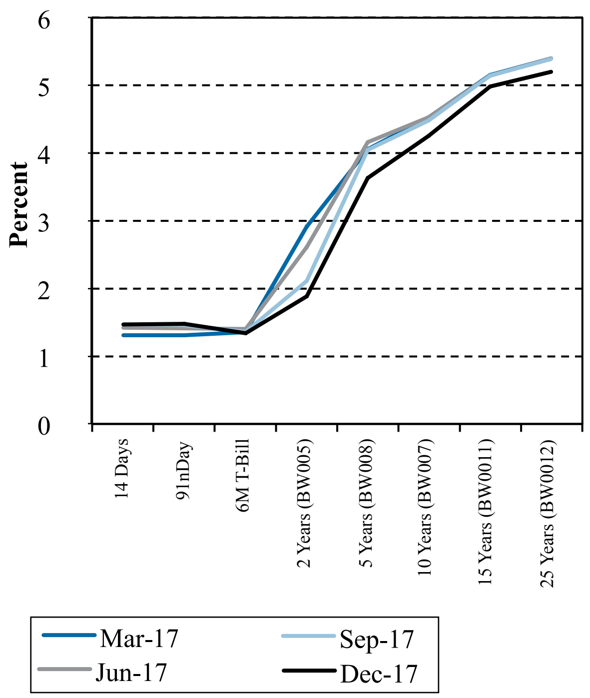
38 A key demand indicator is the "output gap," i.e., the difference between actual output and long-term trend output (as an indicator of productive capacity). A negative output gap means the actual level of output for a given period is below the trend level for that period, thus indicating the economy is operating below its estimated potential.

39 This has been the case since the beginning of 2017.

down from P7.9 billion at the end of the previous year (Chart 1.12). Reverse repurchase agreements (reverse repos) were used to smooth out liquidity fluctuations between weekly BoBC auctions. In December 2017, the amount of excess liquidity absorbed through reverse repos was P54 million compared to P1.3 billion in December 2016.

4.4 During 2017, monetary policy was conducted against the background of below-trend economic activity (a non-inflationary output gap) and a positive medium-term inflation outlook. These developments provided scope for an accommodative monetary policy stance in support of stronger output growth. The Bank Rate was reduced by 50 basis points from 5.5 percent to 5 percent in October 2017, and consequently the prime lending rate of commercial banks decreased from 7 percent to 6.5 percent.[40] Deposit interest rates also fell in line with the reduction in the Bank Rate. However, the nominal yield on the 14-day and 91-day Bank of Botswana Certificates (BoBCs) increased from 0.84 percent to 1.45 percent and 1.01 percent to 1.41 percent, respectively between December 2016 and December 2017 (Chart 1.13).[41] The increase in the BoBC yields reflected the effects of the measures that were introduced by the Bank to improve market efficiency and effectiveness of monetary operations, in particular to better align market interest rates to the policy stance. Notably, relaxation on the amount of BoBCs used to mop up excess liquidity helped to alleviate downward pressure on interest rates and misalignment with the policy stance. In addition, the range of securities eligible for use by commercial banks as collateral when accessing the Bank's credit facility were broadened to include all government securities, regardless of maturity and, also, Pula denominated bonds issued by the International Finance Corporation (IFC), therefore, allowing banks to manage liquid assets more efficiently with less reliance on BoBCs for collateral purposes. In turn, this further reduced the cost of implementing monetary policy.

CHART 1.13: YIELD TO MATURITY ON BANK OF BOTSWANA CERTIFICATES AND GOVERNMENT BONDS



Source: Bank of Botswana

(c) Banking System

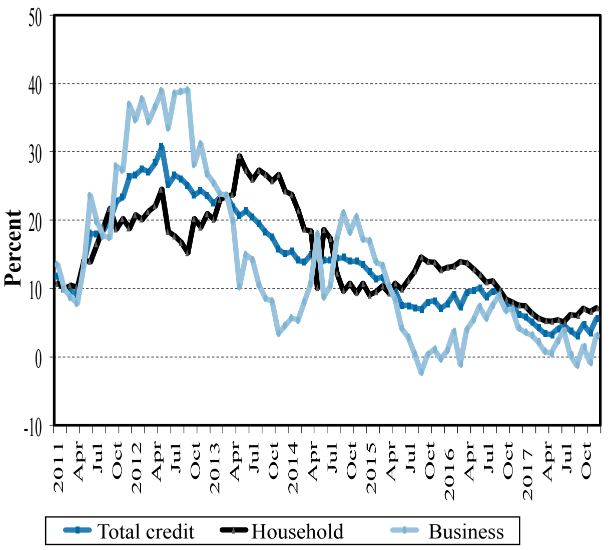
Domestic Credit

4.5 Year-on-year growth in commercial bank credit decelerated from 6.2 percent in December 2016 to 5.6 percent in December 2017, reflecting a slowdown in the yearly increase in lending to the business sector, from 4.2 percent in December 2016 to 3.2 percent in December 2017, mostly due to loan repayments by parastatals and some diamonds cutting and polishing companies. Annual expansion in household credit eased from 7.6 percent to 7.2 percent over the same period (Chart 1.14). As at December 2017, household credit constituted a larger share of total private commercial bank credit at 61 percent (60.1 percent in December 2016).

[40] The MPC maintained the Bank Rate at 5.5 percent at the meetings in February, April, June, and August 2017. After the reduction in the Bank Rate to 5 percent in October, the rate was maintained in December 2017.

[41] The quoted yields for both the 14-day and 91-day maturities are a weighted average of winning bids' yields at auction. The bonds in Chart 1.13 are benchmark bonds and do not depict actual years to maturity. The maturity dates of the BW005, BW008, BW007, BW011, BW012 and BW013 are September 12, 2018; September 8, 2020; March 10, 2025; September 10, 2031; June 13, 2040 and June 7, 2023, respectively.

Chart 1.14: Year-on-Year Commercial Bank Credit Growth



Source: Bank of Botswana

4.6 In terms of components of household credit, growth in unsecured lending increased from 8.3 percent in 2016 to 8.8 percent in 2017, but slowed with respect to mortgage loans from 6.3 percent to 4.8 percent over the same period. The lower growth of mortgage lending was consistent with the weaker residential property market, especially at the upper end, and modest growth of personal incomes, which engendered a cautious approach to lending by banks.

4.7 Overall, banking system performance indicators suggest a stable financial environment. Specifically, the moderation of mortgage credit growth in the context of a slowdown in the performance of the property market bodes well for financial stability as a disproportionate increase in credit could potentially lead to asset price bubbles and/or defaults. The concentration of household credit in the unsecured lending category (67.1 percent of total household credit as at December 2017) requires monitoring for desired impact on sustainable economic activity and to safeguard financial stability. Nonetheless, any risks emanating from this type of lending to households is moderated by the extent to which unsecured credit is diversified and its potential contribution to economic activity, wealth-creation, "consumption-smoothing" and growth[42] activities that it finances. Unsecured household lending is constituted by relatively small amounts spread across many borrowers and sectors, thus mitigating the possibility of widespread escalation of bad debts. The loss of employment income from the closure of several companies, including BCL and its subsidiary in October 2016, is a source of some strain on individuals and entities involved. However, the impact on individual banks and the banking system is expected to be mitigated by collateral, insurance and adequate provisioning in the context of satisfactory levels of profitability and capital.[43] The aggregate ratio of non-performing loans to total loans increased from 4.9 percent in December 2016 to 5.3 percent in December 2017.

Monetary Aggregates

4.8 Annual growth in broad money supply slowed from 5.4 percent in December 2016 to 2.7 percent in December 2017. By component, the rate of growth in transferable deposits (i.e., current accounts) fell substantially from 17.1 percent in December 2016 to 9.5 percent in December 2017. In addition, growth of other deposits slowed down from 2.8 percent in December 2016 to 0.8 percent in December 2017, while growth in currency outside depository corporations increased from 4.8 percent to 7 percent over the same period. Deposits in foreign currency accounts (FCAs) in Pula terms contracted by 3.6 percent in 2017 after growing by 13.3 percent in 2016 and accounted for 16 percent of total deposits at commercial banks in December 2017.

Bank of Botswana

4.9 Total assets and liabilities of the Bank of Botswana contracted by 4.2 percent, from P77.6 billion in December 2016 to P74.3 billion in December 2017. The contraction in the Bank's balance sheet in December 2017 reflected the impact of a 39.4 percent and 4.1 percent decrease in other assets (includes government

[42] For example, there can be wealth gains if such borrowing is used to acquire, construct or improve property that subsequently increases in value and for the acquisition of assets that improve production/productivity and give rise to a prospective increase in income. Moreover, consumption generates business and economic activity.

[43] This episode highlights the extent to which adverse impact can be isolated and risk mitigated.

bonds and other accounts receivable) and foreign exchange reserves, respectively, while fixed assets increased by 3 percent. However, the total shareholder's funds, which are largely comprised of the Government Investment Account (GIA), increased by 2.4 percent, from P55.7 billion in December 2016 to P57.1 billion in December 2017. Commercial bank deposits at the Bank of Botswana (including primary reserve requirement balances) decreased from P3.6 billion in December 2016 to P2.9 billion in December 2017. Over the same period, the value of outstanding BoBCs decreased by 20.7 percent from P7.9 billion to P6.3 billion.

Other Depository Corporations

4.10 The balance sheet of commercial banks increased by 3.4 percent from P80.7 billion in December 2016 to P83.5 billion in December 2017. On the assets side, loans and advances increased by 5 percent from P49.7 billion to P52.1 billion, while the value of debt securities held by banks rose by 40.2 percent. The increase in debt securities was mainly due to the participation of commercial banks in the IFC bond in November 2017. The flexibility of the coupon and eligibility of the bond to be used as collateral for repurchase agreements and accessing the central bank credit facility contributed to its attractiveness. Year-on-year to December 2017, deposits of domestic banks in foreign banks increased by 21.9 percent, while "other assets" grew by 9.9 percent. With respect to liabilities, deposits at commercial banks, capital and reserves and other liabilities rose by 1.8 percent, 3.7 percent and 16.3 percent, respectively, over the same period. Wholesale business deposits remained the main source of commercial banks' funding (75.8 percent of total deposits in December 2017). The credit to GDP ratio was 30.6 percent as at September 2017, lower than 32 percent as at September 2016.

4.11 Total assets and liabilities of the Botswana Building Society increased by 13.2 percent from P3.8 billion in December 2016 to P4.3 billion in December 2017. The increase reflects the 118.9 percent growth in the Society's cash and deposits in the same period. On the liabilities side, the level of capital and reserves increased by 1.2 percent to P1.1 billion in December 2017, while public deposits grew by 13.7 percent.

4.12 For Botswana Savings Bank, total assets and liabilities expanded by 13.4 percent in the year to December 2017, while loans and other advances decreased by 1.2 percent. Mobilisation of deposits resulted in annual growth of 17.6 percent in savings deposits during 2017.

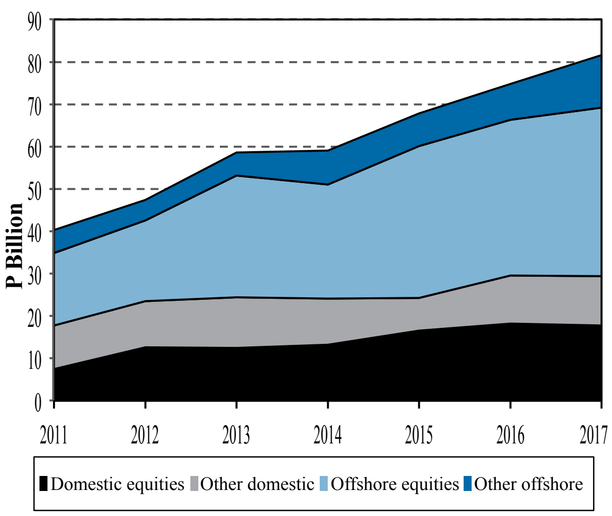
(d) Other Financial Corporations

4.13 The balance sheet of the National Development Bank (NDB) contracted by 30.8 percent, from P1.7 billion in December 2016 to P1.1 billion in December 2017, compared to a growth of 13.2 percent in the year to December 2016. The deterioration in the balance sheet for NDB was attributable to a substantial decline in most categories of assets. Total liquid assets, fixed assets, and loans and advances decreased by 68.3 percent, 4.6 percent and 20.8 percent, respectively, in the twelve months to December 2017, as the bank experienced slow recovery of loans, rising impairments and incurred losses.

4.14 Total assets of Botswana Development Corporation declined by 8.2 percent to P2.3 billion in December 2017, from P2.6 billion in December 2016. This performance was largely attributable to a decline of 21.1 percent and 17.8 percent in investments in related companies and fixed assets, respectively. The decline was largely due to market revaluation losses in listed equity instruments. However, loans, advances and leasing grew by 1.1 percent in the same period.

4.15 The Domestic Companies Index of the Botswana Stock Exchange (BSE) decreased further by 5.8 percent to 8 860.1 in 2017, following a decline of 11.3 percent in 2016. The decline was due to the annual losses in price per share of some companies, namely: First National Bank (21.3 percent), Sefalana (25 percent), Sechaba (27.9 percent) and Standard Chartered (33.7 percent). A total of 775 million shares worth P2.5 billion were traded in 2017 compared to 1 448.4 million shares valued at P2.6 billion traded in 2016. The market capitalisation of domestic companies fell by 4.1 percent from P46.3 billion in the year to December 2016 to P44.4 billion in December

Chart 1.15: Botswana Pension Pund Assets, 2012 - 2017



Sourec: NBFIRA

2017 due to the decrease in share prices of most listed companies. The number of listed domestic companies stood at 24 in both 2016 and 2017, as the delisting of Imara Holdings Limited in March 2017 was followed by the listing of Minergy Limited, a month later. The Foreign Companies Index (FCI) decreased by 0.8 percent to 1 574.9 in 2017, following an increase of 0.8 percent in 2016.

4.16 Pension funds' assets increased by 9.1 percent from P75.1 billion in December 2016 to P82 billion in December 2017 (Chart 1.15).[44] By asset class, investment in domestic equities declined by 2.6 percent to P17.8 billion in December 2017, while holdings of offshore equities increased by 8.3 percent to P39.8 billion. Meanwhile, the value of domestic bonds held by pension funds contracted by 1.8 percent to P8 billion, while that of offshore bonds increased by 21.5 percent to P9.9 billion in the same period. The proportion of assets invested offshore by pension funds increased from 60.1 percent in December 2016 to 63.6 percent in December 2017. The ratio of pension funds' assets to nominal GDP was 46.8 percent in the third quarter of 2017 compared to 44.4 percent in the corresponding period in 2016.

4.17 The P15 billion Government Bond Programme remains in place with the focus on the development of the capital market, although also providing an alternative source of government funding. Outstanding bonds of various maturities and Treasury Bills increased from P9.3 billion at the end of 2016 to P10.2 billion in December 2017. Primary dealers and their customers held P3.9 billion (37.7 percent) and P6.3 billion (62.1 percent), respectively, of the government securities at the end of 2017. Meanwhile, the Bank held P20 million (0.2 percent) of the total outstanding securities for possible repo transactions.

(e) Credit Rating

4.18 In the final quarter of 2017, the international sovereign credit rating agencies, Moody's Investors Service (Moody's) and S&P Global Ratings released updates of Botswana's 2017 sovereign credit rating, which reaffirmed the ratings of A2 and 'A-/A-2,' respectively, for long and short-term bonds in domestic and foreign currency. The outlook has been revised from negative to stable by S&P Global Ratings, while it was reaffirmed stable by Moody's. The ratings are supported by the strong external and fiscal balance sheets, a well-managed economy and low public debt, as well as the country's robust public institutions. The upward revision of the outlook was due to the expectation of positive economic growth supported by improved diamond markets. However, there continues to be a concern about the narrow economic base and relatively slow progress in economic diversification.

44 Figures for December 2017 are provisional.

Chapter 2
Financial Sector Development, Inclusive and Sustainable Economic Growth

1. Introduction

1.1 The financial sector broadly encompasses a set of institutions and markets, which include banks, insurance companies, investment funds, pension funds, stock exchanges and development finance institutions. There is consensus that financial sector development occurs with greater integration among financial instruments, markets, institutions and intermediaries alongside growth in demand and use of related services and resultant reduction in costs of information, intermediation and transactions. Thus, central to financial sector development is efficient performance of functions of the financial system which, in turn, promotes economic growth. Both economic theory and empirical evidence support the existence of a positive relationship between financial sector development and economic growth. This is premised on the recognition that sound and efficient financial systems mobilise and allocate financial resources to their most productive use, hence contributing to economic growth. However, it is also acknowledged that a disproportionately large financial sector relative to the real sector could have detrimental effect on the economy. As such, emphasis should be on optimisation of the financial sector, rather than its increased size.

1.2 Financial sector development can positively contribute to economic growth through a number of channels. First, sound and efficient well-developed capital markets are primary drivers of capital mobilisation, creating a pool of savings that fund operations and long-term investments, both of which are critical to sustain growth. Second, financial sector development supports growth by fostering competition and engendering innovative activities that promote dynamic efficiency. Third, financial instruments, intermediaries and markets facilitate pooling and diversification of risk across firms and industries, improving the efficiency of resource allocation and the return profile, thus raising the overall productivity of capital and promoting economic expansion. Access to credit is important for both consumption smoothing and investment, with the latter more relevant for small businesses that have limited retained earnings and ability to raise venture and share capital. Fourth, consumption smoothing is critical for wealth creation and purchase of large value assets. In this regard, it is recognised that the ability of a country to mobilise financial resources for the promotion of business and other economic activity, including the implementation of development programmes and projects, is determined by, among others, the policy environment, the capacity to raise and manage tax revenue, and the efficiency of its financial system.

1.3 Economic activity, in terms of operations, consumption and investment, involves both the public and private sectors. Among others, economic activity is influenced by the structure, composition and trends with respect to the mobilisation of savings by the financial system and the size of tax and other revenue and the productive or efficient deployment of these resources. Importantly, wider access to finance facilitated by enhanced financial breadth and depth and continuous innovation (key elements of a developed financial sector) can expand opportunities for poorer households to engage in productive activity that would contribute to an improvement in living standards and wealth creation. Notably, financial sector development enhances financial inclusion, which could contribute positively to economic growth and reduce income inequality as appropriate financial instruments would allow the poor or otherwise disadvantaged segments of society to invest in a range of value-adding assets, as well as education and skills development. Overall, it has been established that higher levels of financial development have a significant and robust correlation with economic growth, capital accumulation and improvements in economic efficiency.

1.4 In order for the financial system to efficiently intermediate resources from savers to borrowers and, in turn, support economic growth and development, it has to be efficient, stable and resilient. This is achieved through prudently managed financial institutions reinforced by an effective regulatory and supervisory framework, together with the risk management capacity of banks and sound market infrastructure in both the money and capital markets. At the same time, financial sector development should incorporate facilitation of an operating environment and regulatory frameworks that embrace innovation, secure operational robustness and resilience of the financial system, while retaining confidence among providers of funds (depositors) and consumers of financial services.

1.5 The banking sector in Botswana is regulated and supervised by the Bank of Botswana (the Bank). In 2008, the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) was established to provide a regulatory and institutional framework for all non-bank financial institutions and entities, including those that were hitherto unregulated, such as micro-lenders and asset managers. NBFIRA also oversees collective investment undertakings such as mutual funds.

1.6 The financial sector in Botswana has experienced significant growth in the past decade, although remaining relatively small, with commercial banks and pension funds being dominant when measured by asset size. The sector plays an increasingly important role, as measured by contribution to economic growth, share in overall output as well as employment. The ratio of the value added of the financial sector to total gross domestic product (GDP) increased from 11.9 percent in 2000 to 14.8 percent in 2016, while the ratio of employment in the financial sector to total formal sector employment has averaged 7.8 percent in the period from 2000 to 2016. It is important to note that for more sustainable, inclusive and balanced economic growth to occur, development of the financial sector should be multifaceted, providing a wide range of services to diverse sectors and across income levels. Financial openness is also critical in that it allows for resource mobilisation beyond a country's borders to supplement domestically available resources.

1.7 Foreign capital inflows, especially foreign direct investment (FDI), increase the accumulated capital stock and foster the transfer of technology and skills to local enterprises, while investment by locals abroad could also enhance growth through increased trade, international business opportunities and productivity gains. At the same time, the free flow of portfolio investment fosters development of the securities market and business financing options. This outcome is necessary to transform economic growth in Botswana from heavy dependence on a single commodity (i.e., diamonds) to a well-diversified, sustainable and inclusive economy. However, to achieve this goal, Government and related institutions have to take the lead in ensuring that the necessary physical and institutional infrastructure, as well as the legal and regulatory frameworks supportive of FDI and a range of financial flows, exist. This would serve to promote the role of both foreign participants and the domestic private sector in the development of the Botswana economy.

1.8 Although there has been notable growth in banking and non-bank financial institutions (NBFIs) over the years, it is apparent that there are gaps with respect to competitiveness and efficiency in the provision of financial services to fully support inclusive economic activity. There is, therefore, a need for structural reforms that include policies geared towards promoting specific financial services to ensure effectiveness and sustainability. In addition, the regulatory environment needs to embrace innovation and development of secure financial services, thereby, enhancing the potential to foster financial inclusion, which can contribute significantly to economic growth, employment creation and poverty reduction. Even then, there are concerns relating to opportunities for tax evasion, cybercrime and money laundering, which necessitate continuous upgrading of the regulatory framework and mitigation measures in order to sustain credibility and integrity of the domestic financial system.

1.9 The financial sector is a key element in the potential success of the current industrialisation strategy that focuses on harnessing economic opportunities from natural endowments (minerals, agriculture and tourism), through enhanced beneficiation, as well as creation and strengthening of related value chains. The strategy encompasses the establishment of hubs, clusters and economic zones around natural endowments and areas of concentrated Government and institutional support. Crucially, financial services are identified, alongside minerals, agriculture, tourism and health services, as an area of comparative advantage with scope for further development. This is premised on the existence of a conducive policy and regulatory environment, potential for organic institutional growth and prospects for skills development. The 2012 - 2016 Financial Sector Development Strategy (FSDS) for Botswana is also supportive of this growth agenda. Overall, opportunities exist for institutional expansion, development of services for a growing and currently underserved financial market and clientele, as well as linkages with international institutions. Commercial banks in Botswana are foreign-own private entities, with a few having links to the government of the country of origin, while there are two statutory banks and a building society. Most of the non-bank financial institutions are insurance companies that are predominantly foreign owned.

1.10 The theme chapter, therefore, evaluates financial sector development and prospects for further improvement in order to have a meaningful and durable contribution to inclusive economic growth. In this regard, Section 2 of the theme chapter examines the relationship between financial sector development and economic growth, while Section 3 analyses the evolution of the financial sector in Botswana. Section 4 outlines experiences of other countries, which are compared with Botswana's performance. Section 5 addresses financial resource mobilisation, in terms of the determinants and policy initiatives in Botswana. Section 6 considers prospects for further financial sector development, along with potential benefits to the industrialisation strategy, while Section 7 provides a summary and concluding observations.

2. Financial Sector Development and Economic Growth

(a) Perspectives on the Measurements and Role of the Financial Sector

2.1 There is general consensus on the existence of a positive correlation between financial sector development, economic growth and development. However, there is a difference of opinion on the direction of causality, that is, whether financial sector development induces economic growth or vice versa. Another dimension is that the direction of causality varies with the level and stage of economic development of a country, for example, there is the view that financial development tends to support economic growth in low income and emerging market economies more than is the case for advanced economies.[45] Determination of causality enables appropriate policy design and sequencing to yield the greatest economic and social benefits. Even then, while a well-functioning financial system has a generally positive impact, over economic cycles, adverse conditions in the financial sector could lead to considerable disruption to economic activity. Notably, the 2008 global financial crisis has brought to the fore the risk-benefit trade-off between financial development and financial stability, and the impact of the trade-off on economic growth.

2.2 In this regard, in a recent publication[46] by the Bank for International Settlement (BIS) on a series of papers on the "Frontiers of Macrofinancial Linkages," the authors note that the great financial crisis of 2007 – 9 "was a bitter reminder of how pronounced fluctuations in asset prices can have a dramatic impact on the balance sheets of households, corporations, financial intermediaries and sovereign nations. As asset prices fell sharply and the global financial system edged to the brink of collapse in late 2008, the global economy experienced its deepest contraction in more than half a century. This led to unprecedented challenges for fiscal, monetary and financial sector policies."

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45 Sahay et al. (2015). "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," IMF Staff Discussion Note, 2015.

46 Stijn Claessens and M. Ayhan Kose. (2008). "Frontiers of macrofinancial linkages." BIS Papers No. 95, pp 8. Monetary and Economic Department. January 2008.

2.3 The theoretical foundations of the role of financial development in promoting growth can be traced to Walter Bagehot, who argued, in 1873,[47] that England's efficient capital markets facilitated the industrial revolution. However, Schumpeter[48] is the most cited for, arguably, a profound analysis of the nexus between financial development and economic growth, although the views he espoused did not differ materially from those of Bagehot (1873). Schumpeter's central proposition is that a sufficiently developed financial system is catalytic to technological innovation and economic growth in that it provides financial services to entrepreneurs who, potentially, can effectively pursue innovative products and processes. This is consistent with the view that financial sector development stimulates economic growth.

2.4 Overall, it is generally accepted that the main channels through which the financial system/sector fosters growth are producing information; allocating capital to productive uses; monitoring investments and exerting corporate controls; facilitating trade, diversification, and management of risk; mobilising and pooling of savings; and facilitating payments.[49]

2.5 Regarding causality, Patrick (1966) identified patterns that have since been commonly referred to as "demand-following" and "supply-leading," which explain the possibility of a bi-directional relationship, from either economic growth to financial sector development or the opposite direction.[50] The demand-following argument conveys the idea that the demand for financial services follows economic activity, such that, as the economy grows, it creates additional demand for these services, which leads to the development of the financial sector. The proposition is, therefore, a relationship in which the creation of modern financial institutions, innovation and evolution of financial assets and liabilities and related financial services is in response to the demand by investors, borrowers, savers, merchants and consumers for their respective needs. In this context, it should follow that the speed of financial sector development is dependent upon the pace of growth and other structural developments in the economy.

2.6 In buttressing the demand-leading hypothesis, Robinson (1952) points out that where enterprise leads, finance follows, suggesting that an investment idea can be translated into action through adequate funding. This view is reinforced by the argument that the same impulses within an economy, which induce investment, make wealth owners and risk-takers enterprising. In turn, when a strong impulse to invest is constrained by lack of finance, innovative ways to fund the investment are developed, resulting in new products, services, institutions and financing arrangements.[51] In this context, it should follow that the speed of financial sector development is dependent upon the growth of, and developments in, the economy.

2.7 The supply-leading view, on the other hand, suggests that the creation of modern financial institutions, trends in financial assets and liabilities and related financial services occur in advance of the demand. In this transformation, the transfer of resources from the traditional sectors to modern sectors is enabled, thus stimulating entrepreneurship in the latter. In addition, financial institutions may be able to operate profitably by lending to emerging modern sectors, including economic transition in the developing and underdeveloped economies.

2.8 Furthermore, the financial liberalisation thesis spearheaded by McKinnon (1973) and Shaw (1973) appears to be in agreement with the supply-leading argument. At the centre of financial liberalisation is the contention that the fragmented money and capital markets

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47 Stolbov, Mikhail (2012). "The Finance-Growth Nexus Revisited: From Origins to a Modern Theoretical Landscape," The Open-Access, Open–Assessment E-Journal (http://www.economics-ejournal.org/economics/discussionpapers/2012-45), Discussion Paper no.2012-45, September 2012.

48 Schumpeter, J. (1934). Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle. Harvard University Press, Cambridge, MA.

49 Ross Levine (2005). "Finance and Growth: Theory and Evidence," Handbook of Economic Growth, edited by Phillipe Aghion and Steven Darlauf, New York: Elsevier.

50 Patrick, H. (1966). "Financial Development and Economic Growth in Underdeveloped Countries," Economic Development and Cultural Change, 14: 174-189.

51 Robinson, J. (1952). "The Generalisation of the General Theory," The Rate of Interest and Other Essays, Macmillan, London.

and the generally repressed financial systems in less developed countries hinder economic development as the intermediaries are not adequately empowered and free to engage in savings mobilisation.[52]

2.9 It is, however, noteworthy that, while the foregoing theoretical views on the interlinkages of finance and economic growth appear to differ on the direction of causality and sequence, there is a convergence of views that there is at least a virtuous co-existence of financial sector development and growth in economic activity. Indeed, the finance-based endogenous growth theory[53] acknowledges and encapsulates both the supply-leading concept and the financial liberalisation thesis. The central proposition in this regard is that, because of its positive impact on the levels of capital accumulation and savings, finance is an important determinant of economic growth. Therefore, to the extent that financial development and economic growth not only coexist, but are mutually supportive, policy design to support growth should include focus on financial sector development and long-term stability.

2.10 Importantly, the mutually supportive relationship between financial sector development and economic growth will thrive in an environment where macroeconomic stability, strong institutional foundations, sound policies and proper governance prevail. Macroeconomic stability obtains when inflation is low, stable and predictable, to allow for steady rates of saving, sound investment and spending decisions that promote economic growth. Fiscal prudence is also key, with government following a sustainable fiscal path by limiting the size of deficits (when required) and accumulating surpluses in suitable times, without needlessly stifling potential output growth, to provide for countercyclical spending when the economy experiences negative shocks. The need for government to develop productive public infrastructure to promote participation of the private sector in investment and production, which would increase employment opportunities, cannot, therefore, be overemphasised. There is also the need to foster stability of the external sector by facilitating trade and capital flows and adopting an appropriate exchange rate framework that primarily contributes to international competitiveness of domestic producers, while also not constraining importation of the needed production inputs to support import-substituting industries.

2.11 In addition, the financial sector will effectively support economic growth, or vice versa, when appropriate institutions are in place. Critically, a stable political environment is necessary for the availability of reliable physical public infrastructure that facilitates economic activity and ensures security of persons to promote private investment. Alongside this, non-tolerance of, and a fight against corruption is conducive for proper resource allocation, while a legal framework that guarantees and efficiently enforces property rights is needed to instil confidence in investors about the security of their investments and consequential returns. The financial sector, whose basic foundation is public trust, particularly needs a robust and efficient regulatory and supervisory framework that requires both observance of prudential requirements and adherence to certain practices, such as accounting and auditing standards. A corollary of such a framework is the availability of high-quality and reliable information on financial sector development indicators to appropriately and sufficiently guide would-be investors.

2.12 A complete regulatory and supervisory environment needs to have mechanisms for limiting disruptive failures of financial institutions when they occur to safeguard sustainability of economic growth. This demands establishment of relevant financial safety nets designed in a manner that neither undermines market discipline nor encourages excessive risk-taking behaviour among market participants.

2.13 Finally, policies also play a crucial role in supporting development of the financial sector and economic growth. Broadly, financial sector and economic growth can be promoted by good governance, some key elements of

52 McKinnon, R.I. (1973). "Money and Capital in Economic Development," Washington DC; and Shaw, E.S. (1973). "Financial Deepening in Economic Development," New York.

53 Romer, P.M. (1986). "Increasing Returns and Long-run Growth," Journal of Political Economy.

which include the rule of law, transparency in decision-making and accountability for actions or non-action by both public and private entities in respect of issues of public interest as well as effectiveness and efficiency of public institutions. Therefore, economic and financial sector policies should be designed taking into account the need to promote economic growth and financial sector development, investment, employment creation, wider access to financial services and consumer protection, innovation and market discipline, and reduce public sector distortions and opportunities for tax evasion.

(b) Empirical Studies

2.14 The theoretical causality discussion is also complemented by empirical studies that have been undertaken to examine the relationship between growth and financial development in relation to both direction and degree of influence, individually and/or alongside other factors. In this respect, substantial empirical evidence points to the existence of a mutually beneficial relationship between financial sector development and long-term economic growth. The empirical conclusions on causality between financial sector development and economic growth also depend on the indicator used to determine the level of financial development. Even then, the several studies that confirm this relationship indicate the imperative of necessary preconditions, such as a certain level of financial sector development, an open and competitive financial sector, macroeconomic stability as well as functional and appropriate institutional and regulatory frameworks enunciated above. Importantly, findings buttress the positive impact of financial depth on per capita output growth and productivity. The overriding conclusion appears to be that there is a reciprocal supportive relationship between financial development and long-term economic growth that can be influenced positively by an appropriate macroeconomic policy environment and regulatory framework.

2.15 A well-targeted financial development programme is, therefore, required in order to attain the desired impact of financial development on economic growth, including a meaningful contribution to welfare enhancement, as well as reduction of poverty and income inequality. Essentially, developing the financial sector has to be deliberate and an integral part of the broad macroeconomic policy framework, particularly in developing countries where poverty levels and, often unemployment, tend to be high and unaided structural transformation, financial enterprise and innovation is slower.[54]

2.16 Overall, despite the theoretical and empirical inconclusiveness regarding direction of causality, developing countries such as Botswana, need to consider financial services as an important factor in development, both as a facilitator and a source of growth (or growth area). This is recognised in Botswana's successive national development plans and financial sector development strategies (for example, the 1989 Financial Sector Development Strategy and (FSDS 2012) – 2016) as well as industrialisation policies. Notably, and more recently, the cluster development strategy espouses the financial sector (alongside mining, tourism, agriculture and health) as an area of comparative advantage where value chains and support services could be expanded to promote overall growth of the economy.

(c) Role of the Financial Sector, Measurement and Trends

2.17 The financial sector encompasses a set of institutions, instruments, markets and regulatory frameworks that typically allow for or perform roles as follows:

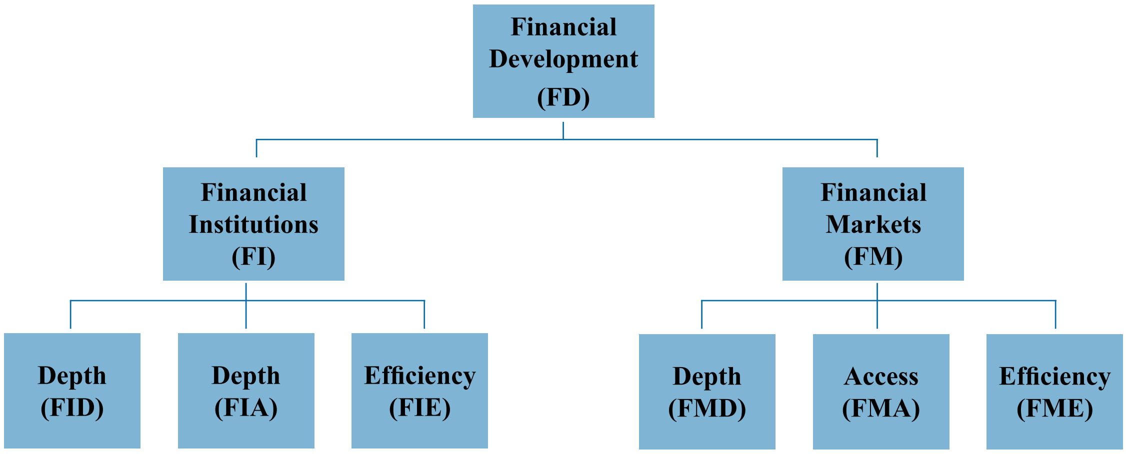
(i) facilitate transactions for goods and services through various payments instruments and facilities;

(ii) mobilise savings and provide credit to economic agents and markets, thus helping to ensure that resources are efficiently allocated to their most productive use;

(iii) provide a variety of investment instruments and vehicles, allowing savers and borrowers choices to optimise with

[54] Demirgüç-Kunt, A., and Levine, R. (2009). "Finance and Inequality: Theory and evidence," Annual Review of Financial Economics and; Beck, T., Demirgüç-Kunt, A., and Levine, R. (2010). "Financial Institutions and Markets across Countries and Over Time," World Bank Economic Review. .

FIGURE 1: FINANCIAL DEVELOPMENT INDEX PYRAMID



Source: Katsiaryna (2016)

respect to varying exposure, liquidity, yield and risk preferences;

(iv) promote information sharing that links investors and entrepreneurs and reduce or manage information asymmetry, thus facilitating access and productive use of finance;

(v) dampen the impact of shocks through a deep, liquid and diverse market that also enables risk mitigation and access to insurance;

(vi) facilitate life-cycle consumption smoothing and investment and, therefore, contribute to wealth generation and welfare; and

(vii) promote financial discipline through commitment to spending and saving plans.

2.18 Notably, financial sector development is relevant for both private and public sector performance. For example, with developed markets, the public sector is able to maintain a treasury bill and bond issuance programme to finance budgets and for infrastructure and human capital development, which would be necessary for sustainable and inclusive economic expansion.

2.19 Across countries, the financial sector has evolved such that the non-bank financial sector has experienced substantial growth relative to the banking sector, thus necessitating the use of indicators of financial development that go beyond traditional banking. It is in this respect that the World Bank has developed a comprehensive conceptual framework to capture the multifaceted nature of the modern financial system. The framework has four dimensions that reflect the essential characteristics of a good and well-functioning financial system, which are depth, access, efficiency and stability. Assessment of these attributes can be applied to the two broad elements of the financial system, namely, financial institutions and financial markets (Figure 1).

2.20 Sahay *et al.* (2015) and Katsiaryna (2016)[55] apply the World Bank's framework by developing indices to measure the level of development of financial institutions and markets in terms of depth, access and efficiency thus, also expanding the range of indicators used to assess financial development. These multifaceted financial indices capture the fact that financial services are provided by a multiple financial institutions and a wide array of products and services catering for

[55] Sahay *et al.* (2015). "Rethinking Financial Deepening: Stability and Growth in Emerging Markets," IMF Staff Discussion Note; and Katsiaryna, S. (2016). "Introducing a New Broad-based Index of Financial Development," *IMF Working Paper 16/5*..

the various diverse saving/investment, credit and transactional requirements. Therefore, the use of multiple sub-indices allows for a more comprehensive assessment of financial sector development.

2.21 Under the financial institutions indices, the depth index combines variables such as private sector credit to GDP; pension fund assets to GDP; mutual fund assets to GDP; and life and non-life insurance premiums to GDP. The access index considers variables such as commercial bank branches per 100 000 adults and ATMs per 100 000 adults. The efficiency index combines variables such as the net interest margin; lending-deposit rate spread; non-interest income to total income; overhead costs to total assets; return on assets and return on equity. On the other hand, under financial markets indices, the depth index combines, in percent of GDP, variables such as the stock market capitalisation; stock market turnover; international government securities outstanding and private non-financial corporations' total outstanding debt securities. The access index combines variables such as the percent of stock market capitalisation outside of the top 10 largest companies and total number of debt security issuers (domestic and external, non-financial corporations, financial corporations). The efficiency index uses the stock market turnover ratio (stock market turnover/capitalisation).

2.22 In an effort to build an effective financial system, many developing countries, including in Africa, are designing strategies that seek to promote financial deepening. As such, financial sector policies are increasingly taking the centre stage in fostering growth and reducing poverty levels. To allow for an orderly development, many countries have adopted financial sector development plans, with the objectives as summarised below:

(i) Developing New Markets and Instruments

2.23 For several countries, the enhancement of financial depth and access involves deliberate promotion of stock market development. A vibrant stock market enables both firms and government to raise capital for investment, business expansion, infrastructure and social programmes and complements bank credit/loans. As a contribution to financial markets development, governments often take the lead by issuing treasury bills and long-dated bonds, largely to establish a benchmark yield curve and operational infrastructure, but which are also available to meet budgetary needs. As the market develops, private sector corporations and state-owned enterprises are expected to participate, leading to broader, deeper and more diversified markets in terms of participants and instruments.

(ii) Promoting Financial Inclusion and Economic Growth

2.24 At the core of the concept of financial inclusion is the objective to widen formal access by the various segments of households and firms to financial services provided in a responsible and cost effective manner in a well-regulated environment that ensures sustainability. With about two billion people worldwide, particularly those in rural areas, the unemployed and low-income earners, lacking access to financial services (unbanked), the need for financial inclusion is recognised the world over. Hence, an increasing number of countries are now adopting financial inclusion policies and programmes. These are increasingly in the context of new financial technology (fintech) which provides accessible channels and platforms for delivery of financial services. Fintech is undoubtedly accelerating the evolution of the financial sector, resulting in increased access to financial services and promoting financial inclusion. In the circumstances, mainstream financial institutions are rapidly embracing fintech and forging partnerships that facilitate improvements in operational efficiency and to respond to customer demands for more innovative services. However, there are regulatory complexities to address and the need for a framework for orderly embracing of fintech approaches to service delivery and financial inclusion while mitigating and managing the attendant risks.[56]

2.25 Financial inclusion also forms part of the financial and economic development agenda for the Sustainable Development Goals

56 PwC (2017). Global FinTech Report

(SDGs) adopted in 2015 because of the potential for a positive impact on structural transformation, poverty alleviation and economic development. In this regard, the G20 countries have contributed to the development of a list of financial inclusion indicators to help with measurement, identification of gaps and, therefore, strategies for improvement. Overall, given the social and economic benefits, financial inclusion programmes are considered a key part of any financial sector development framework or policy.

2.26 Enhanced financial inclusion contributes to inclusive growth as a greater number of businesses and households would be participants in financial intermediation; mobilisation of savings for investment purposes; increased efficiency and productivity of finance; risk mitigation and reduction in relative transaction costs through the use of new technologies. In this respect, Malaysia and Kenya are regarded as models of excellence for financial inclusion among the middle-income and low-income countries, respectively (see Section 4 for a detailed discussion).

(iii) Promoting Financial Development and Financial Stability

2.27 Financial development is initially advantageous as it promotes productive deployment of financial resources and risk sharing, and alleviates the constraints arising from information asymmetry. However, a highly developed and globally integrated financial system entails increased economic and financial vulnerabilities, while also amplifying boom-bust cycles by promoting greater risk taking and leverage. This is a greater challenge and with a potentially increased adverse impact in a poorly regulated and supervised financial system. The 2007/8 global financial crisis illustrates financial development and financial stability trade-offs, where the combination of a lightly regulated and integrated financial system contributed to the financial crisis and the significant adverse impact on macroeconomic outcomes and, in general, economic performance. The rapid development of the financial sector worldwide promotes greater inter-connectedness between financial institutions and the real economy, and creates potential for accelerated, widespread and intense contagion; thus, costly disruption to the financial sector and to economic performance. All these point to the importance of having a stable well-functioning financial system; hence the increased vigilance of central banks in respect of financial stability.

2.28 As part of the strategy to safeguard financial stability, there are concerted international efforts towards a system-wide macroprudential approach to regulation and supervision of the financial sector that also incorporates elements of micro-prudential (an institution-based system) regulation (Table 1). It is recognised that the soundness of an individual financial institution or segments of the financial sector is not enough to ensure financial system stability. Therefore, macroprudential policies derived from a broad-based monitoring framework help to limit systemic risks that could otherwise disrupt the provision of financial services and adversely affect the real economy. According to the Financial Stability Board and the IMF, systemic risk has two dimensions: a time-dimension (vulnerabilities relating to the build-up of risks over time) and a cross-sectional/structural dimension (associated distribution of risk within the financial system at any given point in time).[57]

2.29 Macroprudential policy seeks to address three key areas: increase the resilience of the financial system to aggregate shocks; contain the build-up of systemic vulnerabilities over time; and control structural vulnerabilities within the financial system. It is notable that macroprudential policy, as part of a broad macroeconomic policy framework, takes account of other policies that have a bearing on financial stability. Overall, macroprudential policy aims to reduce the frequency and severity of financial crises. Countries use a wide range of indicators and models to assess systemic risk. The main measurement approaches are summarised in Table 1.

[57] International Monetary Fund, Financial Stability Board and Bank for International Settlements publication on "Elements of Effective Macroprudential Policies; Lessons from International Experience," 31 August 2016.

Table 1: Categories of Measurement Approaches to Systemic Risks

Category	Indicators
Indicators of imbalance	Bank credit, liquidity and maturity mismatch, currency risk, credit-to-GDP gap
Indicators of market conditions	Spreads and risk premia, liquidity risk
Metrics of concentration of risk within the system	Network models to measure interconnectedness among financial institutions, identification of Global Systemically Important Financial Institutions (G-SIFIs)
Macro stress testing	Top-down and bottom-up stress testing tools and models to stress test the financial system as a whole
Integrated monitoring systems	Dashboards and heat maps

Source: Bank for International Settlements, International Monetary Fund and Financial Stability Board, 2011.

(iv) Safeguarding Consumer Rights and Confidence in the Financial System

2.30 A key element for enhancing and maintaining financial stability is the confidence of economic agents in the financial system. This can be promoted by an effective regulatory and supervisory framework that promotes competition among financial institutions and transparency to enable consumers to make informed financial decisions that include ability to switch, at minimum cost, to better financial service options when they become available. One factor that can entrench confidence in the financial system is a legal framework that recognises and effectively enforces property rights, contracts and protects consumer rights.

2.31 With respect to consumer protection, there is need for explicit consumer protection laws backed by sound and effective institutions that are accessible in terms of both cost and ease of requirements for dispute resolution. Therefore, the approach to consumer protection needs to be broadened to include relevant and appropriate financial literacy programmes to enable consumers to fully benefit from access and use of financial products; thus producing a greater impact on welfare and inclusive growth. So far, in Botswana, individual financial institutions and respective regulators address consumer protection issues through sector-based, therefore, fragmented complaints handling mechanisms. Furthermore, there is need for clear, simple, practical and easy to understand enforcement and restitution mechanisms as well as assurance of sustained provision of quality services, including maintenance of reasonable charges (aligned to the level and quality of services). Similarly, a simple deposit protection system targeting small savers will further strengthen public confidence in financial institutions and also reduce the "expectation gap," thus contribute to financial sector stability and growth.

3. Evolution of the Financial Sector in Botswana

3.1 The evolution of Botswana's financial system is well documented in a number of Bank publications, including the *Annual Reports* for 1993, 2001, 2011 and 2013. From 1976 to 1991, the financial system was characterised by financial repression, whereby interest rates were not market determined and government involvement in the provision of key financial services was prominent and entry into the banking sector was highly regulated and restricted. Since then, the development of the financial sector in Botswana beyond the 1990s was influenced by deliberate government policy, economic developments and advancing information technology. However, the financial sector is relatively small and undiversified compared to that of other middle-income countries. In particular, financial intermediation levels, credit and other monetary variables are comparatively low relative to nominal GDP. As noted in the Bank's 2011 *Annual Report*, the financial sector has ample scope and potential to expand its size and role in supporting the overall strategy of economic diversification and inclusive growth. Below is an update on the evolution of the financial sector, including possible innovation to enhance support to economic activity.

(a) Policy and Institutional Developments

3.2 A conducive regulatory environment is critical for financial sector growth, resilience and stability. The regulatory and supervisory framework and the facilitative arrangements that form part of financial development fall in the realm of legislation, institutions, policies and strategies. These need to be carefully designed for purpose, balanced and well-coordinated to align financial sector growth to development objectives, national aspirations and ongoing innovation, as well as structural transformation.

(i) Policy

3.3 The adoption of the FSDS in 1990, following the 1989 Government of Botswana and World Bank joint report entitled "Financial Policies for Diversified Growth," gave impetus to financial sector reforms. This transformed the Botswana financial sector by, among others, introducing a market-oriented regulatory framework, liberalisation of licensing requirements for commercial banks and enhancement of prudential supervision of the banking sector. The strategy also entailed a significant reduction in government involvement and intervention in the provision of some key financial services.[58]

3.4 The financial system has evolved considerably as a result of the FSDS of 1990. In particular, the range of financial services has increased to keep pace with economic development and also to cater for the evolving needs of economic agents. The policy approach to financial sector development was successful when viewed in the context of achievement of the main objectives (Table 2). It is also relevant to note that the switch from defined-benefit pension system to the defined-contribution pension plan for public sector employees had a significant impact on the financial landscape of Botswana.

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[58] In 1990, the assets of statutory banks and other government finance institutions (for example, Financial Assistance Policy (which was later replaced by the Citizen Entrepreneurial Development Agency), Public Debt Service Fund (PDSF), Botswana Development Corporation, Tswelelo (Pty) Ltd) as a percent of GDP was 16 percent, while a similar ratio with respect to commercial banks was 21 percent. By 2012, the ratio of the assets of statutory banks and other government finance institutions to GDP had dropped markedly to 5 percent, and the comparable ratio for commercial banks was 52 percent.

Table 2: Evolution of Financial Sector Development Strategies

Strategies	Recommendations	Response
Financial Sector Development Programme (1989 - 2011) (Derived from Botswana: Financial Policies for Diversified Growth)	• Stimulating greater competition among commercial banks • Promotion of domestic money and capital markets • Improving operating procedures for development finance institutions • Revision of government financial management and development promotion roles in a way that broadens the scope for anti-inflationary monetary and credit policies within a market-oriented environment	• Liberalisation of bank licensing requirements; Banking Act (CAP 46:04) and the Bank of Botswana Act (CAP 55:01) • Establishment of the Botswana Stock Exchange (BSE) • Issuance of government, parastatal and corporate bonds • Listing of domestic and foreign companies on the stock exchange • Establishment of Citizen Entrepreneurial Development Agency, Local Enterprise Authority, Botswana Development Corporation • Deregulation of interest rates • Introductions of Bank of Botswana Certificates (1991) • Government started issuing long-term bonds (10, 15, 18, 20 and 25 years) in 2003 and formalised through regular issuance under a P15 billion programme that includes Treasury Bills and quarterly auctions
Financial Sector Assessment Programme (2007)	• Establishment of a formal financial stability framework • Development of a formal supervisory framework for non-bank financial institutions	• The NBFIRA began operations in 2008 • A dedicated financial stability function within the Bank of Botswana instituted in 2010

Financial Sector Development Strategy 2012 - 2016 and NDP 10	• Enhancing access to private and public sector finance by the wider community, including small and medium scale enterprises and the rural population • Promotion of financial innovation • Sustaining capital market development • Implementation of the privatisation policy with respect to development finance institutions • Maintaining a robust framework for financial sector stability • Improvement in the payment and settlement system • Curtailing opportunities for fraud and money laundering • Continuing review of relevant legislation and the supervisory infrastructure to align it with both domestic and global developments • Improving consumer protection in the financial sector	• MAP, an initiative towards improved financial inclusion • Central Securities Depository established • Increase in the use of mobile money services, depository taking ATMs • NDB and BSB are not yet privatised, whereas BBS is undergoing a demutualisation process in preparation for applying for a banking licence • The Bank has instituted a review of the Banking Act of 1995 and the Bank of Botswana Act of 1996 to achieve modernisation, fit for purpose and functionality in relation to evolving mandate and operational imperatives • Review of legislation administered by NBFIRA to improve supervision and regulation; for example, NBFIRA Act of 2016, Retirement Funds Act of 2016; Securities Act and Insurance Industry Act • Basel II framework adopted and implemented with effect from January 1, 2016 • Establishment of Financial Intelligence Agency (FIA) and Competition Authority, and enhanced focus on enforcement of KYC and AML/CFT Protocols • Assessment of requirements for deposit insurance scheme • Establishment of a credit reference bureaux • Need for the establishment of an independent authority to deal with handling, analysing, monitoring and resolving consumer complaints and disputes
	The MAP study recommended: • Development of the payments ecosystem • Facilitation of low cost, accessible savings products • Development of accessible risk mitigation products • Improvement of the efficiency of the credit market • Consumer protection and empowerment	• Technical Working Group commenced work on financial inclusion implementation

3.5 More recently, the FSDS of 2012 - 16 sought to advance financial sector development with a focus on financial inclusion, promotion of financial innovation, sustaining capital market development, establishing a regime for banking resolution and crisis management, and strengthening the legal and regulatory frameworks for financial sector stability. The strategy was, to a great extent, informed by the joint International Monetary Fund-World Bank Financial Sector Assessment Programme (FSAP) of 2007. The key policy intentions of the strategy are implemented largely through the national development plans, legislation and policy modernisation by the Bank of Botswana, as well as other regulatory authorities and policy institutions.

3.6 There is ongoing work towards enactment of the Electronic Payment Services Regulations in line with the recommendations of the Making Access Possible (MAP) strategy to address growing concerns about lack of specific guidelines to govern electronic money and payment services. The regulations are part of the Bank's broader strategy to create an enabling regulatory environment for convenient, efficient and safe retail payments as well as funds transfer mechanisms. These regulations will provide for the licensing and oversight of electronic payment services providers and general provisions applicable to them. Moreover, the regulations will ensure that the services and infrastructure components are provided in a secure and appropriate manner, within the context of a correctly structured legal and regulatory framework that is responsive to emerging developments, innovation and market imperatives.

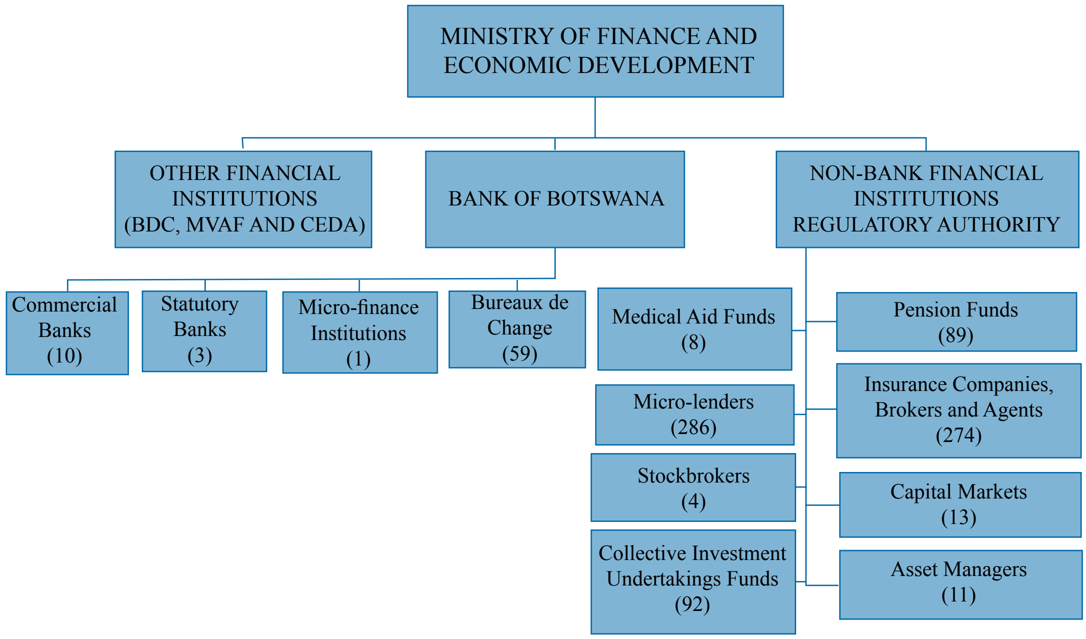
3.7 The MAP strategy effectively represents implementation of the ideas espoused in the FSDS of 2012-16. A reduction in the percentage of adults who are excluded from accessing financial services from 24 percent to 12 percent, and increasing those with access to more than one formal financial product from 46 percent to 57 percent by 2021 (as indicated in the MAP) should help increase economic efficiency and support growth. Crucially, the 2015 MAP Report identifies six priority areas to drive the financial inclusion agenda. The focus is on aspects of development that would facilitate and substantially enhance financial inclusion in the country. These areas encompass development of the payments ecosystem; facilitation of low cost, accessible savings products; development of accessible risk-mitigation products; improvement of the efficiency of the credit market; consumer empowerment and protection; and an implementation framework.

(ii) Regulatory and Supervisory Frameworks

3.8 It is important that financial sector development occurs in the context of an appropriate regulatory and supervisory framework that affords orderly expansion, monitoring and remedial action where necessary. Overall, the aim is to provide a framework that allows for effective performance of the financial sector role in the economy, and safeguards the resilience and stability of the financial system. Figure 2 shows the Botswana's regulatory structure of the financial system. In this context, the Bank, established through the 1975 Bank of Botswana Act and as amended in 1996, has a mandate for price stability and functions that are typical for a central bank. Also, in 1995, the then Financial Institutions Act (Cap 46:04) was replaced by the Banking Act, which strengthened the power of the Bank to license, regulate and supervise banks.

3.9 The Bank has initiated the review of both the Bank of Botswana Act and the Banking Act. The objective of the review of the Bank of Botswana Act is to accommodate the latest issues regarding central bank governance and outlook with respect to policy and institutional arrangements, as well as to address issues of administrative ease and effectiveness of implementation. The review of Banking Act is intended to improve bank resolution and crisis management, strengthen powers of the central bank to mandate remedial supervisory actions as well as ensure effective compliance with anti-money laundering and combating of financing of terrorism protocols. The proposed amendments are in line with the Financial Sector Development Strategy of 2012 – 2016, which emphasised, among others, the need to enhance the legal framework, regulations, prudential standards, and supervisory approach for commercial banking and the establishment

FIGURE 2: REGULATORY STRUCTURE OF THE FINANCIAL SYSTEM



Source: Bank of Botswana and NBFIRA.

of a robust regime for crisis management, as well as the need to address clearing, payments and settlement system issues.

3.10 The Non-Bank Financial Institutions Regulatory Authority (NBFIRA), established through the NBFIRA Act of 2006, has the mandate to regulate, supervise and enforce compliance within the non-bank financial institutions sector to safeguard the stability, as well as promote fairness and efficiency of the sector (Figure 2). The regulatory mandate has been strengthened through a revised NBFIRA Act promulgated in 2016 and enactments of various other legislation intended to support the orderly growth of the financial sector (Table 3). The enactments encompass the Retirement Funds Act of 2014 (Pension and Provident Act of 1987 was repealed); Insurance Industry Act of 2014 (Insurance Industry Act of 1987 was repealed); Securities Act and Botswana Stock Exchange (Transition) Act of 2015;[59] and Collective Investment Undertakings Act of 1999. Both the Bank of Botswana and NBFIRA use the Risk-Based Supervision model to prioritise supervisory focus and timely response to problem areas.

3.11 Meanwhile, the Botswana Communications Regulatory Authority regulates information-technology-based services that contribute to efficient delivery of financial services. The relevant regulations relate to licensing and pricing of services and enforcement of competition rules that affect delivery of financial services and financial inclusion.

3.12 In the international regulatory and supervisory sphere, some countries with mature financial markets have shifted from the traditional model to the twin peaks approach.[60] In the twin peaks framework, the regulatory authority is assigned on the basis of function rather than type of financial institution: one authority focuses on prudential regulation, while the other has regulatory oversight in respect of market conduct for all financial institutions. In South Africa, an important consideration for adopting the twin peaks regulatory model was the desire to ensure that consumer protection and market integrity receive sufficient attention and are not viewed as being secondary to prudential issues.

3.13 In general, adoption of the twin peaks model is predicated on the recognition of different skill sets required for prudential and market conduct

[59] This paves the way to demutualisation of the BSE and ultimately conversion of BSE from being a statutory body to a public company.

[60] This includes the UK, the Netherlands, New Zealand and Qatar, while South Africa is in transition.

Table 3: Recent Non-Bank Financial Institutions' Acts

Statute	Objective
NBFIRA Act (2016)	Facilitates regulation and supervision of non-bank financial institutions in order to ensure: • safety and soundness of the non-bank financial institutions; • highest standards of conduct of business of the non-bank financial institutions; • fairness, efficiency and orderliness of the non-bank financial institutions; • stability of the financial system; and • prevention of financial crime.
Retirement Funds Act (2016)	Provides for the licensing of annuities, preservation funds, beneficiary funds, and external funds, administrators and boards of retirement funds.
Insurance Industry Act (2014)	Provides for the licensing, governance and regulation of all insurers, insurance brokers, insurance agents and representatives operating in Botswana and for matters incidental to or connected therewith.
Securities Act (2015)	Consolidates and amends the laws relating to the regulation and supervision of the securities industry in Botswana; to make provision for the regulation and supervision of securities institutions and markets; to prohibit insider trading and other forms of market abuse; and to make provision for matters connected with the foregoing.
Botswana Stock Exchange Transition Act (2015)	Provides for the registration of BSE as a public company limited by shares under the Companies Act.
National Clearance Settlement Systems (2003)	Provides for the recognition, operation, regulation and supervision of systems for the clearing of transfer instructions between financial institutions, for the settlement of obligations arising from such clearing, for the discharging of indebtedness arising from such settlements made in such clearing systems and to provide for matters connected with and incidental thereto.

Source: NBFIRA and *http://botswanalaws.com*

regulation, hence allowing for optimisation of resource allocation. Typically, a central bank would be designated the prudential authority in acknowledgement of its traditional strength, expertise and effectiveness in the area, more particularly given the alignment of incentives for effective policy transmission channels and efficient payments infrastructure. Any consideration of introducing the twin peaks regulatory approach in Botswana would necessitate skill sets assessment between the main regulators, the Bank and NBFIRA, to ensure appropriate assignment of regulatory responsibility between prudential and market conduct and a definition of inter-agency relationship on issues that require coordination and exchange of views for regulatory development. In addition, the promulgation of a National Credit law in Botswana could expand scope for market conduct to facilitate the design of an appropriate market conduct regulatory framework.

(iii) Addressing Misuse and Crime in the Financial Sector

3.14 To combat financial crime, such as money laundering and the financing of terrorism, the Financial Intelligence Agency was established by the government on March 1, 2010, following promulgation of the Financial Intelligence Act of 2009. In addition, Botswana is a member of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). In 2016, ESAAMLG made an assessment of Botswana's anti-money laundering and the combating of the financing of terrorism (AML/CFT) framework. The Mutual Evaluation Report was released in May 2017. Following the evaluation, Botswana was requested to enhance its AML/CFT legal and regulatory framework. In this regard, relevant sections of the Banking Act are being reviewed to enable the statute to address the identified gaps, including compliance with international obligations on information sharing, cooperation on tax matters and clarity of mandate, to avoid dual accountability, for receiving and processing suspicious transaction reports and access to financial audit trails by the law enforcement agencies.

3.15 Globally, governments have to allocate significant resources to combat the financing of terrorism and establish mechanisms for preventing money laundering mainly through preventive measures. The regulatory approach also entails international cooperation in designing standard methods and processes for combating money laundering and financing of terrorism. For example, the Financial Action Task Force (FATF),[61] an inter-governmental entity, was formed in 1989, originally focussing on drug-related money laundering. Since then, the mandate of the FATF has evolved with an expanding scope to cover new trends of money laundering and financing of terrorism; and following the revision, in 2003, of FATF recommendations, about 180 countries endorsed them along with special recommendations. As a result, these are universally accepted as the international standard for anti-money laundering and countering the financing of terrorism (AML/CFT). In this context, the mandate of the FATF is to set standards and to promote effective implementation of legal, regulatory and operational measures for combating money laundering and terrorist financing. FATF works in collaboration with other international stakeholders to achieve the overall goal of ensuring that the integrity of the international financial system is preserved.

3.16 It is, therefore, clear why countries that fail to comply with AML/CFT standards find themselves isolated from the global financial system, as evidenced by the recent trail of terminations/reductions of correspondent banking relationships globally as a de-risking measure. For any country involved in international trade such as Botswana, it is a requirement that it implements and adheres to the AML/CFT standards to avoid the inconvenience associated with termination of cross-border trade relations. In this regard, FIA handles financial offences, which include money laundering, financing of terrorism and the acquisition of property using proceeds of criminal activities and, in this endeavour, cooperates with counterparty organisations in other countries.

3.17 The Directorate on Corruption and Economic Crime and the FIA complement the regulatory and supervisory entities by focussing on financial crimes, including corruption and fraud that could tarnish the integrity of the financial sector and undermine growth of services. There is a variety of other institutions that play different roles in contributing to an environment that is conducive for financial development (Table 4).

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61 The FATF Recommendations and the international AML/CFT and proliferation standards: updated in November 2017.

Table 4: Other Institutions in Support of Financial Sector Development

Institution	Description	Function
Botswana Investment and Trade Centre (BITC)	Provides professional service to both new and existing investors through its Business Facilitation Unit	• Aims to develop Botswana as a world-class hub for cross-border financial and business services within Africa and the region • Fosters innovation and sophistication in business and financial services • Provides updated, timely information on Botswana's business climate and regulatory regime
Botswana Unified Revenue Service	Responsible for tax assessment and collection on behalf of government	• Takes appropriate measures to counteract tax evasion and to improve taxpayer service, hence facilitating resource mobilisation, which is essential for economic growth • Administers and promotes compliance with Botswana's revenue legislation
Outsource Botswana	Association of the call centre and business process outsourcing industry in Botswana	• Advocates for the creation of a conducive business environment, which is essential for financial development • Protects the interest of the business industry by ensuring that the correct conditions are in place for the industry to grow • Protects the interests of the business industry
Business Botswana	Business association of employers in all sectors of the Botswana economy	• It advocates for a conducive business climate in Botswana, promoting good industrial relations and governance. This contributes to the process of sustainable economic and social development
Botswana Institute of Bankers	Offers professional banking qualifications of theory and practice in banking to enhance efficiency of banking services in the country	• Promotes banking as a career and profession in Botswana • Establishes and promotes the practice of a code of ethics for bankers • Promotes opportunities for members to acquire knowledge of theory and practice in banking
Botswana Fibre Networks	Wholesale provider of national and international telecommunications infrastructure	• Supports the provision of universal service and access to information and communication facilities, which are essential for the development and growth of the financial sector

Source: BITC, 2015 and Frontier Advisory Research, 2015.

3.18 In addition to the impact of technology, innovation also encompasses financial engineering involving several inclusion agenda products and instruments, such as credit and equity creation and financial derivatives/credit risk transfer (CRT) instruments, which include a variety of mortgage-backed securities, credit default swaps, financial guarantees, credit insurance and loan securitisation. Such innovation incorporates transfer and reduction techniques and generally improves market efficiency and facilitates better portfolio diversification.[62] However, there are related challenges that warrant policy intervention and regulatory attention. Some of the challenges are as follows:

(i) aggregate data that does not indicate risk status of individual institutions and inadequate information on how CRT markets are developing in the aggregate;

(ii) lack of transparency due to incomplete disclosure of CRT activities by firms;

(iii) the potential benefit of CRT is facilitation of a wider dispersion of risk that allows for flexible risk profile adjustment. Nonetheless, some aspects of the CRT market are characterised by high concentration;

(iv) divergence in accounting rules that have constrained certain parts of CRT, although this has the potential to bring to prominence the differences in regulatory treatment of credit risk between various types of institutions. In this regard, therefore, an opportunity exists for concerted effort towards more integrated regulatory capital standards;

(v) problems associated with unknown counterparty risk in relation to unfunded risk transfers against the backdrop of the scale and rapidity of changes in exposure and consequential pricing of portfolio instruments.

62 Bank for International Settlements, Committee on the Global Financial System: 'Credit Risk', January 2003.

3.19 Overall, technology has significantly advanced to allow undertaking of sophisticated financial transactions, but there has not been commensurate evolution of both the financial markets and regulatory framework in Botswana to effectively and efficiently accommodate the use of credit risk transfer instruments, which are complex and generally not well known domestically. Thus, Botswana has not kept pace with other countries, particularly large emerging markets and advanced economies in introducing credit risk transfer instruments and other types of derivatives. Financial institutions, especially banks, are, by definition, "risk-traders." Therefore, the absence of risk mitigating techniques is a major deficiency for sustainable financial sector development.

(b) The Banking Market Structure

3.20 Regarding the banking structure, competitiveness and efficiency, there is evident improvement. The Bank has previously determined, using the Hirschman-Herfindahl Index (HHI) and net interest margin (NIM), that the banking market in Botswana is oligopolistic, with domination by a few large banks. The HHI was 0.195 in 2011 and 0.177 in 2015, while the NIM fell from 8.2 in 2013 to 4.7 in 2015. The changes in the HHI indicated gains in competition, while the change in the NIM could be due to both competition and the general decline in interest rates. However, in 2016, these measures increased slightly and continue to signify room for improvement in terms of an enhanced level of financial sector development, inclusion as well as competitiveness in order to foster diversity of banking products and innovation, hence more effective intermediation and coverage.

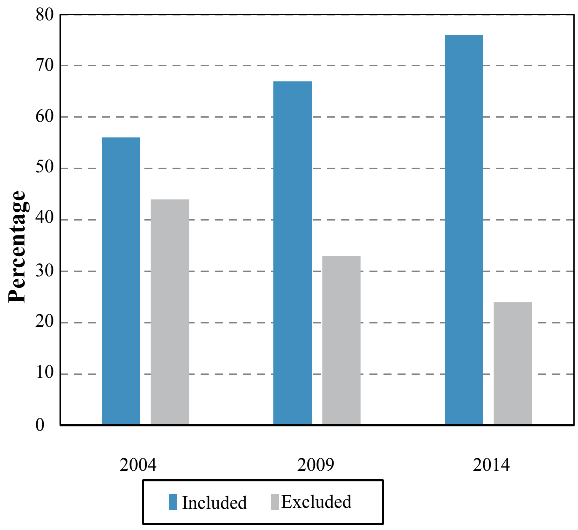
(c) Financial Inclusion

3.21 Financial access has improved in Botswana, as reflected in the FinScope report of 2014, which showed that 76 percent of adults were financially included compared to 56 percent and 67 percent in 2004 and 2009, respectively (Chart 1).[63] Promotion of financial access also includes improving financial literacy as

63 According to FinScope, adults are financially included if they have access to banks products, other formal financial products or informal products.

recognised in the Government's financial inclusion agenda, articulated in the Making Access Possible (MAP) strategy. Even then, to be effective, the strategy should involve an institutional, policy and legal framework that promotes both financial access and literacy.

CHART 1: TRENDS IN FINANCIAL INCLUSION

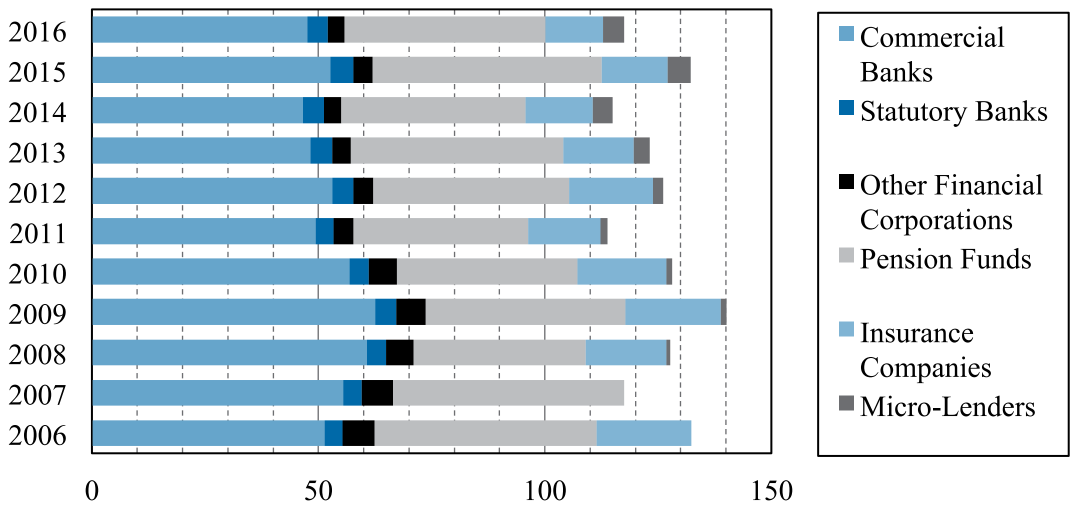


Source: FinScope

(d) Structure of Financial Institutions

3.22 The liberalisation of the financial sector has allowed for a well-diversified, well-connected, and competitive system that is able to offer a variety of financial instruments. To date, the financial system has become more developed and consists of commercial banks, statutory banks, a building society, a micro-finance institution (Women's Finance House), development financial institutions, micro-lenders, investment institutions, insurance companies, pension funds, fund managers and the stock exchange (Chart 2).[64] Figure 3 shows interlinkages of the financial sector institutions, including asset and liability relations as at 2016. Measures of financial depth and breadth, access to financial services and delivery platforms generally show an upward trend, implying a developing financial sector (Table 5). However, the almost unchanged number of commercial banks since 2010 could reflect that the banking market has become saturated, given the size of the economy.

CHART 2: ASSETS OF FINANCIAL INSTITUTION AS A PERCENT OF GDP



Source: Bank of Botswana and NBFIRA

[64] Micro-lenders are dominated by Letshego Financial Services Botswana. Furthermore, the Ministry of Finance and Economic Development (MFED) did not publish the figure for insurance in 2007, while information for micro-lenders was not available for 2006 and 2007.

Table 5: Selected Indicators of Financial Development

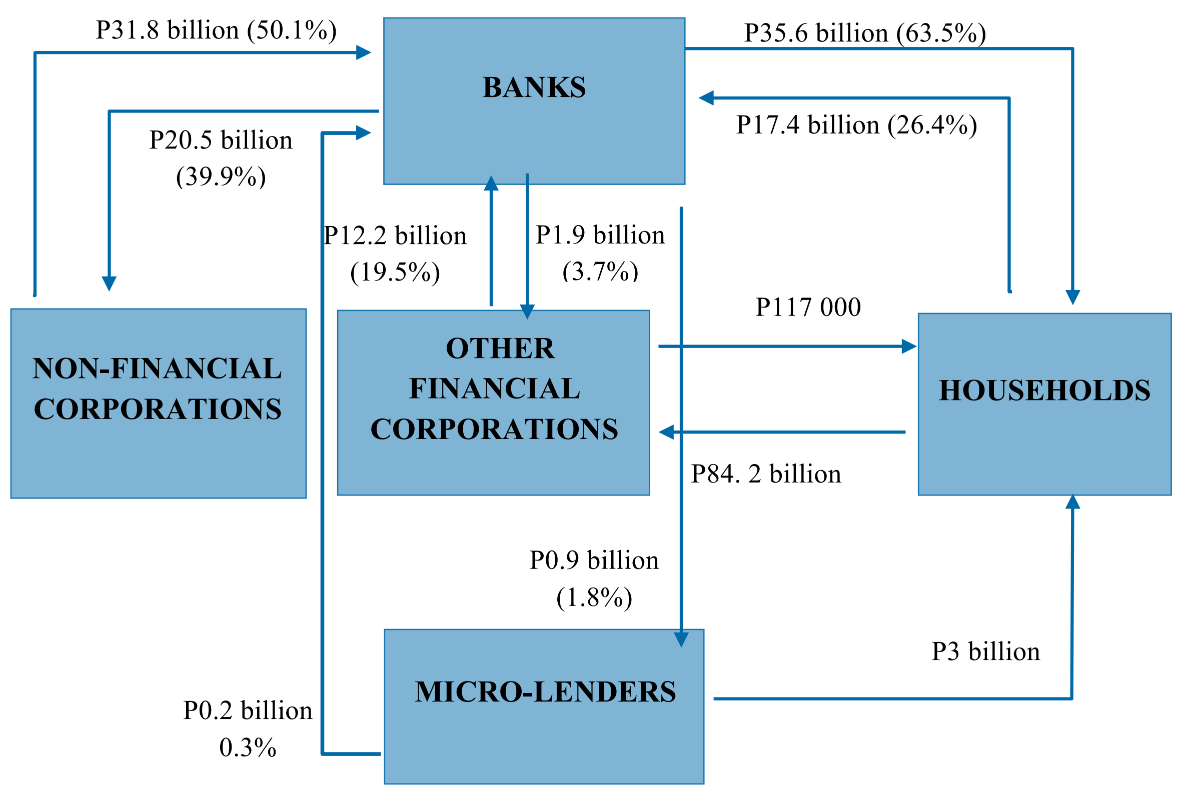
	Number					
Institutions and Mode of Service Delivery	**2000**	**2005**	**2010**	**2015**	**2016**	**2017**
Commercial Banks	4	5	11	10	10	10
Branches	59	71	94	114	115	110
Agencies	17	11	3	18	14	0
Statutory Banks	2	2	2	2	2	2
Building Society	1	1	1	1	1	1
ATMs[1]	112	191	391	427	455	497
Institutions	**Assets in Pula Million**					
Commercial Banks	8 554	17 761	49 376	76 721	80 694	83 468
Statutory Banks	467	1 000	1 689	3 229	3 871	3 607
Building Society	424	953	2 073	4 264	3 765	3 926
Financial Sector Indicators[2]	**Selected Indicators (Percent)**					
Total Commercial Banks' Credit/GDP	17.2	17.3	25.5	33.1	30.1	31.1
Commercial Banks' Deposits/GDP	24.1	25.2	46.5	41.1	36.6	36.5
Stock Market Capitalisation/GDP	18.3	25.6	30.4	34.2	27.1	25.5
Broad Money/GDP[3]	33.4	43.0	49.3	45.8	41.4	41.6
Pension Funds' Assets/ GDP[4]	…	42.6	39.9	50.6	44.0	47.1
Insurance Industry Assets/ GDP	…	…	19.2	14.7	12.6	…
Portfolio Investment/GDP	0.3	1.2	3.4	1.9	1.8	…
	Number of Financial Services Users					
Commercial Banks' Borrowers	…	176 331	242 807	365 687	259 786	252 214
Commercial Banks' Depositors	…	411 431	659 431	917 416	897 251	1 012 482
Registered Mobile Money Accounts	…	…	3 812	1 190 952	1 430 612	…

Notes

1. The number of ATMs comprises both full and mini ATMs and is inclusive of all commercial banks and the Botswana Building Society.
2. GDP figures for 2017 were estimates pending the release of the 2017 quarter four GDP, while commercial bank data are preliminary.
3. Broad money refers to the broadest definition of money prevailing at any reference period. It was M4 in 2000, M3 in 2005 and M2 thereafter.
4. Figures for 2017 are provisional.

Source: Bank of Botswana.

FIGURE 3: STRUCTURE OF THE FINANCIAL SYSTEM IN BOTSWANA



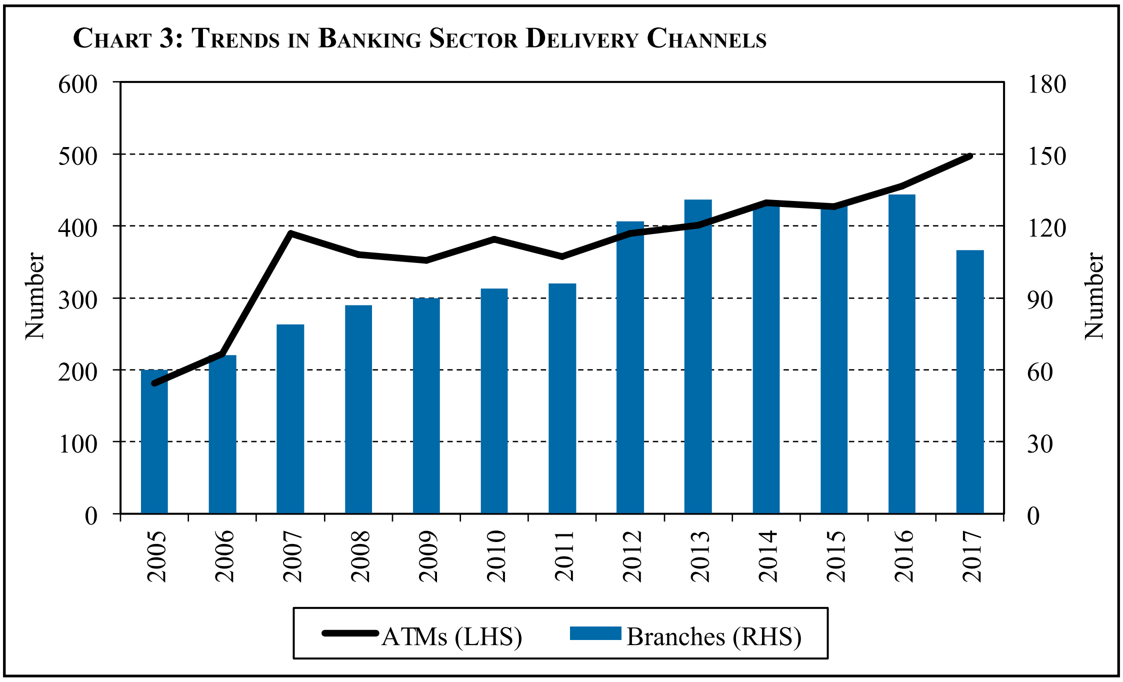
Source: NBFIRA

(i) Banking System

3.23 Hitherto, the financial sector in Botswana had been dominated by the banking sector. However, the dominance of the banking system by asset size in the financial sector has been surpassed by non-bank financial institutions (Figure 3). Nonetheless, the banking system remains a significant player in financial intermediation and provides a wider range of services than the rest of the financial sector. Banks have an extensive branch network and ATMs in major villages, towns and cities, albeit concentrated along the eastern corridor of the country. The sparsely populated areas of the country with low economic activity have limited commercial bank branches and ATMs available in a few villages. There are ten commercial banks in Botswana (four of which are dominant in asset size with at least 73 percent share of the banking industry) and three statutory banks (including a building society).

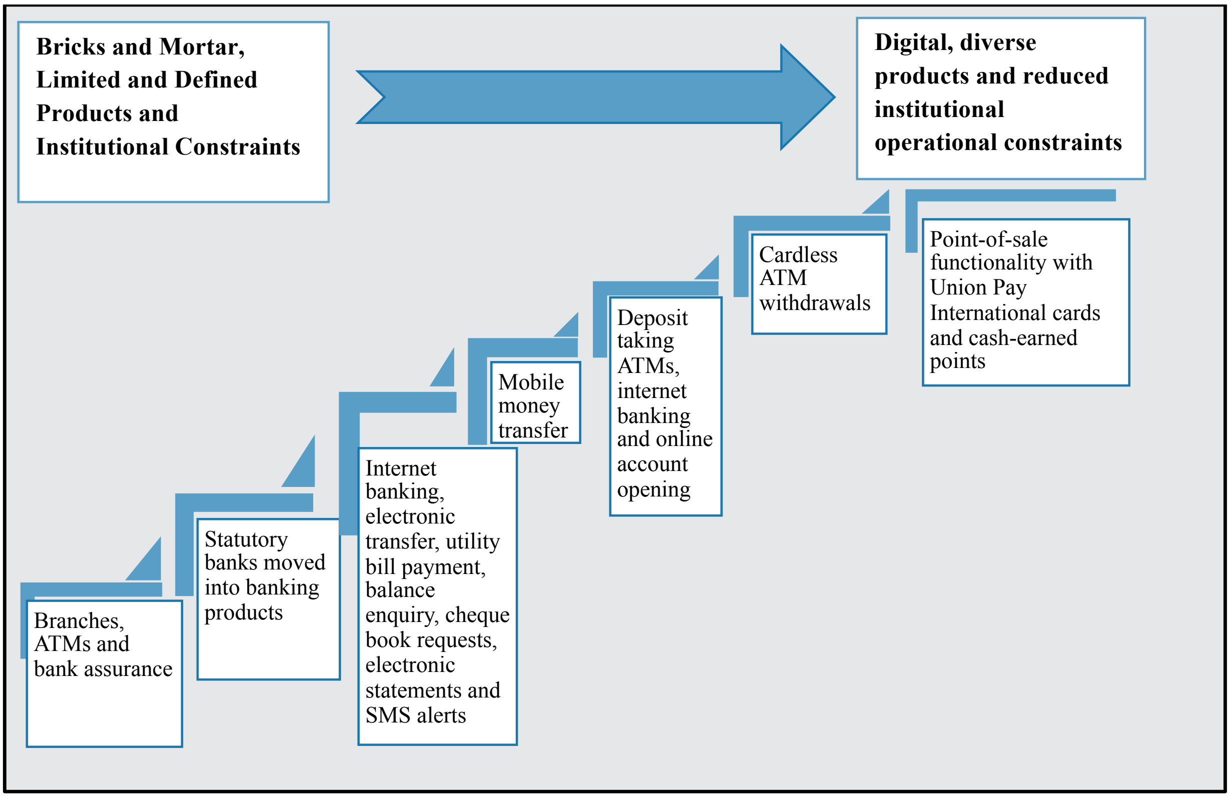
3.24 The banking sector has a comparable range of financial services to more mature markets, such as South Africa. However, in the last decade, bank branches grew at a slow pace, although in some respects compensated for by the rapid deployment of ATMs with more value-added features, such as non-cash transactions and cash deposit capabilities. Moreover, the increased role and application of digital technologies has reduced the need for "brick-and-mortar" infrastructure (Figure 4 and Chart 3). For example, the use of internet banking, mobile banking and mobile money has facilitated quick and direct provision of financial and payment services in the country.

CHART 3: TRENDS IN BANKING SECTOR DELIVERY CHANNELS



Source: Bank of Botswana

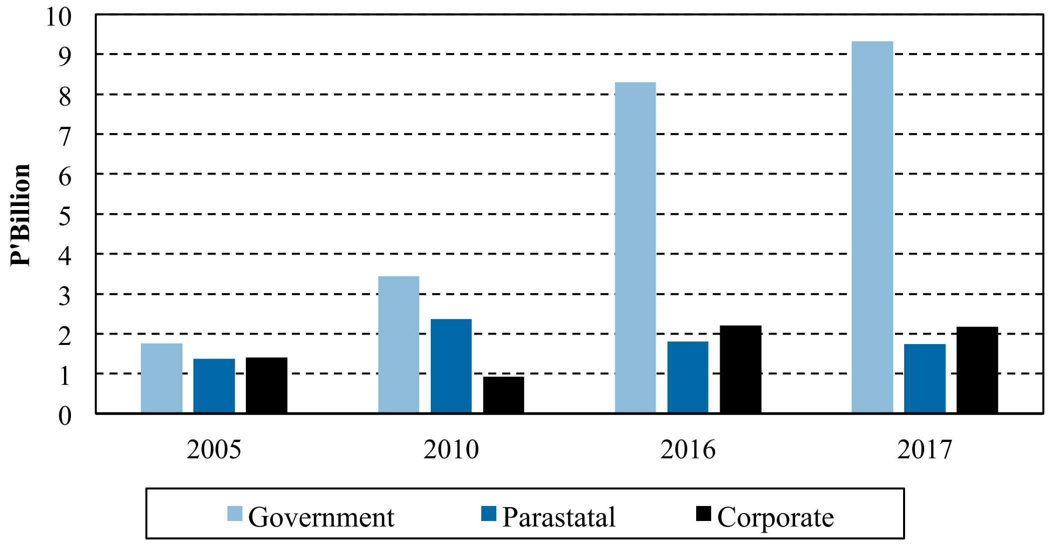
FIGURE 4: TRENDS IN NEW BANKING SERVICES AND DELIVERY CHANNELS[65]



Source: Bank of Botswana.

[65] Provision of banking services through branch networks and ATM was historically the main avenue, however, from the late 2000s, technological advancement led to widespread adoption of additional channels by commercial banks.

CHART 4: DEBT (BOND) MARKET



Source: Botswana Stock Exchange and NBFIRA

(ii) Non-Bank Financial Institutions

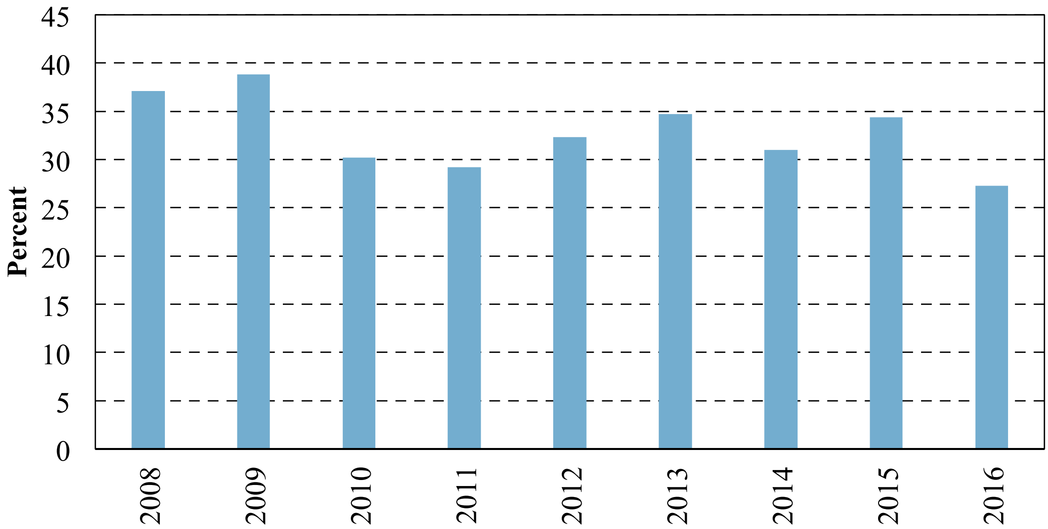
3.25 The non-bank financial sector includes retirement/pension funds, insurance, the capital market, mutual funds and micro-lenders. Pension funds are the single largest sub-sector of the non-bank financial sector, with assets relative to GDP estimated at 47.1 percent in the third quarter of 2017.

Capital Market: Bonds and Stock Markets

3.26 An important aspect of financial development is the evolution of the capital market in Botswana, which has grown markedly over the years. The stock and bond markets in Botswana play an important role of financing government, providing investment opportunities for pension funds, life insurance and annuities as well as new capital for private sector investment. The government bond market, initiated in 2003 and underpinned by sovereign credit ratings for Botswana since 2001, has provided an opportunity for further market development, including appropriate pricing of funds, and improvement in the trading and operational infrastructure and systems. In 2011, the Government increased the P5 billion bond issuance programme to P15 billion and the suite of government bonds now include maturities ranging from 2 - 25 years. The profile of government securities confirms the commitment to deepening the financial markets and addressing the structural bottlenecks that inhibit the intermediation of longer-term funds. However, given the net positive cash position of government and regular budget surpluses, issuance under the Government's note programme remains slow and significantly below the current limit of P15 billion, with an outstanding balance of P10.2 billion, inclusive of Treasury Bills, at end of 2017.

3.27 The bond market is relatively small as a proportion of GDP, and shows a declining trend from 8.9 percent in 2005 to 7.7 percent in 2010 and further to 7.2 percent in 2016. Notably, securities issued by government and government-related institutions dominate the bond market and constituted over 80 percent of the market in 2017 (Chart 4). During the period 2010 to 2017, the stock of issued government bonds fluctuated around a net balance of six, with three additions while three matured. Furthermore, short-to-medium term securities dominate outstanding securities; thus, there is unmet demand for long-dated securities by the pension funds and insurance financial sub-sectors, as evidenced by progressively larger bid to cover ratios on issuance along the maturity spectrum. Moreover, the size of the stock market relative to GDP in Botswana remains very small compared to other countries (Chart 5). This, to some degree, could reflect

Chart 5: Domestic Stock Market Capilisation as a Percent of GDP



Source: Botswana Stock Exchange

the capital structure of domestic firms where businesses may be largely using internal resources (retained earnings) and short-term debt for financing operations, which, notably, is the preferred financing option by the dominant mining sector.

Retirement Funds

3.28 The pension funds industry continues to grow, following the decline occasioned by the 2007/08 global financial crisis that reduced total industry assets by 12 percent between 2008 and 2009. The establishment of the Botswana Public Officers Pension Fund (BPOPF) in 2001 provided impetus to growth of the sector, with membership rising from 52 509 to 237 482 between 2001 and 2016 and assets of the pension funds increasing from P4.5 billion in 2001 to P82 billion in December 2017. In addition to the growth in membership, the increase in pension fund assets was supported by investment returns. However, growth of the pension funds has not translated into corresponding deepening of the annuities market as the annuities market is still dominated by one large entity[66] (Botswana Life Insurance Limited), and has limited domestic investment options.

Insurance Industry

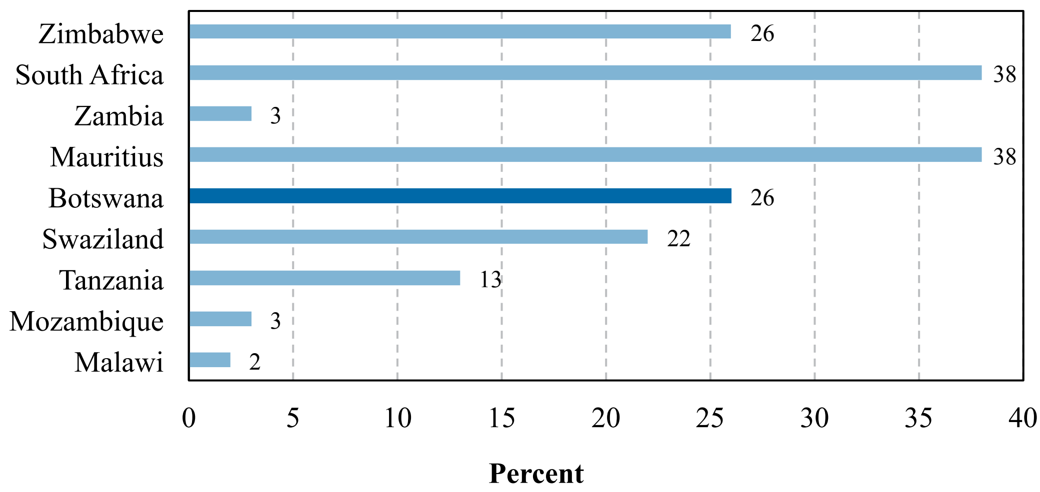
3.29 The insurance industry comprises life insurers, general insurers (accident, engineering, property, guarantee, liability, transportation and miscellaneous insurance services), re-insurers and medical insurance funds. Insurance industry assets relative to GDP have declined over the years, from around 20 percent in 2006 to about 12 percent in 2016. The decline in performance of the industry is a reflection of adverse conditions in the commodities markets, which affected the mining sector as well as households, resulting in a contraction in booking of new policies and cancellations. Insurance penetration has been stagnant at around 3 percent over the past five years.[67] However, insurance penetration, measured in terms of insurance uptake by the adult population in Botswana, is relatively high compared to other African countries, but lags behind Mauritius and South Africa (Chart 6) and is low relative to the country's income level (per capita income).[68] Thus, as of 2015, the uptake of insurance services (30 percent of adult population) is well below that of banking services in Botswana (50 percent of adult population).

66 The market share of gross written premiums for life and annuity of Botswana Life Insurance Limited was 66.5 percent and 17.7 percent for Metropolitan Life Insurance Limited in 2016.

67 Insurance penetration is essentially the contribution of the insurance market in the economy, it is measured as gross written premium as a share of GDP.

68 Botswana: Demand, Supply, Policy and Regulation Diagnostic Report, Centre for Financial Regulation and Inclusion, May 2015.

Chart 6: Population Formally Insured, 2014



Source: FinMark Trust, 2016: Measuring Financial Inclusion in the SADC region using Finscope.

Non-Bank Lenders

3.30 Non-bank lending services include micro-lenders, finance/leasing companies and some of the insurance companies. The bigger micro-lenders[69] mainly service individuals working for government, parastatals and large corporations, where they also have deduction arrangements at source or payroll deductions. In addition, there are several small micro-lenders providing finance in a less formal environment, albeit all required to be registered and regulated by NBFIRA. Micro-lenders' total loan book grew from P388.6 million[70] in 2006 to P3.9 billion at the end of 2016, compared to commercial bank credit of P51.3 billion at the end of 2016. At 7 percent of total market credit, micro-lenders are a relatively small part of the credit market.

Development Finance Institutions (DFIs) and Other Government Financial Support Programmes

3.31 The government has actively participated in the financial sector, mainly to close a perceived gap in financing of small, micro and medium scale enterprises (SMMEs) and, in particular agriculture, as well as promotion of entrepreneurship to foster industrialisation. Table 6 shows development financial institutions and government programmes, their areas of focus and latest asset size and/or extent of success, while Chart 7 presents trends in funding by government-owned financial entities.

3.32 Furthermore, it is notable that state-owned institutions are redefining their roles and objectives and some progress has been made in this regard. In particular, the Botswana Savings Bank (BSB) has been identified as a channel for supporting Government's financial inclusion objectives alongside Botswana Postal Services, to strengthen coverage and efficiency of the deposit-taking function and the adoption of ICT to facilitate transactions, remittances and value added services. In 2017, Botswana Building Society (BBS) began its demutualising process as a precursor to applying for a commercial banking licence, intended to enhance its adaptability and, therefore, competitiveness and effectiveness in the provision of financial services. The privatisation and restructuring of the National Development Bank (NDB), on the other hand, has stalled in the context of lacklustre financial and operational performance. There is, therefore, a need for improvement to

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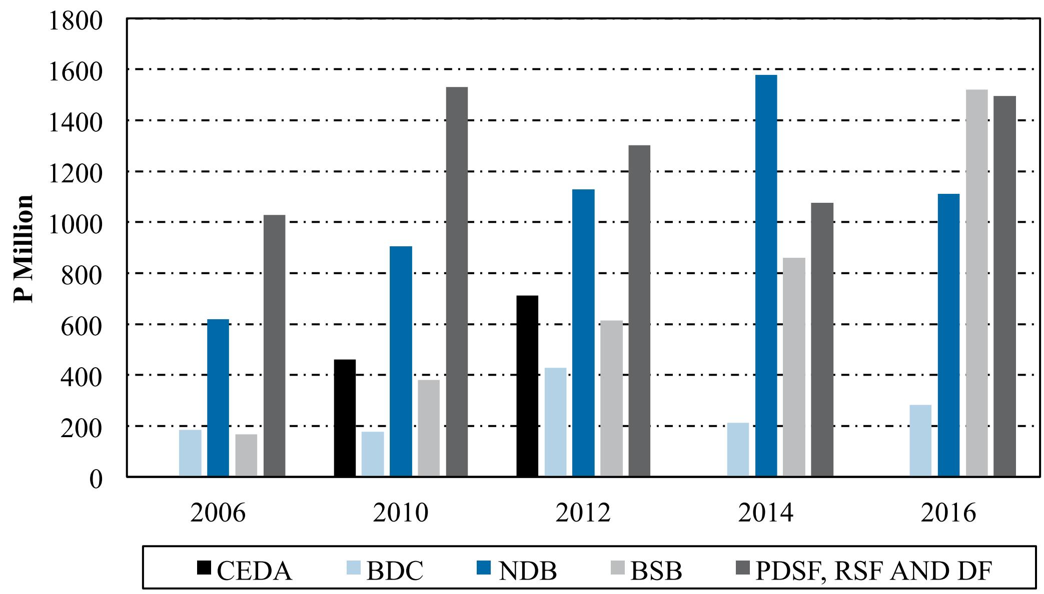
69 Letshego Financial Services is the largest micro-lender in the micro lending sector followed by the following medium-sized micro-lenders: Babereki Investments (Pty) Ltd, Thito Holdings (Pty) Ltd, Afritec (Pty) Ltd, TU Loans (Pty) Ltd, GetBucks (Pty) Ltd, SureChoice (Pty) Ltd and Silver Dollar Investments (Pty) Ltd.

70 The micro-lending figure for 2006 is proxied by Letshego Financial Services gross loans.

CHART 7: FINANCIAL SUPPORT BY GOVERNMENT-OWNED INSTITUTIONS



Source: Bank of Botswana and MFED.

achieve an effective role in meeting the gap in productive finance for the relevant sectors.

3.33 The commonly stated rationale for establishing stated-owned enterprises is to address market failure in the provision of certain essential services on a commercial basis and to fulfil public policy objectives. For Botswana, development finance institutions[71] (DFIs) may still be especially relevant to support economic diversification, financial inclusion, empowerment of citizens and bridge perceived financial gaps, such as where funding of high-risk long-term projects that promise broad economic benefits is required, but not available from private financial institutions. However, DFIs have an unimpressive performance record globally and often become a fiscal burden for governments. Several studies have concluded that increased government presence in the financial sector through DFIs tends to slow down financial development, productivity and economic growth.[72] In addition, country experiences corroborate evidence of poor performance by state-owned financial enterprises. This is because, in practice, credit underwriting standards and criteria are often less strict with respect to assessed commercial/economic viability of projects and collection efforts tend to be weak. It is also possible that credit allocation that is not necessarily based on economic returns would deny the allocation of resources to business firms that have the potential to productively use credit and contribute to economic growth and employment creation. Significantly, the performance of DFIs is often undermined by 'adverse selection', with marginally credit worthy projects and non-viable banking proposals pushed to such entities. Furthermore, DFIs are typically plagued by corporate governance challenges, in part, due to over-representation of public sector employees (with full-time jobs elsewhere) in the governing structures (board of directors) of these institutions.

71 According to Central Bank of Nigeria, development finance institutions are specialised financial institutions established with specific mandates to develop and promote key sectors of the economy considered to be of strategic importance to the overall socio-economic development objectives of the country.

72 IMF Institute for Capacity Development: Course on Financial Development and Financial Inclusion.

Table 6: Development Financial Institutions and Government Programmes/Schemes

Name	Key Characteristics	Size
BDC	Loans, equity participation	Assets: P2.5 billion (2016)
CEDA	Loans from P500 to P30 million at 5 - 7.5 percent interest rate per annum, business advisory services	Loans: P80 million (2017/18)
BBS	Full banking suite at market rate, mortgage loans, short-term loans, savings and investment accounts	Assets: P3.6 billion (2017)
BSB	Full banking suite includes branch networks, small savers, civil servants' loan facilities	Assets: P2.2 billion (2016)
NDB	Lending to agriculture, commerce, real estate, human resources development and industrial sectors at market rates, manage government subsidy programmes	Assets: P2.6 billion (2016)
PDSF	Funding of parastatals at subsidised interest rates	Loans: P1.5 million
Youth Development Fund	Provision of funding to out-of-school, unemployed, underemployed and legally registered business/company that is owned by young citizens (18-35 years old), funding is 50 percent grant and 50 percent interest free loan	P107.7 million funding (2016)
Livestock Management and Infrastructure Development (LIMID)	Promotes food security through provision of support in the livestock industry (cattle and small stock)	34 653 beneficiaries (2017)
Integrated Support Programme for Arable Agricultural Development (ISPAAD)	Develops the arable agriculture sector through provision of seeds, fencing, facilitation of access to credit etc.	100 250 participants (2016/17)

Sources: Botswana Financial Statistics 2017, State of the Nation Address 2017, www.bbs.bw, www.ndb.bw, www.gov.bw.

4. CROSS-COUNTRY EXPERIENCES AND COMPARISONS

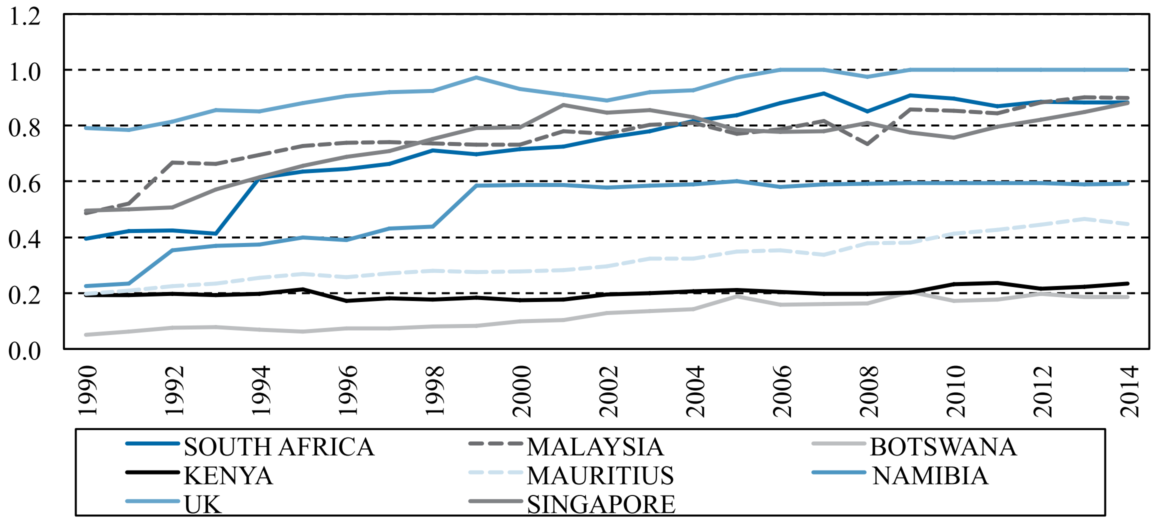
4.1 Upper middle-income countries (UMICs) have progressed in financial development over the past three decades. Both the financial institutions and financial markets, generally, are relatively well-developed in these countries. Among the middle income and lower income countries, Malaysia and Kenya are regarded as models of excellence for financial inclusion achieved through harnessing of information and communications technology. In addition, India offers a case study of transition from very low penetration of formal banking and a large underserved market to extensive utilisation of a well-developed technology ecosystem within a short space of time. Therefore, in order to examine and contextualise Botswana's achievements in financial sector development, a comparison is made with selected countries.

(a) Financial Depth[73]

4.2 As shown by the various measures of financial deepening, the financial sector in UMICs has grown significantly alongside progress in economic activity generally, globalisation and enhanced cross border expansion of banks and other financial institutions, widening of products and services, as well as technological developments. Among the selected countries shown in Charts 8 and 9, and Table 7, South Africa, Singapore and Malaysia experienced the most rapid financial development, especially with respect to financial markets.

4.3 Botswana was the lowest ranked country in financial institutions depth among the selected comparator counties. Although the financial sector in Botswana has improved over the years, it remains relatively small by the

CHART 8: FINANCIAL INSTITUTIONS DEPTH INDEX, 1990 - 2014

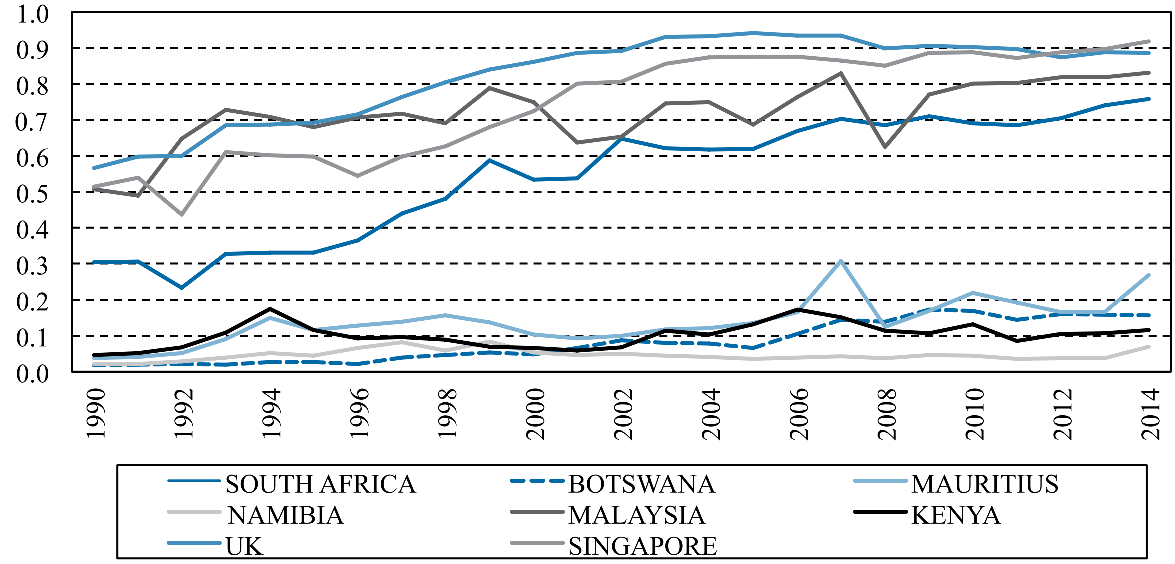


Note: The Financial Institutions Depth index shows how developed financial institutions are relative to the economy. The index combines variables such as private sector credit to GDP; pension fund assets to GDP; mutual fund assets to GDP; and life and non-life insurance premiums to GDP.

Source: http://data.imf.org/

[73] Financial depth indices are constructed using a list of indicators to measure how deep financial institutions and financial markets are. The financial institutions depth index combines variables such as private sector credit to GDP, pension fund assets to GDP, mutual fund assets to GDP; and life and non-life insurance premiums to GDP, while the financial markets depth index combines, in percent of GDP, variables such as the stock market capitalisation, stock market turnover, international government securities outstanding and total debt securities outstanding of private non-financial corporations.

CHART 9: FINANCIAL MARKETS DEPTH INDEX, 1990 - 2014



Note: The Financial Markets Depth index shows how developed financial markets are relative to the economy. The index combines, in percent of GDP, variables such as the stock market capitalisation, stock market turnover, international government securities outstanding, and total debt securities outstanding of private non-financial corporations.

Source: http://data.imf.org/

TABLE 7: 2014 UMICS RANKINGS ON FINANCIAL INSTITUTIONS AND FINANCIAL MARKETS- DEPTH, ACCESS AND EFFICIENCY[74]

Financial Institutions Depth		Financial Institutions Access		Financial Institutions Efficiency	
Position	**Country**	**Position**	**Country**	**Position**	**Country**
1	UK	21	UK	4	Malaysia
7	Malaysia	58	Mauritius	29	Singapore
9	South Africa	70	South Africa	59	Mauritius
10	Singapore	79	Namibia	78	South Africa
29	Namibia	81	Singapore	80	Namibia
36	Mauritius	88	Malaysia	84	UK
74	Kenya	111	Botswana	101	Botswana
86	Botswana	138	Kenya	128	Kenya
Financial Markets Depth		**Financial Markets Access**		**Financial Markets Efficiency**	
Position	**Country**	**Position**	**Country**	**Position**	**Country**
3	UK	12	UK	12	UK
6	Singapore	15	Singapore	24	South Africa
10	Malaysia	16	Malaysia	30	Singapore
14	South Africa	22	Mauritius	38	Malaysia
52	Mauritius	60	South Africa	60	Kenya
75	Botswana	68	Namibia	72	Mauritius
81	Kenya	69	Botswana	82	Botswana
102	Namibia	106	Kenya	88	Namibia

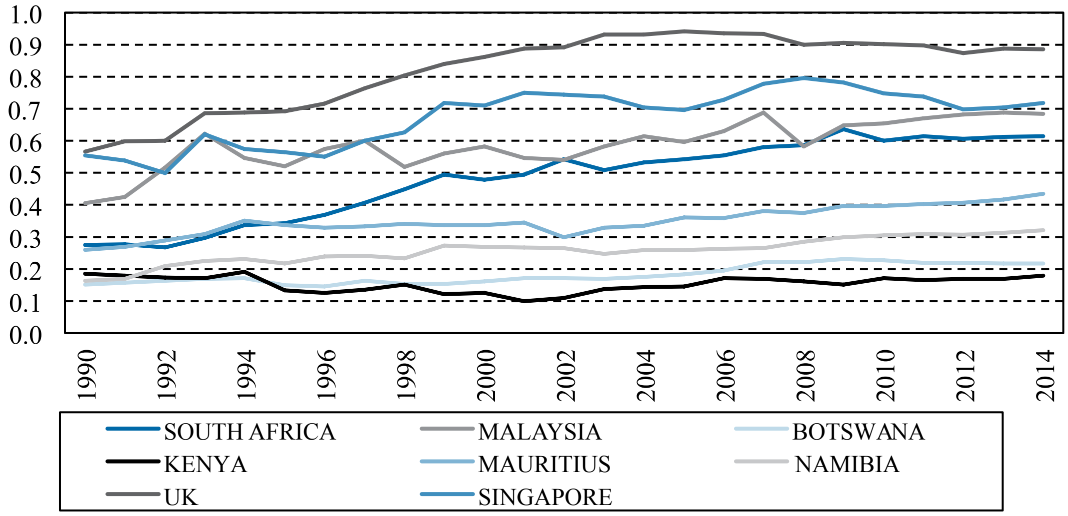
Source: Katsiaryna (2016)

74 The rankings are based on a total of 182 countries and the data are available up to 2014.

Table 8: Financial Development Indicators - Depth, Average for 2011 - 2015 (Percent)				
	Financial Institutions		**Financial Markets**	
	Private Sector Credit/GDP	**Bank Deposits/ GDP**	**Stock Market Capitalisation/GDP**	**Stocks Traded/ GDP**
Botswana	31.1	39.8	32.9	0.9
Kenya	32.2	38.6	26.9	2.1
Malaysia	117.7	122.8	138.4	40.7
Mauritius	99.2	92.1	66.9	3.3
Namibia	50.0	53.4	4.5	0.3
Singapore	122.1	119.9	239.3	87.4
South Africa	147.0	58.8	229.5	61.9
UK	152.8	…	115.4	92.5
UMICs	48.2	45.8	34.8	5.5
High Income Countries	85.1	72.0	59.9	16.0

Source: http://data.imf.org/

Chart 10: Financial Development Index, 1990 - 2014



Note: The Financial Development index measures the level of a country's financial sector development. Financial development is defined as a combination of: size and liquidity of markets; ability of individuals and companies to access financial services; ability of institutions to provide financial services at low cost and with sustainable revenues; and the level of activity of capital markets.

Source: http://data.imf.org/

standards of other UMICs, as measured by the low bank deposits to GDP and private sector credit to GDP ratios (Table 8), hence the low ranking.

4.4 Similarly, Botswana's financial market depth is very low, ranking only better than Kenya and Namibia. Notably, the stock market capitalisation to GDP and stocks traded to GDP ratios of 32.9 and 0.9, respectively, are significantly lower than 239.3 and 87.4 for Singapore, 229.8 and 61.9 for South Africa and 138.4 and 40.7 for Malaysia (Table 8). The above statistics show that the Botswana financial sector remains very small relative to the size of the economy, compared to the selected comparator countries. Meanwhile, the overall financial development index, as indicated in Chart 10, shows that Botswana's financial sector still lags behind high income countries and its UMIC peers.

4.5 The rapid financial sector development in Malaysia (Chart 10) is partly the result of the liberalisation of the financial sector which raised foreign equity ownership limits and allowed more foreign companies to operate in the Malaysian financial services sector. Moreover, new Islamic banking licences[75] were issued to foreign banks with the aim to promote Malaysia as a global Islamic financial services hub.

4.6 In South Africa, financial sector growth was influenced by an increase in secondary level services, such as derivatives markets and associated growth in fund management and other support services. In this regard, there has been a broadening of investment opportunities and greater scope of portfolio diversification and, consequently, risk mitigation products and services.

4.7 For Botswana, financial sector growth, in terms of efficiency and diversity of products, could be constrained by the small national market. Against this background, regional financial integration offers a possible strategy to unlock the efficiency of scale and returns from diverse products, thereby expanding the possible financing options and vehicles for savings in a country. Small countries with a nascent local securities market, such as Botswana, can derive benefit from listing and trading their instruments on a regional financial market. Thus, there have been efforts towards establishing Botswana as a regional international financial services centre. The International Financial Services Centre (IFSC) was therefore set up in 2003, offering incentives and dispensations to attract foreign companies and import services to Botswana, potentially engendering skills development and creating employment opportunities. In 2012, IFSC was merged with the Botswana Export Development and Investment Authority (BEDIA) to form the BITC. Progress for Botswana towards a regional international financial services centre has been slow. There are only seven IFSC accredited companies providing services on fund management, risk management, re-insurance, financial services and asset management.[76] Nevertheless, BITC has the potential to facilitate regional financial integration. Overall, there is scope for Botswana to continue to deepen its financial system through diversity of market instruments, accelerated adaptation of technology and processing infrastructures, as well as skills development.

(b) Financial Access

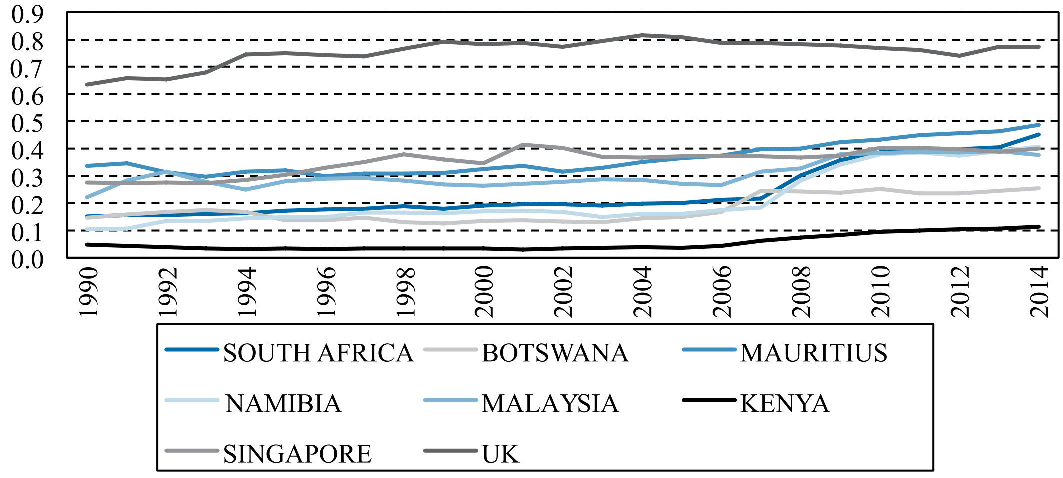
4.8 Botswana generally lags behind high income countries and its UMIC peers on access to both financial institutions and financial markets (Charts 11 and 12 and Table 9). The Finscope Survey of 2014 reports that the financially served group (including those who use formal or informal financial products) represents about 90 percent and 86 percent of the population in Mauritius and South Africa, respectively, compared to about 76 percent and 73 percent of the population in Botswana and Namibia,[77] respectively (Chart 13). Furthermore, only

75 Islamic banking is a banking system operated in accordance with the Shariah Law/Islamic Law. Interest under Islamic Law means anything in "excess" – the investor should not make an "undue" profit from the hard work of the other. Islamic Banks act as agents by collecting deposits from customers and then investing the money in shariat compliant projects and sharing the profits or losses with them.

76 These are: Pivot Administration Services (Pty) Ltd, AON Risk Management (Pty) Ltd, Emeritus International Reinsurance Limited, Imara Holdings Limited, Letshego Holdings Limited, Norsad Finance Limited and AEV Services (Pty) Ltd.

77 The last Finscope consumer survey in Namibia was done in 2012 as compared to 2013 in Kenya, 2014 in Mauritius and Botswana and 2015 in South Africa.

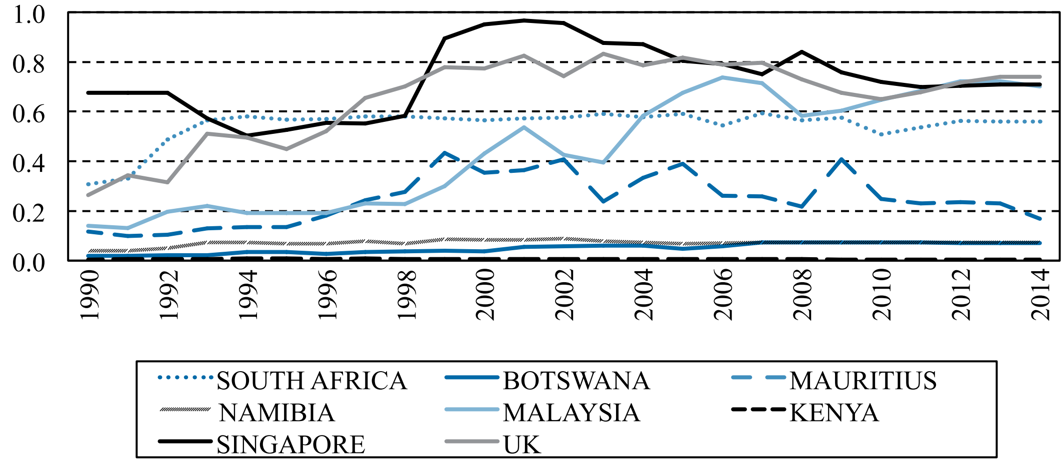
Chart 11: Financial Institutions Access Index, 1990 - 2014



Note: The Financial Institutions Access index measures the level of development of financial institutions in terms of the ability of individuals and companies to access financial services. The index considers variables such as commercial bank branches per 100 000 adults and ATMs per 100 000 adults.

Source: http://data.imf.org/

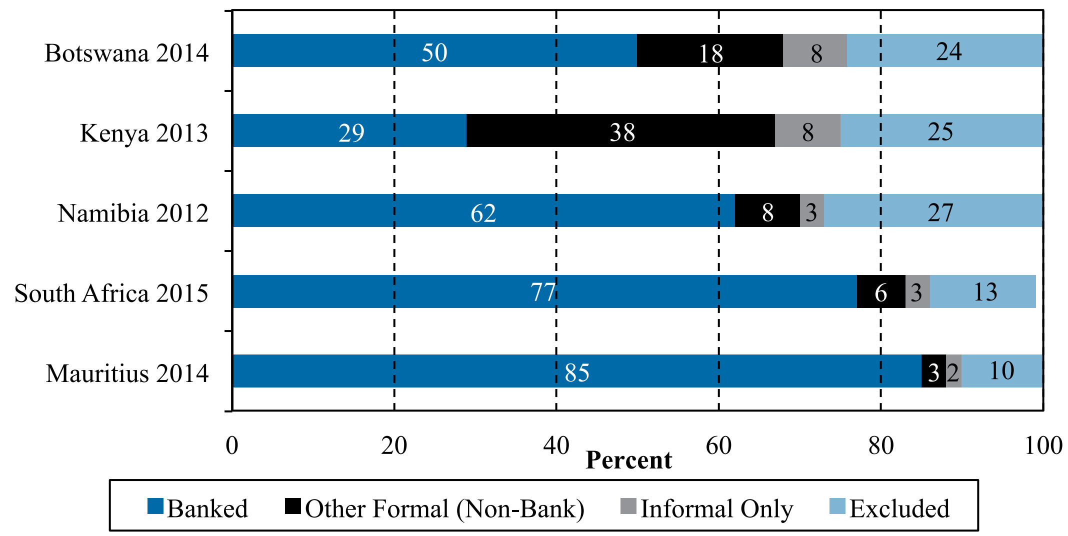
Chart 12: Financial Markets Access Index, 1990 - 2014



Note: The Financial Markets Access index measures the level of development of financial markets in terms of the ability of individuals and companies to access financial services. The index combines variables such as the percent of stock market capitalisation outside of the top 10 largest companies and total number of debt security issuers (domestic and external, non-financial corporations, financial corporations).

Source: http://data.imf.org/

Chart 13: Access Strand for the UMICs and Kenya



Note: Access strand shows access of a country's population to financial services.
Source: FinScope Surveys

Table 9: Financial Development Indicators - Access, Average for 2011 - 2015 (Percent)

	Financial Institutions			**Financial Markets**
	Bank Branches per 100 000 Adults	**ATMs per 100 000 Adults**	**Bank Accounts per 1 000 Adults**	**Percent of Market Capitalisation Outside of Top 10 Largest Companies**
Botswana	8.3	27.2	557.3	…
Kenya	5.5	9.8	905.0	…
Malaysia	10.9	52.8	829.1	63.6
Mauritius	22.8	44.6	…	41.8
Namibia	12.6	51.4	701.9	…
Singapore	9.6	60.6	2 215.6	73.4
South Africa	10.5	62.3	…	76.4
UK		128.0	…	23.8
UMICs	19.1	43.1	743.5	45.7
High Income Countries	24.6	72.5	1 137.2	51.1

Source: The World Bank, Global Financial Development Database

64 percent of the population in rural areas in Botswana have access to formal financial products and services compared to 90 percent and 81 percent in Mauritius and South Africa, respectively. Therefore, there remains an opportunity for Botswana to improve or widen financial inclusion.

4.9 Though Botswana lags behind high income countries and its UMIC peers, access of Botswana's population to financial services has improved over the years. The proportion of households with no access to any form of financial services declined from 31 percent in 2009 to 24 percent in 2014. However, it could

TABLE 10: FINANCIAL DEVELOPMENT INDICATORS - EFFICIENCY, AVERAGE FOR 2011 - 2015 (PERCENT)

	Financial Institutions		Financial Markets
	Lending-Deposit Rate Spread	Net Interest Margin	Stock Market Turnover Ratio
Botswana	6.4	6.0	3.1
Kenya	8.3	8.3	7.8
Malaysia	1.7	2.8	30.0
Mauritius	2.0	3.0	5.1
Namibia	4.5	5.1	1.4
Singapore	5.2	1.6	34.7
South Africa	3.3	3.0	27.8
UK	…	1.7	90.8
UMICs	6.1	4.6	19.1
High Income Countries	4.3	2.0	38.4

Source: The World Bank, Global Financial Development Database

be considered that the 7 percentage points reduction in the proportion of households with no access to financial services is low and disproportionate to the high levels of mobile phones penetration rate in Botswana, which is an impetus to financial inclusion in the more successful jurisdictions. Even then, the proportion of households with access to formal banking increased from 45 percent to 50 percent, driven by the increase in mobile and internet banking and payments channels.

(c) Financial Efficiency[78]

4.10 Botswana has a low level of financial sector sophistication, ranking only better than Namibia in financial market efficiency among the selected comparator countries. Notably, a stock market turnover ratio of 3.1 percent for Botswana is considerably lower than 90.8, 34.7 and 30 percent for UK, Singapore and Malaysia, respectively (Table 10), and also indicates an illiquid market.

4.11 Furthermore, relatively high lending rate-deposit rate spreads indicate lower efficiency of financial institutions in Botswana (Table 10). The relatively high spread and net interest margin can, in part, be attributed to weaker competition in the domestic financial sector. However, the lending rate-deposit rate spread has been narrowing recently, indicative of a lower relative cost of financial services, but also associated with a generalised decrease in interest rates.

(d) Financial Stability

4.12 Financial institutions of the UMICs are generally stable and were mostly resilient during the 2007/08 global financial crisis. Malaysian, South African and Mauritian financial institutions are more stable, with the financial stability measure, z-scores,[79] in excess of the average for high income countries in the last five years (Table 11). Botswana's average z-score for 5 years from 2011 to 2015 is similar to the average for UMICs, indicating resilience

[78] Financial efficiency is defined as the ability of institutions to provide services at low cost and with sustainable revenues, and the level of activity of capital markets. The financial institutions efficiency index combines variables such as the net interest margin, lending-deposit rate spread, non-interest income to total income, overhead costs to total assets, return on assets and return on equity, while the financial market efficiency index uses the stock market turnover ratio (stock market turnover/capitalisation).

[79] Financial stability is approximated by the z-score, which measures the amount of buffers the banking system has to guard against shocks to earnings. The z-score is a weighted average ratio derived from the following: working capital/total assets; retained earnings/total assets; earnings before interest and tax/total assets; market value of equity/total liabilities; and sales/total assets.

Table 11: Financial Development Indicators - Stability, Average for 2011 - 2015 (Percent)

	Financial Institutions z-score	Financial Markets Volatility
Botswana	10.4	4.7
Kenya	15.0	10.6
Malaysia	16.1	9.1
Mauritius	14.8	5.8
Namibia	8.3	18.8
Singapore	21.8	12.4
South Africa	14.0	15.1
UK	8.0	15.0
UMICs	10.4	15.4
High Income Countries	13.0	17.2

Source: The World Bank, Global Financial Development Database

and good prospects for maintenance of financial stability and, therefore, the financial system is well placed to support economic activity, and associated diversification and employment opportunities on a sustainable basis.

Key Lessons from Selected Country Experiences

4.13 In addition to the selected countries considered above, India and Rwanda offer case studies on how fintech innovations impact financial inclusion. Countries such as Kenya, Rwanda, India and Malaysia, have successfully created a flexible regulatory environment that allowed non-bank operators to flourish and integrate with the traditional banking sector. By allowing foreign financial intermediaries and non-bank institutions in the telecommunication and retail sectors to offer financial products and services, these countries made it possible to improve access for the underserved and unbanked communities. However, some of these developments were possible because of investment in supportive physical infrastructure (digital identification), thereby playing a critical role in enhancing financial inclusion. Table 12 highlights key lessons from country experiences.

Table 12: Key Lessons from Selected Country Experiences

Lessons	Remarks
Licensing and Regulations	• The mandate of the central bank of Malaysia, Bank Negara Malaysia (BNM), was amended for it to have legal authority to proactively promote financial inclusion. In 2011, BNM introduced a Financial Inclusion Framework, a comprehensive plan outlining the strategies for an inclusive financial system. In addition, Malaysia introduced an agent banking[80] regulatory framework in 2012 and further enhanced it in April 2015 to allow agents to facilitate the opening of saving accounts on behalf of financial institutions through online real-time systems and biometric identity verification.[81] Agent banking enables consumers to obtain banking services by licensed financial institutions through third-party agents, such as retail outlets and post offices. • The Central Bank of Kenya (CBK) has provided support for the growth of mobile money and financial services in Kenya. In 2007, non-bank financial service providers were allowed to enter the market and deliver low-cost financial services to the unbanked and underserved. A mobile operator, Safaricom, launched M-PESA as a simple method of depositing, withdrawing and transferring funds between users. Safaricom has extended its services to include payment for goods and services through Lipa na M-PESA, savings and provision of loans through M-Shwari and KCB M-PESA. M-PESA remains a key platform for deepening financial inclusion in Kenya. A significant proportion of the Kenyan population has benefited greatly from the establishment of this service, particularly the unbanked and low income earners who relied mostly on risky informal methods of saving and remitting funds to family members and friends. Since its beginning in 2007, M-PESA has reached 68 percent of adults in Kenya, of which 43 percent of the 68 percent were previously excluded from the conventional financial system (African Development Bank Report on Financial Inclusion in Africa, 2013). Moreover, in 2009, an amendment to the Banking Act (passed as part of the Finance Act, 2009) allowed banks to start using agents (Agency banking) to deliver financial services. This allowed banks in Kenya to collaborate with small shops, petrol stations, pharmacies and other retail outlets to reach more people, especially in rural areas. • In 2015, the Reserve Bank of India (RBI) granted companies, including the country's largest mobile service providers, licences to launch payments banks.[82] As a new model of banking, payments banks increased access to financial services for unbanked or underbanked groups such as small businesses, low-income households and migrant workers. The payments banks only accept deposits, but are not allowed to issue loans or credit cards. They are also allowed to pay customers interest on the money that is being deposited and they can be used for either current accounts or savings accounts. These small banks are expected to reach customers mainly through their mobile phones, rather than through traditional bank branches. Low-cost paperless operations through mobile phones allow payments banks to address market segments characterised by low value/high volume transactions.

80 Agent banking is a branchless banking service offered by banking institutions, whereby the bank appoints existing businesses, such as retail and postal outlets, to offer a variety of banking services on its behalf to its clients who are not reached by traditional bank networks, especially those living in remote and rural areas.

81 World Bank Group report on Financial Inclusion in Malaysia: Distilling Lessons for Other Countries, 2017.

82 Reserve Bank of India (2015). "RBI grants 'in-principle' approval to 11 Applicants for Payments Banks," Press Release. India.

	• The Central Bank of the Philippines recognised that 37 percent of municipalities in the Philippines did not have a bank branch, but 80 percent of people had a mobile phone. The Central Bank developed regulations that allowed mobile network operators (MNOs) to compete with banks in delivering mobile money services through a dedicated subsidiary. Competition from MNO-based remittances has not only enriched the variety of services available, it has also been an important driver in lowering the price of remittances – a critical issue in a country where remittances are an important part of the economy.[83] • In 2006, the Monetary Authority of Singapore and Bank of Indonesia introduced regulatory sandboxes[84] for Fintech to encourage and enable experimentation of solutions that utilise technology innovatively to deliver financial products or services.[85] The two countries were following the lead taken by the UK's Financial Conduct Authority in developing a regulatory sandbox initiative.
Demonetisation	• In November 2016, India announced the demonetisation of large denomination bills, with the aim of combating tax fraud, counterfeiting and corruption. This removed a significant amount of currency in circulation, spurring a sharp increase in electronic payments, including interbank fund transfers, retail bank card and mobile-wallet transactions. The demonetisation has accelerated the shift from paper to electronic payments and added momentum to the technology driven transformation of financial services in India.[86]
Partnering of Banks with Non-Bank Companies (e.g., mobile operators and retailers)	• In Malaysia, institutions such as agent banking have extended access to financial services to the most underserved. Small towns and rural communities not served by any bank branches are served by outlets, such as grocery stores, coffee shops and post offices, which partnered with financial institutions.

83 Simone di Castri (2013). "Mobile Money: Enhancing Regulatory Solutions," Global System Mobile Association (GSMA), available at https://www.gsma.com/publicpolicy/wp-content/uploads/2013/02/GSMA2013_Report_Mobile-Money-EnablingRegulatorySolutions.

84 A regulatory sandbox refers to set of rules that allow innovators to test their products/business models in live environment without following some or all legal requirements, subject to predefined restrictions such as limitations on number of clients, time-limited testing, and testing under regulatory supervision.

85 Fintechnews Singapore (2016). "Singapore Gears Up to Become a Fintech Leader, MAS Announces Major Initiatives," available at http://fintechnews.sg/2006/fintech/singapore-gears-become-fintech-leader-mas-announces-major-initiatives/ and Ivo Jenik and Kate Lauer (2017). "Regulatory Sandboxes and Financial Inclusion," Working Paper, CGAP

86 Yogesh Suri. "Demonetization – An Opportunity to Curtail Black Money and Promote Digital Payments." National Institution for Transforming India, Government of India, available at http://niti.gov.in/content/demonetization-%E2%80%93-opportunity-curtail-black-money-and-promote-digital-payments#

Supportive Infrastructure	• In Malaysia, the National Registration Department introduced an identity card known as MyKad in September 2001. The card incorporates both photo identification and fingerprint biometric data on a built-in computer chip embedded in a piece of plastic. MyKad is designed with main functions and information on: identification; driver's licence; travel; health; and an e-cash facility. MyKad has simplified opening of bank accounts as new customers are quickly validated upon the presentation of the MyKad. Moreover, they can also activate MyKad to have additional payment functions linked to their bank account and use it as an ATM card or an electronic means of payment nationwide.[87] • In India, a government agency, the Unique Identification Authority of India (UIDAI), under the Planning Commission, introduced Aadhaar identification cards. The UIDAI issues Aadhaar identification numbers, collecting demographic, biometric and other details during enrolment. The Aadhaar number can be used for paperless identification verification when opening a financial account, reducing the risk of identity fraud. This allows banks to fulfil their KYC requirements for customers. Aadhaar-enabled electronic-KYC (e-KYC) processes also save time and costs relative to paper processes.[88] • Rwanda embarked on developing its rural financial services infrastructure to provide a vehicle that would deliver financial services to the underserved and unbanked. In 2010, Rwanda established cooperative savings and credit organisations, popularly known as Umurenge in each administrative unit across the country to provide a secure and safe place for the poor to save and borrow. The Umurenge policy has been hailed as an impactful financial inclusion policy and a good example of public-private sector partnership for the success of a policy with general interest. The government has since set up the Rwanda Cooperative Agency – a government entity mandated with the regulation and oversight of the Savings and Credit Cooperatives (SACCOs) activities. With this regulation, the activities of SACCOs are checked, providing confidence and trust among the users.[89] This has been key in driving uptake and usage of financial services. Furthermore, in 2003, a national electronic-payment company, RSwitch, was established with a vision to run Rwanda's electronic payment system and has over the years expanded to serve as a financial interoperable solution company. RSwitch's processing system coordinates the flow of various transactions among financial institutions, merchants and customers. RSwitch has developed an interoperable platform, eHuriro, which facilitates banks, mobile network operators, SACCOs and microfinance institutions to electronically move money amongst each other and thus enabling individuals to access their finances using either a card, mobile phone, or online application to transact on ATMs and/or send transfers to bank accounts or mobile wallets. The RSwitch and its interoperable capability has and continues to open up huge opportunities for sustainable partnerships among financial sector players as a catalyst for financial inclusion.[90]

87 World Bank Group report on Financial Inclusion in Malaysia: Distilling Lessons for Other Countries, 2017.

88 Virender Singh Atwal (2016). "Aadhaar Card as a Tool of Financial Inclusion: A Study of Bankers' Perspective." International Journal of Research in Economics and Social Sciences, Volume 6.

89 Alliance for Financial Inclusion (2014). "Rwanda's Financial Inclusion Success Story: Umurenge SACCOs."

90 The Rwandan Banker. Issue no 28, National Bank of Rwanda.

5. Financial Resource Mobilisation and Determinants

(a) Sources of Financial Resources and Evaluation of Resource Mobilisation Efforts

5.1 Historically, economic growth in Botswana had been mainly dependent on primary commodities and, therefore, vulnerable to fluctuations in global commodity prices and markets, generally. The contribution of the mining sector to growth, although declining, remains significant. Therefore, achieving and maintaining diversified, sustainable and inclusive economic growth is a challenge, but is urgent.

5.2 In order to break away from the middle income trap, Botswana requires, among others, sustainable flow of productive financial resources to support implementation of national development programmes and investments which are essential for durable economic growth. According to the World Investment Report of 2014, developing countries face an estimated USD 2.5 trillion annual funding gap for investment in key economic infrastructure, such as power, roads, telecommunications and water, which are critical for attaining sustainable and inclusive economic growth. Although the Government of Botswana has, over the years, been able to finance most investment projects from diamond receipts, there is recognition that growth in diamond revenue has plateaued and might recede in the future. Thus, it is important to explore alternative and sustainable sources of financing for such public infrastructure investments.

5.3 There are several ways in which this apparent infrastructure investment financing gap could be addressed, including, among others, commercial financing;[91] undertaking upstream reforms; addressing market failures; public and concessional resources; expanding the tax base and coverage, and access to credit. Increased mobilisation of domestic resources, especially from the private sector, offers potential benefits, including the reduction of dependency on government funding; therefore, maintenance of modest tax regime, as well as fiscal balance and sustainability. In this respect, the financial sector plays a vital role in facilitating purposeful and efficient mobilisation and allocation of financial resources for various uses. Potential funding sources are considered below.

(i) Taxes

5.4 Taxes are the most common and, if well managed, stable source of government funding. For Botswana, tax has been a significant source of public funds, accounting for an average of 84 percent[92] of total government revenue excluding grants, with mineral tax, mineral royalties and dividends, SACU receipts and VAT accounting for 30.8 percent, 27.3 percent, 25.4 percent and 11.5 percent, respectively. Among the major tax reforms undertaken over the years is the establishment of the Botswana Unified Revenue Service (BURS) in 2004, with responsibility for tax assessment and collection, as well as putting in place measures to combat tax evasion.[93] Related reforms include introduction of the electronic tax filing system and tax self-assessment in 2013 aimed at improving tax compliance and the timeliness of filing tax returns. Furthermore, a Tax Review Committee comprising various stakeholders, such as government, parastatals (Botswana Institute Chartered Accountants, Bank of Botswana and BURS) provides a forum for discussing proposals for tax reforms, with the aim of ensuring optimal coverage, as well as an efficient and fair tax system.

5.5 The progressive reforms have resulted in an increase in tax receipts, rising from P15 billion in 2004 to P36 billion in 2016 and, thus, in real terms, growing by an average of 2 percent per annum in that period.[94] Meanwhile, as shown in Chart 14, Botswana's tax effort compares favourably with other countries, including emerging market and developed countries. The study by World Bank (2012) also classified Botswana among those countries with a high tax effort. However, there is scope for

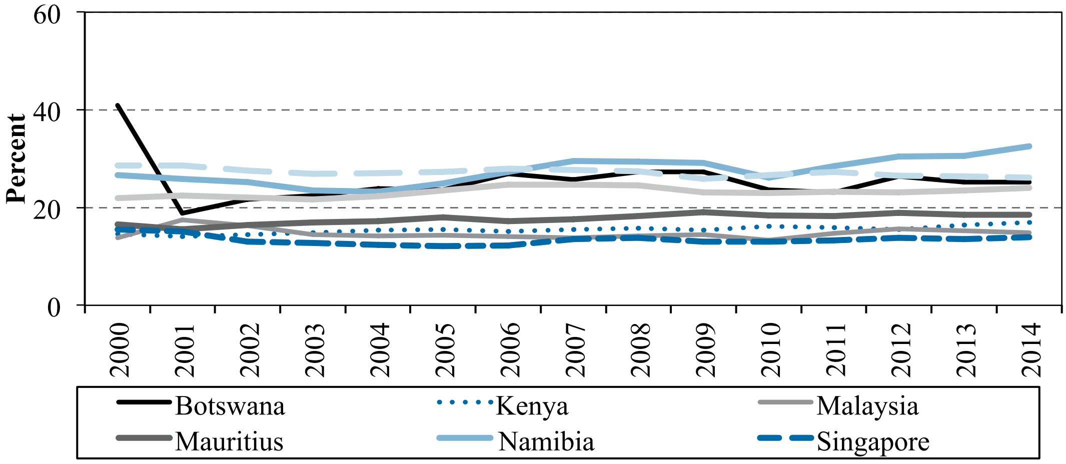
91 Commercial financing here broadly refers to borrowing from the market rather than relying on government funding.

92 Tax here includes mineral royalties and dividends and the average is from 2004 to 2016.

93 Tax Policy in Botswana resides with MFED.

94 For this analysis, tax receipts exclude mineral tax and SACU receipts as they are not affected by tax reforms.

Chart 14: Tax Effort for Selected Countries (Ratio of Total Tax to Nominal GDP)



Note: For comparison purposes, the data was obtained from the same source and it is only available up to 2014.
Source: IMF

further improvement to raise tax collection, in particular, broadening of the tax base by, among others, reducing the number of value added tax (VAT) exemptions on a variety of goods and services and replacing exemptions used for social support (for example, food items) with targeted social transfers and facilitating the collection of taxes from the informal sector. Furthermore, another way of improving the tax base is by avoiding the use of tax concessions[95] to promote domestic investment, which hinders tax collection and is less effective in ensuring long-term investment. Research on investment incentives suggests that tax concessions are often of little value in attracting genuine long-term investment. Investment tax credits or accelerated depreciation allowance are preferable and more effective. There is also potential to review the approach to property taxes where the tax effort is low. For example, taxes levied on purchase of property have been stagnant for a long time and, therefore, lag behind the property market values. Meanwhile, property in tribal land is currently excluded from transfer duty, thereby denying government an opportunity to collect more tax revenue. Furthermore, some natural resources, such as water, are currently not being taxed – no royalties are paid to government by those mining water. Progress in economic diversification and growing the private sector[96] could also contribute towards broadening the tax base and raising tax receipts; thus facilitating government efforts in developing and maintaining infrastructure and providing social amenities and services.

(ii) Banks

5.6 Commercial banks are a primary conduit for finance in most countries, particularly in Africa. However, a significant part of their balance sheet activity is not for long-term finance; the funding structure, which is dominated by short-term deposits, constrains prudent financing of long-term infrastructure projects by commercial banks. However, in developed countries, banks play a larger role in residential mortgages and financing of commercial real estate, which is an artefact of the supporting infrastructure, systems and administration process surrounding land tenure, real estate and property registration laws. Banks and other financial institutions also engage in inter-institution funding through shared credits, derivatives and securitisation arrangements that help to expand and enable more effective trading of available funds in the market as well as facilitate optimal liquidity management. Such intra-sectoral flows and arrangements also enhance the productivity, as well as efficient use and management of funds. Therefore, there is need for a regulatory

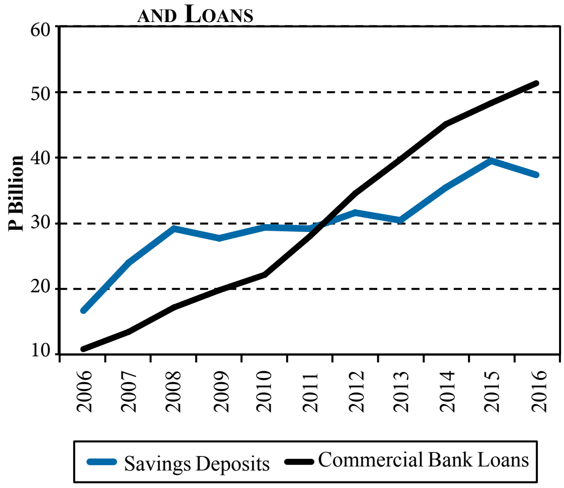
95 A special provision for a business not to pay a tax that it would otherwise pay to government as an inducement to invest.

96 Growing the private sector can be achieved through privatising owned entities, such as Veterinary services, BMC, etc.

and oversight framework that facilitates developmental and innovative approaches to banking, while adequately providing for maintenance of prudence and stability.

5.7 In addition, commercial banks play a very important intermediation role that involves mobilising resources by providing the means for savers to hold monetary and financial assets and, at the same time, allocating these resources for productive investment. This function of banks is significant with respect to the Botswana economy, where banks play an important role in the financial markets. Deposits[97] held with commercial banks have generally been on an upward trend and supporting a similar trajectory for credit; thus indicating the important financial intermediary role played by commercial banks (Chart 15). However, a significant part of commercial bank financing is not long-term business financing, as indicated by the high concentration of financing to household loans, which accounts for about 60 percent of total credit compared to 40 percent for business credit. Therefore, limited financing for long-term investment by commercial banks in Botswana, due to reliance on a static balance sheet structure, suggests the need for banks to improve their maturity transformation role and prospects for derivative products and other financial engineering to enhance flexibility and value generated by deposits.

Chart 15: Commercial Bank Savings Deposits and Loans



Source: Bank of Botswana

[97] These deposits exclude those from NBFIs, such as capital markets, insurance companies and pension funds.

5.8 Other potential sources of long-term finance are regional development banks, which, if well-managed, could bridge the financing gap in relation to less profitable, but socially desirable ventures, infrastructure and priority sectoral development. Indeed, the Government of Botswana has benefited from concessional loans offered by the African Development Bank and other multilateral bodies to finance some of the development projects in the country. Furthermore, regional economic and financial integration offers an opportunity to expand saving and financing options. As such, local investors can derive benefit from listing and trading their instruments on regional financial markets.

(iii) Pension Funds and Insurance Firms

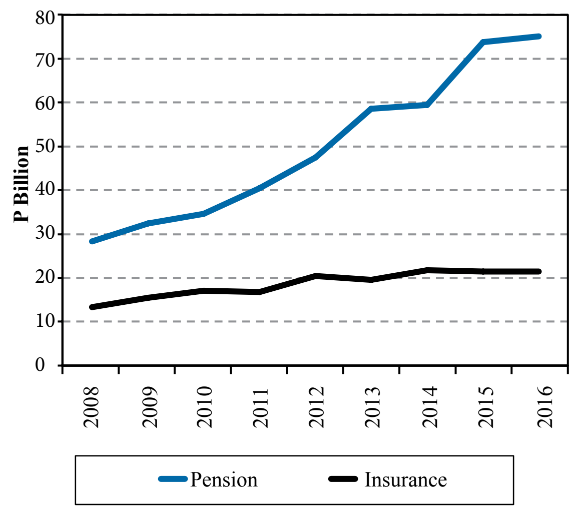
5.9 Pension funds have clearly defined long-term liabilities, particularly suited as a source of finance for long-term investment. Generally, pension funds have large assets (relative to the size of the economy or the financial system); but due to legal and regulatory obstacles in some countries, the funds may not be optimally deployed for long-term financing. Likewise, insurance firms have long-dated liabilities that could enable them to invest on long-term basis. Therefore, an appropriate regulatory and facilitative approach could potentially promote growth and widening of long-term saving in pension funds and pension schemes and, in turn, optimal use towards beneficial and productive investments.

5.10 Both the pension fund and insurance industries in Botswana have grown over the years (Chart 16). In 2008, the assets of pension funds were P28.3 billion and increased to P82 billion in December 2017,[98] while insurance industry assets grew from P13.3 billion to P21.5 billion in 2016. However, up to now, the bulk of pension fund assets have been invested offshore, reflecting the need to diversify investment portfolios and a shortage of high-return, low-risk and liquid domestic investment opportunities. Shallow and underdeveloped money and capital markets, and the resultant lack of financial instruments, and vulnerability to bubbles in a concentrated market, are some of the key reasons for pension funds

[98] The December 2017 values are provisional.

seeking alternative investment instruments abroad, even when Botswana potentially offers an attractive investment environment in the form of political and macroeconomic stability and comparatively high returns. As at the end of December 2016, pension funds had invested P45.2 billion (60.2 percent of their total assets) offshore. Subject to prudent portfolio allocation and return considerations, these funds are potentially available for local deployment. This provides a good opportunity for project and business financing and/or economic development financing in Botswana. The development of the capital markets and associated infrastructure could precipitate the introduction of new and innovative financial instruments that could facilitate the flow and beneficial use of finance.

Chart 16: Botswana's Pension Fund and Insurance Industry Assets



Source: NBFIRA

(iv) Capital Markets

5.11 Capital markets complement banks as suppliers of loanable funds. While deep capital markets are needed for long-term investment, the Botswana capital market, like those for the rest of sub-Saharan Africa, is generally shallow with limited options. The P15 billion Government bond programme provides leverage for an increase in issuance of securities by parastatals and corporates,[99] and beyond that, some basic securitisation of loans in order to increase the maturity profile and range of economy-wide funding for various needs. Both the fixed income (bond) and share markets need improvement in terms of issuers, market making, liquidity and public participation beyond banks and institutional investors. With suitable incentives and oversight, development of both securitisation and the corporate securities market should unlock a significant source of long-term finance to complement bank lending.

5.12 A robust and liquid capital market can also facilitate the privatisation programme, providing funding opportunities in place of government, as well as alternative funding structures to conform to ownership preferences and transition arrangements; for example, technical partnerships, lead investor, employee trusts/ownership and citizen preferences arrangements. Ultimately, there is an opportunity for domestic savers and investors to acquire ownership of privatised entities.

5.13 Stock markets, which provide avenues for long-term finance through, among others, initial public offerings of private companies, can be an efficient and less costly source of funding and support growth of successful small or medium scale ventures. However, the BSE is relatively small, with inadequate legal and regulatory conditions. Nonetheless, the enactment of the Securities Act 2015 to replace the BSE Act, with a regulatory framework for new and existing financial instruments, for example, provides potential for further improvement. As a result, it is important to continue to develop the necessary operational infrastructure and systems, such that the stock market plays a meaningful role in pursuing the country's industrialisation and development aspirations. The recent developments in this regard include:

(a) Legislated P15 billion Government Note Programme, which is largely intended to contribute to the development of the bond market through establishing a reference benchmark yield curve for other issuers;

(b) Opening of the capital market to external investors which helps to widen sources of funds and foster more efficient price discovery (therefore, lower the cost of

99 One way of stimulating issuance of bonds in Botswana can be through limiting the bail outs by government to parastatals.

funds). The improved foreign participation will help improve market liquidity and also bring in the much needed investor diversity in a market whose investor base is largely homogeneous;

(c) Introduce a single central securities depository that will allow government securities to trade on the stock exchange and ensure delivery versus payment (DvP). Government securities, though listed on the stock exchange, are currently only traded over-the-counter (i.e., securities are traded via a dealer network as opposed to the centralised exchange). This, together with lack of DvP, has been cited as one of the reasons why foreign participation, especially in the secondary market, is insignificant;

(d) Proposal to introduce centralised trading of all bonds at the BSE; and

(e) Automated trading platform to improve efficiency in the buying and selling of securities.

5.14 The partial issuance under the Government Bond Issuance Programme (P10.2 billion as at December 2017 out of the P15 billion programme) suggests scope for further issuance and asset holding options for investors. Currently, the bond issuance is done on a quarterly basis. However, increasing the frequency of issuance could help to further develop the capital market through supporting price discovery. Furthermore, there is scope to promote access to the capital market by parastatals, where there could be advantages in terms of focusing attention on appropriate project appraisal, monitoring and optimal tariff structure for long-term amortisation of the cost of capital. However, this would also require freeing up of utilities' tariffs, such that issuance of securities can be supported by reasonable projections of cash flow and returns. In the circumstances, coverage and social support subsidies would be directly and transparently addressed.

5.15 Privatisation of parastatals, as evidenced in the recent limited privatisation of Botswana Telecommunications Corporation Limited (BTCL) through an initial public offering of a minority of BTCL shares, provides another opportunity to develop the capital market. Moreover, the decision by the International Finance Corporation (IFC) to issue a Pula-denominated bond in Botswana should also contribute to capital market development and raise the profile of the Botswana market to international investors.[100] This would open prospects for future issuance by other international organisations and the private sector, thereby contributing further to the development of the market. The IFC programme is particularly notable as it facilitates funding and expansion of local businesses and, broadly, economic activity. Furthermore, the recent decision by the Bank to allow long-dated government bonds to be used as collateral for access to central bank credit facility is a positive development for the capital market as it enhances liquidity and market activity. Meanwhile, activity on foreign currency denominated bonds is very low, perhaps indicating lack of need for foreign exchange by the government, as well as exchange rate and interest rate risks associated with issuance of such bonds.

(v) Foreign Financial Flows (FDI and Portfolios)

5.16 FDI is equity investment by a foreign entity of at least 10 percent of a domestic company's capital. FDI is an integral part of private investment that could supplement domestic investment in driving economic growth. While FDI to developing economies has been increasing, the flows to Africa have been relatively lower. The constraints to FDI flows to Africa include factors such as limited degree of openness, high cost of doing business, burdensome product-market regulation, rigid labour market arrangements, high corporate tax rates, capital controls, direct FDI restrictions, restrictive trade policies and barriers, limited skills, market and incomes, inadequate infrastructure, high distance/

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[100] In 2012, IFC initiated a programme to issue local currency denominated debt instruments for various African countries, with funds intended to be used to finance IFC's local currency denominated investments. The programme is also intended to accelerate the development of capital markets in Africa. For Botswana, the first issuance by IFC was a P260 million bond in November 2017, with a maturity of seven years.

transport costs, as well as risks to political and economic stability.[101] The expectation is that improvements in the macroeconomic policy framework, business and regulatory environment as well as growth in incomes and markets associated with policy maturity/predictability, institutional efficiency and higher levels of economic activity should result in growth of FDI flows. In addition, positive outcomes of regional integration efforts should also contribute to stronger FDI for individual countries.

5.17 It is considered that, apart from adding to the financial resources and capital, FDI entails other benefits, such as technology and skills transfer, employment creation and improved standards of living, access to foreign markets, as well as potential agglomeration of capital and generation of value chains. Furthermore, FDI is considered a more stable component of capital flows. It is substantially less volatile than other types of cross-border financial flows since it involves multi-year investments and physical capital stock and, therefore, more likely to have a durable and transformative impact in the host country.

5.18 Portfolio flows involve short-term investments that mainly come through the stock and bond markets focused on portfolio diversification, trading on volatility and expectations of arbitrage and high returns in the short-term. The main influences are, therefore, macroeconomic policy performance and outcomes with respect to interest rates, exchange rates, inflation and the fiscal balance, as well as profitability of listed corporates. In addition to prospects for providing funding capital, there are benefits in terms of efficient pricing, market liquidity and encouraging discipline in policy design and execution. However, the inherent mobility and volatility of portfolio investment could be disruptive to economic activity and financial markets, especially where policy instruments are limited and less responsive.

5.19 Even though Botswana has no exchange controls and is an open economy,[102] FDI continues to be limited, except in mining and, to some extent, the financial services sector. The Bank's 2016 *Annual Report* identified, among others, the high cost of doing business and slow pace of improvement in the local business environment, as well as protection of some industries by government, as some of the factors that discourage FDI in Botswana. The relatively small size of the BSE and the underdeveloped financial markets, with limited financial instruments, also limit portfolio capital movements. Initiatives being undertaken to address some of these challenges are highlighted in Section 3. The expectation is that such initiatives should improve both the portfolio and FDI flows into Botswana.

(vi) Trade

5.20 Trade is another important source of investment funding. The Monterrey Consensus on Financing for Development of 2002 underscored the point that international trade is, in many cases, the single most important source of development funds and that meaningful trade liberalisation can dramatically boost exports and substantially stimulate economic growth and development worldwide.

5.21 In this regard, trade policy in Botswana and related institutional arrangements operate in the context of an open economy with no exchange controls. The country continues to pursue an outward-looking strategy aimed at supporting market expansion. However, this strategy is constrained and undermined by the contractionary direction of other sector specific policies that are inward looking. As a result, exports of goods and services outside of minerals remains limited; non-mineral export performance is either declining or has stagnated. Therefore, it is important for the country to continue its diversification efforts, while persisting with an open economy and the export-led growth model as it encourages products that can effectively compete in foreign markets. This would contribute to trade related earnings that contribute to both taxes and foreign exchange receipts; in turn facilitating access to imports (fosters consumption and inputs to production). It would also have positive implications for local productivity, expansion of financial services,

101 Available; (http://allafrica.com/stories/201706201015.html)

102 A conducive environment for FDI in Botswana is also buttressed by low and stable inflation as well as a generally stable exchange rate of the Pula. However, there are other factors that investors consider beyond these.

innovation and entrepreneurship while, at the same time, allowing local producers to compete with imports without or with limited need for government support.

(vii) Foreign Aid/Grants

5.22 The share of foreign aid/grants in total government revenue has declined over the years following classification of Botswana as a middle-income country in 1989. Such revenue is currently less than one percent of total government revenue. Therefore, direct foreign aid and grants should not be prioritised as a viable approach to resource mobilisation going forward, except where it involves support to specific projects, institutions and developmental agencies and programmes. In this regard, initiatives, such as the G20 Compact with Africa (G20 CWA), which is intended to promote private investment and boost infrastructure investment in Africa, with a focus on policy design and governance structures for execution, could foster inward investments.

(viii) Sovereign Wealth Funds

5.23 In certain circumstances, Sovereign Wealth Funds (SWFs) may be a source of funding for long-term investments. However, it should be recognised that SWFs are held under formal governance and strategic management guidelines relating to asset allocation and selection involving diverse instruments, including bonds, equities, real estate, private equity and direct stakes in infrastructure and other projects. SWFs are professionally managed with the objective of yielding the appropriate balance between expected long-term returns and exposure to risk. As such, any use of SWFs for specific investments must be consistent with this framework, rather than on an ad hoc basis to bridge funding shortfall. For this reason, SWFs typically include clear guidelines for withdrawals.

5.24 Botswana's Pula Fund (akin to a SWF), is a long-term fund that forms part of the foreign exchange reserves. The Pula Fund has increased substantially in value since its establishment in 1994 due to accumulation of balance of payments and budget surpluses and success of the investment strategy.[103] In addition, through the returns earned on the Government Investment Account (GIA), which represents the Government's direct holding in the total foreign exchange reserves, the Pula Fund is available for budget deficit financing. The current fiscal framework permits drawdowns from the GIA and, ultimately, the Pula Fund, as a source of financing for long-term investments in public infrastructure and human development. However, as envisaged in NDP 11, plans are being considered to strengthen the fiscal framework further to ensure that a portion of annual mineral receipts is put aside for future generations.[104] In turn, this would have implications for the management of subsequent withdrawals from the Fund. Foreign SWFs are also generally available as part of FDI, inward portfolio investment and private equity financing.

(ix) Public Private Partnerships

5.25 A Public Private Partnership (PPP) involves a contractual arrangement between governmental institution and private sector entities to provide public infrastructure assets and/or services, which traditionally are a responsibility of government. PPPs are typically used for the provision of physical public infrastructure, as well as management and administration of related services (facilities, utilities, education, health and social support). The advantages of using PPPs include: containment of cost overruns and delays; improving project design, execution and quality of service; internalising maintenance strategy, thus protecting the value of the asset; and redirecting government focus from hiring/buying inputs and deciding on technologies and processes to defining public policies and expected outputs. However, PPPs require complex contractual arrangements and may reduce budget flexibility by committing public funds in long-term contracts. The African Development Bank has a vehicle for investments in PPPs or in private projects with predictable cash flow, which is known as 'Africa50 – Financing Africa's Infrastructure,' and provides a platform for encouraging PPPs. Although PPPs are not the only

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103 As of September 2017, the Pula Fund stood at P59.1 billion comprising a balanced portfolio of bonds and equities, diversified across markets and maintained within clearly defined risk parameters.

104 Specifically, it is envisaged that 40 percent of mineral revenues will be set aside each year as savings for future generations; however, current fiscal projections mean that this will not be feasible until NDP 12 (NDP 11, paragraphs 5.30 – 5.33).

structures available in project financing, they have emerged as a major legal structure to define project finance investment over a longer horizon. As a result, PPPs have been instrumental in the mobilisation of resources to fund large-scale infrastructure developments.

5.26 The Government has long recognised the importance of partnering with the private sector to finance major investment projects. One such successful and effective partnership is the long standing collaboration between Government and the De Beers Group in diamond production and marketing. The transformation of Botswana from a low-income country to middle-income status is, to a large extent, attributable to the success of this partnership. In recognition of the potential benefits, the Budget Speech of 2002/03 and NDP 9 declared Government's commitment to use PPPs extensively in infrastructure development to ensure sustainable investment in infrastructure, and, in the process, promoting and restoring soundness in public finances. As a result, in 2016, a PPP Unit began operations at MFED for overall coordination and monitoring of the PPP Policy and related projects. However, the country is yet to have a dedicated PPP law. Hence, the need to establish a PPP legislative/regulatory framework that would strengthen the institutional capacity to handle PPP contracts.

(x) Others

5.27 Resource mobilisation also involves measures to stop illicit financial flows. Illicit financial flows mostly originate from corrupt economic practices, fraud, illegal resource exploitation and tax evasion, as well as through profits earned from dubious accounting practices, such as transfer mispricing and complex corporate structure, which results in the loss of tax revenue.[105] Among others, tax evasion involves companies inflating operating costs in order to reduce their reported profits. As a concern for Africa, the 2011 Report of the High Level Panel on Illicit Financial Flows from Africa (referred to as the Mbeki Report) focused on the matter, including the steps that must be taken to radically reduce these outflows to ensure that the resources remain within the continent; these steps include:

(a) instituting laws and regulations to prevent and penalise mispricing in order to enable externalisation of funds, evade or avoid income and trade taxes;

(b) ensuring that African states establish or strengthen the independent institutions and agencies of government responsible for preventing illicit financial flows; and,

(c) endorsing instruments and commitments to combatting illicit financial flows by individual countries and at the global level.

5.28 In this case, a well-developed regulatory framework and tax administration is required to enforce desirable public policy, conformity to accounting standards and to promote willingness to pay taxes. Other potential sources of funds forgone include interest payments on foreign debt and profits repatriated by foreign investors which could reflect a shortage of opportunities to support domestic retention of funds.

(b) Determinants of Financial Resource Mobilisation

5.29 Mobilisation of financial resources to foster growth and implement development programmes and projects is determined by, among others, the quality of governance and effectiveness of institutions; the regulatory framework; the extent of capital controls; macroeconomic policies and performance; the state of financial sector development; and the country's industrialisation policies.

(i) Governance

5.30 Good governance is the key to unlocking private resources and opportunities for financial flows that are essential for sustainable economic growth and development. Good governance encompasses democratic, well-managed and effective institutions that address national aspirations and public policy. It is a facilitative legal and regulatory framework that adequately enforces operational and prudential standards, as well as property rights, contracts and transactions. The absence of good governance breeds inefficiencies and corrupt practices that are inimical to effective resource mobilisation and allocation, as resources are diverted from

105 The Panama case is a typical example.

productive activity that is positive for the broader economy and generally undermines confidence in the financial system and the financial inclusion agenda. Botswana has performed well in governance over the past years. According to the 2016 Ibrahim Index of African Governance Report, Botswana was ranked only second to Mauritius in terms of the overall performance for governance, and was ranked the least corrupt country in Africa in 2016, according to Transparency International. Botswana's credit ratings by the sovereign rating agencies have been impressive over the years, supported by its high score with respect to institutional strength. The score reflects its strong performance in the Worldwide Governance Indicators, especially on control of corruption and adherence to the rule of law.

(ii) Capital Controls

5.31 Capital controls can be targeted at different types of capital movements, but have diverse effects. The use of capital controls in most developing countries is intended to ensure that scarce domestic savings are preserved within the borders and used to finance domestic investment. Retaining domestic savings can be achieved by reducing the return on foreign assets (e.g., through an interest equalisation tax or by raising the implicit cost of moving funds abroad) and by limiting access to foreign assets. However, capital controls can also be regarded as an impediment to business efficiency and disincentive to FDI. The FDI component of capital flows is critical as a source of new investment capital, promoting technology and skills transfer, enhancing market access and, as a result, serving as a catalyst for economic diversification and promotion of inclusive growth. Hence, Botswana has no exchange controls.[106]

(iii) Fiscal Policy

5.32 Fiscal policy has several objectives, including revenue mobilisation, provision of public infrastructure and goods and services and redistribution of income. In many countries, widespread tax evasion and avoidance, mainly due to weak tax administration, both at national and international levels, undermine the mobilisation of financial resources. There is, therefore, need to ensure that tax systems, and policies and administration are aligned with the need to achieve coverage and efficiency of resource mobilisation and productive development that supports inclusive and diversified economic expansion.

5.33 There is, therefore, a requirement for fiscal discipline to ensure prudent management of public funds, that resources are allocated efficiently and deficits are kept low and sustainable to avoid excessive accumulation of public debt, while maintaining macroeconomic stability. At the same time, fiscal policy and behaviour should ensure that government participation in the economy does not crowd out the private sector, and can be more effective in productive mobilisation and deployment of financial resources towards the diversification, inclusion and growth objectives. In this vein, Botswana has fiscal rules that guide the formulation of NDPs and annual budgets to promote prudent and equitable public spending towards achievement of SDGs and Vision 2036 aspirations. However, a sustained focus on the quality of expenditure as well as a re-assessment of VAT exemptions (or zero rated items) is necessary for sustainable budgeting and resource mobilisation.

(iv) Monetary Policy

5.34 Monetary policy is also critical for mobilising financial resources through its influence on the cost and availability of credit, inflation and the balance of payments. Low inflation preserves the purchasing power of money and financial savings, thus allowing households and private businesses to make long-term economic plans and investment decisions. In the case of Botswana, monetary policy is implemented with the primary objective to achieve low and stable inflation to promote savings which can be channelled to productive investment, through financial intermediation by financial institutions.

(v) Exchange Rate Policy

5.35 In addition, it should be noted that national efforts to mobilise resources are interrelated with the external economic and financial

106 Exchange restrictions on current account transactions were abolished in 1995, while the remaining exchange controls on capital account transactions were abolished in 1999.

environment. For example, adverse developments in prices of exports due to sharp fluctuations in key exchange rates can severely constrain efforts to mobilise financial resources. In other words, the degree of exchange rate stability in a country is crucial to its success in raising resources to finance its development. As a result, in Botswana, the exchange rate policy is geared towards ensuring a stable REER in order to, among others, support exports to boost trade and generate revenues.

(vi) Financial Sector Policies

5.36 To conduct effective financial intermediation that addresses financing needs in the economy, a strong and well-developed financial sector with a sound banking system and resilient financial markets is paramount. As a result, extensive reforms aimed at improving efficiency, broadening the range of financial instruments, institutions and markets, and giving market forces a stronger role in the operation of the financial sector have been undertaken in Botswana.[107]

(vii) Regulatory Framework

5.37 The regulatory and supervisory frameworks should ensure that there is a clear understanding by all players in the financial sector of inherent and potential risks. Regulators must set standards and oversee internal processes of the financial sector to ensure that they are appropriate and sound. A high quality regulatory and supervisory framework also helps in the fight against tax evasion, capital flight, money laundering and illicit financial flows. In order to have a sound regulatory and supervisory framework, as well as for ethical considerations, regulatory agencies should be self-funded and have adequate capacity to carry their mandates.

(viii) Industrialisation Policies

5.38 An enabling domestic investment/business environment is vital for mobilising resources by encouraging domestic private sector development and attracting FDI, while minimising capital flight. Therefore, investment enhancing strategies and success in implementing industrialisation policies promote the required financial flows and intermediation. Furthermore, investment in technology and innovation as well as intellectual property rights protection are vital in attracting FDI.

(ix) Trade Policy

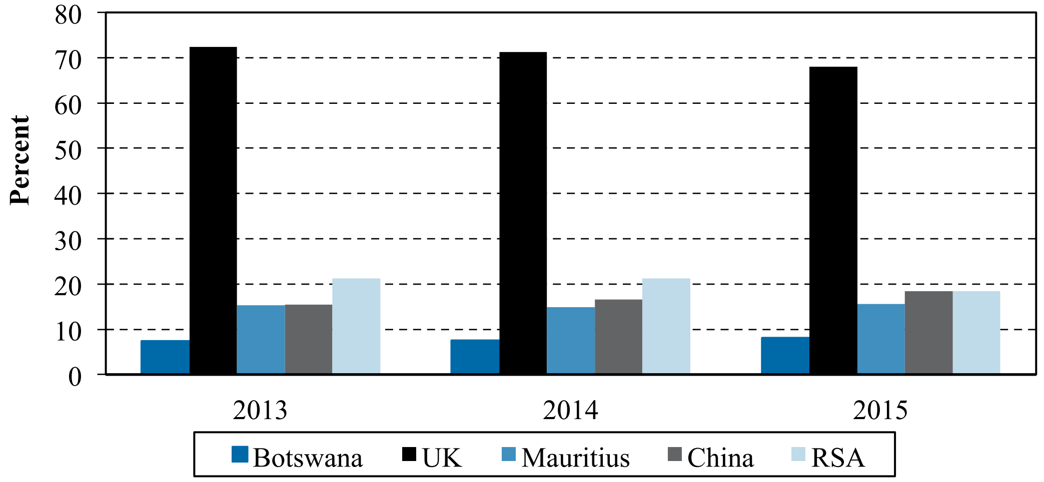
5.39 Trade policy, which is a framework of regulations, agreements and government's guidelines on trade, is another avenue of enhancing resource mobilisation. More open, stable and predictable trade policies are necessary for attracting FDI, as well as promoting the competitiveness of a country's exports in the medium to long term. Botswana's 2009 National Trade Policy is founded on the principle of free trade and capitalises on the country's strengths, while aiming at overcoming characteristic challenges which include: land-lockedness; dependence on a limited number of exports and few export markets; a small industrial base; and a relatively small size of the domestic market. However, some of these challenges can be addressed by exploiting opportunities offered by regional groupings, such as SADC, in order to optimise the benefits of trade.

6. INDUSTRIAL STRATEGY: OPPORTUNITIES FOR THE FINANCIAL SECTOR

6.1 The pursuit of industrialisation and economic diversification towards sustainable and inclusive economic growth should involve concerted effort towards further financial sector reforms. As outlined in the preceding sections of this chapter, there is a symbiotic, virtuous relationship between financial sector development and economic growth. The linkages are clearly recognised in Government policies and strategies, including institutional, development and regulatory frameworks. Notably, expansion of financial services is listed as one of the sectoral growth opportunities in the economic cluster/hub approach to industrialisation. The consideration being that, stable macroeconomic conditions, strong governance institutions and sound regulatory

[107] This has also been covered in the first part of the theme chapter.

CHART 17: MORTGAGE LOANS AS A PERCENTAGE OF GDP - BOTSWANA AND SELECTED COUNTRIES



Source: HOFINET Housing Finance Data and European Mortgage Federation

frameworks represent a comparative advantage/earned endowment that can be a basis for further growth in financial services. Consequently, the 2016 Bank of Botswana *Annual Report* identified three areas of opportunity in this regard, namely, *harnessing existing liquidity for productive purposes, enhanced stability of the financial system and improved operational, advisory and management services.* It is considered that these offer potential for expanding and deepening sectoral economic activity and linkages with other sectors, taking into account the experience of the more successful countries.

(a) Harnessing Existing Liquidity for Productive Purposes

6.2 Evidently, the level of financial sector development in Botswana is comparably low relative to the size of the economy and taking into account the available financial resources. The existence of excess liquidity in the banking system may lead to the sub-optimal use of financial resources, while the preponderance of household personal loans and operational short-term business finance, alongside ample excess liquidity, suggests that there is considerable scope for long-term project and infrastructure financing. However, this requires a refocusing of strategy and deployment of resources to promote long-term financing. In addition, the proportion of mortgage lending is relatively small (Chart 17), which suggests that there is a large part of the housing stock that is self-financed or funded through the more expensive personal loans, due to challenges that include structural, administrative and land tenure issues.

6.3 Overall, there is scope for raising the productivity of financial resources mobilised through the banking system by promoting the expansion and diversity of financial services and products that relate to intermediation, in addition to transactional elements. To this end, the four pillars identified in the FSDS for the expansion of financial services include a focus on, 'Deepening Financial Markets and Supporting the Intermediation of Long-Term Financing,' involving sub-components as indicated below.

(i) Development of a PPP strategy

6.4 The 2002/03 Budget Speech and the National Development Plan 9 announced Government's intentions for extensive use of Public Private Partnerships (PPPs) as a form of procuring and financing infrastructure projects in the public sector to ensure sustainable investment in the infrastructure programme, restoration of soundness in public finances and containment of the budget deficit. For the PPP initiative to attract sufficient uptake from both local and foreign investors, Government should create a conducive environment to garner private sector investments in PPP projects, particularly those perceived as high risk yet promising attractive returns. The FSDS reiterated Government's commitment to enhance capital market growth and development through PPPs, an initiative that should provide attractive ventures for pension funds to invest in the domestic market rather than in offshore markets, thus offering avenues for mopping excess liquidity in the domestic market.

6.5 Though Botswana has made strides in developing a PPP-related institutional framework, as evidenced by the establishment of: the Public Enterprises, Evaluation and Privatisation Agency (PEEPA, 2000); the Public Procurement and Asset Disposal Act (2001); the PPP Implementation Policy and Framework (2009) and the Public Procurement and Asset Disposal Regulations (2014), the country has no dedicated PPP law. However, a study by PEEPA, supported by the SADC Banking Association, to establish whether the current domestic environment with regards to policies, laws and suitable sponsoring institutions is supportive of PPP projects' implementation, as well as to determine the additional measures that may be required to create the necessary conducive environment for PPPs concluded that "…the general PPP policy and legal framework in Botswana is considered less enabling to deal efficiently with partnerships between government and the private sector, and although there are no major impediments to inhibit PPP projects' implementation, there are no standardised approaches, process and guidelines to deal with the structure of PPP projects and no uniform framework to guide the treatment of tendered and unsolicited proposals…"

6.6 There is, therefore, a need for Government to establish a PPP legislative/regulatory framework that would strengthen institutional capacity to handle PPP contracts and projects as recommended in the FSDS. These would supplement the role played by the already established PPP Unit, responsible for custodianship of the PPP policy and overall co-ordination of implementation of the PPP projects, including harmonisation of institutional roles of PPP facilitators, regulators and implementers in Government, including PEEPA, Public Procurement and Asset Disposal Board (PPADB), MFED and others. Currently, draft documentation exists which would require finalisation if the envisaged role of PPPs in domestic capital markets development and financing of infrastructure development projects is to be realised.

6.7 Empirical evidence suggests that appropriate legal and regulatory structures, alongside comprehensible procurement frameworks to both procurers and bidders, boost investor confidence and mitigate against risks, leading to successful PPP arrangements, globally. The case of Brazil, in the road sector, has been cited as the most *systematic in applications of the concession model type PPP,*[108] underpinned by strong capacity in the public sector to structure PPPs, including the role of the national development bank. The result of this has been growing private sector participation in the model and, consequently, delivery of improved services at a lower cost to government.

6.8 Closer to home in South Africa, there has been a progressive increase in the number of PPP projects spanning a wide range of sectors; transport, office accommodation, healthcare, eco-tourism, social development and correctional services. The success of PPPs in South Africa is supported by the Public Finance Management Act, which presents a clear and transparent framework for government and its private sector partners to enter into mutually beneficial commercial transactions, for the public good. In addition, in Kenya, the Managed Equipment Services partnership, a type of PPP that allows customers to adopt a 'pay for service expenditure plan,' offers a number of benefits, including funding to cover equipment and maintenance costs, has proven to be a success.

[108] Under this model, a private partner provides a service directly to the public, on behalf of government, which has control over the provided service. The concessionaire, which is the direct service provider, is allowed to charge consumers a service fees for using the facility, generally through paying a toll, that serves to reimburse the concessionaire's costs of building and operating the facility. At the end of the concession period, the facility reverts to government ownership.

(ii) Developing the Government and Corporate Bond Markets

6.9 Annuity funds have a large and growing need for government bonds to match annuity liabilities, and the supply is inadequate, encouraging a 'buy and hold' strategy, because of concerns that any positions liquidated through trading would be difficult to re-establish. This unwillingness to sell leads to inefficient pricing of instruments and undermines the efficiency of market activity. Therefore, it is imperative that both corporate and bond markets be expanded so that they could adequately cater for long term investment needs. With respect to developing government bonds, there is a need to finalise the Public Debt Management Strategy that would serve to provide information on issuance calendar and funding strategy to the market, including the introduction of small denominated retail bonds, consistent with FSDS recommendations. This will widen participation and enhance liquidity. Regarding corporate bond market development, the FSDS suggests broadening participation to allow small businesses to access financial instruments and services.

6.10 Participation in the bond market is currently heavily skewed towards institutional investors, suggesting the need for measures aimed at developing the investor base, first by nurturing domestic investible assets (pensions, insurances, and household savings) to deploy funds into capital markets. This is critical for developing a sustainable domestic capital market which, once achieved, could serve as a launchpad for promotion of foreign listings and regional exchanges for further development of the local financial system. However, this would require an adequate enabling environment anchored on supportive financial sector infrastructure and macroeconomic stability. In Kenya, the Treasury Mobile Direct project is focused on improving retail access to government instruments distributed through mobile phones. The first Kenyan Government bond, the M-Akiba infrastructure bond offered exclusively on a money transfer and micro-financing mobile platform M-Pesa, was sold at a minimum investment amount of 3,000 Kenyan shillings ($28). The M-Akiba offered the people of Kenya an opportunity to reap higher rates of return on government securities (10 percent) compared to bank deposits, through a convenient platform. This kind of system offers a window of opportunity for Botswana to expand the use of mobile phones to beyond provision of basic services and to broaden household participation in the public capital and bond markets.

6.11 Public education on both the demand and supply side of the market would be necessary in the process of developing the financial system, and broadening participation in capital and bond markets beyond government and the banking sector. As per the FSDS, this would take proactive launching of road shows by MFED and the Bank to raise awareness and deepen the market.

(iii) Support the Development of a Secondary Market

6.12 Poor bond market liquidity can often be traced to lack of depth of the secondary market, whereas deep and liquid public bond markets are the cornerstone for cost-effective funding for governments and the development of efficient fixed income markets that can support economic growth. Thus for Botswana, the development of a more robust secondary market trading in bonds and creation of a meaningful yield curve are fundamental to taking the government and corporate bond market to a level where the country's developmental needs can be better financed with funds afforded by the market. It is argued that market transparency can attract more participants by increasing their confidence in the pricing process, hence announcement of an advanced calendar for the primary market is also generally deemed beneficial to the secondary market development. The preannounced dates of the auctions, sizes and dates of maturity of bond issues are vital to the market in that they demonstrate government's commitment to the issuance programme, while allowing market participants an opportunity to plan for their bids in advance.

6.13 In addition to recent developments, as alluded to in section 5 under capital markets, Botswana should continue preannouncing and committing to an issuance calendar in order to boost investor confidence and, hopefully, secure increased participation in the government bond market. To retain flexibility, government can preannounce the maximum allotment and give an indication of the minimum so that alterations can be made in accordance with changes in government's credit needs as is the case in some countries.

(b) Enhanced Stability of the Financial Sector

6.14 Among other factors, financial sector development hinges around institutional arrangements that safeguard financial sector stability. When grappling with issues of financial deepening and inclusion, potential tension owing to concerns about stability of financial systems is inevitable. To this end, the Bank established a financial stability function in 2010, followed by the formation of the Financial Stability Division (FSD) in 2012, with the view to give prominence to financial stability matters. In addition, the FSDS has included among its pillars, 'Maintaining a robust framework for financial sector stability.' This pillar (as stated in the FSDS) calls for rethinking of regulatory frameworks for systemic risk that extends the current approaches regarding capital, asset, liquidity, and governance requirements to more holistic macro-prudential assessments and contingency planning systems.

6.15 Efforts are underway to strengthen the financial stability function of the Bank. Among others, this includes the establishment of an oversight framework in the form of a Financial Stability Council with a primary focus on coordinated macro-prudential monitoring, analysis and response with respect to any financial system imbalances or distress. This recognises the shared responsibilities for regulation and supervision of the financial system, as well as for the design and implementation of financial sector legislation, policies, regulatory and oversight frameworks. In addition, regulatory authorities for relevant operations of the financial sector would have to enter into MOUs that define roles for each of the agencies involved in safeguarding financial stability. Moreover, individual regulatory authorities need to strengthen their contribution to the financial stability framework in Botswana, through requisite supervisory frameworks and maintaining resource capability for safeguarding financial stability.

6.16 There is also a need for a deposit protection scheme which would serve to protect depositor interests, while strengthening stability of the financial sector by averting destabilising runs on non-viable banks. To this end, the ongoing review of the Bank of Botswana Act of 1996 (CAP 55:01) and the Banking Act of 1996 (CAP 46:04) accommodates the establishment of a Deposit Protection Scheme which would contribute to Botswana's financial sector stability and minimise exposure to loss of deposits. Policy proposals are being developed in this regard. Overall, there is growing focus on a framework for financial sector analysis, monitoring sectoral vulnerabilities, response mechanisms, including implementation of macroprudential policies and crisis regulation as necessary. The Financial Stability Council will, therefore, oversee this framework.

6.17 Some countries already have functional Financial Stability Oversight Councils (FSOCs), which could provide a benchmark for Botswana. The USA established FSOC in 2010, with the main responsibilities of identifying, monitoring and mitigating excessive risks to the U.S. financial system and emerging threats to U.S. financial stability. The Swedish Financial Stability Council is a forum with representatives from the Ministry of Finance, the Swedish Financial Supervisory Authority, the Swedish National Debt Office and the Riksbank (the Swedish Central Bank). The council meets regularly to discuss financial stability issues, and its four institutional members have signed an MOU addressing issues relating to financial stability and crisis management. Regionally, South Africa has set up a Financial Stability Oversight Committee to assist the Reserve Bank to maintain, protect and enhance financial stability.

(c) Improved Related Operational, Advisory and Management Services

(i) Operational Services

6.18 Operational efficiency with regards to saving costs and upgrading capacity to respond to market needs is also an important aspect of financial sector development. Lately, impetus to the drive for efficiency in the financial sector arises from the prevailing low interest rate and slow-growth environment, which are driving down interest rate margins. At the same time, preferences of financial services consumers are leaning towards newer products and services that are affordable, easily accessible and conveniently delivered. Accommodating these changes in customer preferences necessitates advanced technological capabilities by financial institutions to deliver services and products more efficiently and to meet their customers' evolving needs.

6.19 It is indisputable that automation and fintech are increasingly becoming more entrenched in financial sector operations, and domestic financial institutions cannot afford to fall behind. Therefore, in order for Botswana to fulfil its aspirations of becoming a financial services hub, as envisaged in the establishment of the IFSC, it is important to recognise that technological advancements have become an integral part of financial sector development and operations. Thus banks and non-bank financial institutions should embrace these technological innovations, while putting in place the necessary risk management strategies towards addressing cybercrime and other related financial crimes that are inherent in the new platforms of service delivery.

6.20 Additionally, the regulatory and supervisory environment should be supportive of the development of innovative products and services, such as mobile money, through accommodative laws and regulations. That could, in turn, spur competition and help develop and grow the financial sector, while supporting efforts towards financial deepening and inclusion.

6.21 The FSDS recognises the importance of exploiting the mobile platform as a pathway to achievement of its pillar of 'Promoting competitive and cost-effective access to finance' through the facilitation of the development of mobile and agency banking and money transfer services. In this regard, the FSDS has recommended the review of the Banking Licensing Policy to provide for different classes of banking licenses with different, but stringent minimum prudential standards and requirements and observance of AML/CFT laws. Moving with speed to implement this review would facilitate entry of mobile banking and mobile money services into the financial sector, and fill the gap in the provision of financial products and services that are unattractive to conventional banks. Promulgation of the Electronic Payment Services (EPS) regulations, which are still at the drafting stage, is a step in this direction. The EPS regulations are intended to establish a regulatory framework for the provision and usage of electronic payment services in Botswana, while promoting an enabling environment for innovations in financial services delivery channels without compromising the integrity, safety and efficiency of payment systems.

6.22 Efficient payment and settlement systems promote economic and financial-sector development by boosting consumers' confidence in the use of money, and thus encouraging the use of financial sector services and promoting the growth of the sector. Implementation of the FSDS recommendations of expanding payment system participation to non-bank institutions, through electronic payments regulation and establishment of a single Central Securities Depository (CSD), with a view to linking it to the Real Time Gross Settlement (RTGS) system[109] would provide a robust settlement and custody system which ensures timely and safe payments delivery, while mitigating against 'failure-to-settle' risk.

(ii) Advisory Services

6.23 Botswana is among the founding members of the International Forum of Sovereign Wealth Fund (IFSWF) and was one of the architects of the Santiago Principles in 2008. The country is among the top natural resource rich countries with a well-established sovereign wealth fund, the Pula Fund, established in 1994, with the objective of preserving part of the income from diamond exports for Botswana's future generations. The management of the Pula Fund is entrusted to the Bank of Botswana to ensure the legal soundness of the Fund and its transactions.

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109 Locally referred to as Botswana Interbank Settlement System (BISS)

6.24 Through the years, a number of countries expecting a windfall following the discovery of oil, diamonds or other natural resource have visited Botswana to seek advice on matters surrounding the establishment of a sovereign wealth fund, its management and rules and regulations regarding its usage. The expertise that the country has gained in managing the Pula Fund since its establishment, offers the opportunity for provision of formal advisory services in sovereign wealth fund management. This would not only serve to widen employment opportunities in the country for financial advisors, but would also help to build confidence in the domestic financial sector, since expertise in sovereign wealth management can be translated in to advice for the financial system in general. That the financial system in Botswana is sound, profitable and stable and has, generally, been operating smoothly since its establishment provides an added advantage to boosting confidence in the domestic financial sector.

(iii) Management Services

6.25 Supportive financial infrastructure, which is the framework of laws, regulations, policies, standards and accounting practices governing financial transactions and the logistics and operations of the payments system, is paramount for financial sector development. In this regard, the Botswana FSDS recommendations are centred on the need to revamp the legal, regulatory and institutional frameworks to align them to the new landscape of financial sector developments. To this end, a number of Acts have been introduced or reviewed, including the Securities Act of 2014. However, other important laws and regulations remain work in progress; while for the rest, no progress has been made. It is, therefore, critical that the reviews of the Banking Act and Bank of Botswana Act be finalised to close gaps in the regulation and operations of the financial sector, which could be detrimental to the development of a sound and efficient domestic financial system.

6.26 There are only four major annuity providers in Botswana: Botswana Life Insurance Limited, BONA Life, and the Debswana and Botswana Public Officers Pension Funds. While the number of annuity policies is relatively small, the amount of money involved (about P10 billion) is large and growing rapidly. According to the FSDS, the strategy for strengthening annuities in Botswana focuses on ensuring the supply of appropriate matching assets, improving the regulatory framework, and enhancing competition in the sub-sector. Scope for increased competition in terms of new entrants in the market provides ground for improved services and more players in the annuity space, which would contribute to expansion and development of the domestic financial sector. On the other hand, enactment of a dedicated annuities law and regulations would allow for establishment of a regulatory or supervisory framework addressing the specific risks that annuities face, and, hence, guard against excessive risk exposure annuity providers. Diminished risk to service providers and investors would support further activity in the market and, hence, contribute towards growing the financial sector, while making available, the liquidity required to finance infrastructure development and drive economic growth.

7. Conclusions and Policy Recommendations

7.1 As noted in this theme chapter, both theory and empirical studies support the existence of a mutually reinforcing relationship between economic growth and financial sector development in the context of a conducive environment. Therefore, Botswana's financial sector contributes positively to the country's economic performance, and this can be strengthened through further financial sector development. Moreover, this relationship is virtuous and amplified where there is simultaneous existence of, among others, macroeconomic stability, properly functioning public institutions, robust regulatory and supervisory infrastructure, well-thought-out economic and financial policies, mechanisms for limiting disruptive impact of financial institutions failures, as well as appropriately designed safety nets for financial institutions that can preserve economic growth and stability.

7.2 Botswana has long recognised the importance of financial sector development in pursuit of deep financial markets, sustainable and inclusive economic growth. Against this background, the evolution of the financial sector in Botswana has been guided by deliberate policy formulation, advancement in financial technology, evolving user needs in the economy, as well as adoption of international standards and best practice. In this regard, the country has adopted various financial sector development strategies that sought to promote development of different aspects of the financial system, including financial markets and instruments, competition and adequate supervisory frameworks for all financial institutions. Achievement of some of these objectives necessitated reviews, amendments of statutes and outright enactment of new legislation.

7.3 As a result, some of the key achievements were enhanced competitiveness of the banking system and adoption of market-oriented policies; introduction of market instruments such as Bank of Botswana Certificates and government securities; enhanced potency of monetary and financial sector policies; adaptation of new technology in the provision of financial services; the establishment of a financial stability function at the Bank of Botswana; and adoption of Basel regulatory and supervisory frameworks. With respect to legislation, there were several enactments to establish the NBFIRA with regulatory oversight over NBFIs; the FIA to combat financial offences and enforce AML/CFT laws in cooperation with international counterparty entities; as well as the Retirement Funds, Insurance Industry and the Securities legislation.

7.4 Nevertheless, international experience shows that Botswana lags behind in several respects, including financial institutions and market depths, financial access and size relative to the economy. The country has also not kept pace with peers in financial innovation and, as such, there is a dearth of financial derivatives that are important in risk management as well as in harnessing financial technology to reap maximum benefits. The foregoing review acknowledges that, in order for the country to realise the full benefits of financial sector development, appropriate financial sector policies should be formulated and implemented, focusing on promotion of a conducive operating environment, sound regulatory and supervisory frameworks, fostering the development of financial markets and broadening financial inclusion.

7.5 In this context, while the positive correlation between financial sector development and economic activity is evident, financial services in Botswana, although growing, remain relatively low relative to overall output, and in comparison to other countries. At least five areas can be highlighted as representing opportunities for addressing existing needs, inclusive growth and innovative expansion of the financial sector. These include increasing the size of mortgages in the balance sheet of banks and relative to GDP; enhancing productivity of resources flowing into the agriculture sector; expansion of support for the small and medium scale enterprises; effective packaging and harnessing of resources for long-term project funding; and accelerated integration of technology in the provision of financial services.

7.6 In addition, resource mobilisation that encompasses stable and sustainable resources flowing to the Government and a variety of foreign capital flows provides opportunities for deepening and growing the money and capital markets. As well as being beneficial to economic activity directly, such an environment augurs well for expansion of the financial sector, as well as ease of conducting business and effectiveness of macroeconomic policies. Moreover, development of government and corporate securities markets that involves foreign participation and includes a robust derivatives market would widen participation, enhance domestic liquidity and efficient price discovery, while providing a platform for diversified financial services and increased choice of risk management instruments in both the credit and equity markets. This would also enhance the skills base and expertise in financial management in the country, and promote effective integration in regional and global financial markets activities.

7.7 The scope for growth in the areas highlighted above is crucially linked to structural and enabling transformation with respect to legislation and regulation, institutional support, adequate and purposeful infrastructure and availability of relevant skills. Therefore, ongoing review of relevant legislation to modernise, close gaps and foster enabling provisions, as well as implementation of ideas reflected in the 2012 – 2016 FSDS need to be sustained. At the same time, there is need to maintain a disciplined approach to policy formulation and governance, as well as entrench high regulatory standards in order to retain integrity and wide patronage of the financial sector.

7.8 Among measures to reinforce financial sector stability, the Bank of Botswana, in consultation with MFED, are at an advanced stage of establishing a Financial Stability Council that would promote information exchange, cooperation and coordination in all areas relevant to financial system stability, including bank crisis resolution, while the establishment of a deposit insurance scheme also remains a priority. These would help to lay down clear guidelines on financial sector crises detection, prevention and resolution and restore consumer and investor confidence in the domestic financial sector.

7.9 Fostering healthy competition, cost effective access and introduction of innovative financial products and services through harnessing of fintech is considered to be a necessary agent for financial sector development. To this end, there is need to ensure that a supportive licensing, regulatory and business environment is in place to accelerate the penetration of mobile, agency and internet banking, including through the promulgation of electronic payment services regulations. Such an environment would promote market participation by both suppliers and consumers of financial products. A key lesson from other experiences is that countries, such as Kenya, Rwanda, India and Malaysia, have allowed non-bank institutions in the telecommunications and retail sectors to offer financial products and services, thereby creating competition and making it possible to improve access for the underserved and unbanked communities. In this regard, Botswana's high mobile phone connectivity provides an opportunity for a more inclusive financial sector that offers low-cost financial services to the unbanked and underserved, within an appropriate regulatory framework.

7.10 In order to encourage participation of fintech companies in the domestic financial sector, appropriate licensing and regulatory practices through the so-called 'regulatory sand boxes' (experimental regulatory approaches) could be adopted. This would accelerate the pace of adoption of technology in the delivery of innovative financial products and services.

7.11 Beneficial contribution of the financial sector to economic activity also hinges upon efficiency in the payment and settlement systems and this is increasingly in digital and electronic form; hence, the need for supportive infrastructure, connectivity and interoperability, as well as enabling regulatory and administrative processes that also help mitigate fraudulent and inappropriate use. Prospective developments include the enactment of EPS regulations to enable expansion of participation in the payment system to non-bank financial institutions and establishment of a single CSD that is linked to the real time gross settlement (RTGS) system to ensure timely and safe payments delivery. Supportive infrastructure also relates to management of customer data. Countries such as India and Malaysia, have adopted the use of technology-based collection and management of bio-data to facilitate access to services. Such an approach also lowers significantly the burden and cost of adherence to KYC/AML protocols. Thus, purposeful and appropriate configuration and centralisation of bio-data and other personal identification information to fit various service access needs and records management is necessary to help ease the conduct of diverse facets of economic activity.

7.12 The Treasury Mobile Direct project of Kenya, through the M-Akiba infrastructure bond on the M-Pesa platform, offers a benchmarking opportunity for Botswana to consider broadening household participation in the capital and bond markets. Furthermore, financial literacy and dissemination of relevant information through public education campaigns provide an effective avenue for increasing private sector participation in the capital and bond markets. Thus, it is imperative to intensify public awareness campaigns, by both operators and regulators. This is also important in mitigating exposure of the public to fraudulent operations that can undermine the public's confidence in the banking system, thus work against the financial inclusion agenda and potential beneficial role of the financial sector in economic activity.

7.13 For Botswana, financial sector development, particularly efficiency and diversity of products, could be constrained by the small national market. Considering this, regional economic and financial integration offers a possible strategy to unlock the efficiency of scale and returns from diverse products, thereby expanding the possible financing options and vehicles for savings in the country. Accordingly, small countries with a nascent local securities market can benefit from listing and trading instruments on a regional stock market. Botswana has, therefore, ratified the SADC Protocol on Finance and Investment aimed at the promotion of cooperation in regional capital and financial markets.

7.14 This review highlighted gaps in infrastructure development financing that can be reduced through exploring a number of sources of funds, including commercial bank loans; undertaking upstream reforms; resolving market failures; drawing upon public and concessional facilities; and accessing the capital market. In this regard, Botswana's capital markets, including the issuance and trading in bonds and shares need to be improved with respect to number and scope of issuers, liquidity and public participation beyond banks and institutional investors, while development of the corporate securities market provides an opportunity to unlock substantial long-term finance that could complement commercial bank lending. With the amount of outstanding government bonds and T-bills currently at P10.2 billion out of the P15 billion Government Bond Programme, there is scope for more and regular issuance that could further stimulate the bond market.

7.15 It is also noted that resources for public sector financing of infrastructure development can be mobilised through the use of the PPP initiative. For this mode of financing to be unlocked and succeed, enactment of a specific PPP legislation and adoption of an appropriate regulatory framework is paramount, hence the need for expeditious finalisation of relevant laws.

7.16 Given that the latest financial sector development strategy was adopted in 2012 and has run its course, going forward, there is a void in as far as formal policy to guide financial sector development is concerned. As such, a comprehensive review of the financial sector with a view to formulating an FSDS that can be formally adopted by government and incorporated into NDP 11, at the time of the mid-term review, and subsequent NDPs, is recommended. Such a strategy would clearly define an envisioned state of a developed financial sector and set out the goals and objectives to be achieved to that end. In addition, the strategy would identify key performance indicators and measureable targets to facilitate monitoring and designate authorities that can be held accountable for ensuring the FSDS is effectively and timely implemented.