ANNUAL REPORT 2018

BANK OF BOTSWANA

STRATEGIC INTENT STATEMENTS

VISION

The Bank aspires to be a world-class central bank with the highest standards of corporate governance and professional excellence.

MISSION

The mission of the Bank is to contribute to the sound economic and financial well-being of the country. The Bank seeks to promote and maintain:

- monetary stability;
- safe, sound and stable financial system;
- efficient payments mechanism;
- public confidence in the national currency;
- sound international financial relations;

and to provide:

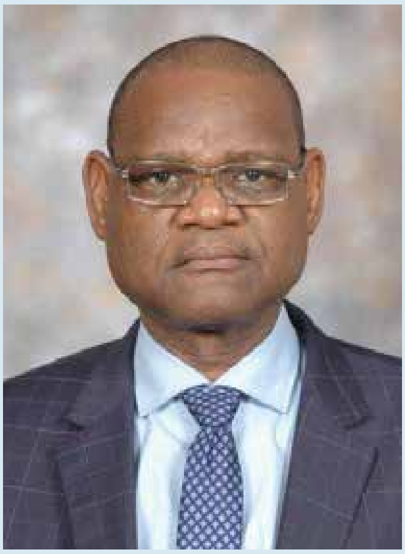
- efficient banking services to its various clients; and
- sound economic and financial advice to Government.

BANK OF BOTSWANA

ANNUAL REPORT

2018

Board Members
(as at year-end 2018)

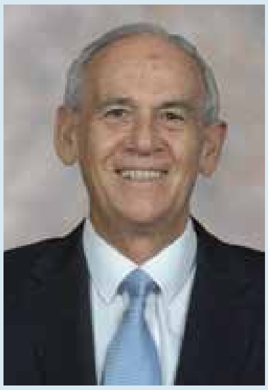


Moses D Pelaelo
Governor
(Chairman)

Solomon M Sekwakwa*

Gordon K Cunliffe

Dr Joel Sentsho



Robert N Matthews

Dr Malebogo Bakwena

Daphne K Briscoe

Bernard M Ditlhabi

Victoria T Tebele

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

Board Members

(as at year-end 2018)

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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 - 2018

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Charts and Tables

CHARTS

TABLES

Abbreviations Used in the Report

AACB	-	Association of African Central Banks
AfDB	-	African Development Bank
Afrexim	-	African Export-Import
AML	-	Anti-Money Laundering
ARC	-	Audit and Risk Committee
BACH	-	Botswana Automated Clearing House
BBS	-	Botswana Building Society
BCL	-	Bamangwato Concessions Limited
BDC	-	Botswana Development Corporation
BDF	-	Botswana Defence Force
aBEDU	-	Botswana Enterprises Development Unit
BFS	-	Botswana Financial Statistics
BISS	-	Botswana Inter-bank Settlement System
BITRI	-	Botswana Institute for Technology, Research and Innovation
BNDES	-	Brazil National Development Bank
BoBCs	-	Bank of Botswana Certificates
BSB	-	Botswana Savings Bank
BSE	-	Botswana Stock Exchange
CCBG	-	Committee of Central Bank Governors
CEDA	-	Citizen Entrepreneurial Development Agency
CFT	-	Combating of the Financing of Terrorism
CISO	-	Chief Information Security Officer
CITF	-	Construction Industry Trust Fund
CORFO	-	Corporation for Promotion of Production
CSD	-	Central Securities Depository
DBGSS	-	De Beers Global Sightholder Sales
DBM	-	Development Bank of Mauritius
DBS	-	Development Bank of Singapore
DBSA	-	Development Bank of Southern Africa
DFIs	-	Development Finance Institutions
EDB	-	Economic Development Board
EFT	-	Electronic Funds Transfer
EPZ	-	Export Processing Zone
FAP	-	Financial Assistance Policy
FATF	-	Financial Action Task Force
FCA	-	Foreign Currency Account
FDI	-	Foreign Direct Investment
FMIs	-	Financial Market Infrastructures
FSC	-	Financial Stability Council
GDP	-	Gross Domestic Product
GEC	-	Governance and Ethics Committee
GIA	-	Government Investment Account
GLCs	-	Government-Linked Companies

ICT	-	Information and Communication Technology
IDC	-	Industrial Development Corporation
IFC	-	International Finance Corporation
IFRS	-	International Financial Reporting Standards
IIP	-	International Investment Position
IMF	-	International Monetary Fund
KBL	-	Kgalagadi Breweries Limited
KDB	-	Korea Development Bank
KRB	-	Korea Reconstruction Bank
LAPCAS	-	Land Administration Procedures, Capacity and Systems
LEA	-	Local Enterprise Authority
M&E	-	Monitoring and Evaluation
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
MPC	-	Monetary Policy Committee
MPR	-	Monetary Policy Report
MPS	-	Monetary Policy Statement
NBFIs	-	Non-Bank Financial Institutions
NDB	-	National Development Bank
NDP	-	National Development Plan
NEER	-	Nominal Effective Exchange Rate
NEF	-	National Empowerment Fund
NFTRC	-	National Food Technology Research Centre
NPLs	-	Non-Performing Loans
NPS	-	National Payments System
ODC	-	Okavango Diamond Company
OEHT	-	Austrian Tourism Development Bank
OPEC	-	Organisation of Petroleum Exporting Countries
PDSF	-	Public Debt Service Fund
PEEPA	-	Public Enterprises, Evaluation and Privatisation Agency
PPP	-	Public Private Partnership
R&D	-	Research and Development
REER	-	Real Effective Exchange Rate
REMCO	-	Remuneration Committee
RTGS	-	Real Time Gross Settlement
SACU	-	Southern African Customs Union
SADC	-	Southern African Development Community
SDGs	-	Sustainable Development Goals
SDR	-	Special Drawing Rights
SEA	-	South East Asia
SEZ	-	Special Economic Zones
SEZA	-	Special Economic Zone Authority
SIPS	-	Systematically Important Payments Systems

SMEs	-	Small Medium Enterprises
SMMEs	-	Small Micro and Medium-sized Enterprises
SOEs	-	State-Owned Enterprises
SPEDU	-	Selebi-Phikwe Economic Diversification Unit
SWFs	-	Sovereign Wealth Funds
SWIFT	-	Society for Worldwide Interbank Financial Telecommunication
THL	-	Temasek Holdings Limited
UK	-	United Kingdom
UNCTAD	-	United Nations Conference on Trade and Development
USA	-	United States of America
USD	-	United States Dollar
UNWTO	-	United Nations World Tourism Organisation
VAT	-	Value Added Tax
YDF	-	Youth Development Fund

Part A

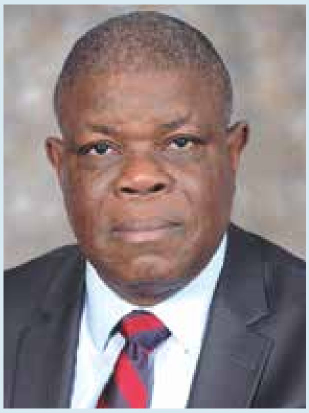
Statutory Report on the Operations and Financial Statements of the Bank – 2018

Bank of Botswana

Senior Management as at December 31, 2018

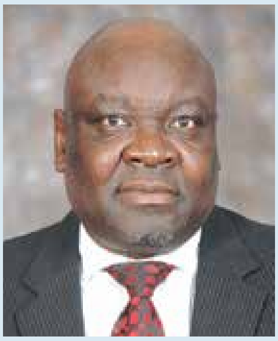
Deputy Governors

Dr Kealeboga S Masalila



Andrew M Motsomi

Ewetse T Rakhudu
General Counsel



Richard H Nlebesi
General Manager

Heads of Department

Ralesedi E Somolekae
Human Resources

Daniel N Loeto
Finance

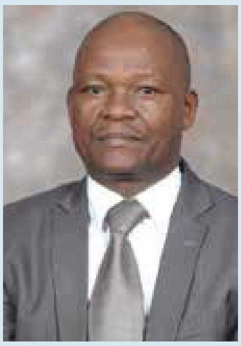
Julius Ghanie
Information & Communications Technology

Dr Tshokologo A Kganetsano
Research & Financial Stability

Dr Lesedi Senatla
Banking Supervision

Matthew Wright
Financial Markets

Keletso M Mothusi
Internal Audit Services



Marshall Kgokgothwane
Protective Services

Sheila M Sealetsa
Banking & Currency

Patricia C Tumedi
Payments & Settlement

Governor's Foreword

The 2018 *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, 2018.

The *Report* also covers the Bank's key functions and responsibilities. It outlines the accountability framework for the Bank's performance. These functions and responsibilities can be grouped into ten broad categories, namely: conduct of monetary policy; maintenance of 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 selected public institutions; economic research; policy advice to Government; and production and publication of balance of payments, financial and monetary statistics.

The *Annual Report* contains a review of recent economic developments in the Botswana economy and a theme chapter titled '*Botswana: Financing Strategies for Industrialisation and Transition to High Income Status*.' The theme chapter identifies and evaluates practical approaches to implementation of the country's industrialisation strategy, in this instance, effective harnessing of finance as a resource and input to expansion and, also, to enhancing productivity of identified sectors. The discussion in this theme chapter expounds on some of the concluding observations of the 2017 *Annual Report* theme topic and articulates alternative financing models and resource mobilisation approaches that are likely to best serve the cluster/hub industrialisation strategy and advance the country to high - income status. In this regard, the theme chapter discusses the potential for clusters, hubs, and SMMEs in relation to the industrialisation strategy. The existing financing options and impact on industrialisation initiatives in the past are assessed in terms of either "gaps" or design deficiencies and, accordingly, the theme chapter evaluates prospects for improvements to ensure sustained adequate funding of the sectors identified for execution of the industrialisation strategy. The theme chapter compares Botswana's financing and industrialisation strategies and performance with the successful countries in these areas with a view to identifying the lessons to be drawn from such countries. Furthermore, the theme chapter provides a perspective on measures to enhance policy and institutional performance to foster industrialisation.

The Bank was successful in implementing the 2018 work programme and, in general, achieved its policy objectives for the year, notwithstanding challenges in the domestic and external environment, dominated by uncertainty and downside risks. Global economic activity was modest in 2018 with growth of 3.7 percent, compared to the 3.8 percent in 2017, mainly reflecting a slower pace of increase in global demand.

For Botswana, both mining and non-mining output growth strengthened in the twelve months to September 2018, compared to the corresponding period in 2017. However, overall economic expansion was constrained by subdued domestic and global demand.

Inflation in Botswana was dampened by modest growth in personal incomes, the moderate increase in bank credit, the resultant subdued domestic demand and benign global and trading partners' inflation. Inflation was, for most of 2018, within the 3 – 6 percent medium-term objective range and close to the lower bound, breaching the lower bound twice, in March and September 2018. Average inflation for the twelve months to December 2018 was 3.2 percent.

Monetary policy was conducted against the background of a 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. Hence the Bank Rate was maintained at 5 percent in 2018 and, consequently, the prime lending rate of commercial banks was unchanged at 6.5 percent, while deposit interest rates were similarly, virtually stable. Monetary policy entailed the use of Bank of Botswana Certificates (BoBCs) to mop-up excess liquidity in an effort to maintain interest rates that are consistent with the monetary policy stance. Consequently, outstanding BoBCs amounted to P8.2 billion in December 2018, an increase from P6.3 billion in December 2017, reflecting an increase in banking system liquidity that had to be mopped-up to anchor the monetary policy stance.

The Bank's implementation of the exchange rate policy in 2018 entailed a 0.3 percent downward annual rate of crawl to stabilise the real effective exchange rate (REER); thus moderate the risk of a further appreciation of the REER, which was evident in the last half of 2017. The Pula basket weights were maintained at 45 percent and 55 percent for the South African rand and the Special Drawing Rights (SDR),[1] respectively. The REER, however, appreciated marginally by 0.3 percent in the twelve months to December 2018, as the positive inflation differential between Botswana and trading partner countries was slightly larger than the downward rate of crawl.

With regard to the financial condition and performance, the Bank's total assets declined by P2.1 billion to P72.2 billion in December 2018 (P74.3 billion in December 2017), of which P71.4 billion was foreign exchange reserves. In foreign currency terms (United States dollars (USD) and Special Drawing Rights), the foreign exchange reserves decreased from USD7.5 billion to USD6.7 billion and from SDR5.3 billion to SDR4.8 billion in the same period. At this level, the foreign exchange reserves were equivalent to 15 months of import cover of goods and services. The decrease reflects, among others, drawdowns of foreign exchange by government and significant adverse valuations, specifically global equity markets towards the end of the year.

The Bank's net income for 2018 was P2.9 billion, compared to P739.5 million in 2017. After transferring non-distributable currency gains of P4 billion to the Currency Revaluation Reserve and market valuation losses of P5.9 billion to the Market Revaluation Reserve,[2] the net distributable income to Government was P4.8 billion, higher than the P1.9 billion in 2017.

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 statement of financial position (the balance sheet) increased by 9.3 percent, from P83.5 billion in December 2017 to P91.3 billion as at December 31, 2018. The industry's total deposits rose by 9 percent from P63.6 billion in 2017 to P69.3 billion in 2018, while loans and advances increased by 7.6 percent from P54.2 billion to P58.3 billion during the same period. Overall, annual credit growth accelerated from 5.6 percent in 2017 to 7.7 percent in 2018, with a faster expansion in credit to business, while growth in lending to households slowed in an environment of modest increase in personal incomes.

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 that were driven by developments in information and communications technology, competition and customer requirements. The Bank also implemented related security and risk mitigation measures to avert any possible cyber-attacks, fraud and misuse of payments systems.

During 2018, Moody's Investors Service and Standard & Poor's Global Ratings affirmed Botswana's investment grade ratings of A2 and 'A-/A-2', respectively, for long and short-term bonds in domestic and foreign currency. The outlook was reaffirmed to be stable by both the credit rating agencies. The strong external and fiscal

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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).

2 The revaluation gains were due to the implementation of the new investment guidelines and rebalancing of the liquidity portfolio.

balance sheet, a well-managed economy and low public debt, as well as the country's robust public institutions and a stable political environment supported the ratings. However, both rating agencies reiterated the concerns relating to the narrow economic base and relatively slow progress in economic diversification.

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 productivity and leadership capability.

In fulfilment of its statutory obligations, the Bank's *Annual Report* and *Banking Supervision Annual Report* for 2017 were submitted to the Minister of Finance and Economic Development on March 31 and June 30, 2018, respectively. The Bank also continued to publish the monthly *Botswana Financial Statistics*, the *Monetary Policy Statement* (MPS), the biannual *Business Expectations Survey* and the *Research Bulletin*.

The Bank published, for the first time, the *Monetary Policy Report* (MPR) in August and October 2018. Going forward, the Bank will, in addition to the MPS, publish three MPRs in April, August and October each year to provide a continuous comprehensive update on the formulation and implementation of monetary policy. These serve to meet the public's expectation of a transparent and accountable central bank in fulfilling the monetary policy mandate set out in the Bank of Botswana Act (CAP 55:01).

In 2018, the Bank spearheaded the establishment of the Financial Stability Council (FSC), an inter-agency administrative body aimed at strengthening the implementation of the financial stability mandate. The FSC's primary focus is to foster coordinated macro-prudential analysis, monitoring and response to financial system imbalances or distress to ensure a sound and stable financial system, which is supportive of sustainable macroeconomic environment.

During 2018, the Bank introduced a legal function to its operations, the Corporate and Legal Affairs Department, to strengthen capacity in addressing and responding to legal matters and risks relating to the Bank's mandates and operations. Similarly, the Bank established a Chief Information Security Officer (CISO) function to create institutional arrangements for strengthening its resilience in managing risks arising from cyber and other information technology related crimes.

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

The management and staff of the Bank owe a debt of gratitude to the Board for the guidance and support in implementing the 2018 work programme. It is hoped that stakeholders will find the 2018 *Annual Report* informative.

Moses D Pelaelo
GOVERNOR

Statutory Report on the Operations and Financial Statements of the Bank – 2018

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. Consistent with the monetary stability objective, the Bank endeavours to foster monetary, credit and financial conditions conducive to the orderly, balanced and sustainable economic development of the country. Based on this primary statutory mandate, the Bank's functions and responsibilities can be grouped under the following categories.

(a) Monetary stability - a principal objective of the Bank is to preserve the purchasing power of the Pula currency by keeping the rate of inflation low and stable. A sound and stable macroeconomic environment is conducive for sustainable economic growth. Price stability is achieved through monetary policy formulation and implementation, which involves the setting of the policy rate (Bank Rate) and conduct of open market operations. The Bank engages in open market operations through weekly auctions of BoBCs. It also engages in repo and reverse repo transactions and extends overnight credit facilities to banks. These operations enable the Bank to influence monetary conditions and ensure that market interest rates are aligned to the policy stance, also serving to foster the orderly and efficient functioning of the financial system.

(b) Exchange rate policy implementation - the Bank implements the Government's exchange rate policy, the objective of which is to promote and maintain the international competitiveness of domestic firms and contribute to overall macroeconomic stability.

(c) Financial stability - vulnerability assessments and performance monitoring of the financial sector are conducted with the view to help inform policy and adoption of appropriate macro-prudential supervision measures to respond to any financial sector imbalances and, therefore, maintain financial stability.

(d) Banking regulation and supervision - the Bank regulates and supervises commercial banks to ensure operational safety and soundness.

(e) Issuance of currency (banknotes and coin) - currency management ensures an adequate supply of high quality banknotes and coin to facilitate transactions and economic activity. This entails adherence to stringent standards in design and production to avert possible counterfeiting and loss of confidence in the currency.

(f) Central banking services - the Bank provides banking services to the Government, commercial banks and selected public institutions. This includes membership of Botswana Automated Clearing House (BACH) operated by the Bankers Association of Botswana.

(g) Payment infrastructure and settlement - facilitation and maintenance of the integrity of payments systems enables the flow of payments and efficient payment settlement. Moreover, oversight and regulation entrenches confidence in the payments and settlement systems and mitigates systemic risks.

(h) Management of official foreign exchange reserves and making foreign payments on behalf of Government - the Bank manages the country's foreign exchange reserves on behalf 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 guarantee safety, liquidity and return within acceptable risk parameters.

(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 order 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: Legal and Compliance, Risk Management, Internal Audit, Security, Business Continuity Planning and Cyber Security
- Operating Platforms: Information Technology Systems, Physical Infrastructure and Facilities
- Accountability, Stakeholder Feedback and Communication

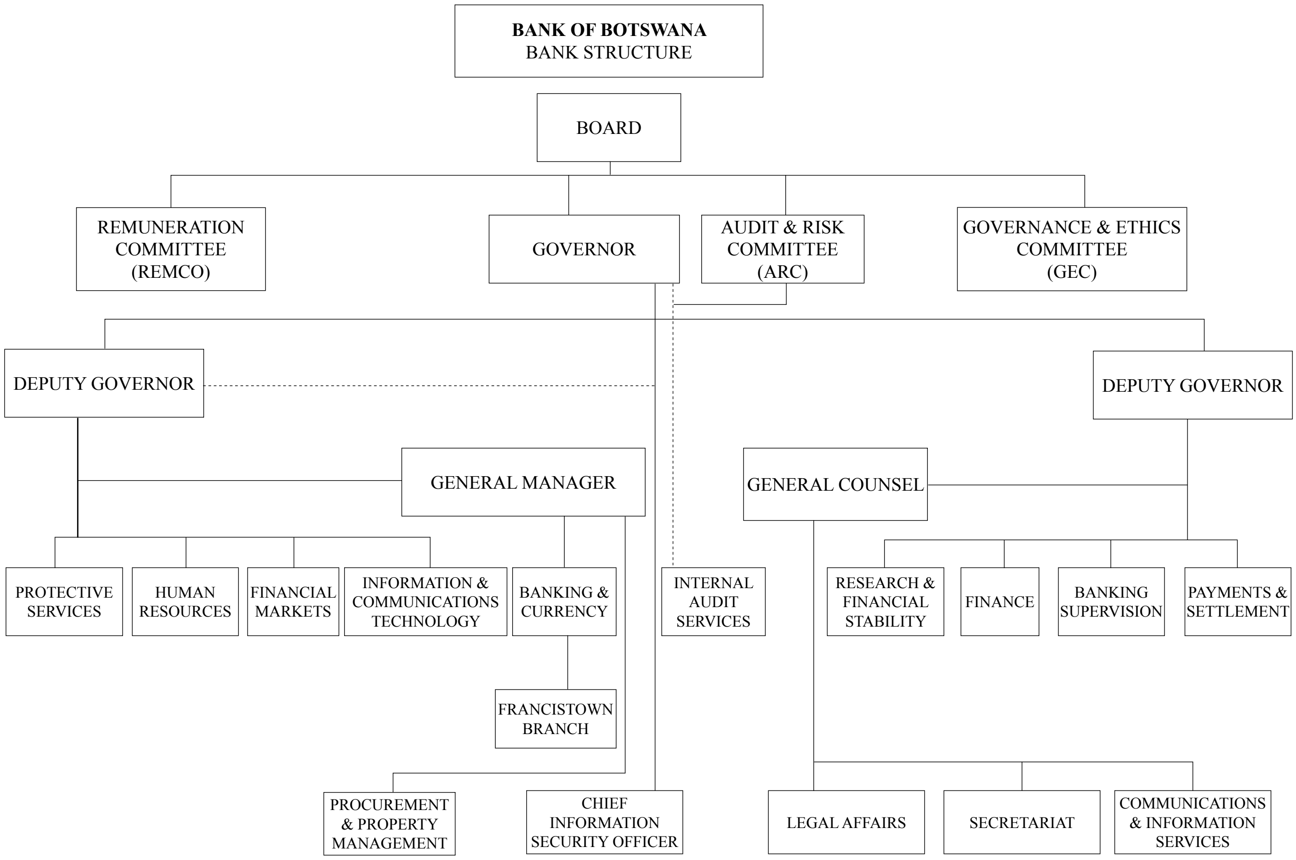
Mission, Objectives and Functions	Instruments and Activities
Monetary Stability and Operations	Bank Rate, Open Market Operations, Exchange Rate Management, Primary Reserve Requirement, Policy Focused Research, Inflation Modelling and Forecasting and Policy Communication
Financial Stability	Macro-Prudential Policy, Surveillance and Monitoring
Sound Banking System	Banking Regulation, Licensing, Supervision and Enforcement Action
Efficient Payments System	Banking, Payments Systems, Regulation and Oversight, Clearing and Settlement Systems
Issuance of Quality Banknotes and Coin	Currency 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	Reserves Management and Investment Guidelines; Foreign Exchange Trading and Dealing
Economic Analysis and Policy Advice to Government, Collection, Production and Publication of Statistics	High-Level Bank Representation, Direct Advice, Joint Committees, Research and Other Publications, 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 eleven departments and four divisions; supported by two Deputy Governors, a General Manager, a General Counsel and, heads of departments and divisions (Figure 2). The governance structure promotes coordination and synergy between policy-oriented activities and support functions, including human resource management and training, adoption of efficiency-enhancing technology, planning and 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, 2018



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, being 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, and two of them may be public officers. The Governor and the two Deputy Governors are appointed by the President. The two Deputy Governors are not Board members, but are required, and do attend all Board meetings.

The Board had three committees in 2018, namely: the Audit and Risk Committee (ARC), Remuneration Committee (REMCO) and Governance and Ethics Committee (GEC), which are chaired by non-executive Board members. The Committees deliberate on matters pertaining to their respective mandates and make 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 2018, six Board meetings were 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.

Table 1: Board Meetings and Attendance in 2018

Meeting	BB 1/18 (Feb 16)	BB 2/18 (Mar 26)	BB 3/18 (Jun 15)	BB 4/18 (Aug 24)	BB 5/18 (Oct 26)	BB 6/18 (Dec 7)
M D Pelaelo (Board Chairman)	✓	✓	✓	✓	✓	✓
S Sekwakwa (Ex-officio) (REMCO & GEC)	×	✓	✓	×	✓	✓
G K Cunliffe (ARC Chairman)	✓	✓	✓	✓	×	✓
R N Matthews (ARC & GEC)	✓	×	×	✓	✓	✓
J Sentsho (ARC)	✓	✓	×	✓	✓	✓
M Bakwena (REMCO Chairman)	✓	×	✓	✓	✓	✓
D K Briscoe (REMCO & GEC)	✓	✓	✓	✓	✓	✓
V T Tebele (ARC)	✓	✓	✓	✓	✓	✓
B M Ditlhabi (GEC Chairman & REMCO member)	✓	✓	✓	✓	✓	×

Key: ✓ Attended
× Not attended
BB Board Meeting
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 (March), 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 its receipt 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 in the non-executive Board of Governors of the International Monetary Fund (IMF).

Executive Committee

The Executive Committee comprises Deputy Governors, General Manager, General Counsel 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, as well as other developments in the Bank.

Departments and Divisions

The Bank has eleven departments, five of which fulfil the Bank's core mandates, while six departments provide auxiliary support and corporate services (Figure 2). The Research and Financial Stability Department undertakes macroeconomic forecasting and policy review in support of the Bank's conduct of monetary policy and implementation of the exchange rate policy. 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 data collection, research and macroeconomic analysis, monitors the financial sector and evaluates emerging risks and other developments emanating from the macroeconomic environment. In addition, the Department is responsible for production and dissemination of the Bank's publications, namely; the *Annual Report*; monthly *Botswana Financial Statistics* (BFS); the *Research Bulletin*; *Monetary Policy Statement* (MPS); the *Monetary Policy Report* (MPR) and the *Business Expectations Survey* (BES).

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 inappropriate 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 and implements monetary policy through the conduct of open market operations. The department also conducts other money and capital market activities, which include issuance of government bonds and treasury bills.

The management of currency (Pula and thebe banknotes and coin) and provision of banking services to the Government, commercial banks and selected institutions is carried out by the Banking and Currency Department, whilst oversight and regulation of payments and settlement transactions is carried out by the Payments and Settlement Department. The latter is also responsible for operating the Bank's Real Time Gross Settlement (RTGS) system, known as the Botswana Interbank Settlement System (BISS) and overseeing the BACH system owned and operated by commercial 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, as stipulated in the Bank of Botswana Act (CAP 55:01) and International Financial Reporting Standards (IFRS). The Department also coordinates strategic planning, risk management, and the business continuity programme. The Human Resources Department is responsible for staff recruitment, training, remuneration and welfare, while the Information and Communications Technology Department ensures that the Bank's information technology systems and infrastructure are robust and effective in meeting the needs of the Bank. The CISO, who reports directly to the Governor, is responsible for managing risks arising from cyber and information technology related crimes. Meanwhile, the Protective Services Department has responsibility for ensuring the safety and security of Bank staff, information and property.

The Internal Audit Services Department 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 Corporate and Legal Affairs Department is responsible for all matters of a legal nature, including legislature review, litigation, contracts and compliance related matters. In addition, through the Secretariat Division, the Department serves the Board, Executive Committee and provides Mail Registry and protocol services. The Communications and Information Services Division coordinates communications activities in relation to media and effective transmission of information relating to the Bank's mandate, policies and practices to stakeholders. The Division coordinates the Bank's Public Education Programme and related policies to promote financial and economic literacy and improve the public's understanding of the Bank's role in the economic development of the country. This ensures an overall positive image of the Bank. The Division is also responsible for the Library and records management.

Other support services are undertaken through the specialised activities of the Procurement and Property Management division, which undertakes procurement (including coordination of the tendering process), custody and maintenance of immovable and movable assets of the Bank, including related equipment.

Review of the Bank's Main Activities in 2018

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 primary reserve requirements. While the Bank may use prudential regulations and moral suasion, the primary instruments used to manage liquidity and influence short-term deposit and lending interest rates in the economy, are the Bank of Botswana Certificates (BoBCs).

In 2018, 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. Hence, the Bank Rate was maintained at 5 percent and consequently, the prime lending rate of commercial banks was unchanged at 6.5 percent, while deposit interest rates were, similarly, virtually stable. The nominal 3-month (88-day) deposit interest rate of commercial banks increased from 1.10 percent in December 2017 to 1.56 percent in December 2018. Meanwhile, inflation was mostly within the Bank's 3 – 6 percent medium-term objective range and closer to the lower end of the objective range throughout the year.

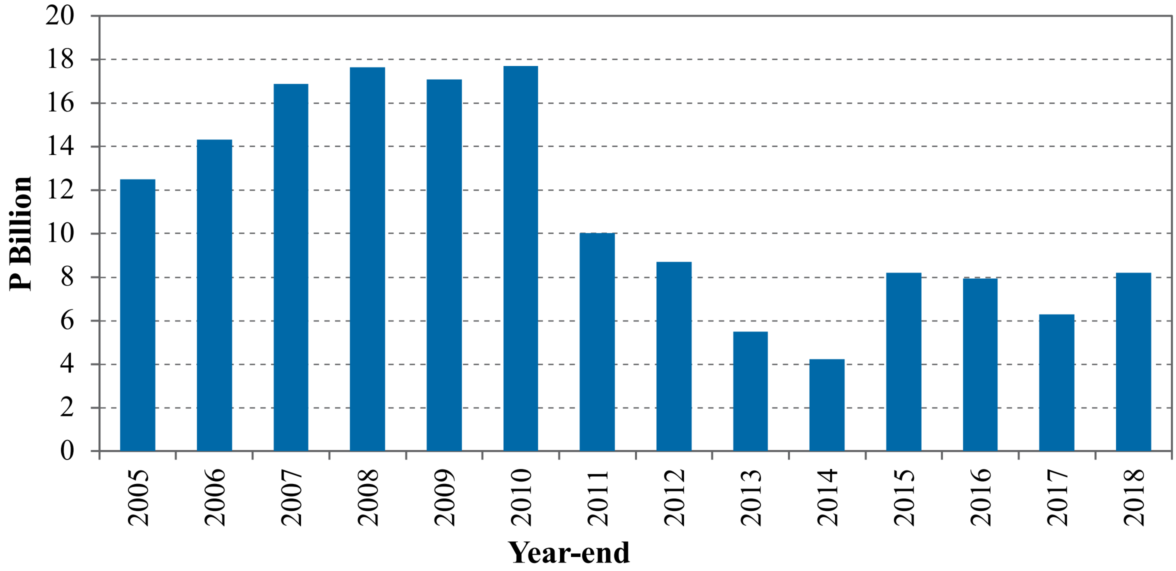
During 2018, the Bank held six Monetary Policy Committee (MPC) meetings, all followed by media briefings, which allowed dialogue between the Bank and the media, thus enhancing the Bank's accountability, credibility and transparency.

The Bank introduced and published, for the first time, the MPR in August and October 2018, following the publication of the MPS in February. These publications are the main medium through which the Bank informs the public about the formulation and implementation of monetary policy and, therefore, serve to meet the public's expectation of a transparent and accountable central bank in fulfilling the monetary policy mandate set out in the Bank of Botswana Act (CAP 55:01). The MPS and MPRs provide a comprehensive assessment of economic and financial developments that are likely to influence the inflation path in the medium term and, in turn, the Bank's future policy choices based on the forward-looking framework for monetary policy formulation by the MPC. The Bank increasingly uses the communication tool to clarify its mandate, policy performance and to provide guidance. In this respect, the publications promote an understanding of the conduct of monetary policy in order to anchor public expectations of a low, predictable and sustainable level of inflation.

Money and Capital Markets

Open market operations were used to absorb excess liquidity in the market to ensure that interest rates were at levels that were consistent with the monetary policy stance. The outstanding value of BoBCs increased from P6.3 billion at the end of 2017 to P8.2 billion in December 2018 (Chart 1). Repurchase Agreements (repos) and reverse repos were used during the year to manage liquidity between auctions, and P1.1 billion worth of reverse repos was outstanding at the end of 2018, compared to P54 million in December 2017. There were no outstanding repos as at the end of 2018 (Table 2).

Chart 1: Bank of Botswana Certificates 2005 - 2018



Source: Bank of Botswana

Table 2: Money Market 2017 - 2018

	End - 2017			End-2018		
	Outstanding Balances[1] (P Billion)	Interest Rate (Percent)[2]		Outstanding Balances[1] (P Billion)	Interest Rate (Percent)[2]	
		Nominal	Real		Nominal	Real
6-month Treasury Bills[2,3]	0.87	1.34	-1.80	0.67	1.55	-.188
14-day BoBCs[2]	2.90	1.47	-1.68	5.53	1.59	-1.85
91-day BoBCs[2]	3.40	1.48	-1.67	2.67	1.59	-1.85
Reverse Repos	0.054	1.00	-2.13	1.10	1.00	-2.42
Repos	0	4.50	1.26	0	4.50	0.97
88-day Deposits	3.00	1.10	-2.03	3.49	1.56	-1.87
Prime Rate		6.50	3.20		6.50	2.90

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

Source: Bank of Botswana

The 14-day BoBC weighted average yield increased from 1.47 percent in December 2017 to 1.59 percent in December 2018, while the yield on the 91-day BoBC increased from 1.48 percent to 1.59 percent during the same period. In line with the Bank's commitment to encourage 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 equal to the prevailing Bank Rate less 3.5 percentage points,[3] with progressively 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, while also providing an alternative source of government funding. As the Government continued borrowing from the domestic market in 2018, outstanding bonds of various maturities and Treasury Bills increased from P10.2 billion at the end of 2017 to P10.3 billion in December 2018 (Table 3). Primary Dealers and their customers held P3.2 billion (31 percent) and P7.1 billion (69 percent), respectively, of the government securities at the end of 2018

Table 3: Government Bonds and Treasury Bills 2017–2018

Bond Code[4]	End 2017			End 2018		
	Outstanding (P Million) [1,2]	Market Yields[3] (Percent)		Outstanding (P Million) [1,2]	Market Yields[3] (Percent)	
		Yield	Real		Yield	Real
6-month Treasury Bills	870	1.34	-1.80	670	1.55	-1.88
BW005 (12/09/2018)	2 008	1.88	-1.28	-	-	-
BW008 (08/09/2020)	2 047	3.63	0.42	2 147	3.61	0.11
BW013 (07/06/2023)	250	3.81	0.59	939	3.83	0.32
BW007 (10/03/2025)	1 897	4.26	1.03	1 974	4.35	0.82
BW014 (05/09/2029)	-	-	-	596	4.88	1.33
BW011 (10/09/2031)	1 803	4.98	1.72	2 103	4.94	1.39
BW012 (13/06/2040)	1 328	5.20	1.94	1 528	5.15	1.59
BW015 (02/09/2043)	-	-	-	301	5.21	1.65
	10 203			**10 258**		

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 0.30 percent downward rate of crawl of the nominal effective exchange rate (NEER) during 2018, given that domestic inflation was projected to be slightly higher than average inflation forecast for the trading partner countries. The 0.3 percent downward rate of crawl was also implemented with a view to moderating the risk of a further appreciation of the REER, which was evident in the last half of 2017. The Pula basket weights were maintained at 45 percent and 55 percent for the South African rand and the IMF's Special Drawing Rights (SDR), respectively.

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

In the twelve months to December 2018, the trade-weighted NEER of the Pula depreciated by 0.3 percent, consistent with the rate of crawl of the Pula exchange rate (Table 1.5). Meanwhile, the REER appreciated marginally by 0.3 percent in the twelve months to December 2018, as the positive inflation differential between Botswana and trading partner countries was slightly larger than the downward rate of crawl. A 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 the 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 2018, the Bank continued to monitor the performance of banks through a system of monthly and quarterly returns; risk-based supervision; on-site examinations; bilateral and trilateral meetings (the Bank, banks and their external auditors); ad hoc consultations as necessary. The Bank also convened the biannual meetings of the Banking Committee, which comprises the Bank and chief executive officers of banks to facilitate discussion of industry-wide matters. The banking sector was adequately capitalised, profitable and liquid as at December 31, 2018. The industry's compliance with the regulatory and prudential requirements was satisfactory (Table 4). The asset quality of the banking sector deteriorated slightly as indicated by the increase in the ratio of non-performing loans to gross loans and advances from 5.3 percent in 2017 to 5.5 percent in 2018.

Most banks reported higher profit levels compared to the previous year, with the exception of one bank, which made a loss for the year ending December 31, 2018. The banking sector's balance sheet increased by 9.3 percent from P83.5 billion in 2017 to P91.3 billion in 2018. Meanwhile, the industry's total deposits rose by 9 percent from P63.6 billion in 2017 to P69.3 billion in 2018, while loans and advances increased by 7.6 percent from P54.2 billion to P58.3 billion in the same period. Consequently, the financial intermediation ratio[4] fell from 85.2 percent as at December 31, 2017 to 84.2 percent at the end of 2018. All banks were adequately capitalised, liquid and complied with the minimum prudential and statutory capital and liquidity requirements. However, one bank had a capital adequacy ratio below 15 percent, which is the prudential limit, as at December 31, 2018. In addition to the prudential supervisory role, the Bank continued to monitor business conduct to ensure that banks treated their customers in a fair, professional and transparent manner.

4 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 in an economy.

TABLE 4: FINANCIAL SOUNDNESS INDICATORS RANGE FOR LICENSED BANKS (2015 - 2018)

Financial Indicators	Range of Indicators for Local Banks (Percent)			
	2015	2016	2017	2018
Capital Adequacy Ratio	16.4 – 31.0	16.3 – 35.9	15.2 – 36.6	13.3 – 42.6
Liquid Asset Ratio	2.9 – 28.6	13.5 – 46.3	12.2 – 35.1	12.3 – 41.0
Profitability (Return on Assets)	(1.0) – 2.7	(1.9) – 2.5	(3.6) – 2.9	(1.2) – 3.1
Profitability (Return on Equity)	(6.4) – 21.4	(10.5) – 20.4	(29.1) – 22.1	(5.3) – 23.1
Asset Quality (Non-Performing Loans/Total Loans)	0.6 – 8.4	0.8 – 8.5	1.3 – 10.0	1.3 – 10.4
Intermediation (Advances/ Deposits)	51.1 – 104.6	58.3 – 91.3	65.3 – 137.9	62.8 – 166.8

1. Numbers in parentheses are negative.
Source: Bank of Botswana

Liquidation of the defunct Kingdom Bank Africa Limited 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, was in progress as at December 31, 2018.

Abandoned funds continued to be administered in accordance with the provision of Section 39 of the Banking Act (CAP. 46:04). As at December 31, 2018, the balance of abandoned funds was P15.1 million, up from P10.6 million in 2017. During the year, P423 292 was claimed, while P1.3 million was transferred to the Guardian Fund.[5]

In an effort to strengthen the implementation of the financial stability mandate, the Bank spearheaded the establishment of the Financial Stability Council (FSC), an inter-agency administrative body comprising senior representatives of the Ministry of Finance and Economic Development, the Bank, Non-Bank Financial Institutions Regulatory Authority, and the Financial Intelligence Agency. The FSC's primary focus is to foster coordinated macro-prudential analysis, monitoring and response to financial system imbalances or distress to ensure a sound and stable financial system, which is supportive of sustainable economic development.

During 2018, five new bureaux de change were licensed, while nine licences of bureaux de change were revoked for two reasons. Four bureaux de change voluntarily surrendered their licences, while five contravened the Bank of Botswana (Bureaux de Change) Regulations of 2004. Therefore, 57 bureaux de change were in operation as at December 31, 2018.

The Bank carried out full scope on-site prudential and anti-money laundering and combating financing of terrorism (AML/CFT) examinations at selected banks in 2018. In this regard, concerned banks are required to implement remedial and corrective supervisory actions, where deficiencies were found. In addition to adverse citings relating to governance and operational processes, a total of P299 160 in penalties was levied on some banks for legal and regulatory transgressions. Going forward, the combination of supervisory action and response by the banks should result in an improvement in implementation and compliance with respect to AML/CFT requirements and related governance and risk management.

The October 2018 meeting of the Financial Action Task Force (FATF) on AML/CFT, determined that progress made by Botswana was not adequate to address identified strategic deficiencies. Therefore, the country

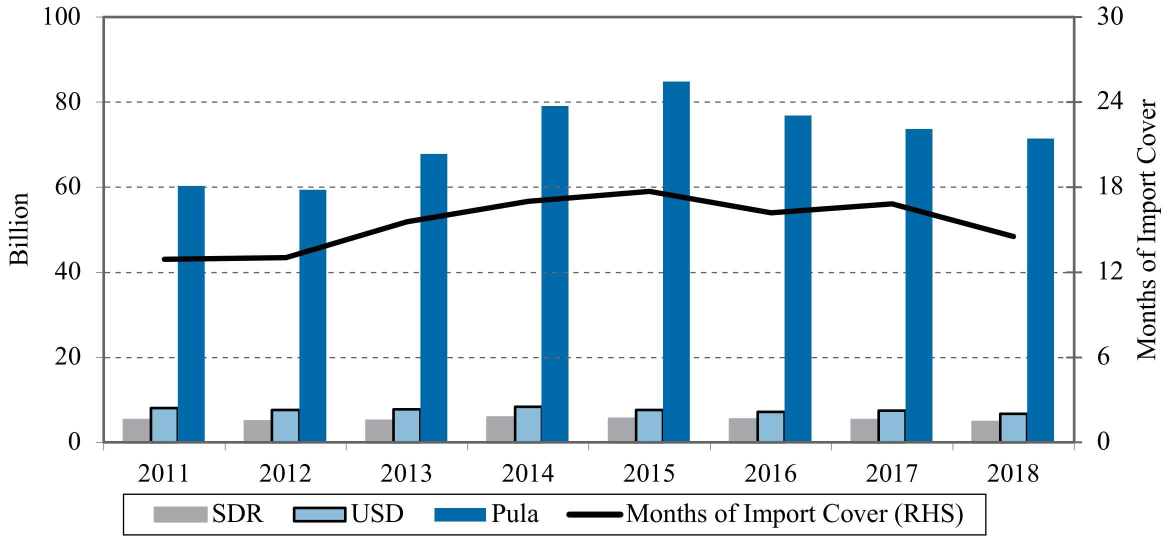
5 The Guardian Fund is administered under the Administration of Estate Act (CAP. 31:01). It is under the custody of the Master of the High Court and was created to keep and administer funds whose rightful owners could not be readily located.

was placed under observation by the FATF and a public statement was issued on Botswana pointing out the strategic AML/CFT deficiencies for which an action plan was developed for the country to address. The FATF will closely monitor the implementation of the action plan, and once a determination is made that Botswana has substantively addressed all the elements in the action plan, an on-site visit will be organised to confirm the implementation of the necessary legal, regulatory and/or operational reforms. If the on-site visit has a favourable outcome, the FATF may decide to remove the country from the 'grey list.'

Foreign Exchange Reserves Management

At the end of December 2018, foreign exchange reserves amounted to P71.4 billion, a decrease of 3.1 percent from P73.7 billion in 2017 (Chart 2). This was equivalent to 15 months of imports[6] of goods and services. The decrease reflects, among others, drawdowns of foreign exchange by government and adverse valuations on equity investments towards the end of the year. In foreign currency terms, the level of reserves decreased by 10.7 percent from USD7.5 billion to USD6.7 billion, while decreasing in SDR terms by 9.4 percent from SDR5.3 billion to SDR4.8 billion in the same period.

Chart 2: Level of Foreign Exchange Reserves



Source: Bank of Botswana

The Bank manages the official foreign exchange reserves 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. Part of the reserves (50 percent and exclusively the fixed income securities) are managed internally, while the other part in managed by selected reputable international fund managers. In addition, the Bank employs the services of a well-rated global custodian to safeguard the reserve assets, and also, a portfolio consultant.

During 2018, the Bank implemented the revised Reserves Management Guidelines, approved by the Board in October 2017, under the guidance of the Bank's Investment Committee. The new policies provide a broad framework for the management of the foreign exchange reserves in recognition of the continually changing market environment. In particular, sovereign wealth funds, reserve managers and other fund managers are

[6] The calculation of import cover excludes imports of rough diamonds as these are almost entirely for re-export.

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 parameters. This has become increasingly relevant given the low and in some cases, negative yields on the traditional assets that continue to prevail in more developed global financial markets.

Currency Operations

The Bank continued to manage the supply of banknotes and coin to ensure availability and high quality of currency in circulation. In this regard, soiled and damaged currency was withdrawn from circulation, retired and replaced, in line with the Bank's Clean Banknote Policy. Alongside the Botswana Police Service and other law enforcement agencies, the Bank was also involved in developing strategies to address banknote counterfeiting.

On February 1, 2018, the Bank introduced a new P10 polymer banknote that circulates concurrently with the cotton-based P10 banknote, which was already in use. Unlike the conventional cotton-based banknotes, polymer banknotes are not easy to counterfeit, more durable and resistant to dirt and moisture, with an expected lifespan of 3 – 4 times higher than that of paper-based substrates. The P10 polymer banknote is the first of its kind in Botswana.

The annual rate of growth of banknotes in circulation decreased from 10 percent in 2017 to 3.7 percent in 2018. There were significant decreases in the net issuance of the P200, P100, P50 and P20 banknote denominations from 10.2 percent, 6.5 percent, 9.1 percent and 18.6 percent, respectively, in 2017 to 6 percent, 2.8 percent, 5.8 and -5.5 percent, respectively, in 2018. Conversely, there was a significant increase in the net issuance of the P10 banknote denomination from 1.3 percent in 2017 to 14.6 percent in 2018. However, the P200 denomination continued to have the highest share of net total issuance (quantity) of banknotes, at 30.2 percent in 2018.

The net issuance (quantity) of all coin denominations increased slightly from 5.4 percent in 2017 to 5.5 percent in 2018. The relatively low net issuance in 2018 was attributable to the sufficiency of coin in 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. BISS rules were revised to cater for the most recent system upgrades. 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. Banks continued to settle all payment transactions on a real time basis and in a secure robust and efficient manner.

The Bank also closely monitors the operations of the BACH, another key FMI and Systemically Important Payment System (SIPS) in the NPS, to ensure that all retail payments effected through cheques, electronic funds transfers and card payments continued to clear and settle under a well-managed risk environment. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) system is also consistently upgraded in line with evolving market and financial infrastructure developments, to improve security, efficiency and connectivity with correspondent banks and other counterparties.

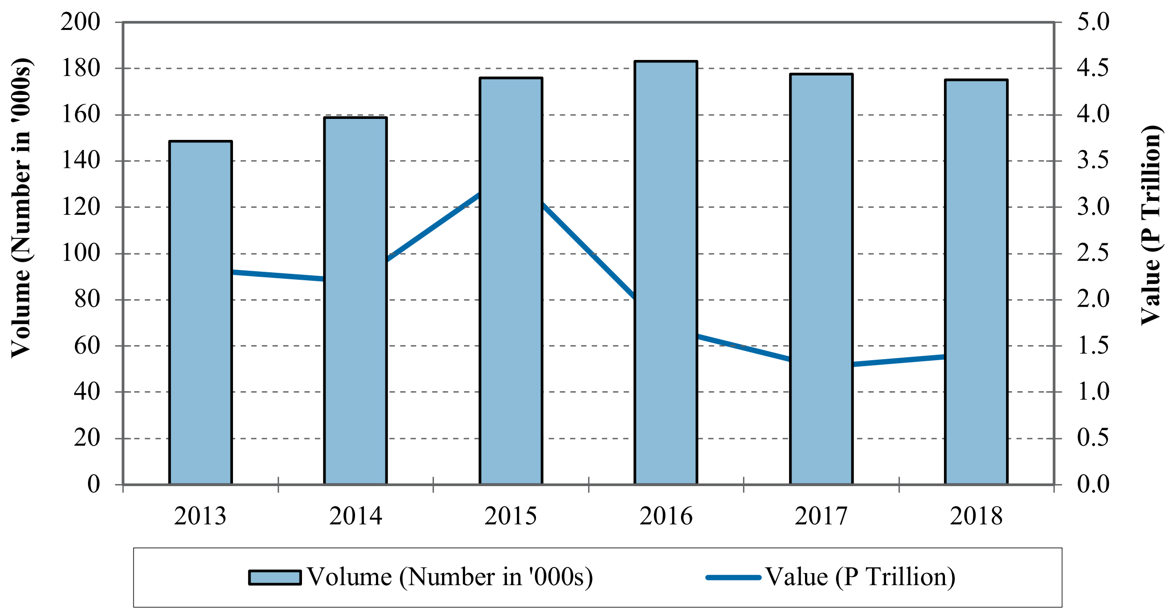
The NPS landscape continued to evolve, as evidenced by an increase in participants and new payment methods leveraging on information, communications and financial technology (FinTech) developments, to improve efficiency in the delivery of payments and involving collaborating with banks. During 2018, five payments providers, all relating to mobile money services were approved, while Mobile Network Operators (MNOs) also added international markets for their existing services for payments remittances. These developments necessitated a close monitoring of the operations and provision of oversight in respect of 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.

The Bank's payments modernisation and reform programme continued to include collaboration with other regional central banks, with the view to upgrade the regional payment system and integrate cross-border payments in line with the SADC framework and plans. Two local banks continue to participate in the SADC-Real Time Gross Settlement (SADC-RTGS) system and have registered considerable amount of transactions in volume and value terms in 2018. An additional bank is currently on-boarding the SADC-RTGS, a process which commenced in mid-2018.

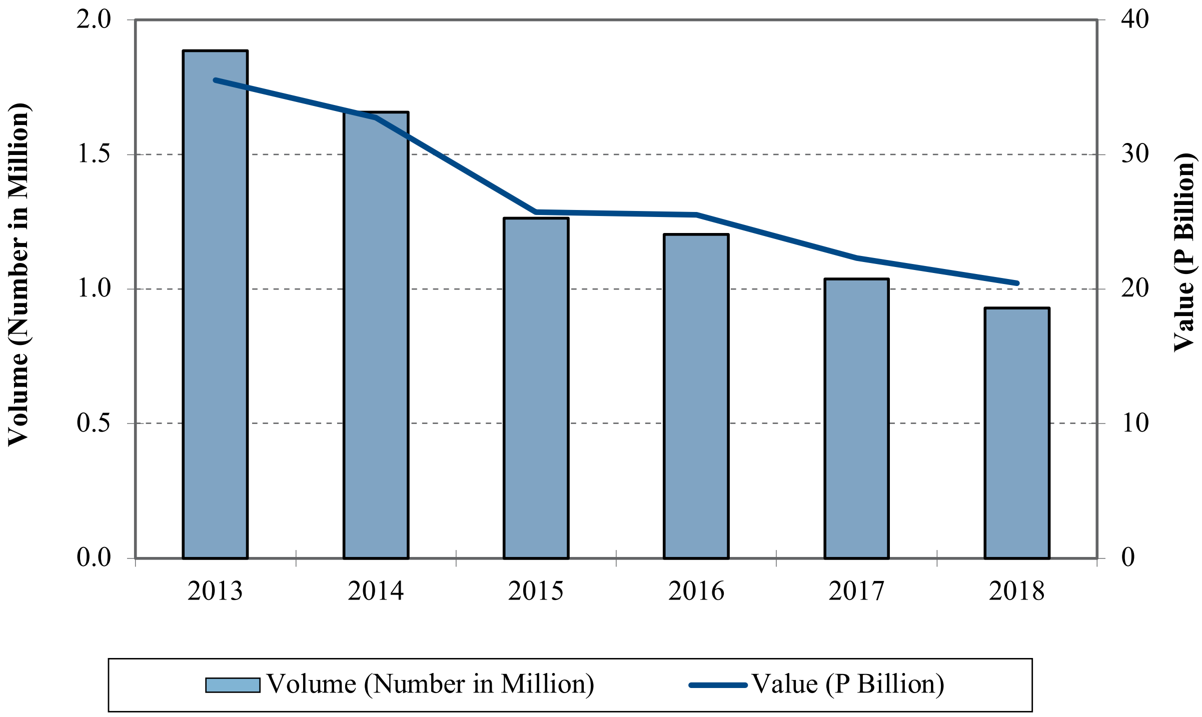
The volume of transactions processed through the BISS decreased by 1.5 percent in 2018, while the value increased by 11.1 percent (Chart 3), signalling that the BISS serves as a high value wholesale settlement system. Cheque transactions continued to decline, falling by 10.5 percent in volume and 8.4 percent in value (Chart 4). This is due to the increase in use of alternative electronic payments channels. Correspondingly, electronic funds transfer (EFT) transactions through the automated clearing house increased by 4.6 percent in volume and 8.7 percent in value terms (Chart 5).

Chart 3: Botswana Interbank Settlement System (BISS) Transactions (2013 - 2018)



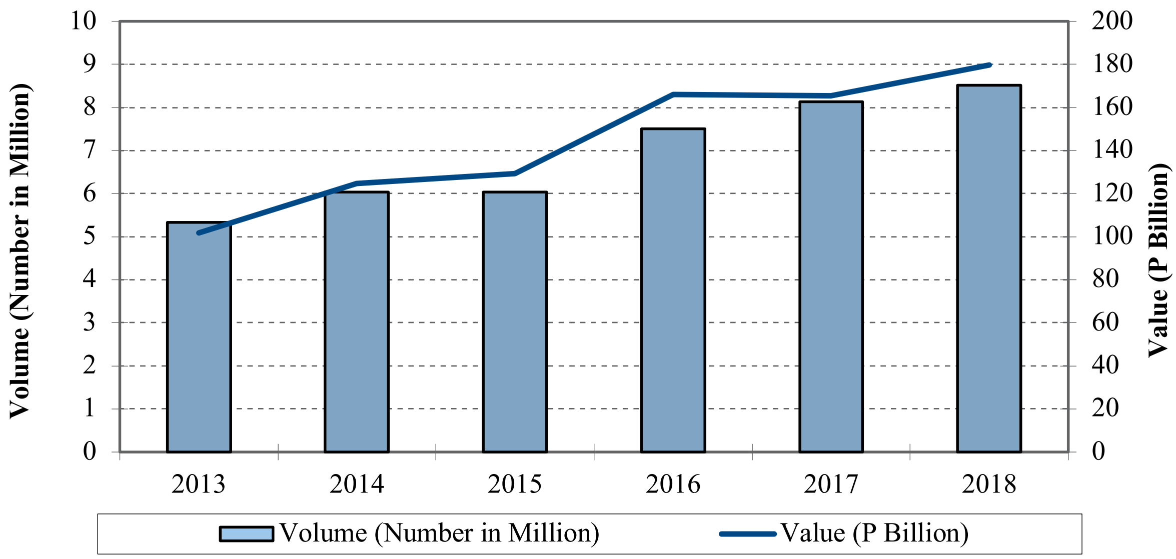
Source: Bank of Botswana

Chart 4: Electronic Clearing House - Cheque Processing (2013 - 2018)



Source: Bank of Botswana

Chart 5: Electronic Clearing House - Electronic Funds Transfers (2013 - 2018)



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 safeguard and retain the integrity and functionality of mission-critical systems, achieve operational efficiency, as well as to guard against cyber-crime.

Human Resources, Staff Welfare and Staff Pension Fund

Human Resources and Staff Welfare

As at December 31, 2018, the Bank's Staff Establishment was 596, marginally higher than the 590 as at December 31, 2017. The vacancy rate stood at 3.7 percent in 2018, down from 5.8 percent at the end of 2017. Twenty-seven (27) staff joined the Bank, while ten (10) 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 2018, eleven staff members were on long-term post-graduate training (Masters and Doctor of Philosophy). Several staff committees and clubs coordinate staff welfare activities, including health and wellness and sports.

Staff Pension Fund

The Bank of Botswana Defined Contribution Staff Pension Fund declared an investment return of 7.58 percent and 7.02 percent for active and deferred members, respectively, for the year ended September 30, 2018. This marks a decline from the 2017 declared return of 9.45 percent and 8.89 percent for the active and deferred members, respectively. Notwithstanding, these rates of return were higher than average inflation of 3.2 percent in Botswana during 2018.

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 2018.

External Relations

The Bank facilitated and/or 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, the World Bank and the IMF. At a regional level, the Bank participated in meetings organised by the Southern African Customs Union (SACU), the SADC Committee of Central Bank Governors (CCBG), the Association of African Central Banks (AACB) and the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI), for which Governor Pelaelo was the Board Chairman during the period 2017-2018. Furthermore, in 2018, the Executive Board of the IMF carried out the Article IV consultation with Botswana.

During 2018, the Bank hosted the meeting of the Financial Stability Board Regional Consultative Group for Sub-Saharan Africa, co-chaired by Governor Pelaelo and Governor Kganyago of the South African Reserve Bank, in Kasane. In addition, the Bank, in collaboration with the IMF and the Bank of Canada, hosted the Fintech and Financial Inclusion conference in Gaborone in July 2018. Furthermore, during July 25 - 26, 2018, the Bank hosted the country visit by the Deputy Managing Director of the IMF, Mr Tao Zhang.

The Bank also hosted Moody's Investors Service (Moody's) and Standard & Poor's (S&P) Global Ratings sovereign credit rating agencies, who affirmed Botswana's 2018 investment grade ratings of A2 (long and short-term bonds) and 'A- (long-term bonds in domestic and foreign currency)/A-2 (short-term bonds in domestic and foreign currency),' respectively. The outlook was reaffirmed to be stable by both credit rating agencies. The ratings were 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 and a stable political environment. However, there was concern raised about the narrow economic base and relatively slow progress in economic diversification.

Publications, Communications and Public Education

The Bank submitted the 2017 *Annual Report* on the Bank's operations and financial statements and the 2017 *Banking Supervision Annual Report*, in accordance with statutory requirements, to the Minister of Finance and Economic Development on March 31, 2018 and June 30, 2018, respectively. The 2018 *Monetary Policy Statement*, *Monetary Policy Reports*, monthly *Botswana Financial Statistics*, the bi-annual *Business 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 2017 *Annual Report*. 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.

The Bank initiated the legal review of the Bank of Botswana Act, to modernise it, enhance governance and clarify the core mandate, including financial stability; expected to be promulgated in 2019/20.

ANNUAL FINANCIAL STATEMENTS

2018

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 of the annual financial statements of the Bank which give a true and fair view, comprising the Statement of Financial Position at December 31, 2018, 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, including significant accounting policies.

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 what 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 give a true and fair view in accordance with the applicable financial reporting framework.

Approval of the Annual Financial Statements

The annual financial statements of the Bank, as identified in the first paragraph, were approved by the Board on March 28, 2019 and signed on behalf of the Board by:

Moses D Pelaelo
Governor

Victoria T Tebele
Board Member and Chairman
(Audit and Risk Committee)

KPMG

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Independent Auditor's Report

To the Shareholder of 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, 2018, 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 46 to 59.

In our opinion, the financial statements give a true and fair view of the financial position of Bank of Botswana as at December 31, 2018 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.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

KPMG

Valuation of financial assets

The disclosures associated with the valuation of financial assets are set out in the following notes to the financial statements: Financial instruments - page 49 to 56 Categories of financial instruments - Note 13 Risk management in respect of financial instruments - Note 31 Fair value of financial instruments - Note 32	
The key audit matter	**How the matter was addressed in our audit**
Financial assets represent 99 percent of the Bank's assets and include short term investments (Liquidity Portfolio) and long term investments (Pula Fund) in debt securities, equities, bonds and derivatives. The majority of financial assets are classified as level 1 and 2 financial instruments under IFRS 13 - *Fair value measurement* ("IFRS 13"). Level 1 financial assets represent 65 percent of the Bank's assets. As level 1 financial instruments are valued using quoted market prices, they are not subject to a significant level of judgment. However, due to their significance in the context of the financial statements as a whole, they are considered to be one of the areas which required the greatest level of work effort. Level 2 financial assets represent 35 percent of the Bank's assets. The valuation of level 2 financial instruments are based on complex models, with certain inputs not fully observable resulting in higher degrees of management judgment required. Due to the significance of level 1 financial assets and the work effort required and the judgment and complex models involved in determining the fair value of financial assets classified as level 2 financial instruments the valuation of financial assets was considered to be a key audit matter.	Our procedures included, amongst others: - We obtained and reviewed the System and Organisation Controls Reports referred to as type 2 reports for the Bank's fund managers and investments custodian. - We inspected the year end investment and open position reconciliations for investments held by the Bank between the investments custodian, fund managers and the Bank's general ledger. - We obtained confirmations directly from the fund managers and investments custodian for securities and investments held by the Bank at the reporting date. - For financial instruments qualifying as Level 1, we compared pricing inputs to external data sources and verified that they were correctly input into the pricing models. - For level 2 financial instruments, with the assistance of our valuation experts, we assessed the appropriateness of models used and the reasonableness of related key inputs and assumption by revaluing the instruments using independent inputs and compared the recalculated amounts to the fair values as per the general ledger. - We considered whether the associated disclosures in the financial statements are compliant with IFRS.

Other Information

Members of the Board are responsible for the other information. The other information obtained at the date of this auditors' report is the "Statement of Responsibility of the Board and Approval of the Annual Financial Statements." The other information 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.

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

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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.

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

- Conclude on the appropriateness of the Board members' 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 Board members 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 Board members 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.

From the matters communicated with the directors, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

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Certified Auditors
Practicing member: Francois Roos (20010078.45)
March 28, 2019
Gaborone

STATEMENT OF FINANCIAL POSITION
As at December 31, 2018

	Notes	2018 P'000	2017 P'000
ASSETS			
Foreign Assets			
Liquidity Portfolio	1.1	22 537 039	16 353 257
Pula Fund	1.2	47 469 559	55 998 024
International Monetary Fund (IMF)			
Reserve Tranche	2.1	518 695	388 855
Holdings of Special Drawing Rights	2.2	878 644	931 310
General Subsidy Account	2.3	22 694	21 295
Total Foreign Assets		71 426 631	73 692 741
Domestic Assets			
Property and Equipment	3	449 544	407 820
Government of Botswana Bond	4	-	21 741
Other Assets	5	273 861	208 378
Total Domestic Assets		723 405	637 939
TOTAL ASSETS		72 150 036	74 330 680
LIABILITIES AND SHAREHOLDER'S FUNDS			
Foreign Liabilities			
Allocation of IMF Special Drawing Rights	6	856 878	804 336
Liabilities to Government (IMF Reserve Tranche)	7	19 647	-
Total Foreign Liabilities		876 525	804 336
Domestic Liabilities			
Notes and Coin in Circulation	8	3 286 916	3 136 545
Bank of Botswana Certificates	9	8 192 670	6 277 908
Reverse Repurchase Agreements	9.1	1 054 903	54 001
Deposits	10	5 744 995	5 730 000
Dividend to Government	11	4 285 902	1 042 198
Other Liabilities	12	226 961	197 191
Total Domestic Liabilities		22 792 347	16 437 843
Total Liabilities		23 668 872	17 242 179
Shareholder's Funds			
Paid-up Capital	14	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		24 292 639	30 778 873
Currency Revaluation Reserve		22 375 834	19 170 357
Fair Value Revaluation Reserve		187 691	5 514 271
General Reserve	15	1 600 000	1 600 000
Total Shareholder's Funds		48 481 164	57 088 501
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		72 150 036	74 330 680
FOREIGN ASSETS IN US DOLLARS (000)[1]		6 656 962	7 501 921
FOREIGN ASSETS IN SDR (000)[2]		4 785 584	5 261 662

[1] United States dollar/Pula – 0.0932 (2017: 0.1018)

[2] SDR/Pula – 0.0670 (2017: 0.0714)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
For the year ended December 31, 2018

	Notes	2018 P'000	2017 P'000
INCOME			
Interest – Foreign exchange reserves	16	1 116 588	1 166 293
Dividends – Foreign exchange reserves	17	541 557	451 649
Interest – Government of Botswana bond		1 387	2 000
Net realised fair value gains on disposal of securities	18	3 628 354	1 037 027
Net realised currency gains	19	2 653 543	-
Net unrealised currency gains	20	1 393 188	-
Profit on foreign exchange deals		17 179	29 347
Other income		12 278	12 588
		9 364 074	2 698 904
EXPENSES			
Interest expense	22	113 108	100 602
Administration costs		542 645	552 378
Depreciation expense	3	27 694	28 008
Net realised currency losses	19	-	12 009
Net unrealised currency losses	20	-	1 255 595
Net unrealised fair value losses	21	5 815 828	10 781
Impairment loss on financial assets		266	-
		6 499 541	1 959 373
NET INCOME		2 864 533	739 531
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)
Net unrealised fair value gains on "available-for-sale" financial instruments		-	2 107 688
		-	1 439 252
TOTAL COMPREHENSIVE INCOME		2 864 533	2 178 783

STATEMENT OF DITRIBUTION
For the year ended December 31, 2018

	Note	2018 P'000	2017 P'000
TOTAL COMPREHENSIVE INCOME		2 864 533	2 178 783
Net unrealised currency losses on non-monetary "available-for-sale" financial instruments		-	668 436
Net unrealised fair value gains on "available-for-sale" financial instruments		-	(2 107 688)
NET INCOME		2 864 533	739 531
TRANSFER OF (GAINS)/LOSSES TO CURRENCY REVALUATION RESERVE	23	(3 973 704)	1 131 458
TRANSFER OF LOSSES TO FAIR VALUE REVALUATION RESERVE	24	5 919 758	-
NET INCOME TO GOVERNMENT		4 810 587	1 870 989
TRANSFER FROM/(TO) GOVERNMENT INVESTMENT ACCOUNT		30 315	(297 791)
DIVIDEND		(740 000)	(708 000)
RESIDUAL NET INCOME	11	(4 100 902)	(865 198)

STATEMENT OF CASH FLOWS
For the year ended December 31, 2018

	Notes	2018 P'000	2017 P'000
OPERATING ACTIVITIES			
Cash generated from/(used in) operations	27	7 732 169	(1 562 462)
INVESTING ACTIVITIES			
Net withdrawals from foreign exchange reserves		392 020	3 313 094
Proceeds on redemption of Government bond (at cost)		20 194	-
Interest received from Government of Botswana bond		2 000	2 000
Proceeds from disposal of property and equipment		474	731
Purchase of property and equipment	3	(69 996)	(41 258)
NET CASH GENERATED FROM INVESTING ACTIVITIES		344 692	3 274 567
FINANCING ACTIVITIES			
Dividend to Government	11	(1 597 198)	(2 736 952)
Government (withdrawals)/investments		(6 630 034)	746 437
NET CASH USED IN FINANCING ACTIVITIES		(8 227 232)	(1 990 515)
NET INCREASE IN CURRENCY IN CIRCULATION		(150 371)	(278 410)
CURRENCY IN CIRCULATION AT BEGINNING OF THE YEAR		(3 136 545)	(2 858 135)
CURRENCY IN CIRCULATION AT YEAR END		(3 286 916)	(3 136 545)

STATEMENTS OF CHANGES IN SHAREHOLDER'S FUNDS
For the year ended December 31, 2018

	Paid-up Capital P'000	Currency Revaluation Reserve P'000	Fair Value Revaluation Reserve P'000	General Reserve P'000	Government Investment Account P'000	Accumulated Profit P'000	Total P'000
BALANCE AT JANUARY 1, 2017	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 to 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
Transfer to statement of profit or loss on realisation of Government Bond (BW005)	-	-	(934)	-	-	-	(934)
Total profit	-	-	-	-	-	2 864 533	2 864 533
Transfers (to)/from Government Investment Account:	-	(768 227)	594 112	-	(6 486 234)	30 315	(6 630 034)
Net unrealised fair value losses	-	-	594 112	-	(594 112)	-	-
Net unrealised currency gains	-	(768 227)	-	-	768 227	-	-
Deficit of Government share of net income from Pula Fund over dividend	-	-	-	-	(30 315)	30 315	-
Government withdrawals	-	-	-	-	(6 630 034)	-	(6 630 034)
Transfer to Currency Revaluation Reserve	-	3 973 704	-	-	-	(3 973 704)	-
Transfer of losses to Fair Value Revaluation Reserve	-	-	(5 919 758)	-	-	(5 919 758)	-
Dividend to Government	-	-	-	-	-	(740 000)	(740 000)
Residual net income	-	-	-	-	-	(4 100 902)	(4 100 902)
BALANCE AT DECEMBER 31, 2018	25 000	22 375 834	187 691	1 600 000	24 292 639	-	48 481 164

SIGNIFICANT ACCOUNTING POLICIES
For the year ended December 31, 2018

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, 2018 and represent the Bank's statutory financial statements. 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 unless otherwise stated.

The Financial Statements were authorised for issue by the Board on March 28, 2019.

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.

Change in Accounting Policy

International Financial Reporting Standard No. 9 (IFRS 9) – "Financial Instruments" replaced International Accounting Standard No. 39 (IAS 39) – Financial Instruments: "Recognition and Measurement", and requires classification and measurement of financial assets to be based on the entity's business model and contractual cash flow characteristics. The effects of measurement and classification of IFRS 9 compared to IAS 39 has brought categories and classification of Amortised Cost; Fair Value through Other Comprehensive Income (FVOCI); and Fair Value through Profit or Loss (FVTPL). In addition, transition to IFRS 9 requires entities to revoke previous designations of financial assets per IAS 39 and bring about impairment requirements to apply on financial assets measured at amortised cost and FVOCI, and also to recognise expected credit loss unlike IAS 39 where credit losses were recognised after their occurrence.

By adopting the standard, unrealised currency gains/losses on non-monetary financial instruments and unrealised fair value gains/losses on long term investments (Pula Fund) are no longer reported in Other Comprehensive Income but are reported in profit or loss. However, in line with the Bank's existing policy, these are not distributed, but are appropriated to the Currency Revaluation Reserve and Fair Value Revaluation Reserve, respectively. The net effect of this change and the comparative figures for the year ended December 31, 2017 are not restated. The effect on the Statement of Profit or Loss as a result of the change in accounting policy referred to above is as follows:

	P'000
Net unrealised currency losses on non-monetary financial instruments	(668 436)
Net unrealised fair value gains on financial instruments	2 107 688
Impairment Provision on Financial Assets	(74)
Impairment Provision on ex-staff loans	(323)
Net effect on net income available for distribution	1 438 855

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

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 periods 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 has no impact on the Bank's financial statements due to the nature of revenue transactions the Bank transact.	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. There is no impact on the financial statements of the Bank resulting from the application of IFRIC 22.	January 1, 2018
IFRS 9 - Financial Instruments (Replacement of IAS 39) The Bank has applied IFRS 9 as issued on July 2014 effective January 1, 2018 and adopted amendments to IFRS 9 (Prepayment Features with Negative Compensation) on the same date. The new hedge accounting model under IFRS 9 is not adopted as the Bank is not engaged in hedging operations. The revised classification and measurement requirements on the adoption of IFRS 9 has no significant impact on financial statements of the Bank, including impairment requirements and the related amendments to IFRS 9. The key changes to the Bank's accounting policies as a result of adopting IFRS 9 are summarised below:- **Classification of Financial Assets and Financial Liabilities** The classification is based on the business model in which the financial asset is managed and the contractual cash flow characteristics of the financial assets. The existing IAS 39 categories of held-to-maturity, loans and receivables and available-for-sale are no longer applicable. An explanation of how the Bank classifies financial assets under IFRS 9 is detailed under the accounting policies' section relating to financial instruments. IFRS 9 largely retains the existing requirements in IAS 39 for the classification of financial liabilities. The change relates to the presentation of gains or losses for financial liabilities designated as FVTPL, and this does not impact the liabilities of the Bank as none are classified as FVTPL.	January 1, 2018

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

ADOPTION OF REVISED STANDARDS AND INTERPRETATIONS (Cont'd)

Standard	Effective for annual periods beginning on or after
IFRS 9 - Financial Instruments (Replacement of IAS 39) (Cont'd) **Impairment of Financial Assets** IFRS 9 introduces the "expected credit loss" model where credit losses are recognised earlier, compared to IAS 39 which operated on an "incurred loss" model. For an explanation of how the Bank applies the impairment requirement of IFRS 9, refer to Note 31. **Transition** Changes in accounting policies resulting from adoption of IFRS 9 have been applied as described below: • As permitted by the transitional provisions of IFRS 9, the Bank has elected not to restate comparative figures. The impact of the difference in the carrying amounts of financial assets resulting from adoption of IFRS 9 as at January 1, 2018 is immaterial to the statement and financial position of the Bank. Consequently, for notes disclosures, the consequential amendments to IFRS 7 disclosures have also been applied to the current period. The comparative period notes disclosures repeat the disclosures made in the prior year.	January 1, 2018

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 periods beginning on or after
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. The impact is expected to be immaterial since most of the leased assets are already reported in the statement of financial position and the aggregate value of the leased assets is immaterial to the statement of financial position of the Bank.	January 1, 2019

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

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 refundable, 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 that are directly attributable to the acquisition of the financial asset are subsequently accounted for depending on their classification as either measured at armotised cost, fair value through other comprehensive income or fair value through profit or loss. The classification of financial assets is dependent upon the Bank's business model for managing its financial assets, and the contractual cash flow characteristics of the financial asset.

Business Model Assessment (Policy per IFRS 9)
The Bank's business model is determined based on how it manages groups of financial assets in order to achieve set objectives. The Bank, therefore, makes an assessment of the objective of its business model in which assets are held at portfolio level, and not on individual instrument basis. The information considered in assessing the business model include:

- 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, i.e. 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.

Contractual Cash Flow Characteristics Assessment (Policy per IFRS 9)
The Bank considers the contractual cash flow characteristics of the financial assets it holds in terms of whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding. The assessment includes determining whether the financial asset contains a contractual term that could change the timing or amount of contractual cash flows such that it would not meet this condition.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

FINANCIAL INSTRUMENTS (Cont'd)

Financial Assets at Amortised Cost (Policy per IFRS 9)
Financial assets are measured at amortised cost if they are held within a business model whose objective is to hold assets to collect contractual cash flows; and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Financial Assets at Fair Value through Other Comprehensive Income (Policy per IFRS 9)
Financial assets are classified at fair value through other comprehensive income if they are held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and the contractual terms of the financial asset meet the solely payments of principal and interest on the principal amount outstanding criterion.

Fair value gains and losses are recognised in other comprehensive income and reclassified to profit or loss on derecognition of the financial asset; while interest income, impairment losses and foreign exchange gains/ losses are recognised in profit or loss.

Financial Assets at Fair Value through Profit or Loss (Policy per IFRS 9)

Financial assets are measured at fair value through profit or loss where the business model does not meet the criteria for classification at either amortised cost or fair value through other comprehensive income, that is a residual category. The business model is neither hold-to-collect nor hold-to-collect and sell, and the cash flows are not solely payments of principal and interest on the principal amount outstanding. The Bank's investments in fixed income securities, derivatives and equity instruments are held for trading, and hence are all classified at fair value through profit or loss.

Fair value gains and losses of financial assets measured at fair value through profit or loss are recognised in profit or loss.

The classification and measurement of the Bank's financial assets is detailed as below.

Short-term Investments (Liquidity Portfolio) - Policy per IFRS 9
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 held for trading in support of the normal business of the Bank and measured at fair value through profit or loss. The primary objective of the Liquidity Portfolio of managing liquidity is achieved by realising cash flows through frequent selling, therefore, collecting contractual cash flows is incidental. The business model is neither "hold-to-collect" nor "hold-to-collect and sell".

Short-term Investments 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. In line with the Bank's policy, realised currency gains/losses are not distributable as income, on money market instrument and bonds whose proceeds are reinvested but, are transferred to the Currency Revaluation Reserve. However, those realised on domestic foreign exchange transactions are retained in profit or loss.

The realised and unrealised fair value and currency gains and losses recognised in the profit or loss exclude interest and dividend income.

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

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

FINANCIAL INSTRUMENTS (Cont'd)

Long-term Investments (Pula Fund) - Policy per IFRS 9
This is a long-term fund intended to generate returns and maintain the purchasing power of reserves, and is invested in foreign financial instruments. The Fund invests in bonds, equities and derivatives. These investments may be sold in response to needs for liquidity, changes in interest rates, market prices, exchange rates, etc. Investments in debt securities, equity and derivatives are classified at fair value through profit or loss. 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 and unrealised currency gains/losses are recognised in profit or loss. However, in line with the Bank policy, all currency gains/losses for this Fund are not distributable and are, therefore, transferred to the Currency Revaluation Reserve.

All realised and unrealised fair value changes in investment securities are recognised in profit or loss. Unrealised gains and losses arising from fair value changes of the instruments in this Fund are non-distributable as per the Bank's policy and are transferred to the Market Value Revaluation Reserve. However, when the investment securities are disposed off, the related accumulated fair value gains/losses are distributable.

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 (Policy per IFRS 9)
The Bank acquires Government of Botswana bonds for purposes of facilitating orderly trading in the local bond market. The bonds are held with an intention to sell in response to the need to intervene in the market. These bonds held under "other" business model, do not meet the 'hold-to-collect' or 'hold-to-collect and sell' qualifying criteria, consequently, are classified as FVTPL.

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 profit or loss. 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.

Short-Term Deposits (Policy per IFRS 9)
Short-Term deposits are placed with different deposit taking institutions in the international markets. The duration of the fixed deposits are typically one week to three months. Most are in the Liquidity Portfolio specifically to meet international payments and other transactional needs. The deposits are held with central banks and other high investment graded institutions, with the exception of South Africa where deposits are always held despite the rating because of the important economic and business relationship that exists between Botswana and South Africa. South Africa is Botswana's largest trading partner.

The deposits are initially recognised at fair value and subsequently measured at amortised cost using the effective interest method. The resulting gain or loss is recognised in the profit or loss. The expected credit loss model is applied to the deposits under this category. Risk assessment of default to calculate expected credit loss is detailed per Note 31.

Other Assets (Policy per IFRS 9)
These 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. Other assets include prepayments, advances to banks and staff advances 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.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

FINANCIAL INSTRUMENTS (Cont'd)

Derivative Instruments (Policy per IFRS 9)
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 (Policy per IFRS 9)
The Bank applies the IFRS 9 expected credit loss model for recognition and measurement of impairment losses on financial assets measured at amortised cost. The new impairment model is forward looking and recognises expected credit losses (ECL) from the point at which financial assets are originated or purchased. The standard states that if there has been significant increase in the credit risk of the financial asset after initial recognition, a lifetime expected credit loss should be recognised. However, the Bank only invests in high quality investment grade financial instruments which are considered to have close to zero risk of default. The Bank, therefore, measures impairment on financial assets using the 12-month expected credit loss. The Bank determines at each reporting date whether financial assets have low credit risks.

Financial assets are credit 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. Evidence that a financial asset is credit-impaired include the following observable data:

- significant financial difficulty of the deposit taker;
- a breach of contract such as a default or past due event;
- it is becoming probable that the deposit taker will enter bankruptcy or other financial reorganisation; or
- the disappearance of an active market for a money market instrument because of financial difficulties.

Staff advances are categorised as low risk assets, with controls on issue of loans and their recovery in place. An annual assessment of materiality of any ECL is undertaken. In the case of ex-staff debts, where there are no terminal benefits to recover the outstanding debt, the remaining debt is wholly impaired. However, determined effort is undertaken to recover the debt. Advances to Bank's are collaterised against Bank of Botswana Certificates, therefore the risk of default is none.

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.

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.

Financial Assets (Policy prior to IFRS 9)
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 or loss or available-for-sale.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

FINANCIAL INSTRUMENTS (Cont'd)

Loans and Receivables (Policy prior to IFRS 9)
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 (Policy prior to IFRS 9)
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) – (Policy prior to IFRS 9)
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 (Policy prior to IFRS 9)
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.

Long-term Investments (Pula Fund) – (Policy prior to IFRS 9)
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 appropriated 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.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

FINANCIAL INSTRUMENTS (Cont'd)

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 (Policy prior to IFRS 9)
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 (Policy prior to IFRS 9)
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 (Policy prior to IFRS 9)
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.

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.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

FINANCIAL INSTRUMENTS (Cont'd)

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 any 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.

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. 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.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

FINANCIAL INSTRUMENTS (Cont'd)

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.

For financial assets measured at amortised cost, future cash flow estimates are based on the carrying amounts of financial assets adjusted for loss allowances. Changes in carrying amounts are recognised in profit or loss.

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 fair value through profit or loss investment securities calculated on an effective interest rate basis.

(c) Dividends on fair value through profit or loss 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, 2018

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.

FAIR VALUE 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 Fair Value 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 including its share of unrealised fair value and currency gains and losses.

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 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. The valuation takes place every three years.

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. Land is not depreciated because it is considered to have an infinite useful life.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

PROPERTY AND EQUIPMENT (Cont'd)

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

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 under a lease agreement that transfers substantially all of the risks and rewards of ownership to the Bank 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.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
For the year ended December 31, 2018

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 mutually agreed terms and conditions 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, 2018

	2018 P'000	2017 P'000
1. **FOREIGN EXCHANGE RESERVES**		
1.1 **Liquidity Portfolio**		
Bonds: FVTPL	7 033 866	-
Bond held-for-trading	-	8 965 032
Amounts due from Pula Fund: amortised cost	842 373	807 985
Short-term deposits: amortised cost	14 660 962	6 580 240
Less: impairment loss	(162)	-
	22 537 039	16 353 257
1.2 **Pula Fund**		
Equities: FVTPL	18 598 255	-
Equities: available-for-sale	-	22 574 949
Bonds: FVTPL	20 986 293	-
Bonds: available-for-sale	-	32 496 355
Derivative instruments: assets (Note 13.3)	(31 033)	(8 457)
Amounts due to Liquidity Portfolio: amortised cost	(842 373)	(807 985)
Derivative instruments: liabilities (Note 13.3)	15 206	19 332
Short-term deposits: amortised cost	8 743 274	1 723 830
Less: impairment loss	(63)	-
	47 469 559	55 998 024
(a) **Statement of Financial Position**		
Capital Employed		
Government	23 990 632	30 278 873
Bank of Botswana	23 478 927	25 719 151
	47 469 559	55 998 024
Employment of Capital		
Investments	47 469 559	55 998 024
Investments expressed in US dollars ('000)[3]	4 424 163	5 700 599
Investments expressed in SDR ('000)[4]	3 180 460	3 998 259
(b) **Statement of Profit or Loss and Other Comprehensive Income**		
Income		
Interest and dividends	1 246 219	1 149 914
Realised currency revaluation gains	2 274 871	378 575
Unrealised currency revaluation gains/(losses)	874 059	(1 049 444)
Realised fair value gains	3 817 102	1 164 395
Unrealised fair value losses	(5 919 758)	-
Impairment loss on financial assets	(63)	-
Sundry income	2 174	13 640
	2 294 604	1 657 080
Expenses		
Administration charges	(174 570)	(160 074)
	(174 570)	(160 074)
Net income	2 120 034	1 497 006
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)
Net unrealised fair value gains on "available-for-sale" financial instruments	-	2 108 848
Other comprehensive income	-	1 440 412
Total comprehensive income	2 120 034	2 937 418

[3] United States dollar/Pula – 0.0932 (2017: 0.1018)

[4] SDR/Pula – 0.0670 (2017: 0.0714)

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

	2018 P'000	2017 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		
Quota SDR 197 200 000; (2017: SDR 197 200 000)	2 942 195	2 761 905
Less: IMF Holdings of Pula	(2 423 500)	(2 373 050)
Reserve Position in IMF	518 695	388 855
The IMF Holdings of Pula are represented by the Non-Interest Bearing Note of P1 477 900 684 (2017: 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		
The balance on the account represents the value of Special Drawing Rights (SDR) allocated and purchased less utilisation to date.	878 644	931 310
2.3 General Subsidy Account		
Face value (SDR 1 520 000)	22 678	21 289
Interest	16	6
	22 694	21 295

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, 2018

3. **PROPERTY AND EQUIPMENT**

	Freehold Land P'000	Leasehold Land P'000	Buildings P'000	Capital Works in Progress P'000	Other Assets P'000	Total P'000
Cost - December 31, 2018						
Balance at the beginning of the year	2 065	4 932	404 154	23 401	216 067	650 619
Additions	-	-	-	60 570	9 426	69 996
Disposals	-	-	-	-	(5 976)	(5 976)
Transfers from WIP	-	-	6 878	(7 949)	1 071	-
Balance at year-end	2 065	4 932	411 032	76 022	220 588	714 639
Accumulated Depreciation						
Balance at the beginning of the year	-	-	107 279	-	135 520	242 799
Charge for the year	-	-	10 926	-	16 768	27 694
Disposals	-	-	-	-	(5 398)	(5 398)
Balance at year-end	-	-	118 205	-	146 890	265 095
Net book value at December 31, 2018	2 065	4 932	292 827	76 022	73 698	449 544
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

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). A register of the assets is kept with the Bank and is available for inspection.

Open Market Valuation for Property

An opinion of the best price at which the sale of an interest in the property would have been completed unconditionally for cash consideration on the date of valuation, assuming:

(a) a willing seller;
(b) that prior to the date of valuation there had been a reasonable period (having regard to the nature of the property and the state of the market) for the proper marketing of the interest, for the agreement of the price and terms, and for the completion of the sale;
(c) that the state of the market, level of values, and other circumstances were on any earlier assumed date of exchange of contracts the same as on the date of valuation.
(d) that no account is taken of any additional bid by a prospective purchaser with a special interest; and
(e) that both parties to the transaction had acted knowledgeably, prudently, and without compulsion.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

	2018 P'000	2017 P'000
4. GOVERNMENT OF BOTSWANA BOND		
Government Bond BW005, matured on September 12, 2018, bearing interest at the rate of 10 percent, receivable semi-annually in arrears:		
Fair value	-	21 128
Interest accrued	-	613
	-	21 741
5. OTHER ASSETS		
Staff loans and advances	107 382	66 125
Prepayments	5 154	3 472
Donor funds – Government projects	156 886	126 711
Other	4 439	12 070
	273 861	208 378
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.	856 878	804 336
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).	19 647	-
8. NOTES AND COIN IN CIRCULATION		
Notes	3 121 783	2 981 032
Coin	165 133	155 513
	3 286 916	3 136 545

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.

	2018 P'000	2017 P'000
9. BANK OF BOTSWANA CERTIFICATES		
Face value	8 196 000	6 281 000
Unmatured discount	(3 330)	(3 092)
Carrying amount	8 192 670	6 277 908

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

	2018 P'000	2017 P'000
9.1 REVERSE REPURCHASE AGREEMENTS		
Fair value	1 054 903	54 001

The reverse repurchase agreements matured on January 3, 2019 (2017: January 3, 2018).

	2018 P'000	2017 P'000
10. DEPOSITS		
Government	1 124 315	1 084 943
Bankers - current accounts	156 692	253 291
- statutory reserve accounts	2 904 996	2 693 180
Other	1 558 992	1 698 586
	5 744 995	5 730 000

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.

11. DIVIDEND TO GOVERNMENT

	2018 P'000	2017 P'000
Balance due at the beginning of the year	1 042 198	2 205 952
Dividend to Government from Pula Fund	740 000	708 000
Paid during the year	(1 597 198)	(2 736 952)
Residual net income	4 100 902	865 198
Balance due at the end of the year	4 285 902	1 042 198

The final instalment of the pre-set dividend of P185 000 000 and the residual net income of P4 100 902 000 unpaid as at December 31, 2018 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.

12. OTHER LIABILITIES

	2018 P'000	2017 P'000
Accounts payable	6 217	10 055
Donor funds – Government projects	156 886	126 711
Other payables and accruals	63 858	60 425
	226 961	197 191

13. CATEGORIES OF FINANCIAL INSTRUMENTS

13.1 Financial Assets

	2018 P'000	2017 P'000
Measured at FVTPL		
Equities	18 598 255	-
Bonds	28 020 159	8 965 032
Derivatives	(31 033)	(8 457)
	46 587 381	8 956 575
Measured at FVOCI		
Bonds – Pula Fund (2017: available-for-sale)	-	32 496 355
Government of Botswana bonds (2017: available-for-sale)	-	21 741
Equities – available-for-sale	-	22 574 949
	-	55 093 045
Measured at armotised cost		
IMF Reserves	1 420 033	1 341 460
Staff loans and advances	107 423	66 125
Short-term deposits	23 404 236	8 304 070
Less: impairment loss	(266)	-
	24 931 426	9 711 655
Total Financial Assets	71 518 807	73 761 275

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

	2018 P'000	2017 P'000
Total Foreign Assets	71 426 631	73 692 741
Add: Derivative instruments (liabilities) (Note 1.2)	(15 206)	(19 332)
Government of Botswana bonds	-	21 741
Other Assets - staff loans and advances (Note 5)	107 382	66 125
	71 518 807	73 761 275

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

	2018 P'000	2017 P'000
13. CATEGORIES OF FINANCIAL INSTRUMENTS (Cont'd)		
13.2 Financial Liabilities		
Held-for-trading		
Derivative instruments (Note 1.2)	(15 206)	(19 332)
Other Financial Liabilities - at amortised cost		
Bank of Botswana Certificates	8 192 670	6 277 908
Reverse Repurchase Agreements	1 054 903	54 001
Allocation of SDR (IMF)	856 878	804 336
Liabilities to Government (IMF)	19 647	-
Deposits	5 744 995	5 730 000
Dividend to Government	4 285 902	1 042 198
Other liabilities	226 961	197 191
	20 366 750	14 086 302

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 2018 (P'000)	Liabilities 2018 (P'000)	Notional Amount 2018 (P'000)	Assets 2017 (P'000)	Liabilities 2017 (P'000)	Notional Amount 2017 (P'000)
Fixed Income Futures	-Buy	(36 556)	-	1 559 947	(9 158)	-	190 291
	-Sell	-	22 734	(2 956 621)	-	20 306	(363 027)
Other Options	-Buy	-	-	-	(10)	-	20
	-Sell	-	-	-	-	4	(14)
Swaps	-Buy	5 523	-	3 705	711	-	643
	-Sell	-	(7 528)	(4 507)	-	(978)	(1 872)
		(31 033)	15 206	(1 397 476)	(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, 2018

13. CATEGORIES OF FINANCIAL INSTRUMENTS (Cont'd)

13.4 Impact of transition to IFRS 9

The following Table reconciles the carrying amounts of financial assets from their previous measurement category in accordance with IAS 39 to their new measurement categories upon transition to IFRS 9 on January 1, 2018.

	IAS 39 Carrying Amount December 31, 2017 P'000	Reclassification P'000	Remeasurement P'000	IFRS 9 carrying amount January 1, 2018 P'000
Held-for-trading				
Bonds – Liquidity Portfolio	8 965 032	-	-	-
To FVTPL	-	(8 965 032)	-	-
Derivatives	(8 457)	-	-	-
To FVTPL	-	8 457	-	-
Closing balance (A)	8 956 575	(8 956 575)	-	-
Available-for-sale				
Bonds – Pula Fund	32 496 355	-	-	-
To FVTPL	-	(32 496 355)	-	-
Equities – Pula Fund	22 574 949	-	-	-
To FVTPL	-	(22 574 949)	-	-
Government of Botswana bond	21 741	-	-	-
To FVTPL	-	(21 741)	-	-
Closing balance (B)	55 093 045	(55 093 045)	-	-
Amortised Cost				
IMF Reserves	1 341 460	-	-	1 341 460
Staff loans and advances	66 125	-	(323)	65 802
Short-term deposits	8 304 070	-	(74)	8 303 996
Closing balance (C)	9 711 655	-	(397)	9 711 258
FVTPL				
From held-for-trading bonds – Liquidity Portfolio	-	8 965 032	-	8 965 032
Derivatives	-	(8 457)	-	(8 457)
From available-for-sale-bonds Pula Fund	-	32 496 355	-	32 496 355
From available-for-sale Government of Botswana bond	-	21 741	-	21 741
From available-for-sale – equities Pula Fund	-	22 574 949	-	22 574 949
Closing balance (D)	-	64 049 620	-	64 049 620
Total Financial Assets (A+B+C+D)	73 761 275	-	(397)	73 760 868

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

	2018 P'000	2017 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.

	2018 P'000	2017 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		
Bonds: FVTPL	113 331	-
Short-term deposits: amortised cost	292 619	294 801
Bonds: held-for-trading	-	157 050
IMF Reserves: amortised cost	3 802	2 537
Pula Fund		
Short-term deposits: amortised cost	75 106	34 301
Bonds: FVTPL	631 730	-
Bonds: available-for-sale	-	677 604
	1 116 588	1 166 293
17. DIVIDENDS - FOREIGN EXCHANGE RESERVES		
Pula Fund		
Equities: FVTPL	541 557	-
Equities: available-for-sale	-	451 649
18. NET REALISED FAIR VALUE GAINS ON DISPOSAL OF SECURITIES		
Liquidity Portfolio		
Bonds FVTPL	(188 748)	-
Bond: held-for-trading	-	(127 367)
Pula Fund		
Bonds: FVTPL	(162 283)	-
Bonds: available-for-sale	52 730	2 724
Derivative instrument: FVTPL	-	(38 537)
Equities: FVTPL	3 926 655	-
Equities: available-for-sale	-	1 200 207
	3 628 354	1 037 027

Included above in 2017 is an amount on net fair value gains of P1 161 670 000, which has been reclassified from equity to profit or loss on disposal of investments measured at FVOCI which was classified as available-for-sale.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

	2018 P'000	2017 P'000
19. NET REALISED CURRENCY GAINS/(LOSSES)		
Liquidity Portfolio		
Short-term deposits: amortised cost	348 966	(453 208)
Bonds: FVTPL	29 706	-
Bonds: held for trading	-	62 624
Pula Fund		
Derivative instruments: FVTPL	(52 730)	(2 472)
Short-term deposits: amortised cost	186 061	(19 040)
Bonds: FVTPL	957 086	-
Bonds: available-for-sale	-	264 292
Equities: FVTPL	1 184 454	-
Equities: available-for-sale	-	135 795
	2 653 543	(12 009)

Included above in 2017 is an amount on net currency gains of P400 087 000 which has been reclassified from equity to profit or loss on disposal of investments measured at FVOCI which was classified as available-for-sale.

	2018 P'000	2017 P'000
20. NET UNREALISED CURRENCY GAINS/(LOSSES)		
Liquidity Portfolio		
Short-term deposits: amortised cost	106 673	60 282
Bonds: FVTPL	409 874	-
Bonds: held-for-trading	-	(265 445)
IMF reserves: amortised cost	2 582	(988)
Pula Fund		
Short-term deposits: amortised cost bonds: FVTPL	229 724	(37 949)
Bonds: FVTPL	729 109	-
Bonds: available-for-sale	-	(1 021 822)
Equities: FVTPL	(86 926)	-
Derivative instruments: FVTPL	2 152	10 327
	1 393 188	(1 255 595)
21. NET UNREALISED FAIR VALUE LOSSES		
Liquidity Portfolio		
Bonds: FVTPL	103 930	-
Bonds: held-for-trading	-	(11 329)
Pula Fund		
Derivative instruments: FVTPL	(17 979)	548
Bonds: FVTPL	(311 339)	-
Equities: FVTPL	(5 590 440)	-
	(5 815 828)	(10 781)
22. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	97 720	87 995
Reverse Repurchase Agreements	15 388	12 607
	113 108	100 602
23. NET CURRENCY REVALUATION GAINS/(LOSSES) RETAINED IN PROFIT OR LOSS		
Total net realised gains/(losses) (Note 19)	2 653 543	(12 009)
Total net unrealised gains/(losses) (Note 20)	1 393 188	(1 255 595)
Total net currency revaluation gains/(losses)	4 046 731	(1 267 604)
Appropriated to Currency Revaluation Reserve:		
Net realised currency losses/(gains) reinvested in foreign assets	5 366 892	(124 137)
Net unrealised currency (gains)/losses (Note 20)	(1 393 188)	1 255 595
Transfer (to)/from Currency Revaluation Reserve	(3 973 704)	1 131 458
Net currency revaluation gains/(losses) retained in profit or loss	73 027	(136 146)

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

	2018 P'000	2017 P'000
24. NET FAIR VALUE LOSSES APPROPRIATED TO FAIR VALUE REVALUATION RESERVE		
Total net realised gains (Note 18)	3 628 354	-
Total net unrealised losses (Note 21)	(5 815 828)	-
Total net fair value losses	(2 187 474)	-
Appropriated to Fair Value Revaluation Reserve:		
Transfer of losses to Fair Value Revaluation Reserve	5 919 758	-
Net fair value gains retained in profit or loss	3 732 284	-

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

The Bank's contribution to the Bank of Botswana Defined Contribution Staff Pension Fund for the year ended December 31, 2018 is P34 408 671 (2017: P29 501 000).

26. 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.

	2018 P'000	2017 P'000
27. CASH GENERATED FROM OPERATIONS		
Net income for the year adjusted for:	2 864 533	739 531
Net realised and unrealised exchange (gains)/losses	(3 973 704)	1 131 458
Unrealised fair value losses	5 919 758	-
Depreciation expense	27 694	28 008
Impairment loss on financial assets	225	-
Loss on disposal of Property and Equipment	104	469
Interest: Government of Botswana bond	(1 387)	(2 000)
	4 837 223	1 897 466
Adjustments for movements in:		
Deposits: banks and other	(24 377)	(577 882)
Deposits: Government	39 372	525
Bank of Botswana Certificates	1 914 762	(1 640 462)
Reverse Repurchase Agreements	1 000 902	(1 248 878)
Other assets	(65 483)	162 017
Other liabilities	29 770	(155 248)
Cash generated from/(used in) operations	7 732 169	(1 562 462)
28. CAPITAL COMMITMENTS		
Approved and contracted for	83 453	142 814
Approved, but not contracted for	122 598	13 820
	206 051	156 634

These capital commitments will be funded from internal resources.

29. COLLATERAL

(a) Credit Facility
There were no open positions as at December 31, 2018 (2017: 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 P6.1 billion (2017: P9.7 billion). The Bank has accepted securities with a fair value of P6.3 billion (2017: P10.2 billion) as collateral for the securities lent under this programme.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

30. 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, 2018 is provided below:

Government of Botswana Bonds and Treasury Bills issued during the year 2018

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)
BW007	Mar 7, 2018	Mar 10, 2025	8	77 000	17 345	94 345	3 080	1 923
BW008	Mar 7, 2018	Sept 8, 2018	7.75	100 000	10 585	110 585	3 875	2 462
BW0011	Mar 7, June 6, 2018	Sept 10, 2031	7.75	300 000	87 800	387 800	11 625	7 258
BW012	June 6, 2018	June 13, 2040	6	200 000	22 149	222 149	6 000	626
BW013	June 6, Sept 5, Dec 5, 2018	June 6, 2023	4.5	689 000	19 416	708 416	10 238	2 129
BW014	Sept 5, Dec 5, 2018	Sept 5, 2029	4.8	596 000	(8 046)	587 954	-	9 325
BW015	Sept 5, 2018	Sept 2, 2043	5.3	301 000	(61)	300 939	-	5 288
BW050918	Mar 7, 2018	Sept 5, 2018	-	220 000	(1 632)	218 368	1 632	-
BW051218	June 6, 2018	Dec 5, 2018	-	450 000	(3 573)	446 427	3 573	-
BW060319	Sept 5, 2018	Mar 6, 2019	-	320 000	(2 611)	317 389	-	1 693
BW050619	Dec 5, 2018	June 5, 2019	-	350 000	(2 839)	347 161	-	421
TOTAL				**3 603 000**	**138 533**	**3 741 533**	**40 023**	**31 125**

(a) Net proceeds realised from the issue of the bonds of P3 741 533 000 (2017: P4 141 835 000) were invested in the Government Investment Account. The nominal value of holdings of total outstanding Government bonds and treasury bills as at December 31, 2018, was P10 258 000 000 (2017: P10 203 000 000). The nominal value of redemptions during the year to December 31, 2018 was P3 548 000 000 million (2017: P2 988 000 000).

(b) Interest is payable on all interest earning bonds on a semi-annual basis in arrears. During the year to December 31, 2018, total interest payments of P787 977 900 were made (2017: P692 312 150) 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.

31. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS

Risk is inherent in the Bank's management of financial instruments comprising primarily foreign currency denominated assets, which are held in various financial instruments and currencies. 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 prudent and diversified investment strategy. 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)
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31. 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 the strategic asset allocation strategy. 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 reviews and approves the Investment Guidelines for the foreign exchange reserves. It meets regularly to review developments in the international financial and capital markets. Where necessary, the Investment Committee makes strategic decisions on Bank-managed portfolios. The Investment Committee also monitors the performance of the external fund managers and reports on same to the Board.

(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 and performance measurement for the Bank's portfolios.

(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, 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 the risk-free rate. 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 recurring 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 shorter-dated assets. There is a sub-portfolio, the Transaction Balances Tranche (TBT), comprising highly-liquid investments 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.

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

(a) Currency Risk

Currency risk or exchange rate risk arises when exchange rates move against the reporting currency. The reserves are invested in diverse currencies to mitigate the impact of exchange rate movements. The Bank's policy is to invest only in currencies with investment grade ratings assigned by Moody's Investors Services, Standard and Poor's and Fitch Ratings. Through a diversified currency allocation, 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 is 15 percent for currencies rated AAA, 10 percent for currencies rated between AA+ and AA-, 7 percent for A+ to A- and 5 percent for BBB+. At the end of 2018, the Bank's total exposure to investment currencies was P66.4 billion (2017: P70.3 billion). The Bank is also exposed to SDR currency risk on net IMF balances amounting to P582 802 000 (2017: 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 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 2018, the average modified duration of the fixed income portion of the Pula Fund was 6.5 years (2017: 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 2018, the Liquidity Portfolio's average modified duration was 2.20 years (2017: 1.9 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 equity markets. The investment guidelines stipulate the holding levels of equities. Holdings of more than 10 percent in one company are not permitted and the portfolio must hold a reasonable number of stocks. 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 2018, the equity portion of the Pula Fund was P18.6 billion (2017: P22.6 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, 2018

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

December 31, 2018

Risk Variable	Beneficial market change			Adverse 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 (P '000)
Interest Rate Risk		Increase in yields by 50 basis points	824 674	Decrease in yields by 50 basis points	824 674
Currency Risk	Investment currencies	Strengthening of the Pula by 1 percent	(677 931)	Weakening of the Pula by 1 Percent	677 931
	South African rand	Strengthening of the Pula by 1 percent	(36 335)	Weakening of the Pula by 1 percent	36 335
Equity Risk	Global Equities	Decline in global equity prices by 5 percent	(929 913)	Increase in global equity prices by 5 percent	929 913

December 31, 2017

Risk Variable	Adverse market change			Beneficial market change	
		Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income[6] (P'000)	Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income (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	Investment 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

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 portfolio manager 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 high quality investment grade 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. This is with the exception of the "Strategic Yield" portfolio, where a minimum rating of B- is applied. The Strategic Yield portfolio comprises not more than 5 percent of the Pula Fund. In cases where the new lower rating necessitates a lower exposure, holdings are reduced to ensure that the new limit is not exceeded.

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

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

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

31. 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.

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	2018 P'000	2017 P'000
Financial Assets			
Liquidity Portfolio			
Bonds: FVTPL	1.1	7 033 866	-
Bonds: held-for-trading		-	8 965 032
Short-term deposits: amortised cost		15 503 335	7 388 225
Pula Fund			
Bonds: FVTPL	1.2	20 986 293	-
Bonds: available-for-sale		-	32 496 355
Derivative instruments: FVTPL		(31 033)	(8 457)
Short-term deposits: amortised cost		7 900 901	915 845
International Monetary Fund- amortised cost			
Reserve Tranche	2.1	518 695	388 855
Holdings of Special Drawing Rights	2.2	878 644	931 310
General Subsidy Account	2.3	22 694	21 295
Government of Botswana bond: available-for-sale	4	-	21 741
Other Assets- staff loans and advances: amortised cost	5	107 382	66 125
Total		52 920 777	51 186 326
Analysis of Credit Exposure by class:			
Measured at fair value			
Bonds		28 020 159	41 461 387
Derivatives		(31 033)	(8 457)
Government of Botswana bond		-	21 741
Measured at amortised cost			
IMF Reserves		1 420 033	1 341 460
Staff advances		107 382	66 125
Short-term deposits		23 404 236	8 304 070
Total		52 920 777	51 186 326

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, 2018.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

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

Credit Quality Analysis

The Bank uses the following criteria to assess issuer risk

Normal – an issuer or bank will be considered as normal if its credit rating is maintained within investment grade. For staff loans, the Bank mitigates the credit exposure by considering the staff overall indebtness and all loans are deducted at source.

Concerned – the Bank will be concerned if the credit rating falls to the lowest scale within the investment grade category. Such an issuer will be placed under watch for regular review. The Bank may decide to disinvest if such an issuer is under negative watch for an extended period. For ex-staff debts carrying amounts are recovered from terminal benefits.

Sub-investment grade – an issuer is considered to be in sub-investment grade if the credit ratings fall below bbb5 rating.

Default – an issuer is considered to be in default if it is rated below investment grade by two rating agencies. If the rating falls below investment grade, all investments on the issuer will be terminated immediately. In case of deposits, such deposits are expected to be received on their due date. For ex-staff debts, where there are no terminal benefits to recover from, the whole outstanding debt is impaired.

The Bank uses international rating agencies namely, Moody's, Standard and Poor's and Fitch Rating for its credit risk assessment. For deposit taking institutions, and commercial banks investments are allowed only in investment grade rated issuers with a minimum rating of BBB- (investment grade). Central banks assume the credit rating of their sovereign.

The Table below shows the Bank's risk criteria mapped to external ratings for short-term deposits

Risk Criteria	Fitch	Moody's	Standard and Poor's
Normal			
	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
	A+	A1	A+
	A	A2	A
	A-	A3	A-
	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
Concerned	BBB-	Baa3	BBB-
Default		Bbb	BB

The Table below sets out credit quality analysis for financial assets measured at amortised cost. The gross carrying amount of financial assets represent the Bank's exposure to credit risk on these assets.

	12-Month ECL Staging		2018
	Staff Loans P'000	Short-term Deposits P'000	Total P'000
Credit Grade			
Normal – investment grade	107 382	22 973 180	23 080 562
Concerned – standard monitoring	-	429 377	429 377
Default[7]	41	1 679	1 720
Gross carrying amount	107 423	23 404 236	23 511 659
Loss allowance	(41)	(225)	(266)
Carrying amount	107 382	23 404 011	23 511 393

[7] Default includes deposits held with Banks in South Africa for transactional purposes despite the ratings because of important economic and business relationship that exist between Botswana and South Africa.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

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

Credit Exposure on Bonds

Moodys/S&P Rating	Government (P'000)	Corporate (P'000)	2018 Total (P'000)	2017 Total (P'000)
AAA	15 670 945	174 966	15 845 911	26 297 087
AA+	1 204 533	23 152	1 227 685	1 252 318
AA	2 890 722	257 763	3 148 485	7 699 839
AA-	132 884	207 306	340 190	-
A+	2 310 128	373 347	2 683 475	3 206 168
A	312 448	405 953	718 402	363 251
Other[8]	1 407 175	2 633 010	4 040 185	2 642 724
	23 928 835	4 075 497	28 004 332	41 461 387

Credit Exposure to Banks (Short-term deposits)

Fitch Rating	2018 (P'000)	2017 (P'000)
AAA[9]	3 665 325	3 032 728
AA+	723 643	-
AA	41 329	317 492
A	310 726	200 642
a+5	432 165	6 020
a1	1 127 589	276 232
a5	1 974 408	299 530
aa2	644 471	-
aa-1	751 767	196 598
aa-2	2 362 599	442 399
aa-5	5 695 699	1 255 460
a-5	966 764	435 481
a-1	644 839	98 320
BB+	3 631 856	1 582 259
Bbb5/bbb+5	429 377	160 909
bb+3	1 679	-
	23 404 236	8 304 070

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.

Inputs, Assumptions and Techniques used for Estimating Impairment

The key judgements and assumptions adopted by the Bank in addressing the requirements of IFRS 9 for calculation of expected credit losses are discussed below.

Amounts arising from ECL

ECL is measured on a 12-month basis on initial recognition, subsequent measurement where there are no significant increase in credit risk and for low risk financial assets. A 12 month ECL represent financial assets' lifetime ECL that are expected to arise from default events that are possible within 12 month period following origination of an asset or from each reporting date.

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8 Other includes investments rated below A-, but still remain within the acceptable investment grades as per the investment guidelines

9 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, 2018

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

Significant increase in credit risk

The Bank carries high quality financial instruments whose risk is low. Subsequently, no tracking of deterioration is required. An annual assessment of the risk of default at the reporting date is done.

Measurement of ECL

The Bank has adopted the Probability of Default and Loss Given Default models in the determination of ECL. In applying these models, the Bank considers factors such as current economic circumstances of the markets in which it holds investments, forward looking economic and financial indicators to consider the likelihood of a default occurring within the next 12 months.

The key inputs into the measurement of ECL are the following:

- Probability of Default (PD) – is the likelihood of default over a given time horizon of one year. The PD is based on the issuer's credit rating such that the probability of default increases as the credit quality deteriorates;
- Loss Given Default (LGD) – is the magnitude of the likely loss, if there is a default by the issuer. It is a percentage of the exposure at default or the share of the exposure to a financial asset that the Bank could lose in the event of default;
- Exposure at Default (EAD) – represents the expected exposure in the event of a default. This is the total value holding of a financial instrument at the time of default.

In determining LGD, the following formula is used:

LGD=1-Recovery Rate (RR); where

RR= Value of Collateral/Value of the fair value of investment.

The Bank places time deposits with approved correspondent banks, central banks and other reputable international deposit taking institutions, and these depositories are considered to have minimum risk of default in line with international ratings. As such, the Bank's short term deposits are not collateralised, consequently the RR is zero; thus, the LGD remains constant at one. This results in the loss rates being equal to the PDs.

Financial instruments are grouped on the basis of shared risk characteristics that include instrument types, credit risk gradings, collateral type, date of initial recognition, remaining term to maturity, industry and geographical location of the borrower.

Model Inputs: 1-Year Default Risk

In determining the Probability of Default for the various sovereigns, PD sourced from Bloomberg are used. These probabilities are derived from models based on economic and financial data that the Bank considers sufficiently comprehensive to provide credible estimates of default risk. The variables listed below are the main inputs in the calculation of the PD for each country the Bank holds investments in cash and cash equivalents.

(i) Expenditures (as a percentage of GDP)
(ii) Revenues (as a percentage of GDP)
(iii) Debt due in twelve months (as a percentage of GDP)
(iv) Long-term debt (as a percentage of GDP)
(v) Refinancing ability
(vi) Budget surplus/deficit (as a percentage of GDP)
(vii) Non-performing loans (as a percentage of total loans)
(viii) GDP growth
(ix) Political risk score

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

Loss allowance

The following Table shows reconciliation from the opening to the closing balance of the loss allowance by class of financial instrument.

	2018 12-month ECL P'000	2017 P'000
Short-term Deposits at Amortised Cost (2017: loans and receivables)		
Balance at January 1, 2018	397	-
Transfer to 12-month ECL	-	-
Net remeasurement of loss allowance	266	-
New financial assets purchased	-	-
Financial assets that have been derecognised	(397)	-
Balance at December 31, 2018	266	-

(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 investment grade corporate bonds rated BBB- 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. This is with the exception of the Strategic Yield Portfolio, which can invest in issuers rated below investment grade with a credit limit of B-.

(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.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

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

Financial Liabilities at Undiscounted Cash Flows

The table below summarises the maturity profile of the Bank's financial liabilities as at December 31, 2018, based on contractual undiscounted repayment obligations.

December 31, 2018	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	8 196 000	-	-		8 196 000
Reverse Repurchase Agreements	1 054 903	-	-		1 054 903
Deposits	5 744 995	-	-		5 744 995
Allocation of SDR - IMF	-	-	-	856 878	856 878
Liabilities to Government - IMF	-	-	19 647		19 647
Dividend to Government	4 285 902	-	-		4 285 902
Other Liabilities	226 961	-	-		226 961
	19 508 761	-	19 647	856 878	20 385 286

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

(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 and Risk Committee of the Board, respectively.

32. 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, due to their short-term duration.

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.

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

Valuation models and techniques(cont'd)

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, 2018

32. 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, 2018	Note	Level 1 P'000	Level 2 P'000	Total P'000
Financial Assets				
Investments measured at FVTPL				
Bonds		28 020 159	-	28 020 159
Derivatives Instruments		-	(31 033)	(31 033)
Equities		18 598 255	-	18 598 255
Investments Measured at Amortised Cost		-	24 931 426	24 931 426
		46 618 414	24 900 393	71 518 807
Financial Liabilities				
Held-for-trading				
Derivatives Instruments		-	(15 206)	(15 206)
Other financial liabilities				
Bank of Botswana Certificates		-	8 192 670	8 192 670
Other liabilities		-	12 189 286	12 189 286
		-	20 366 750	20 366 750

December 31, 2017	Note	Level 1 P'000	Level 2 P'000	Total P'000
Financial Assets				
Held-for-trading (Measured at FVTPL)				
Bonds		8 965 032	-	8 965 032
Derivatives Instruments		-	(8 457)	(8 457)
Available-for-sale(Measured at FVOCI)				
Bonds		32 496 355	-	32 496 355
Equities		22 574 949	-	22 574 949
Government Bond		-	21 741	21 741
Loans and Receivables (Measured at Amortised cost)		-	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

There were no transfers between levels during the year.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
For the year ended December 31, 2018

33. RELATED PARTY BALANCES AND TRANSACTIONS

Balances and Transactions with the Government
The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2018, 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 P1 387 000 (2017: P2 000 000).

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.

	2018 P'000	**2017 P'000**
Botswana Savings Bank	5 668	51 676
Botswana Unified Revenue Service	157 666	97 851
Total	163 334	149 527

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, General Counsel and Heads of Department.

Gross emoluments of the key management personnel are:

	2018 P'000	**2017 P'000**
Non-Executive Board members	202	135
Executive Management		
Salaries, allowances and other short term benefits	22 894	13 390
Post-employment benefits	5 120	3 099
	28 216	16 624

Of the Staff Loans and Advances per Note 5, P985 108 (2017: P1 647 000) are attributable to Executive Management.

34. CONTINGENCIES

The Bank is defending an action instituted by one of the depositors of Kingdom Bank Africa Limited that is liquidated. 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 P32 million.

35. 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 2018

Theme Chapter:

Botswana - Financing Strategies for Industrialisation and Transition to High Income Status

Bank of Botswana

Chapter 1
The Botswana Economy in 2018

1. Output, Employment and Prices

(a) National Income Accounts

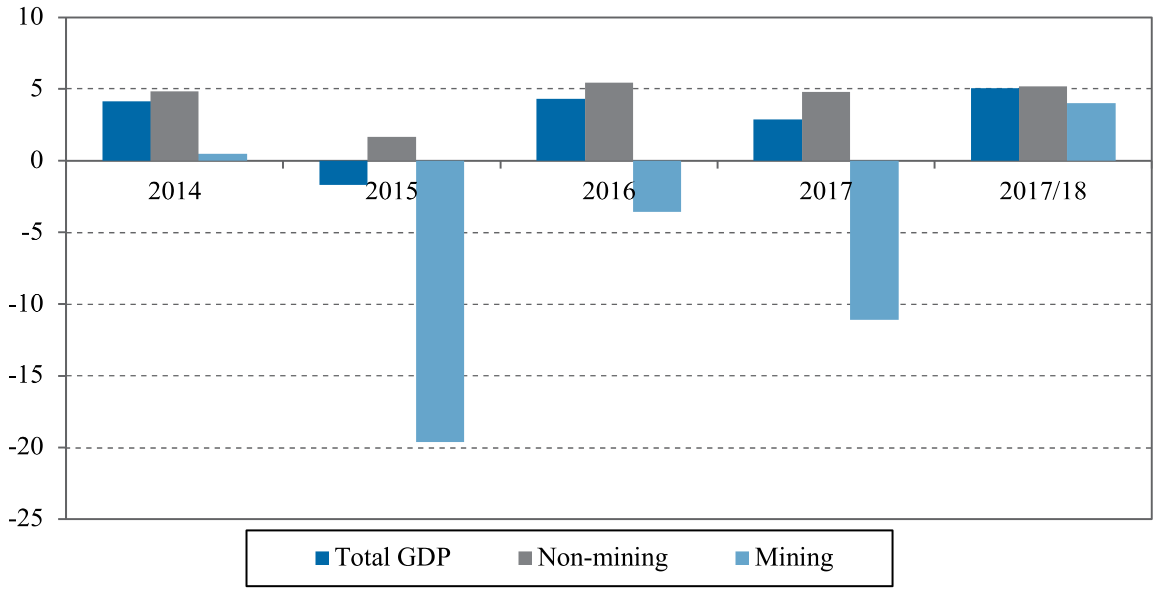
Overview

1.1 Real GDP grew by 5.1 percent in the twelve months to September 2018, compared to a lower expansion of 2.4 percent in the year to September 2017. This was attributable to the recovery in *mining* output and continued improvement in *non-mining* sectors. *Mining* output expanded by 4 percent in the year to September 2018, compared to a contraction of 12.4 percent in the corresponding period ending September 2017. The improved performance in *mining* was driven by the *diamond* industry and the resumption of production of soda ash at the Botash Mine, following its maintenance programme in the second quarter of 2017. Other *mining* sub-sectors also registered positive growth rates in the period under review, with a notable increase of 109 percent in *copper* output, mainly reflecting the base effects associated with the closure of BCL mine in October 2016, and resumption of production by a smaller mine.[7]

1.2 *Non-mining* GDP grew by 5.2 percent in the twelve months to September 2018, compared to 4.4 percent in the corresponding period ending September 2017. The overall expansion in *non-mining* GDP was mainly supported by the *trade, hotels and restaurants* (7.5 percent)[8] and *finance and business services* (4.7 percent).

Furthermore, there was significant growth with respect to *water and electricity* (27.3 percent) as local electricity production increased and the effects of closure of the BCL mine in 2016 fell out of the calculation.[9]

Chart 1.1: Real GDP Growth 2014 - 2017/18 (Percent)



1. Data for 2017/18 are for the 12-month period to September 2018.
Source: Statistics Botswana

7 Mowana Mine had started producing copper effective April 2017, and later suspended its operations in November 2018, due to lack of capital.

8 This sector also includes *tourism*.

9 Despite the significant growth rate of *water and electricity* sector, its contribution to total GDP growth is lower than that of *trade, hotels and restaurants* and *finance and business services* sectors.

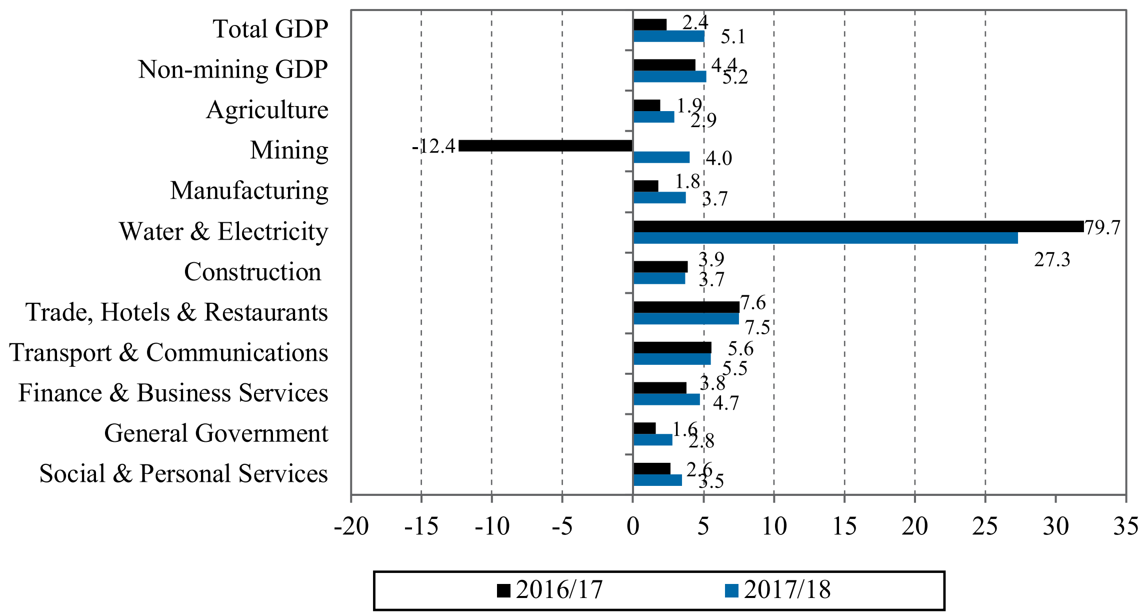
Sectoral Performance

1.3 Output for all economic sectors increased in the twelve months to September 2018 (Chart 1.2), hence contributing positively to real GDP growth (Chart 1.3).

1.4 The overall expansion in the *mining* sector was mainly due to output of the *diamond* industry, which increased by 3.2 percent. The improved performance of the *diamond* industry in the year to September 2018 was attributable to an increase of 3 percent in rough diamonds produced by Debswana. Similarly, *diamond* production from Karowe Mine expanded by 30.3 percent in the twelve months to September 2018, compared to a contraction of 25.9 percent in the corresponding period ending in September 2017.[10] The expansion of *soda ash* output by 15.4 percent compared to a contraction of 14.7 percent, also contributed to the increase in *mining* output. Production by the other *mining* sub-sectors also increased in the period under review, with a notable growth of 109 percent for *copper*, albeit from a very low base (just P14.7 million in constant 2006 prices as the hitherto bigger mines are out of operation). Coal production increased by 14.2 percent in the year to September 2018, attributable to higher demand for electricity generation at the Morupule B power plant.

1.5 *Water and electricity* output was 27.3 percent higher in the year to September 2018, compared to growth of 79.7 percent in the year ending September 2017. The lower increase was attributable to slower increase in the *water* sub-sector output, from 22 percent to 5 percent on account of reticulation challenges experienced in the third quarter of 2018. Meanwhile, the *electricity* sub-sector output rose almost ten-fold due to an increase in the local production and the diminished base effects of the closure of the BCL mine in 2016.

Chart 1.2: Real GDP Growth by Sector (Percent)

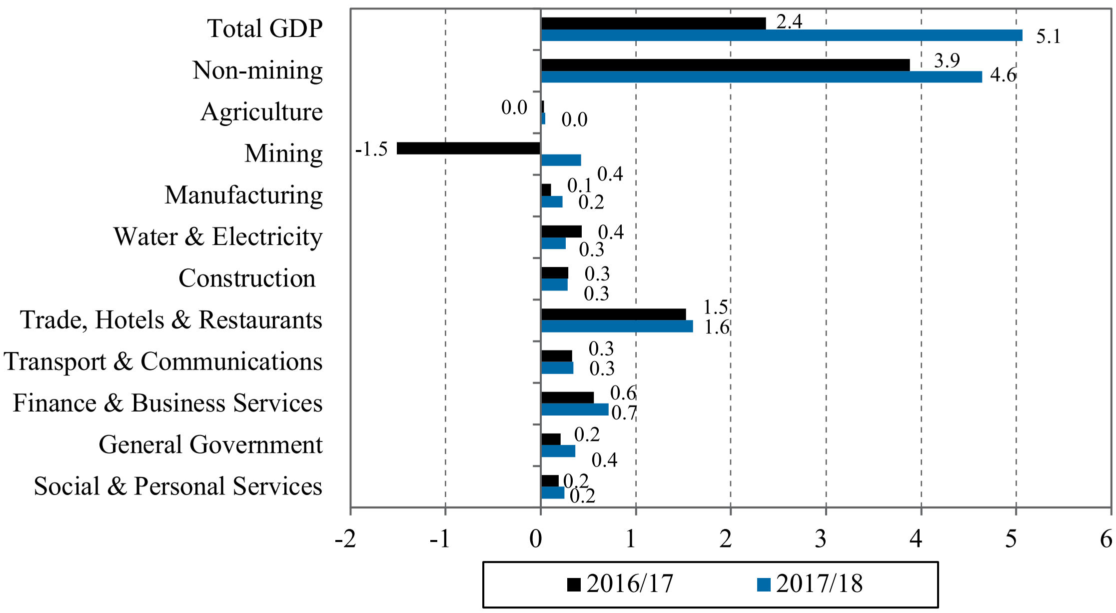


1. Data are for the 12-month period ending September 2017 and September 2018.
Source: Statistics Botswana

1.6 The *trade, hotels and restaurants* sector grew by 7.5 percent in the year to September 2018, slightly down from the 7.6 percent expansion in the prior year, with robust performance across all the sub-sectors; thus, *wholesale* (16.3 percent),

[10] The increase in production is attributable to improved efficiency in the recovery of smaller sized diamonds. Despite the notable increase in production, Karowe's sales decreased by 30.8 percent to USD172.7 million in the twelve months to September 2018, from USD249.6 million in the corresponding period in 2017, reflecting the lower number and quality of exceptional diamonds sold in the year to September 2018 compared to the corresponding period in 2017. Sales for 2017 also included the sale of the Lesedi La Rona for USD53 million, which resulted in a higher average price per carat in 2017.

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



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 2017 and 2018.

Source: Statistics Botswana

retail (7 percent) and *hotels and restaurants* (6.4 percent). The much faster expansion for the *wholesale* sub-sector was due to positive performance of downstream diamond industries.

1.7 The *transport and communications* sector output expanded by 5.5 percent in the year to September 2018, slightly lower than 5.6 percent growth in 2017. All sub-sectors registered positive growth, with the exception of the *railway* sub-sector, which contracted by 3.2 percent, as a result of lower exports and imports of goods transported by rail during the fourth quarter of 2017 and a temporary halt in train services[11] at the beginning of 2018.

1.8 The *finance and business services* sector expanded by 4.7 percent in the review period, compared to 3.8 percent in the year ending September 2017 and involved notable growth rates for the sub-sectors, namely, *real estate* (6.5 percent), *business services* (6.3 percent), *banks* (3.5 percent), *owner occupied dwellings* (2.8 percent), *business prospecting* (2.7 percent) and *insurance* (1.6 percent).

1.9 *Construction grew* by 3.7 percent in the twelve-month period to September 2018, down from 3.9 percent in the corresponding period in 2017. The reduction in growth was partly due to completion of some of the construction projects under the Economic Stimulus Programme. Some private construction projects, particularly in the Gaborone Central Business District and Palapye, were also completed.

1.10 *Agriculture* output increased by 2.9 percent in the twelve-month period to September 2018, compared to an increase of 1.9 percent in the corresponding period ending in September 2017. All the *agriculture* sub-sectors expanded, led by *livestock* production at 2.6 percent, followed by *other agriculture (horticulture)* production at 2.5 percent and *crop* production at 2.3 percent. The improvement in performance is in the context of good rainfall across the country in the last quarter of 2017 and first quarter of 2018.

1.11 For the *manufacturing sector*, output rose by 3.7 percent in the year ending September 2018, following growth of 1.8 percent in the year to September 2017, mainly due to the relatively higher increase of 5.1 percent in production of

[11] This was after a goods train derailed following heavy rains.

meat and meat products. *Other manufacturing and beverages* output increased by 3.8 percent and 3.1 percent, respectively. Production was lower in 2018 for the *textiles* and *tanning* and *leather products* sub-sectors compared to 2017.

(b) Economic Growth Prospects

1.12 Global output expansion is projected to decelerate to 3.5 percent in 2019, compared to an estimated expansion of 3.7 percent in 2018. Growth in advanced economies is projected to ease to 2 percent in 2019, from an estimate of 2.3 percent for 2018. For emerging markets and developing economies, output expansion is forecast at 4.5 percent for 2019, slightly down from 4.6 percent in 2018. Overall risks to global economic activity are skewed to the downside, with the escalation in trade tensions presenting a key source of risk to the outlook. Risk sentiments could further deteriorate, influenced mainly by a no-deal Brexit, slackening growth momentum in the euro zone and greater than currently anticipated deterioration in growth in China. In South Africa, prospects for growth remain modest amid policy uncertainty, with growth projected to rise to 1.4 percent in 2019 from 0.8 percent in 2018. However, prospects for economic recovery in South Africa hinge on the pace of structural reform implementation, as well as sentiment relating to policy credibility and proposed constitutional review relating to land reforms.

1.13 Domestically, real GDP is projected to increase by 4.5 percent and 4.2 percent in 2018 and 2019, respectively, mainly driven by the recovery in mining activity. The non-mining sectors are also projected to perform better in 2018 and going into 2019. Prospects for the non-mining sectors are underpinned by, among others, the accommodative monetary conditions in the domestic economy and the expected growth in government expenditure. Furthermore, improvements in electricity and water supply, as well as the reforms to further improve the business environment, would be positive for economic activity generally. In addition, prospective recovery of commodity prices and robust global market for exports should also support performance of the domestic economy. The positive sentiment is also indicated in the improvement in business confidence (September 2018, Business Expectations Survey), thus the likelihood of rising investment and greater contribution of the private sector to economic growth.

Table 1.1: Global Growth Estimates and Forecasts 2017 - 2019 (Percent)

	2017	2018	2019 (Projections)
Global	3.8	3.7	3.5
Advanced economies, of which,	2.4	2.3	2.0
USA	2.2	2.9	2.5
Euro area	2.4	1.8	1.6
Japan	1.9	0.9	1.1
Emerging markets, of which,	4.7	4.6	4.5
Sub-Saharan Africa	2.9	2.9	3.5
China	6.9	6.6	6.2
India	6.7	7.3	7.5
South Africa	1.3	0.8	1.4
Botswana	2.9	4.5	4.2

Source: International Monetary Fund, World Economic Outlook, January 2019 update and Ministry of Finance and Economic Development

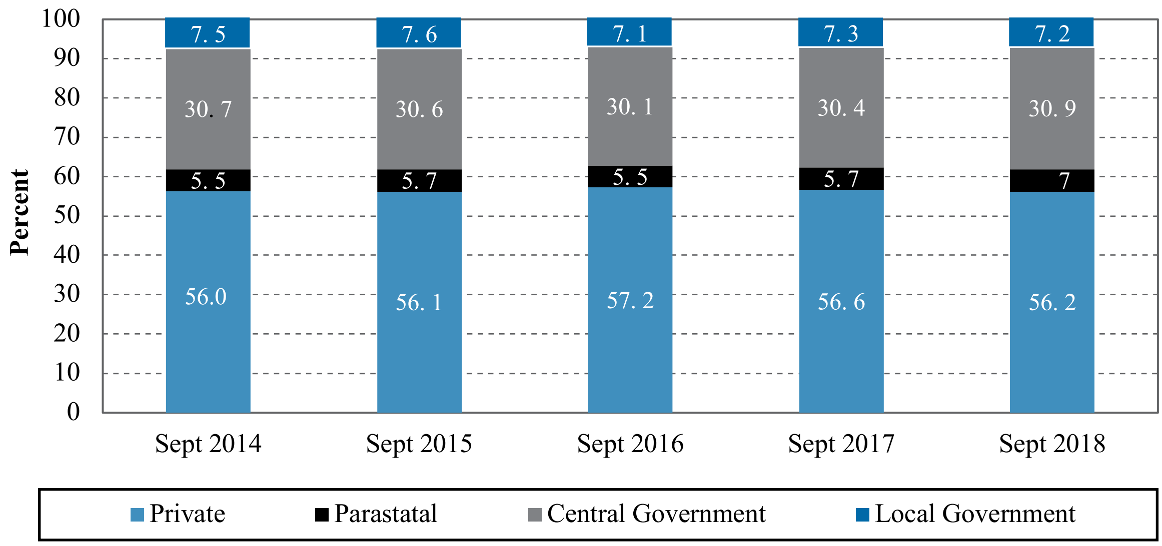
(c) Employment

1.14 Formal sector employment increased by 1.6 percent from 341 874 in September 2017 to 347 357 in September 2018.[12] Employment in the private sector increased by 0.9 percent, mainly due to job creation in the finance industry (increase of 3.4 percent), associated with additional bank branches across the country. Meanwhile, employment in central government increased by 3.1 percent as vacancies were filled, while for parastatals and local government respective were 1.6 percent and 0.9 percent. As shown in Chart 1.4, the broad distribution of employment between the public and private sectors is largely unchanged in the past five years, with the private sector accounting for about 56 percent of the formal sector work force.

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

[12] 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

rate at 17.7 percent of the labour force.[13] The unemployment rate was higher for women than men (19.1 percent compared to 16.3 percent).

1.16 The Formal Sector Employment Survey of September 2018 indicates that, average public sector wages increased by 3.8 percent in the nine months to September 2018, while private sector wages increased by 1 percent in the same period. Overall, nominal national wages increased by 2.3 percent in the nine months to September 2018, marginally lower than the average inflation of 3.2 percent in 2018, suggesting benign inflationary pressures emanating from both fiscal policy and wage growth.

(d) Inflation

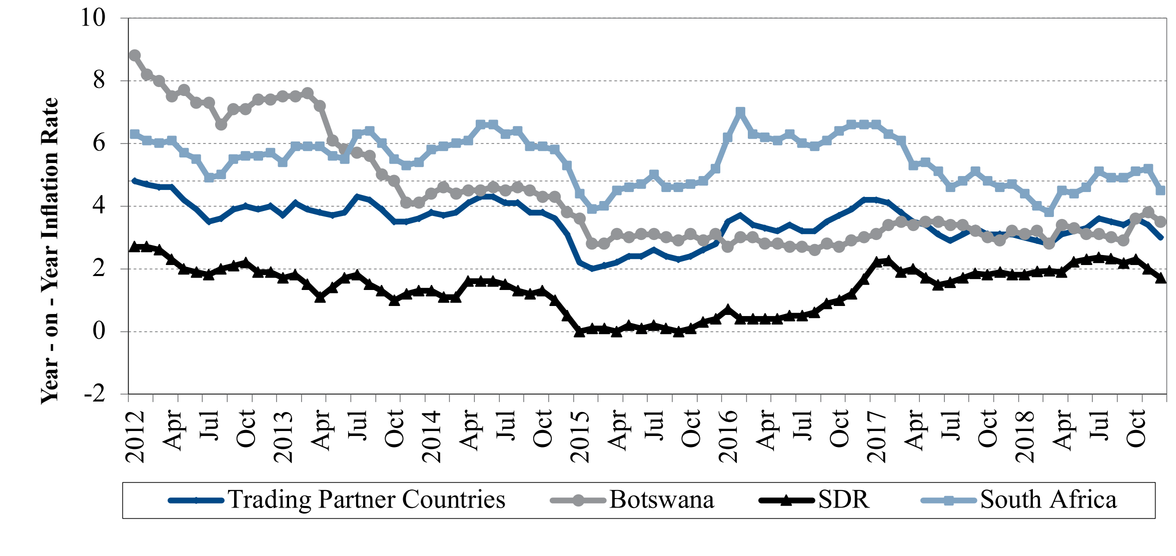
1.17 In 2018, global inflation increased mainly due to the upward trend in international oil prices. For example, the OPEC crude price increased by 32.4 percent to an average of USD69.5 per barrel in 2018 from an average of USD52.51 per barrel in 2017. The recovery in oil prices was influenced mainly by prospects of a shortfall in supply arising from sanctions against a major crude exporter, Iran. However, oil prices dropped significantly in December 2018, weighed down by rising inventories amid a weak economic outlook and slowdown in the rate of growth of consumption. Global inflation is estimated to have increased from 3.2 percent in 2017 to 3.8 percent in 2018. Meanwhile, international food prices declined by 3.5 percent in 2018, from an increase of 8.1 percent in 2017 influenced by lower prices for sugar, vegetable oil, meat and dairy products, while international prices rose for all the major cereals. Generally, international oil and food prices exerted marginal upward pressure on domestic inflation in 2018.

1.18 With respect to Botswana's trading partner countries, trade-weighted average inflation[14] fell slightly from 3.1 percent in December 2017 to 3 percent in December 2018. Similarly, for the SDR countries (USA, UK, Japan, Eurozone and China), inflation decreased from 1.8 percent in December 2017 to 1.7 percent in December 2018. Meanwhile, headline inflation in South Africa decreased from 4.7 percent in December 2017 to 4.5 percent in December 2018, and was within the target range of 3 - 6 percent (Chart 1.5).

[13] 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.

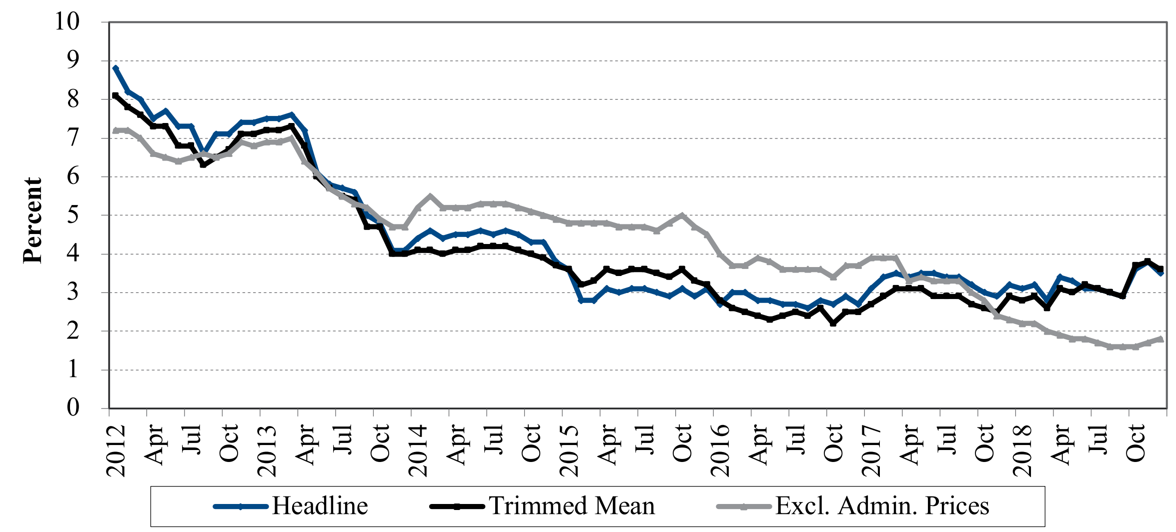
[14] Being the weighted average of the South African inflation and that of the countries whose currencies comprise the IMF's unit of account, the Special Drawing Rights (SDR).

Chart 1.5: Botswana and Trading Partner Countries' Inflation (2012 - 2018)



Source: Statistics Botswana, Bank of Botswana and Bloomberg

Chart 1.6: Botswana Headline and Core Inflation (2012 - 2018)



Source: Statistics Botswana

1.19 In Botswana, inflation increased from 3.2 percent in December 2017 to 3.5 percent in December 2018 and was within the Bank's 3 – 6 percent objective range (Chart 1.6). The increase in inflation reflected the rise in administered prices, including domestic fuel prices, which were raised in May, October and November 2018, as well as the increase in public transport fares and electricity tariffs. Nevertheless, the reduction in voice call tariffs and the alcohol levy during the year moderated the upward pressure on inflation. Meanwhile, food price deflation slowed, from 1.1 percent in December 2017 to 0.2 percent in December 2018. Regarding core inflation measures, the 16 percent trimmed mean inflation increased from 2.9 percent in December 2017 to 3.6 percent in December 2018, while inflation excluding administered prices decreased from 2.3 percent in December 2017 to 1.8 percent in December 2018.

(e) Inflation Outlook

1.20 Global inflationary pressures are forecast to be modest in the short to medium term, reflecting below-potential output. There is, however, upward pressure on inflation emanating from the increase in commodity prices, particularly oil, strengthening labour markets, as well as the expansionary monetary and fiscal policies. In 2019, global inflation is forecast at 2 percent in advanced countries and 4.6 percent in emerging market and developing economies. Overall, global inflation is forecast at 3.8 percent in 2019. 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.

1.21 In Botswana, headline inflation is projected to be within the 3 – 6 percent objective range in the medium term, and fluctuate slightly above the lower bound of the objective range. The higher short-term inflation projection reflects the impact of the increase in domestic fuel prices and private school fees in the fourth quarter of 2018 and first quarter of 2019, respectively. The projection also takes into account the upward adjustment in public sector salaries in the second quarter of 2019. However, there are base effects associated with the increase in administered prices in the second quarter of 2018, which contribute to the decline in inflation in the second quarter of 2019. 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 2019/20 BUDGET

2.1 The government budget for 2019/20 marks the third year of implementation of National Development Plan (NDP) 11, and is in line with 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 a modest increase in global economic activity due to uncertain policy and trade tensions in the larger economies. Hence, the implication for the domestic economy is that revenue prospects are uncertain given the vulnerability of the mineral and customs and excise revenues to global economic performance and trade conditions. Therefore, slower growth in revenue and, consequently, a budget deficit are projected for the 2019/20 fiscal year. On the other hand, given stickiness of recurrent needs, increase in public service salaries and development needs, there is a budgeted increase in government spending (allocated to the various ministries), thus contributing to the budget deficit. In seeking to optimise the allocation of resources in line with national priorities, the 2019 Budget Speech focused on three policy initiatives; viz., economic consolidation, social development, and maintaining governance and security. The priorities are consistent and aligned to NDP 11 and the objectives of the SDGs and Vision 2036.

(a) Budget Performance: 2017/18 and 2018/19[15]

2017/18 Budget Outturn

2.2 The budget outturn for the 2017/18 financial year was a deficit of P2 billion (1.1 percent of GDP), which was lower than the deficit of P4.1 billion envisaged in the revised budget estimates and the P2.4 billion deficit projected in the original budget. The deficit was mainly due to lower domestic tax revenue. In contrast, Bank of Botswana payments, mineral revenues and SACU receipts, surpassed the revised budget estimates. Domestic tax revenue underperformed due to much lower 'other withholding tax' category[16] of non-mineral income tax. Meanwhile, the increase in payments from Bank of Botswana is due to the residual income to Government, which is the remaining income after the Bank has met its expenditure and pre-set dividend for the year. Additionally, mineral revenue exceeded the revised estimate for the 2017/18 fiscal year,

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15 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.

16 This category includes withholding taxes on interest, commercial royalties, management and consultancy fees, entertainment and dividends and contract payments from both residents and non-residents.

driven by improved rough diamond demand and prices, hence, an improvement in sales. Overall, revenue decreased by P987.4 million (1.8 percent) to P56.4 billion in 2017/18, compared to the previous fiscal year.

2.3 Total expenditure and net lending increased from P56.3 billion in 2016/17 to P58.4 billion in 2017/18, but was below the revised budget estimate of P61.2 billion, due to underspending of the development budget. Of the total spending, recurrent expenditure amounted to P43.6 billion compared to P44.2 billion in the revised budget estimates, representing a slight decrease of 1.4 percent, largely due to underspending in personal emoluments (the bulk of recurrent expenditure).[17] Underspending in grants and subventions also contributed to the decrease in recurrent spending. On the other hand, development spending underperformed by 13.8 percent and was P14.7 billion compared to the revised budget estimate of P17.1 billion. The recurring underspending of the development budget compared to the revised budget is due to project implementation challenges, such as late commencement of projects, procurement inefficiencies and delays in processing payments.

2018/19 Revised Budget Estimates

2.4 The revised budget estimates for 2018/19 show a deficit of P7 billion (3.5 percent of GDP), compared to the original budget deficit of P3.6 billion. The revised deficit results from a slower growth in revenue (than projected in the original budget), due to underperformance of the mineral and non-mineral income tax revenue items. Mineral revenue has been revised downwards following the decision by Debswana to commence the implementation of the Cut 9 and Cut 3 projects in Jwaneng and Orapa, respectively, during the 2018/19 financial year, financed through dividends forfeiture. The non-mineral income tax underperformed due to lower-than-anticipated collections by the revenue authority. Overall, the revenue estimates were revised downwards by 9.4 percent from P64.3 billion in the original budget to P58.2 billion.

2.5 The estimate for expenditure and net lending was also revised slightly downward, from P67.9 billion to P65.2 billion or 32.9 percent of GDP (almost three percentage points above the fiscal rule limiting total expenditure to 30 percent of GDP). The P2.7 billion downward revision in the estimate for expenditure was mainly due to the development budget, and takes into account implementation capacity challenges faced by both the public and private sectors in executing projects.

(b) The 2019/20 Budget Proposals

2.6 According to the 2019 Budget Speech, the proposed budget allocation for 2019/20 is mainly informed by the need to consolidate

Table 1.2: Government Budget 2017/18 – 2019/20 (P Million)

	2017/18			2018/19		2019/20
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	**57 187**	**57 187**	**56 411**	**64 277**	**58 229**	**60 199**
Mineral Revenue	16 334	16 334	18 686	24 592	20 287	21 092
Non-Mineral Revenue	40 853	40 853	37 725	39 685	37 942	39 107
Expenditure	**59 544**	**61 259**	**58 393**	**67 867**	**65 188**	**67 540**
Recurrent Expenditure	43 071	44 208	43 562	48 637	48 637	50 580
Personal Emoluments	21 450	22 210	21 068	21 168	21 168	22 439
Grants & Subventions	12 496	12 687	12 192	14 864	14 864	16 110
Public Debt Interest	903	903	990	969	969	1 007
Other Charges	8 222	8 408	9 313	11 634	11 635	7 433
Development Expenditure	16 520	17 099	14 746	19 306	16 627	17 034
Net Lending	-47	-47	85	-76	-76	-76
Balance	**-2 357**	**-4 072**	**-1 982**	**-3 589**	**-6 959**	**-7 339**

Source: Ministry of Finance and Economic Development

[17] According to MFED, the decline in personal wages and emoluments is within their margin of estimation error and, hence, should not be considered alarming.

the country's development gains achieved over the years, in order to support economic transformation, promote sustainable economic growth, boost employment creation and alleviate poverty.

Revenue

2.7 Revenue for 2019/20, including grants, is projected to be P60.2 billion, which is 3.4 percent higher than the revised budget for 2018/19 (Table 1.3). This largely reflects a projected 4 percent increase in mineral revenue from P20.3 billion in 2018/19 to P21.1 billion in 2019/20. Minerals remain the largest source of revenue, representing 35 percent of the total. Both non-mineral income tax and value-added tax (VAT) revenue are projected to increase by 7.9 percent, thus accounting for 19.2 percent and 15.2 percent of the budgeted revenue, respectively. In contrast, SACU receipts are forecast to decrease from P14.5 billion in 2018/19 to P14 billion in 2019/20. However, there are downside risks associated with these revenue estimates, emanating largely from the continuing vulnerability of the mineral and SACU revenues to exogenous factors.

Expenditure

2.8 Total expenditure and net lending for 2019/20 is budgeted at P67.5 billion (31.8 percent of expected GDP), an increase of 3.6 percent from the P65.2 billion in the revised estimates for 2018/19 (Table 1.3). Recurrent expenditure is projected to increase by 4 percent, from the revised budget projection of P48.6 billion in 2018/19 to P50.6 billion in 2019/20, accounting for 74.9 percent of total spending and above the expenditure allocation rule that calls for a 70 percent and 30 percent split between recurrent and development spending, respectively. The development spending budget is projected to grow by 2.4 percent from a revised budget of P16.6 billion in 2018/19 to P17 billion in 2019/20.

2.9 Consequently, a budget deficit of P7.3 billion or 3.5 percent of GDP is forecast for 2019/20, which would be financed by a combination of drawing down of Government savings, as well as domestic and foreign borrowing. The 2019/20 budget retains the principle of fiscal prudence of ensuring fiscal sustainability in the medium to long term, which is balanced against developmental/infrastructure needs and government operations necessary to support inclusive and sustainable economic activity.

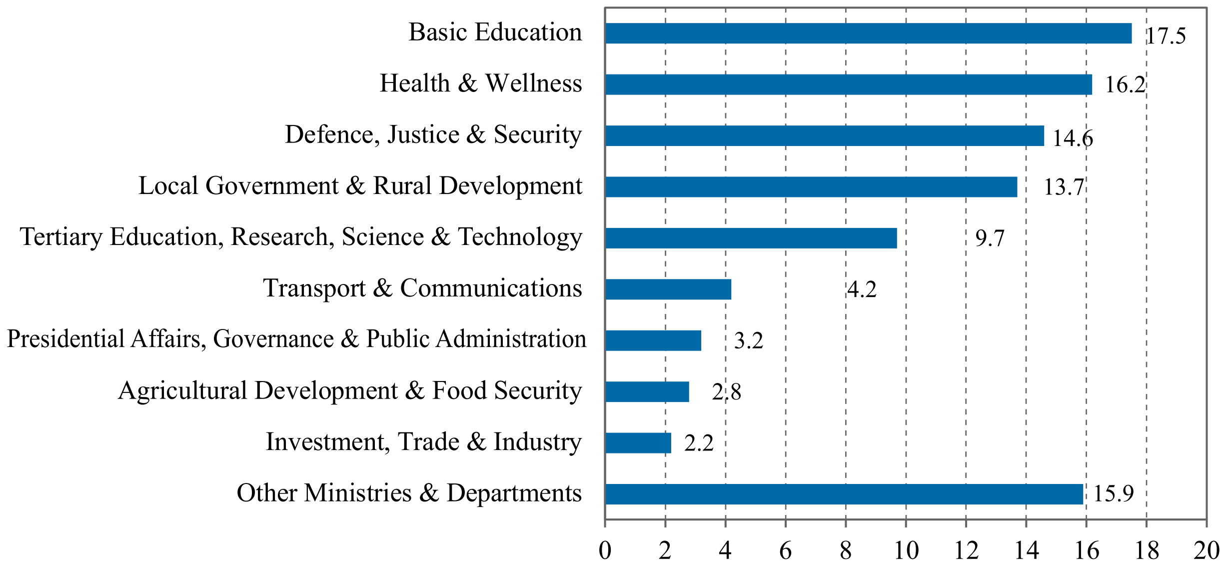
TABLE 1.3: GOVERNMENT BUDGET 2014/15 – 2019/20

Fiscal Year (FY)	2014/15	2015/16	2016/17	2017/18	2018/19*	2019/20*
GDP, current prices (P Million)	147 920	149 111	174 836	182 408	198 250	212 587
Growth rate (percent)	12.7	0.8	17.3	4.3	8.7	7.2
Budget					**Revised Budget**	**Budget**
Revenue & Grants	55 904	47 420	57 398	56 411	58 229	60 199
Recurrent Expenditure	37 583	40 413	41 166	43 562	48 637	50 580
Development Expenditure	13 072	12 773	15 161	14 746	16 627	17 034
Net Lending	-91	1 225	-52	85	-76	-76
Expenditure & Net Lending	50 564	54 411	56 275	58 393	65 188	67 540
Balance	**5 340**	**-6 991**	**1 124**	**-1 982**	**-6 959**	**-7 339**
Share of GDP (percent):						
Revenues & Grants	37.8	32.0	32.8	30.9	29.4	28.3
Recurrent Expenditure	25.4	27.2	23.5	23.9	24.5	23.8
Development Expenditure	8.8	8.6	8.7	8.1	8.4	8.0
Expenditure & Net Lending	34.2	38.0	32.2	32.0	32.9	31.8
Balance	**3.6**	**-4.7**	**0.6**	**-1.1**	**-3.5**	**-3.5**

* Projections

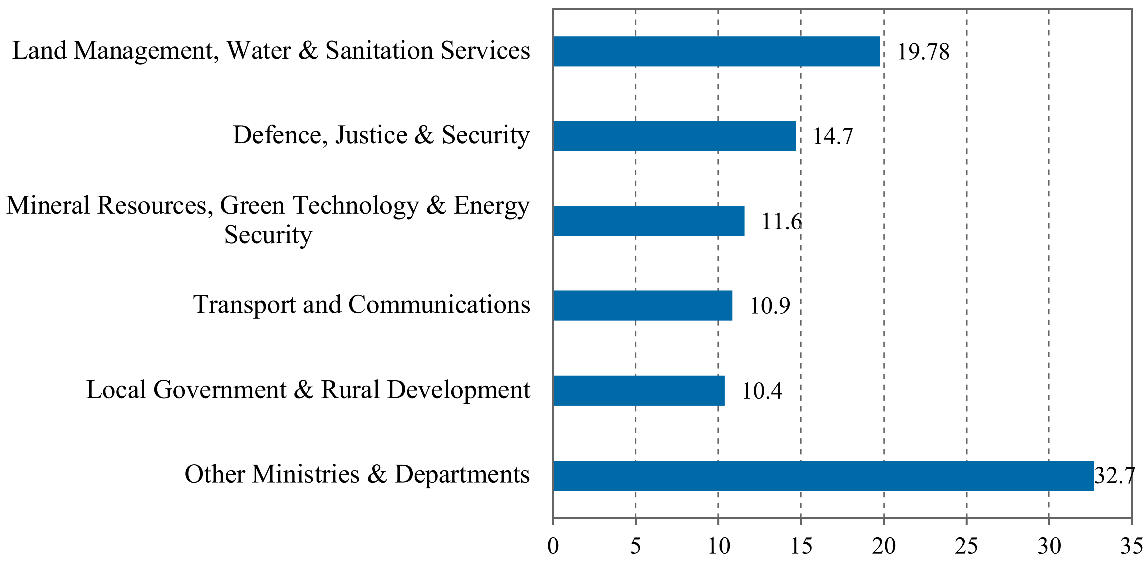
Source: Ministry of Finance and Economic Development

CHART 1.7: PROPOSED MINISTERIAL ALLOCATION OF THE RECURRENT BUDGET (PERCENT)



Source: Ministry of Finance and Economic Development

CHART 1.8: MINISTERIAL ALLOCATION OF THE DEVELOPMENT BUDGET (PERCENT)



Source: Ministry of Finance and Economic Development

2.10 A significant proportion of the 2018/19 recurrent spending, P22.4 billion (47.8 percent), is on personal emoluments, which includes wages and salaries as well as pensions and gratuities. The balance (52.2 percent) is allocated to grants and subventions to parastatals and local authorities (P16.1 billion or 34.3 percent), "other charges[18]" (P7.4 billion or 15.8 percent), and interest on public debt (P1 billion or 2.1 percent). Recurrent spending on Basic Education leads the ministerial allocations with a share of 17.5 percent, as reflected in Chart 1.7.

2.11 More than half of the development budget was allocated to water, security, electricity and construction-related projects (Chart 1.8).

[18] Other charges represent all other costs on the recurrent budget but excludes public debt charges.

Thus, the largest share of P3.4 billion or 19.8 percent was allocated to the Ministry of Land Management, Water and Sanitation Services, mainly to improve water supply and management in the country. The Ministry of Defence, Justice and Security received the second largest proportion (14.7 percent), mostly to finance the provision of infrastructure and maintenance of equipment for the Botswana Defence Force and the Botswana Police Service. The Ministry of Mineral Resources, Green Technology and Energy Security was allocated 11.6 percent of the development budget, followed by Ministry of Transport and Communications with 10.9 percent, in order to support infrastructure development and enhanced provision of utilities (for example, electricity and information and communications technology connectivity).

Debt Management

2.12 Government and government-guaranteed debt for the 2018/19 fiscal year is projected at P46 billion,[19] of which P36.1 billion is Government's own debt; the balance is government-guaranteed debt (Table 1.4). Total external debt amounts to P30.5 billion or 15.4 percent of GDP, while domestic debt, at 7.8 percent of GDP, amounts to P15.5 billion. Overall, total projected debt as at March 31, 2019, is equivalent to 23.2 percent of forecast GDP and below the statutory ceiling of 40 percent of GDP, with both domestic and external debt being lower than the 20 percent of GDP limit for each category.[20]

TABLE 1.4: GOVERNMENT DEBT AND GUARANTEES 2015/16 – 2019/20 (P MILLION)

Financial Year	2015/16	2016/17	2017/18	2018/19	2019/20
	Actual			Projected	
External					
External Debt	17 060	16 162	23 215	22 751	24 509
External Guarantees	8 010	8 960	7 738	7 738	7 738
Total External Debt	25 069	25 122	30 953	30 489	32 247
Internal					
Internal Debt	8 102	8 701	12 454	13 387	18 597
Internal Guarantees	886	1 004	2 136	2 136	2 136
Total Internal Debt	8 988	9 704	14 590	15 523	20 733
Grand Total	34 058	34 827	45 543	46 012	52 980
GDP for FY	149 111	174 836	182 408	198 250	212 587
Percent of GDP					
External Debt & Guarantees	16.8	14.4	17.0	15.4	15.2
Internal Debt & Guarantees	6.0	5.6	8.0	7.8	9.8
Total Debt & Guarantees	22.8	19.9	25.0	23.2	24.9

Source: Ministry of Finance and Economic Development

19 An increase of 1 percent compared to the balance outstanding at the end of 2017/18 fiscal year.

20 Figures were sourced from the 2019/20 Budget in Brief.

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. In 2018, the weights of the Pula basket currencies were maintained at 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, a downward rate of crawl of 0.3 percent for the nominal effective exchange rate (NEER) was implemented in 2018, as the projected domestic inflation was higher than the trading partner countries' forecast average inflation. Consequently, the NEER of the Pula depreciated by 0.3 percent in the twelve months to December 2018 (Table 1.5). Against the Pula basket currencies, the nominal Pula exchange rate appreciated by 7 percent against the South African rand and depreciated by 5.9 percent against the SDR over the twelve months period. The Pula depreciated against all the SDR currencies; it depreciated by 9.9 percent against the Japanese yen, 8.1 percent against the US dollar, 3.9 percent against the euro, 2.9 percent against the Chinese renminbi and 2.4 percent against the British pound.

3.3 In real terms, the Pula exchange rate (using headline inflation) appreciated by 6 percent against the South African rand and depreciated by 4.2 percent against the SDR, in 2018. The REER appreciated marginally by 0.3 percent in the twelve months to December 2018, as the positive inflation differential between Botswana and trading partner countries was slightly larger than the downward rate of crawl. The largely stable REER suggests maintenance of international competitiveness of domestic firms.

[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 changes in the relative competitiveness of the country's tradeable goods and services.

However, it should be noted that the exchange rate alone is not sufficient to ensure sustainable competitiveness of local producers. Durable competitiveness of domestic producers is mainly achieved through a sustained improvement in productivity, which also contributes to lower inflation.

Table 1.5: Pula Exchange Rates against Selected Currencies

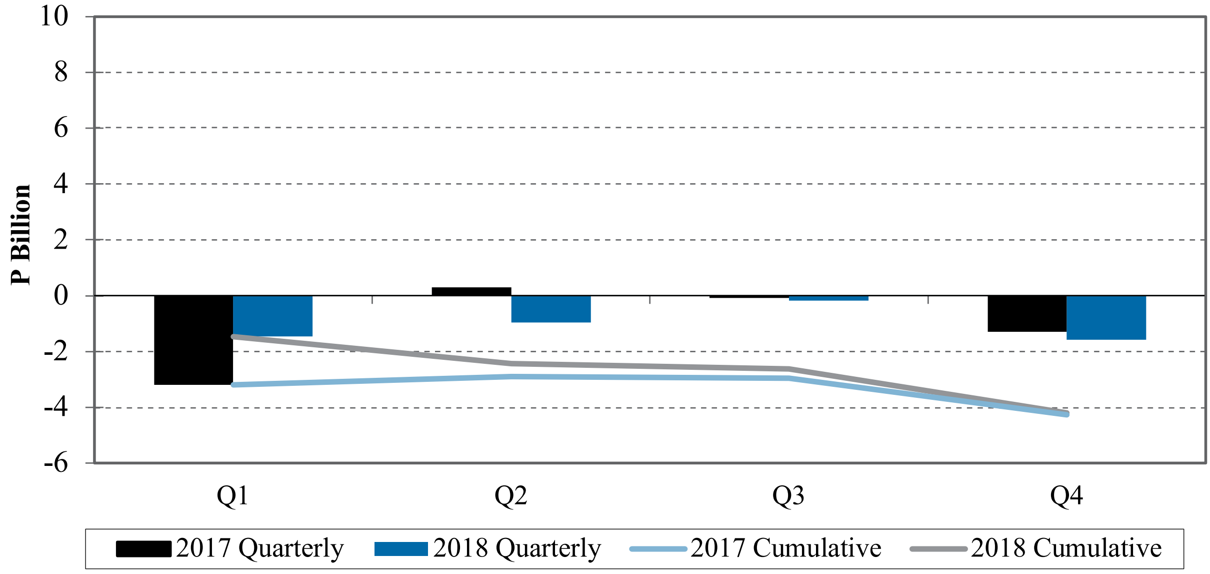
Currency	December 2017	December 2018	Change (Percent)
Nominal Exchange Rates (Foreign Currency per Pula)			
SA rand	1.2563	1.3441	7.0
SDR	0.0713	0.0671	-5.9
US dollar	0.1013	0.0932	-8.1
British pound	0.0753	0.0734	-2.4
Japanese yen	11.42	10.28	-9.9
Euro	0.0848	0.0815	-3.9
Chinese yuan	0.6605	0.6411	-2.9
NEER (Sept. 2016 = 100)	100.4	100.1	-0.3
Real Pula Exchange Rate Indices[1] (Sept. 2016 = 100)			
Currency	**December 2017**	**December 2018**	**Change (Percent)**
SA rand	95.8	101.5	6.0
SDR	104.9	100.5	-4.2
US dollar	106.8	99.8	-6.6
British pound	101.7	100.6	-1.1
Japanese yen	119.7	111.3	-7.0
Euro	100.5	98.4	-2.0
Chinese yuan	102.6	101.2	-1.4
REER	100.6	100.8	0.3

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

(b) Balance of Payments

3.4 Provisional balance of payments figures of 2018 show an overall deficit of P4.2 billion in 2018, compared to a revised deficit of P4.3 billion in 2017 (Chart 1.9 and Table 1.6). The deficit was among others attributable to government financial obligations and payments for imports.

Chart 1.9: Quarterly Balance of Payments 2017 - 2018



Source: Bank of Botswana

Table 1.6: Balance of Payments 2014 - 2018 (P Million)

	2014*	2015*	2016*	2017*	2018#
Current Account	15 566	3 219	13 222	9 613	3 522
of which:					
Merchandise Trade	6 653	-6 947	15 979	8 357	3 184
Services	-2 206	-2 093	-1 829	-2 684	-2 888
Income	-4 234	-4 598	-13 846	- 13 317	-13 126
Current Transfers	15 351	16 856	12 918	17 257	16 352
Financial Account	-5 557	-8 884	-8 625	-11 270	-233
Capital Account	-	2	-	16	8
Net Errors and Omissions[22]	-3 763	1 515	-7 877	-2 637	-7 500
Overall Balance	**6 246**	**-4 148**	**-3 280**	**-4 278**	**- 4 204**

* Revised
\# Provisional
Source: Bank of Botswana

Current Account[23]

3.5 The current account surplus is estimated at P3.5 billion in 2018, compared to a revised surplus of P9.6 billion in the previous year. The 2018 surplus was primarily the result of revenue inflow from the SACU and a surplus in the merchandise trade account, despite both decreasing, by 3.7 percent and 61.9 percent, respectively, from the 2017 balances. The larger reduction in the merchandise trade account balance is mainly accounted for by a larger increase in imports, 16.3 percent in 2018 compared to a smaller 5.7 percent increase in exports.

22 The net errors and omissions suggest either an overestimation/underestimation of the current account or an underestimation/overestimation of capital outflows from the financial account. Efforts are continuing to improve on data coverage to have these net errors and omissions within more acceptable levels.

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

Merchandise Trade[24]

3.6 Trends in merchandise trade continue to be driven by the diamond trade, mainly by De Beers Global Sightholder Sales (DBGSS), which includes a substantial import and re-export trade for rough diamonds[25] (Table 1.7). The merchandise trade account balance decreased from P8.4 billion in 2017 to P3.2 billion in 2018, largely reflecting the larger increase in imports of goods than exports of goods during the review period. Diamonds constitute nearly 90 percent of total exports, and 29 percent of total imports. The De Beers' aggregation process involves a larger share of diamonds from Botswana, approximately 64 percent in 2018 from an average of 54 percent in 2012 and 2013, when aggregation and sales functions relocated from the UK to Botswana, respectively. The relocation also shifted the direction of diamond trade significantly, with the major export destination switching from the UK to Belgium, followed by India, South Africa, United Arab Emirates and Namibia.[26] These five countries collectively account for an annual average of 67 percent of Botswana's total diamond exports for the period 2014 - 2018 (Table 1.8).

Table 1.7: Diamond Trade 2016 - 2018 (P Million)

	Exports					
	Rough		Polished	Total	Imports	Re-Exports
Period	Botswana Sales	Exports	Exports	(Rough and Polished)		
	(1)	(2)	(3)	(4)=(2)+(3)	(5)	(6)=(2)-(1)
2016	43 647	66 386	4 395	70 781	18 905	22 739
2017	36 036	49 877	5 582	55 459	14 356	13 841
2018:						
Q1	8 835	10 963	1 382	12 345	4 281	2 128
Q2	7 462	15 038	2 215	17 253	4 565	7 576
Q3	11 916	10 646	2 344	12 990	3 351	-1 270
Q4	8 836	13 222	2 477	15 698	5 814	4 386
Total	**37 049**	**49 869**	**8 417**	**58 286**	**18 010**	**12 819**

Source: Bank of Botswana

1. **Botswana Sales** refers to the value of rough diamonds mined by Debswana and sold to DBGSS and the Okavango Diamond Company (ODC)
2. **Exports:** Represent the value of exported rough diamonds produced in Botswana, including re-exports, which implies that the subtraction of Botswana diamonds from this total approximates the gross value of re-exports, the value of which accrues to De Beers. However, due to time lags in data availability, the value of re-exports computed in this manner and the value of re-exports accruing to De Beers is not fully comparable, especially over short periods.

[24] 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 exports of commodities, the trade statistics data are supplemented by additional information collected directly from the exporters.

[25] In addition to Botswana mined diamonds, 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.

[26] This is based on the average of exports by destination from 2014 to 2018.

TABLE 1.8: TOTAL EXPORTS BY DESTINATION IN 2013 - 2018 (PERCENT)

Country	2013	2014	2015	2016	2017	2018
United Kingdom	31.0	0.9	0.8	1.3	0.7	0.8
Belgium	12.0	23.6	19.8	18.9	22.6	23.8
India	2.7	13.7	12.4	15.1	18.5	17
United Arab Emirates	1.0	4.3	5.4	9.7	16.2	10.9
South Africa	15.4	13.4	15.6	13.5	9.7	9.1
Israel	5.7	7.7	6.0	6.1	7.4	6.7
Hong Kong	0.7	2.7	1.9	2.5	4.3	5.1
Namibia	11.7	9.8	11.8	11.6	3.4	2.9
United States of America	1.3	2.7	2.5	2.3	2.1	2.1
Canada	6.3	6.5	6.3	5.0	0.8	0.6
Others	12.1	14.8	17.4	14.0	14.3	21.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Bank of Botswana

3.7 In 2018, total exports increased by 5.7 percent, mostly due to a 5.1 percent increase in diamond exports from P55.5 billion in 2017 to P58.3 billion. Growth in diamond exports occurred against the background of favourable trading conditions in the diamond market. In particular, the demand for diamonds in the second quarter of 2018 surged during the Las Vegas Trade Show, resulting in an increase of 39.8 percent in sales from the first quarter of 2018. Exports of other commodities also increased, including copper and nickel (74 percent); textiles (28.5 percent); gold (16.4 percent); soda ash (8.2 percent) and vehicles and transport equipment (5.2 percent). The increase in copper and nickel exports was due to resumption of operations at the Mowana Copper Mine in 2017, following its takeover by Leboam Holdings and the absence of the hitherto much larger BCL output. Gold exports were boosted by, amongst others, improved global demand and to a lesser extent, the increase in average gold prices from USD1 258 per ounce in 2017 to USD1 270 per ounce in 2018.

TABLE 1.9: EXPORTS, 2017 – 2018 (P MILLION)

			Percent Share		
	2017	2018	2017	2018	Percentage Change
Total Exports	**61 563**	**65 066**			**5.7**
of which:					
Diamonds	55 459	58 286	90.1	89.6	5.1
Copper-Nickel	41	71	0.1	0.1	74.0
Beef	886	821	1.4	1.3	-7.2
Soda Ash	970	1 050	1.6	1.6	8.2
Gold	383	446	0.6	0.7	16.4
Textiles	182	233	0.3	0.4	28.5
Vehicles & Transport Equipment	578	608	0.9	0.9	5.2
Other Goods	3 066	3 550	5.0	5.5	15.8

Source: Bank of Botswana

3.8 Imports increased in 2018, mainly due to larger diamond purchases (for aggregation), which grew from P14.4 billion to P18 billion, accounting for 29 percent of total imports in 2018. Imports also increased with respect to vehicles and transport equipment (27.4 percent); metal and metal products (17.4 percent); machinery and electrical equipment (16.2 percent); food, beverages and tobacco (13.8 percent); textile and footwear (8.5 percent) and fuel (5.1 percent).

Table 1.10: Imports, 2017 – 2018 (P Million)

	2017	2018	Percent Share 2017	Percent Share 2018	Percentage Change
Total Imports	**53 207**	**61 882**			**16.3**
of which:					
Diamonds	14 356	18 010	27.0	29.1	25.5
Fuel	8 099	8 508	15.2	13.7	5.1
Food, Beverages &Tobacco	6 953	7 913	13.1	12.8	13.8
Machinery & Electrical Equipment	7 249	8 421	13.6	13.6	16.2
Chemicals & Rubber Products	5 678	5 722	10.7	9.2	0.8
Metals & Metal Products	2 478	2 909	4.7	4.7	17.4
Textile & Footwear	1 646	1 785	3.1	2.9	8.5
Vehicles & Transport Equipment	4 163	5 304	7.8	8.6	27.4
Other Goods	2 585	3 309	4.9	5.3	28.0

Source: Bank of Botswana

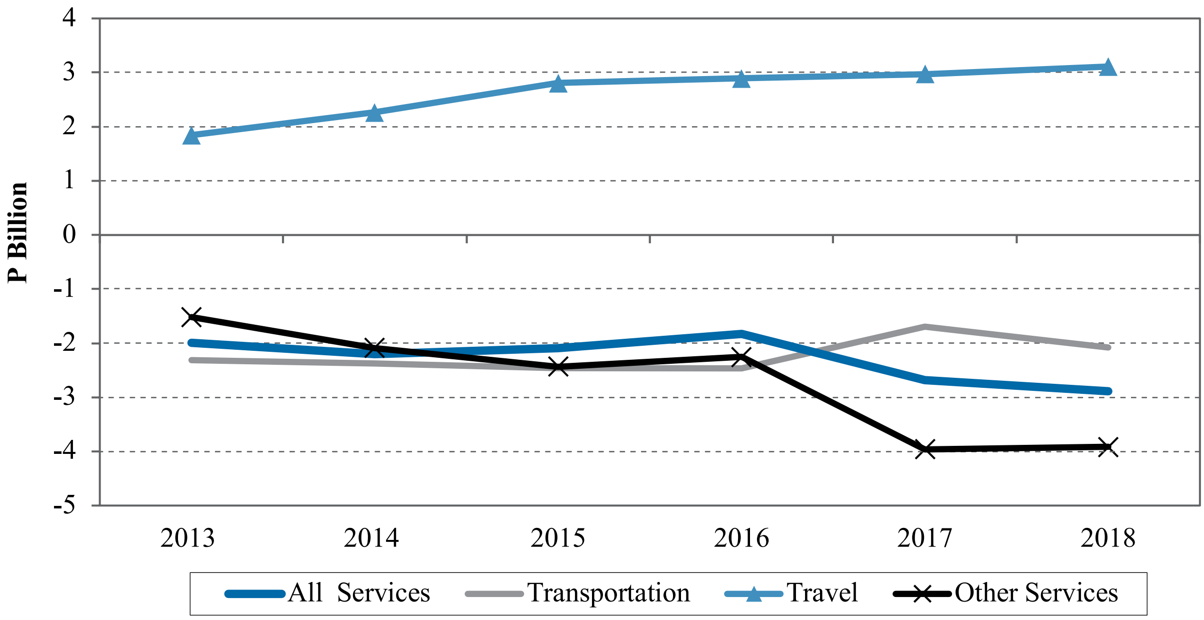
Services

3.9 The services account registered a deficit of P2.9 billion in 2018 compared to a revised deficit of P2.7 billion in the previous year (Chart 1.10). Exports of transportation services[27] decreased by 15.7 percent, from P528 million in 2017 to P445 million in 2018, mainly because of freight, which decreased by 14.8 percent from P454.3 million to P387 million during the same period. Imports of transportation services increased by 13.6 percent, from P2.2 billion to P2.5 billion during the same period, almost entirely driven by freight for imported goods. The larger increase in imports of transportation services resulted in an overall deficit of P2.1 billion in transportation services. Exports of travel services increased by 5.4 percent, from P5.6 billion to P5.9 billion, primarily because of the increase in personal travel, dominated by tourism expenditure, which increased by 5.5 percent from P5.5 billion to P5.8 billion. Imports of travel services also increased by 3.8 percent from P2.6 billion to P2.7 billion, also attributable to personal travel expenditure in other countries. Consequently, travel services recorded a surplus of P3.1 billion in 2018. Exports of 'other' services declined by 2.8 percent from P3.6 billion in 2017 to P3.5 billion in 2018, compared to a decline in imports of 2.6 percent, from P7.6 billion to P7.4 billion during the same period. The 'other' services, which is dominated by government and mining related fees[28] was, therefore, P3.9 billion in deficit.

27 Transportation services include: passenger fares; freight (road, sea, air, rail and clearing charges) and 'other' services (landing fee, aircraft hire and air charter).

28 These include; license, royalties, advertising, marketing and legal fees.

Chart 1.10: Balance of the Trade in Services (2013 - 2018)



Source: Bank of Botswana

Income Account

3.10 The income account registered an estimated deficit of P13.1 billion in 2018, from the previous year's revised deficit of P13.3 billion. The deficit is primarily a result of dividends and reinvested earnings paid to foreign investors. The credit side of the income account comprises salaries received from abroad and income earned from foreign investments, dominated by foreign exchange reserves earnings. For 2018, income on foreign exchange reserves was unchanged from the previous year's P1.6 billion. The debit component of the income account comprises salaries paid abroad and income paid to foreign investors by direct investment enterprises operating in Botswana. Dividends and retained earnings[29] are the major items of the income outflows. These are estimated to have slightly increased by 1.7 percent, from P11.9 billion in 2017 to P12.1 billion in 2018. A larger proportion of this component in 2018 was dividends paid by Debswana to De Beers.

Current Transfers

3.11 Current transfers consist of government and private transfers, with the former constituting the largest share. In 2018, net current transfers are estimated to have decreased by 5.2 percent from P17.3 billion in 2017 to P16.4 billion, reflecting reduced SACU receipts. The decline in SACU receipts was mainly a result of the recovery of overpayments made to Botswana from the Common Revenue Pool in the 2016/17 fiscal year. The decline led to a 3.7 percent contraction in revenues to government, from P16.3 billion in 2017 to P15.7 billion in 2018. Thus, government transfers decreased from a surplus of P16.1 billion to P15.4 billion, while private transfers declined from a surplus of P1.1 billion to P986 million.

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

Capital and Financial Accounts

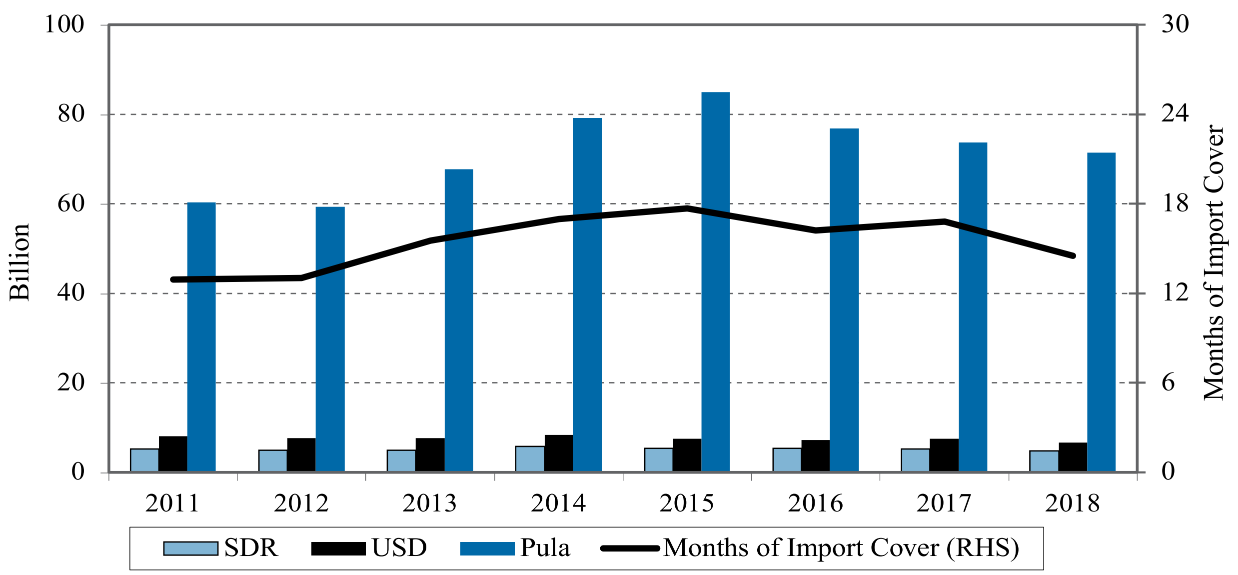
3.12 The capital account records transfers of financial assets by migrants to/from Botswana and, as in previous years, these transfers were insignificant in 2018. The financial account, comprising 'direct,' 'portfolio' and 'other' investment,[30] is estimated to have registered a net outflow of P233 million in 2018[31] compared to a larger revised outflow of P11.3 billion in 2017. With respect to direct investment, investment in foreign assets is estimated to have increased by P1.2 billion in 2018 compared to a revised decline of P9 million in 2017. The rise was mainly due to increases in loans extended to foreign affiliates by enterprises operating in Botswana in the non-financial sector. On the other hand, it is estimated that investments by non-residents in Botswana increased by P1.8 billion in 2017 and by P2.3 billion in 2018, largely as a result of reinvestment of earnings in the mining sector.

3.13 The portfolio assets are estimated to have declined by P6.8 billion in 2018, compared to an increase of P7.1 billion in 2017, on account of a decrease in offshore investment in debt and near-cash instruments by pension funds. Similarly, portfolio liabilities decreased by P483.3 million in 2017 and declined further by P1.4 billion in 2018, due to a reduction in foreign investor participation in the domestic capital market. 'Other' investments are estimated to have recorded a net outflow of P6.7 billion in 2018 compared to a revised outflow of P5.5 billion in the previous period, reflecting an increase in foreign financial assets (foreign notes held in local vaults and deposits abroad) held by Botswana residents. Foreign financial assets increased by P5.4 billion in 2017 and P6.6 billion in 2018. Meanwhile, foreign financial liabilities fell by P194 million in 2017 and P109 million in 2018. This was a result of a decrease in long-term loans following repayments by Government and the private entities during the same period.

Foreign Exchange Reserves

3.14 The foreign exchange reserves decreased by 3.1 percent from P73.7 billion in 2017 to P71.4 billion in 2018 (Chart 1.11). The decrease reflects, among others, drawdowns of foreign exchange by government and significant

Chart 1.11: Level of Foreign Exchange Reserves



Source: Bank of Botswana

30 '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. Other equity is an investment that is below 10 percent and not tradable.

31 The 2018 balances are based on preliminary estimates.

adverse valuations, specifically global equity markets towards the end of the year. The level of reserves in 2018 was equivalent to 15 months of import cover[32] of goods and services. In foreign currency terms, the level of reserves decreased by 10.7 percent from USD7.5 billion to USD6.7 billion, while decreasing in SDR terms by 9.4 percent from SDR5.3 billion to SDR4.8 billion over the same period.

(c) Balance of Payments Outlook

3.15 The current account balance is expected to remain in surplus in 2019, supported by maintenance of moderate output growth (4.2 percent in 2019, compared to 4.5 percent in 2018). The sustained positive growth derives from the expected recovery in the mining sector due to the anticipated increase in global demand and increase in prices for commodities. The positive outlook is further underpinned by the anticipated good performance in 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, which is expected to boost revenues for travel services. 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 in 2019.

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

(i) International Investment Position

3.16 Preliminary estimates for 2018 indicate that Botswana's net international investment declined by 11.1 percent from P70.9 billion in 2017 to P63 billion in 2018, with total foreign assets decreasing by 5.4 percent from P151.4 billion to P143.3 billion, and total foreign liabilities also decreasing by 0.2 percent from P80.5 billion to P80.3 billion during the same period. On the assets side, 'direct investments', 'portfolio investments' and 'foreign exchange reserves' decreased by 6.9 percent, 13.1 percent and 3.1 percent, respectively, while 'other investments' increased by 12.8 percent during the same period. The decline in 'direct investment' resulted from the reduction in loans extended to related business enterprises abroad, from P9 billion in 2017 to P8.2 billion in 2018. 'Portfolio investment' decreased mainly due to the decline in 'equity securities' and 'debt securities' invested abroad, with offshore bonds and equities falling from P49.8 billion to P42.5 billion in the same period. The decrease in 'foreign exchange reserves' reflects, among others, drawdowns of foreign exchange by government and significant adverse valuations, specifically global equity markets towards the end of the year. A rise in 'other investments' was a result of an increase in 'currency and deposits' with parent companies abroad. On the liabilities side, 'direct investment' and 'portfolio investment' increased by 1.9 percent from P51.6 billion to P52.6 billion and by 8.7 percent from P782 million to P850 million between 2017 and 2018, respectively. The increase in direct investment liabilities was mainly from loans extended by parent companies abroad to their subsidiaries in Botswana, especially towards the mining and retail sectors. 'Other investment' declined by 4.6 percent from P28.1 billion to P26.8 billion in the same period.

(ii) Investment in Botswana by Industry and Country Classification in 2017

3.17 Tables 1.11 and 1.12 show the stock of Botswana's foreign liabilities at the end of 2017, classified by industry and country. Investments in the mining, retail and wholesale, and finance sectors constitute the largest shares of foreign direct investment at 35.1 percent, 27.9 percent and 19.9 percent, respectively. The mining activities capture significant inflows, mainly from the UK, with DBGSS dominating the retail sector through its global diamond sales operations. Europe is the major source of direct investment in mining, accounting for 56 percent, of which 50.9 percent is from the UK, where the DBGSS parent company is located. Africa is also a major source of foreign direct investment at 36 percent, of which South Africa accounts for 20.5 percent, most of which is directed to the domestic finance sector.

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

3.18 *Other investment* is mainly driven by government loans. In 2017, government external debt, classified under 'public administration,' amounted to 57.7 percent of 'other investment.' This is followed by the electricity, gas and water category at 18.1 percent, dominated by a loan sourced from China for the Morupule B power project. The finance sector accounted for 9.6 percent of 'other investment'. By region, the largest share of 'other investment' is from Africa, constituting 57.2 percent of the total, with government borrowing from the African Development Bank (AfDB) accounting for 46.7 percent. Other regions and Asia Pacific constitutes 21.2 percent and 18.2 percent, respectively. The former includes government loans from multilateral development banks, such as the World Bank.

Table 1.11: Level of Foreign Investment in Botswana by Industry 2017 (P Million)

Industry	Foreign Direct Investment	Other Investment	Total
Mining	18 116	488.3	18 605
Manufacturing	4 924	94	5 018
Finance	10 251	2 774	13 024
Retail and Wholesale trade	14 384	725	15 109
Electricity, Gas and Water	0	5 219	5 219
Real Estate and Business Services	506	32	538
Transport, Storage and Communication	1 848	135	1 983
Construction	475	0	475
Hospitality	640	75	715
Public Administration	0	16 659	16 659
Other	451	2 676	3 127
Total	**51 594**	**28 878**	**80 472**

Source: Bank of Botswana

Table 1.12: Level of Foreign Investment in Botswana by Region and Selected Countries 2017 (P Million)

Country	Foreign Direct Investment	Other Investment	Total
North and Central America	1 602	167	1 769
Of which			
United States	45	166	211
Europe	28 895	760	29 655
Of which			
United Kingdom	26 286	585	26 872
France	535	15	550
Netherlands	514	0	514
Luxembourg	102	0	102
Other Europe	1 459	160	1 618
Asia Pacific	1 167	5 249	6 417
Africa	18 589	16 527	35 116
Of which			
South Africa	10 555	2 311	12 866
Mauritius	6 849	140	6 989
Ivory Coast	0	13 472	13 472
Middle East	1 306	42	1 348
Other	35	6 132	6 167
Total	**51 594**	**28 878**	**80 472**

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. The policy is also formulated with a view to safeguarding the stability of the financial system. A low and predictable level of inflation and conducive monetary and financial conditions foster savings mobilisation, productive investment and international competitiveness of domestic producers which, in turn, contribute towards the broader national objectives of sustainable economic development and employment creation.

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 into account prospects for economic growth and developments relating to stability of the financial system. To this end, in formulating an appropriate policy stance, the Bank factors in projections of real monetary conditions in the context of other relevant domestic and international economic and financial developments, and their impact on the output gap[33] and, ultimately, inflation. The policy framework recognises the importance of communication in an effort to maintain transparency, predictability and accountability with respect to the policy framework and actions; thus fostering market participation, influencing expectations and policy credibility. In this regard, in addition to the MPS, the Bank publishes the Monetary Policy Report following the April, August and October Monetary Policy Committee (MPC) meetings. Furthermore, the Bank publishes the MPC dates for the year ahead and the Governor delivers a statement at a press briefing subsequent to each meeting of the MPC to allow for engagement with the media and dissemination of the Bank's policy stance.

(b) Interest Rates and Bank of Botswana Certificates

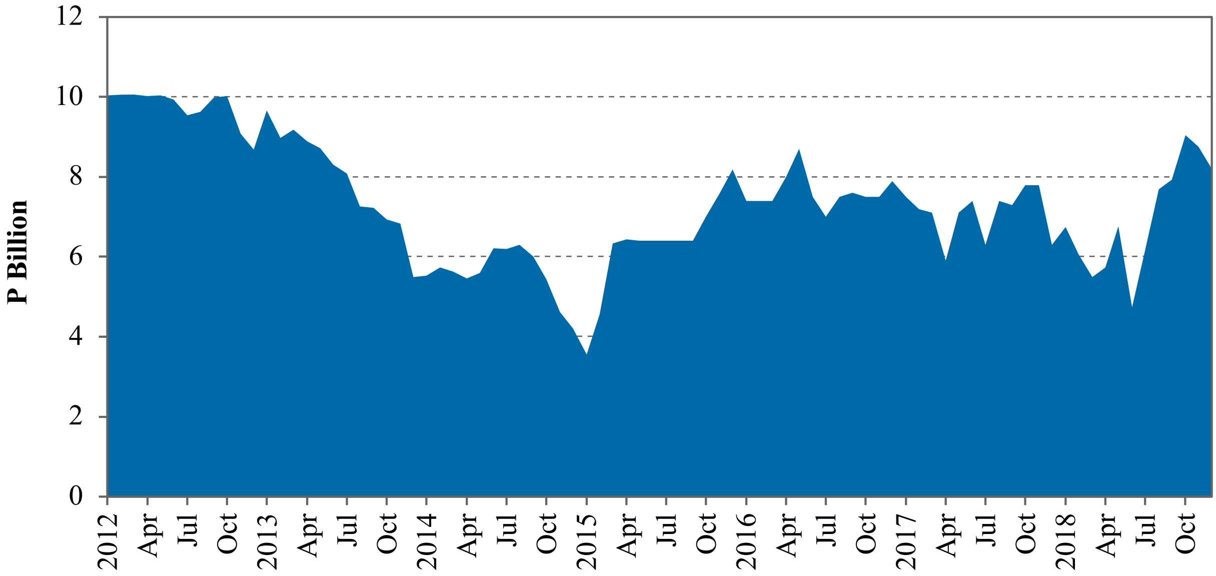
4.3 Monetary policy implementation entailed the use of Bank of Botswana Certificates (BoBCs) to mop-up excess liquidity[34] in an effort to maintain interest rates that are consistent with the monetary policy stance. The Bank had previously introduced measures, including the lifting of the P5 billion cap on BoBCs in November 2016, to improve market efficiency and effectiveness of monetary operations, in particular to better align market interest rates to the policy stance. In the circumstances, outstanding BoBCs amounted to P8.2 billion in December 2018, an increase from P6.3 billion in December 2017 (Chart 1.12), reflecting an increase in liquidity that had to be mopped-up in the same period to anchor the monetary policy stance.

4.4 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. Hence, the Bank Rate was maintained at 5 percent in 2018, and, consequently, the prime lending rate of commercial banks was unchanged at 6.5 percent, while deposit interest rates were, similarly, virtually stable. BoBC yields increased modestly in 2018, reflecting a continuing process of normalisation in money market rates structure. Thus, the 14-day BoBC stop-out yield increased from 1.47 percent in December 2017 to 1.59 percent in December 2018, while the 91-day BoBC stop-out yield also increased, from 1.48 percent to 1.59 percent during the same period. However, consequent to the larger increase in inflation compared to nominal interest rates between December 2017 and December 2018, the real 14-day BoBC rate decreased from -1.68 percent in December 2017 to -1.85 percent in December 2018, while the real 91-day BoBC yield also decreased from -1.67 percent to -1.85 percent in the same period.

33 The output gap refers to the difference between actual output and long-term trend output (as an indicator of the productive capacity of the economy). A negative output gap means the actual level of output for a given period is below the trend level for that period, thus indicating that the economy is operating below its estimated potential.

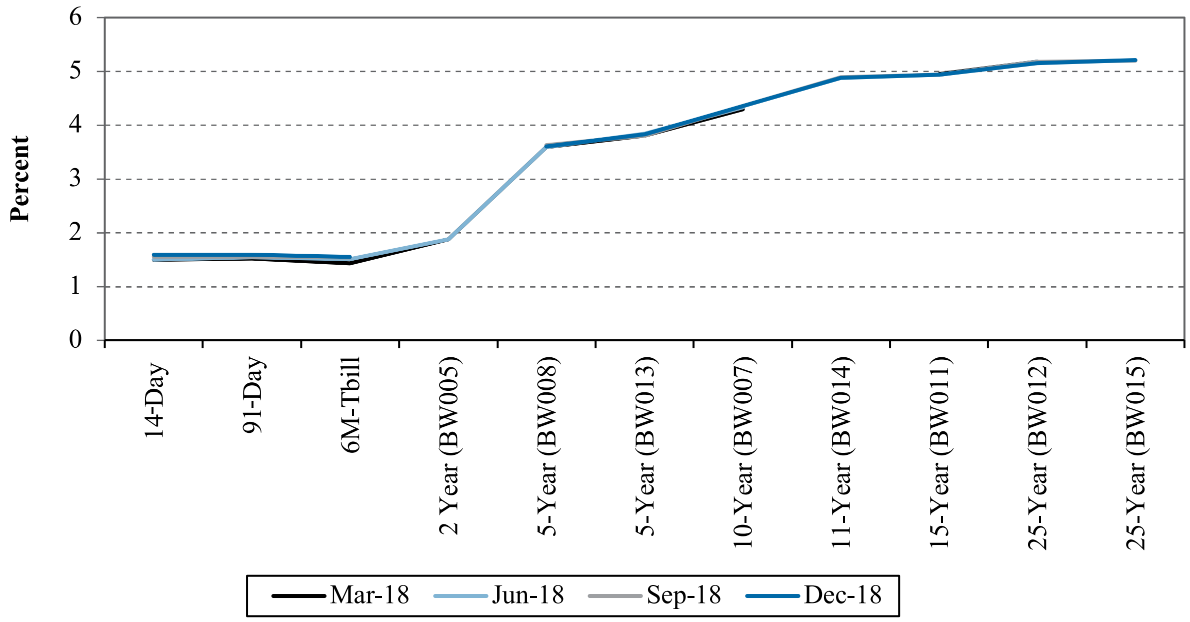
34 Excess liquidity is the sum of commercial banks' overnight deposits with the Bank (current account), money absorbed through BoBCs and outstanding reverse repos, less both repos and borrowing from the Bank's credit facility. This is "excess" in the sense that it is the net liquidity that the central bank has to absorb (take out of the system), over and above the structural liquidity that is held by the banks in the Primary Reserve Requirement accounts.

Chart 1.12: Outstanding Bank of Botswana Certificates



Source: Bank of Botswana

Chart 1.13: Yield to Maturity on Bank of Botswana Certificates and Government Bonds



Source: Bank of Botswana

(c) Banking System

Domestic Credit

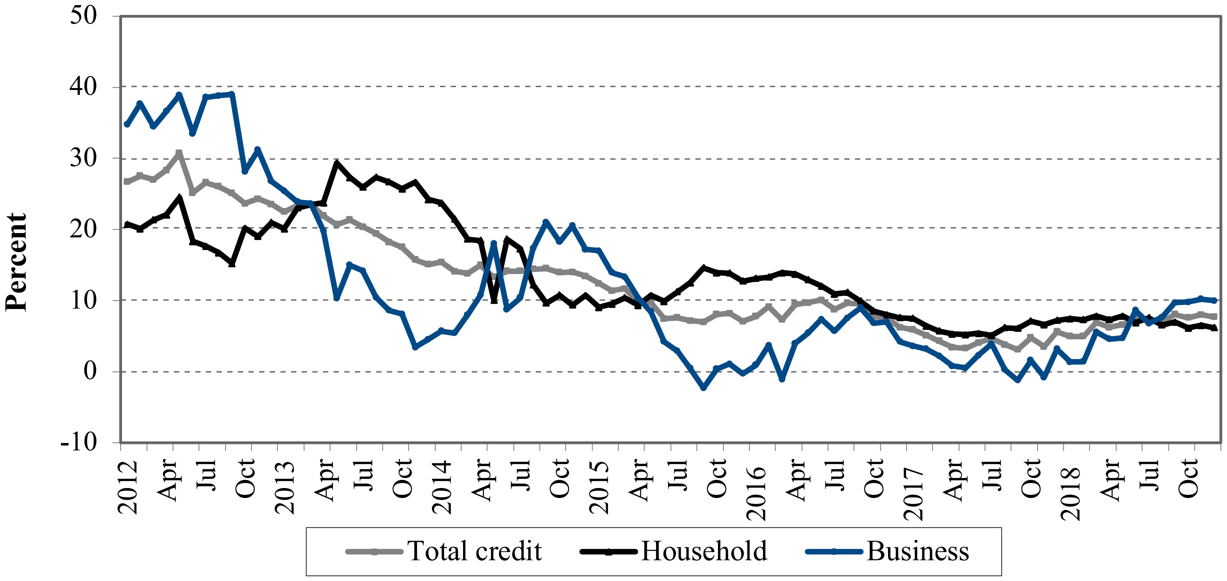
4.5 Annual growth in commercial bank credit accelerated from 5.6 percent in 2017 to 7.7 percent in 2018 (Chart 1.14). The annual credit expansion was mostly associated with a faster increase in lending to businesses, from 3.2 percent in 2017 to 10 percent in 2018, with a notable increase in credit with respect to financing of trade, hospitality, tourism, construction and financial services. For households, annual credit growth decreased slightly, from 7.2 percent in 2017 to 6.2 percent in 2018. The lower rate of increase in lending to households was mostly due to the slower uptake of personal loans, from growth of 9.2 percent in 2017 to 7 percent in 2018. The rate of increase in the unsecured component slowed from 8.8 percent to 6.8 percent in the same period. The share of mortgages in total bank credit to households decreased slightly from 27.8 percent in December 2017 to 27.4 percent in December 2018. Household credit continued to account for a larger proportion of credit, at 60.2 percent of total bank credit in December 2018.

4.6 The level of non-performing loans (NPLs) to total credit remained sustainable at about 5 percent between December 2017 and December 2018. The ratio of non-performing loans to total loans for households decreased from 4.5 percent in December 2017 to 4.2 percent in December 2018; while for businesses, the NPL ratio decreased to 5.3 percent in December 2018, from 6.2 percent in December 2017. In addition, household debt as a proportion of household formal employment income ranged between 46 percent and 50 percent in the period 2016 - 2018. These levels of household indebtedness are considered low by international standards. However, it is observed that household credit is concentrated in unsecured lending (67 percent in December 2018). A concern would arise in the event of high levels of borrowing that are out of line with trends in economic and personal income growth, which would amplify the risk or exposure of households and businesses to economic shocks and may adversely affect their ability to repay debt. Overall, current levels of credit continued to be supportive of economic activity, while risks are sufficiently mitigated by income, collateral, insurance, diversification, as well as prudential supervision by the Bank.

Monetary Aggregates

4.7 The broad money supply (M2) increased by 8.2 percent in the year to December 2018, compared to 2.7 percent in 2017. The year-on-year increase in money supply in December 2018 reflects the expansionary effect of the 7.4 percent increase in credit[35] to the private and parastatal sectors and the 9.7 percent decline in government deposits as well as the 1.0 percent contraction in net foreign assets. By component, the annual increase in transferable deposits (i.e., current accounts) decelerated from 9.4 percent in 2017 to an increase of 0.3 percent in December 2018. Conversely, annual growth of other deposits accelerated from 0.8 percent in 2017 to 10.9 percent in December 2018. Meanwhile, currency outside depository corporations contracted by 3.8 percent in the year to December 2018, from an increase of 7.0 percent in 2017. Deposits in foreign currency accounts (FCAs) in Pula terms increased by

CHART 1.14: YEAR-ON-YEAR COMMERCIAL BANK CREDIT GROWTH



Source: Bank of Botswana

14.4 percent in 2018 after contracting by 3.6 percent in 2017, and accounted for 16.8 percent of total deposits at commercial banks in 2018.

Bank of Botswana

4.8 Total assets and liabilities of the Bank of Botswana contracted by 2.9 percent from P74.3 billion in December 2017 to P72.2 billion in December 2018. The decrease in the Bank's balance sheet in December 2018 was mainly due to the 3.1 percent decline in foreign exchange reserves (including a 15.2 percent contraction in the Pula Fund). However, fixed and other assets increased by 10.2 percent and 18 percent, respectively. The shareholder's total funds, which largely comprise the Government Investment Account, decreased by 15.1 percent, from P57.1 billion in December 2017 to P48.5 billion in December 2018. Commercial bank deposits at the Bank of Botswana (including primary reserve requirement balances) increased slightly, from P2.9 billion in December 2017 to P3.1 billion in December 2018.

Other Depository Corporations

4.9 The balance sheet of commercial banks grew by 9.4 percent from P83.5 billion in December 2017 to P91.3 billion in 2018. On the assets side, loans and advances increased by 7.7 percent from P52.1 billion in 2017 to P56.2 billion in 2018, while the value of debt securities held by banks fell by 8.7 percent. In 2018, deposits of domestic banks in foreign banks increased by 13.2 percent, while "other assets" declined by 11 percent. With respect to liabilities, deposits at commercial banks, capital and reserves and other liabilities rose by 9.1 percent, 10.7 percent and 11.4 percent, respectively, in 2018. Wholesale business deposits remained the main source of commercial banks' funding (76.7 percent of total deposits in 2018). The banks' Credit to GDP ratio was 30.6 percent in September 2018, virtually the same as the 30 percent reported in September 2017.

4.10 Total assets and liabilities of the Botswana Building Society declined by 5.7 percent from P4.3 billion in 2017 to P4 billion in 2018. The decline reflects the 38.7 percent contraction in the Society's cash and deposits in the same period. On the liabilities side, the level of capital and reserves decreased by 47.7 percent from P1.1 billion in 2017 to P595 million in 2018, while public deposits grew by 11.4 percent in the same period.

4.11 For Botswana Savings Bank, total assets and liabilities increased by 0.5 percent in 2018, while loans and other advances decreased by 3.2 percent. Savings deposits declined by 0.7 percent in 2018, from P2.14 billion to P2.13 billion, compared to an increase of 17.6 percent in 2017.

(d) Other Financial Corporations

4.12 The balance sheet of the National Development Bank (NDB) contracted by 18 percent in 2018, from P1.1 billion in 2017 to P938.7 million in 2018, compared to a decline of 30.8 percent in 2017. The bank experienced low recovery of loans, rising impairments and incurred losses. The deterioration in the balance sheet for NDB was attributable to a substantial decline in most categories of assets. Loans and advances, total liquid assets and fixed assets decreased by 21.1 percent, 6.2 percent and 5.2 percent, respectively, in 2018.

4.13 Total assets of Botswana Development Corporation grew by 20.1 percent to P2.8 billion in 2018, from P2.3 billion in 2017. This performance was largely attributable to an increase of 165.9 percent in loans, advances and leasing, reflecting new loans disbursed in 2018. Fixed assets increased from P6.5 billion in 2017 to P181.1 billion in 2018, due to the recording of all lease assets in compliance with the new accounting standard IFRS 16. Meanwhile, investments in related companies declined slightly by 0.4 percent in 2018.

4.14 The Domestic Companies Index of the Botswana Stock Exchange decreased further by 11.4 percent to 7853.5 in 2018, following a decline of 5.8 percent in 2017. The decline was due to the relatively weak performance, in terms of price per share, of several companies, namely: Choppies (-71.5 percent), Botswana Telecommunications Corporation Limited (-48.4 percent), Olympia (-40 percent), Standard Chartered Bank (-25.5 percent) and Letlole (-18.1 percent). There were 1.3 billion shares worth P2.4 billion traded in 2018 compared to 775 million shares valued

[35] Includes credit by commercial banks, Botswana Building Society and Botswana Savings Bank.

at P2.5 billion traded in 2017. The market capitalisation of domestic companies fell by 4.5 percent, from P44.4 billion in 2017 to P42.4 billion in 2018, due to the decrease in share prices of most listed companies. The number of listed domestic companies increased from 24 in 2017 to 26 in 2018, following the listing of Seed Co International Limited in October 2018 and BancABC in December 2018. The Foreign Companies Index decreased by 0.3 percent to 1570.3 in 2018, following a decrease of 0.7 percent in 2017.

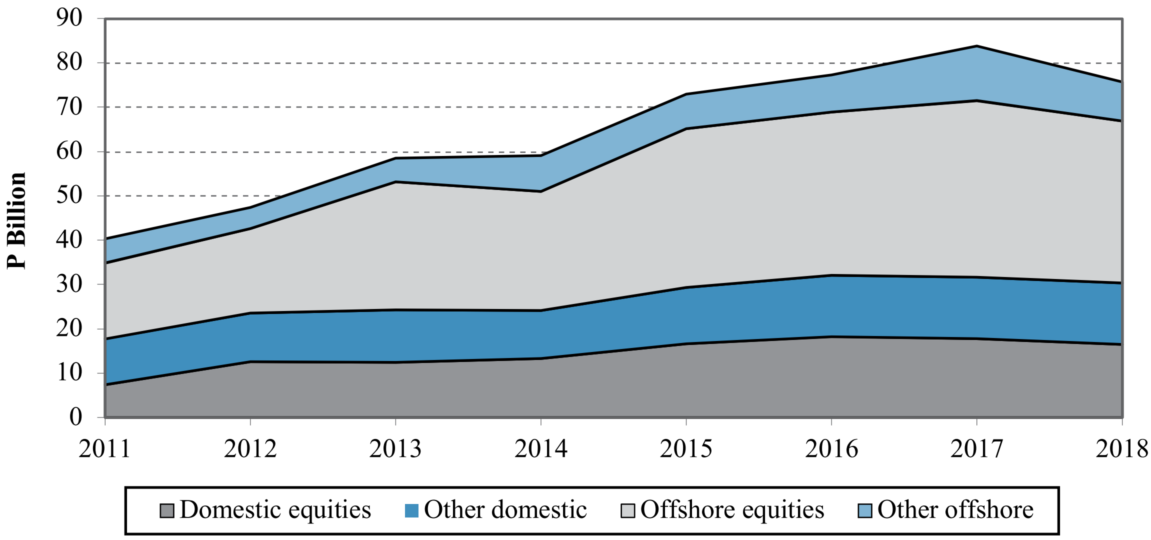
4.15 Pension funds' assets declined by 3.7 percent from P82 billion in 2017 to P79 billion in 2018 (Chart 1.15), reflecting the decrease in investment by BPOPF. By asset class, investment in domestic equities declined by 7.3 percent to P16.5 billion in the twelve months to 2018, while holdings of offshore equities decreased by 8.1 percent to P36.6 billion due to the reduction in prices and unfavourable exchange rates. Meanwhile, the value of domestic bonds held by pension funds increased by 5.1 percent to P8.4 billion, while offshore bonds decreased by 41.1 percent to P5.8 billion in 2018. The proportion of assets invested offshore by pension funds decreased from 63.6 percent in 2017 to 57.4 percent in 2018. The ratio of pension funds' assets to nominal GDP was 58.8 percent in the third quarter of 2018 compared to 60.8 percent in the corresponding period in 2017.

4.16 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 P10.2 billion in 2017 to P10.3 billion in 2018. Primary dealers and their customers held P3.2 billion (31 percent) and P7.1 billion (69 percent), respectively, of the government securities at the end of 2018.

(e) Credit Rating

4.17 The annual Credit Analysis Update Report, released in October 2018 by Moody's Investors Service (Moody's), and S&P Global Ratings affirmed Botswana's ratings of A2 and 'A-/A-2', respectively, for long and short-term bonds in domestic and foreign currency. The outlook has been reaffirmed to be stable by both credit rating agencies. The strong external and fiscal balance sheets, a well-managed economy and low public debt, as well as the country's robust public institutions and a stable political environment, support the ratings. However, there continues to be concern about the narrow economic base and relatively slow progress in economic diversification.

CHART 1.15: BOTSWANA PENSION FUND ASSETS (2011 - 2018)



Source: NBFIRA

Chapter 2
Botswana - Financing Strategies for Industrialisation and Transition to High Income Status

1. Introduction

1.1 The Government has adopted an industrialisation strategy premised on harnessing the country's economic potential and value chains in relation to endowments, including natural resources and sectors/areas (industrial clusters and/or hubs), where there is prospective comparative advantage for the country. In this regard, mining, agriculture, tourism, health and financial services sectors were identified as having potential to lead Botswana's industrialisation. As a contribution to evaluation and propagation of the strategy, the Bank's 2016 *Annual Report* highlighted the relevant broad themes. In turn, the Bank's 2017 *Annual Report* narrowed the discussion to prospective developments and the relevant policies for beneficial evolution of the financial sector and its impact on sustainable and inclusive growth; thus recognising the positive correlation between financial sector development and economic growth. It is, therefore, opportune that the 2018 *Annual Report* identifies and evaluates practical approaches to implementation of the country's industrialisation strategy; in this instance, effective harnessing of finance as a resource and input to expansion and also to enhancing productivity of the identified sectors.

1.2 As discussed in previous Bank of Botswana *Annual Reports*, the various requirements for industrialisation leading to sustained and inclusive growth relate to policies, regulation, institutional and governance arrangements, administrative aspects, markets and inputs, including infrastructure, utilities, skills and finance. The state of Botswana, as assessed relative to other countries on these factors, is apparent from the Competitiveness and Doing Business indices and rankings published by, among others, the World Bank and World Economic Forum. These institutions consistently list lack of access to finance, especially to small, micro and medium-sized enterprises (SMMEs), as one of the top constraints to doing business in Botswana.

1.3 Internal policy review also helps to evaluate performance and inform policy initiatives, for example, as articulated in National Development Plan 11 and the Financial Sector Development Strategy 2012 – 2016. Furthermore, Business Expectation Surveys (BESs) of local firms also rank lack of finance as a challenge to successful business operation and, in particular, entrepreneurship. In this respect, finance is recognised as a key input to performance of individual firms, sectors and industry generally. Therefore, having identified specific sectors to spearhead industrialisation, it is appropriate, at this point, to narrow down the analysis and evaluation, to the impact of finance in raising output and productivity of the identified sectors. In particular, it would be informative to assess the existing allocation of finance/financing arrangements for these sectors and, in turn, examine the alternative approaches that could better serve the industrialisation strategy. It is recognised that idiosyncratic aspects relating to agriculture, mining, tourism and services could rank higher in influencing performance and productivity. However, it is important to ensure that financial sector policies are not a constraint and that they are appropriately calibrated to support exploitation of business opportunities, as well as the optimisation and productive allocation of finance. The following key considerations and analytical aspects are relevant for the discussion.

1.4 First, the country's strategies for industrialisation and development of citizen businesses and entrepreneurship encompass the use of development finance institutions and targeted support (to augment self- and private financing). There is, therefore, a need for evaluation of the effectiveness of this approach, and identification of any improvements and/or variations that might be beneficial. Second, it continues to be necessary to reconcile the apparent financing gap, in terms of both the quantum and quality of funding (therefore, productivity of investment) with the availability of funds/liquidity in the market, as well as explore the potential for external resource mobilisation. Alternatively, consideration could be given to beneficial repatriation of externalised funds (assuming adherence to prudence and governance arrangements). Third, given the desire for Botswana to make the transition to high-income status, it would be instructive to undertake an in-depth assessment of the approaches to financing of industrialisation (in particular, any targeted sectors) by some countries that have overcome the middle-income trap.

1.5 Overall, it is appropriate to link the evaluation and policy considerations to the current structure of allocation of finance to the identified cluster/hub sectors and, therefore, explore the need and prospects for enhancements to ease any financing constraints. In addition, there is need to acknowledge the prospects for adjustments and evolution with respect to macroeconomic policies and regulatory frameworks, in order to ensure they remain relevant, facilitative and appropriate for maintenance of stability.

1.6 As a thematic continuation, the discussion will expound on some of the concluding observations of the 2017 *Annual Report* theme topic and articulate alternative financing models and resource mobilisation approaches that are likely to best serve the cluster/hub industrialisation strategy and advance the country to high-income status.

1.7 This Theme Chapter is organised as follows. Section 2 discusses industrial clusters, hubs, and SMMEs as they relate to the industrialisation strategy. Section 3 reviews the existing financing options and their funding of industrialisation initiatives in the past; their weaknesses and ways they could be enhanced to ensure the continued adequate funding of selected sectors in order to generate well-balanced economic growth and propel the country to attain a high-income status. A comparison between Botswana's financing and industrialisation strategies and those of successful countries in these areas is made in Section 4, which also proposes some key lessons to be drawn from these country experiences. Section 5 provides a perspective on measures to enhance policy and institutional considerations going forward, to foster industrialisation and transition to a high-income status. Finally, Section 6 provides conclusions and recommendations.

2. The Case for Special Economic Zones, Cluster and Hub Industrialisation Strategy

2.1 Industrialisation through the successive stages is a key factor in the achievement of sustainable and inclusive growth, employment creation and improved standards of living. Several countries have embarked on an industrialisation drive, through the creation of Special Economic Zones (SEZs), industrial clusters and hubs. SEZs are designated areas in a country where targeted incentives that are different from other locations are provided. These include special dispensations relating to regulations, trade and tax laws, access to finance, technology and infrastructure. Such incentives are offered in order to attract both foreign and domestic businesses to the areas, and ultimately facilitate economic growth. In addition, the SEZs are closely linked to, and nurture domestic enterprises and industrial clusters through supply or value chains. This connection does not only help with the achievement of economies of scale and business efficiency, but also stimulates synergistic learning and enhances industrial competitiveness.[36]

2.2 SEZs are selected based on, among others, the uniqueness of the locality in the economy, availability of relevant labour skills, other productive resources and infrastructure. The world's first known SEZs can be traced to the 1947 industrial park set up in Puerto Rico. This was followed in the 1960s by Ireland and Taiwan. However, a breakthrough occurred in the 1980s through China's largest SEZ consisting of the metropolis of Shenzhen.[37] In the 1990s, Africa saw a rise in the type of SEZ known as an Export Processing Zone (EPZ). Currently, the SEZs are spread globally, with the most effective ones in Asia, followed by Latin America and the Caribbean. Mauritius is considered a successful EPZ due to its high

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36 Zeng, D. Z., (2010). "Building Engines for Growth and Competitiveness in China: Experience with Special Economic Zones & Industrial Clusters," World Bank, Washington, DC.

37 http://studybay.net/it/free-essays/special-economic-zones-sez-features-and-benefits.

level of employment creation, gross and net exports and its ability to receive high levels of foreign direct investment (FDI).[38]

2.3 The most successful SEZ story is that of China which, together with economic clusters, have turned around the performance of the Chinese economy. "By 2016, Chinese SEZs contributed 22 percent of China's gross domestic product (GDP), 45 percent of total national FDI and 60 percent of exports. These SEZs have also increased the income of participating farmers by 30 percent and accelerated industrialisation, agricultural modernisation and urbanisation."[39] However, not all SEZs have been that successful globally. In India, SEZs contributed hardly 4 percent of GDP and 25 percent of exports, while only 223 are operational out of 420 approved SEZs.[40]

2.4 Increasingly, there is a worldwide realisation that the creation of sustainable businesses and strong industries requires clustering together of related or mutually dependent businesses in a locality that provides a conducive operating environment. Thus, related to the SEZs are clusters and hubs, which refer to a geographic concentration of interconnected businesses, suppliers and associated institutions in a particular area. Given the market opportunities, this arrangement encourages specialisation by industries, hence increasing their productivity and output, while reducing costs. Therefore, if successfully executed, the SEZs, clusters and hubs arrangement can accelerate innovation, industrialisation, creation of employment opportunities and access to markets (domestic and foreign) through competitive products and services.

2.5 Typically, economic clusters are made of an interrelated range of small to large producers, suppliers and users of goods and services, including suppliers of support services from both the private and public sectors: thus a symbiotic market structure that incorporates services and logistical support. The cluster development strategy is often anchored on natural endowments, areas of competitive advantage and locations where there is concentrated government and institutional support. While, traditionally, economic clusters were established on physical locations and structures, increasingly they can also operate on virtual platforms that use the internet as a medium of operation. Broadly, in addition to key attributes relating to natural endowments and competitive advantage, the other key inputs to a successful strategy include, inter alia, the following:

(i) well-articulated policy framework and vision that covers both the investment and industrialisation aspects;

(ii) sound macroeconomic environment and policy certainty;

(iii) effective support institutions and legal framework, that is, good quality public institutions, in general;

(iv) good and accessible infrastructure, utilities and logistics;

(v) access to resources which include skills, finance and welfare elements, such as education, health and social amenities;

(vi) practical and detailed implementation plans, a clear timeline for action and a division of responsibilities among the public and private sectors;[41]

(vii) flexible labour markets;

(viii) trust in the political system;

(ix) supportive government bureaucracy;

(x) judicial efficiency reflected in, among others, timely adjudication and enforcement of property rights and business contracts.

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38 www.specialeconomiczones.com.

39 Political Economy of Special Economic Zones: China vs India.

40 T. E. Cheong, (2018). The Key Success Factors of Special Economic Zones.

41 United Nations Conference on Trade and Development (UNCTAD), World Investment Report, 2018.

(a) Special Economic Zones, Cluster and Hub Industrialisation in Botswana

2.6 In pursuit of the broader industrialisation agenda, and need to attract world-class domestic and foreign investors, the Government adopted the Special Economic Zone Policy in 2010 (SEZs Policy) to provide a framework that formalises the establishment of SEZs. This was followed, in 2015, by Parliament's approval of a Special Economic Zones law to streamline investment into the eight sector-targeted geographic areas (outlined in paragraph 2.8). The overarching objective of establishing the SEZs was to encourage economic diversification and bolster exports to overcome challenges posed by the relatively small domestic market. In addition, the SEZs are expected to create job opportunities, boost foreign exchange earnings and, ultimately, broaden sources of tax receipts, hence government revenues, once the tax incentives are lifted.

2.7 Related to SEZs is the Cluster Development Strategy,[42] undertaken in the context of economic hubs established to coordinate activities in various economic sectors. The Special Economic Zone Authority (SEZA), established in 2016, oversees the implementation of the SEZ programme. Botswana has so far identified six hubs, including those for agriculture, diamonds, transport, education, innovation and health. Among these economic hubs, a number of business clusters have also been earmarked, including, the core areas of diamonds, the traditional sectors made up of beef, mining and tourism and the emerging ones, which include financial, education and health services. The hubs are intended to offer investors a transparent, predictable, free and fair environment for doing business, which is, in turn, expected to allow enterprises in Botswana's SEZs to produce globally competitive goods and services. Thus, a business friendly environment is important for achieving the country's objectives of developing a vibrant and globally competitive private sector, industrial development, economic diversification, employment creation and poverty eradication. Table 1 provides a description of the common types of SEZs. The model for each of the SEZs identified in Botswana is defined based on one or more of these zone types or a combination of some. The identification of the Zones was preceded by sectoral studies, which defined the attributes of the zone that may be developed in the area and the relevant zone configuration to adopt. However, a master plan and detailed designs would be developed in order to reaffirm the types of SEZs and sectors to be adopted.[43]

Table 1: Types of SEZs and their Intended Purpose

Type of SEZ	Intended Purpose
EPZ	To primarily focus on foreign markets for domestically produced goods and services.
Enterprise Zone	To revitalise distressed urban or rural areas, via tax incentives and grants.
Free Port	A location that accommodates all types of activities; that is, provides a broader set of incentives and benefits.
Single Factory EPZ	Provides incentives to an individual enterprise, regardless of location.
Specialised Zone	Includes science and technology parks.

Source: Ministry of Investment, Trade and Industry (MITI)

2.8 According to the 2016 Budget Speech, the implementation of the SEZ programme was to be done in three (3) phases. Phase I includes three sites, namely: (a) the mixed use site near Sir Seretse Khama International Airport, comprising international diamond activities, auto components manufacturing, agro-processing, pharmaceuticals, and general manufacturing; (b) the Gaborone Fairgrounds site for financial services; and (c) the Pandamatenga site for integrated farming, agro business and food processing. Activities under

42 Government, following Professor Michael Porter's presentation to the Economic Committee of Cabinet in 2012, further embraced this strategy.

43 SEZA and MITI.

Phase 1 commenced in the 2016/2017 fiscal year. Phase II of the SEZs is planned for the Francistown, Selebi-Phikwe and Lobatse areas, while Phase III will focus on the Tuli Block and Palapye areas.

2.9 In September 2018, it was reported that Government was working on legislation, to be finalised in December 2019, that would fast track the processing of applications for the change of land use so that the land owners can benefit from its optimal utilisation. SEZA had raised concern with regard to issues of land allocation and availability of land to be zoned and that these were impeding the Authority from performing its mandate, and thus delaying progress.[44] The success of SEZs is also dependent on, among others, site location; competition policies; good/proper zone development practices; less cumbersome government procedures and controls; effective coordination and adequate administrative structures, with few bodies involved in zone administration.

2.10 Furthermore, to ensure the sustainability of the SEZs, there is a need to take advantage of achieving economies of scale within the frameworks of the Southern African Development Community (SADC) and the Southern African Customs Union (SACU) trade preferences[45] to expand the limited/small domestic market. These include the SADC Free Trade Area and the European Free Trade Agreement with SACU. Additionally, the growth of local industries can be supported by prioritising the participation of SMMEs, by developing targeted local supply chain linkages, which would nurture the micro and small domestic businesses, while ensuring that they remain commercially viable. This would, in addition to other supportive factors, attract business to the SEZs, which would survive competition and continue to operate after the reduction or expiry of incentives.

2.11 Evidence from many parts of the world suggests that SEZs have the potential to spur growth and employment. For example, during the 1980-1986 period, EPZ firms in Mauritius created 30,000 jobs, and were seen as a major instrument for reducing economy-wide unemployment from 17 to 12 percent.[46] The unemployment rate in Mauritius declined further to 5 percent in 1990 as growth in value added from the EPZs averaged 30 percent annually, between 1983 and 1988.[47] The Jebel Ali Free Zone in Dubai experienced substantial growth in companies, from 19 in 1985 when the SEZ was established, to 7 000 in 2012, employing 170 000 people, or 13 percent of Dubai's workforce during that year. In the Dominican Republic, employment in the industrial free zones rose from 500 in 1970 to almost 200 000 in 2007. In Costa Rica, the EPZ share of manufactured exports jumped from less than 10 percent in 1990 to 55 percent in 2003, with export items changing from mainly apparel and textile products and electronic components to a wide array of manufacturing products, including high technology exports, for example, Intel microchips.[48]

2.12 In Madagascar, a USD165 million World Bank SEZ-related project contributed to a tenfold increase in the stock of formal enterprises and a near sevenfold increase in the number of formal jobs in the growth poles of Fort Dauphin and Nosy Be, despite a complex political environment. The project successfully integrated a number of reforms to improve the business climate and job creation around these growth poles.[49]

44 Business Botswana Annual General Meeting, 2018.

45 Marandu, E. E., and Amanze, D., (2016). "Developing Sustainable Special Economic Zones in Botswana: A Conceptual Discussion." Archives of Business Research – Vol.4, No.6.

46 Gulhati, R., and Nallari, R., (1990). "Successful Stabilisation and Recovery in Mauritius." Economic Institute of the World Bank. Analytical Case Studies; No. 5. World Bank Institute Case Studies. Washington, DC: The World Bank.

47 Curran, S., *et al.*, (2009). "The Impacts of Special Economic Zones," Evans School of Policy Analysis and Research.

48 Foreign Investment Advisory Service, (2008). "Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development," The World Bank, Washington DC.

49 World Bank Group, 2016.

(b) The Role of SMMEs in the Industrialisation Process

2.13 The contribution of SMMEs to the development of the world economy is significant, both in terms of contribution to GDP and employment creation,[50] in both developed and developing economies. In particular, SMMEs tend to be more adaptive, responsive to the changing economic environment, less resource intensive, work with less capital, but are more labour-intensive and operate with low cost management and support services.

2.14 The flexibility of SMMEs, resilience to adverse economic conditions, and low contagion effect, contribute to a diverse and stable ecosystem. As a result, many countries have established policies and support structures for SMMEs, as they are considered important stakeholders for advancing competitiveness, entrepreneurship, innovation and broadening of gainful economic activity and income earning opportunities. There is, therefore, a need for an integrated strategy to support SMMEs, as part of the industrialisation strategy. Among others, this needs to encompass training, access to information, provision of financing, assistance in accessing modern technology and a generally favourable macroeconomic environment. These efforts are in recognition of the fact that the SMME sector faces challenges that call for substantial interventions by government and other related stakeholders. These challenges include constrained operational capacity; limited management and entrepreneurial skills; lack of initiative to engage in sophisticated business endeavours; lack of bankable collateral; poor quality of products and services; lack of trade and industry-related information; and poor planning.

2.15 In the case of Botswana, the Government continues to implement strategies and policies aimed at nurturing the SMME sector. To this end, in mid-2018, the Ministry of Investment, Trade and Industry (MITI) announced the proposed new strategy of the 'Apex Model.'[51] The strategy comprises three apexes of: (a) SMME development, (b) investment promotion and (c) export development. Under the SMME development apex, the focus would be on easing the regulatory burden on SMMEs, to facilitate their participation in the country's industrialisation process.[52] The investment promotion apex is intended to alert potential (domestic and foreign) investors, with the capacity to provide capital, jobs, skills and technology to the local market, of investment opportunities in Botswana. The final apex of export development seeks to explore export-led growth by promoting export of goods for which the country has a comparative advantage. This encompasses the creation of market access through negotiation of trade agreements with strategic partners, identification of priority sectors according to export readiness and capacity development of export incentives. The objectives of the three apexes are to support the MITI mandate of creating a conducive environment for the promotion of investment and development of sustainable industries and trade, thereby diversifying and growing the economy. At the same time, wealth and employment would be generated, to facilitate prosperity for all.

2.16 In the SADC region, governments have introduced policies, initiatives and programmes that support the development and financing of SMME.[53] However, these efforts have been largely ineffective in sustaining and promoting the SMME sector, with the failure and exit rates of these business entities being generally high.[54] In Botswana, it is estimated that SMMEs contribute about 35 percent to GDP, as well as contributing meaningfully to employment creation, economic diversification and poverty alleviation.[55] Despite the challenges that SMMEs in Botswana face, such as competition from cheaper imports, especially from Asia, their ability to become more innovative and,

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50 UNCTAD, (2018). World Investment Report.

51 The APEX Model appears to be an operational structure, rather than a fully-fledged strategy like the IDP.

52 Honorable Minister Kenewendo, B., (2018). Ministry of Investment, Trade and Industry, Botswana.

53 SADC, Development Finance Resource Centre website.

54 Nemaenzhe, P. P., (2010). "Retrospective Analysis of Failure Causes in South African Small Businesses," University of Pretoria, September 2010.

55 Mutoko, W. R., (2014). "Challenges of Access to Markets and Opportunities for Small, Medium and Micro Enterprises (SMMEs) in Botswana," Botswana Accountancy College, August 2014.

hence, more competitive and their ability to access the value and supply chains of larger corporates should ensure their survival going forward. Also, adoption of appropriate technologies, including in digital marketing and sales channels (e-commerce), would help the SMMEs to become commercially competitive.

(c) Special Economic Zones/Cluster Financing

2.17 Botswana, like other developing countries, especially in Africa, is facing constraints in developing and funding infrastructure projects, which limit the speed of development and industrialisation and, therefore, restrain economic prospects. Long-term growth and competitiveness of countries, including Botswana, are very much dependent on, among others, infrastructure development and, more specifically, the related infrastructure needed to support the cluster/hub industrialisation process. To this extent, Government has undertaken to make budgetary provisions to ensure the success of the SEZ initiative. For the six-year NDP 11 period (April 2017-March 2023), a total of P960 million has been allocated to MITI for the economic cluster project. Of this amount, P500 million under infrastructure development, is devoted to funding of the special economic zone common facilities. P225 million is allotted to the leather industry park. Furthermore, of the P230 million budgeted for the Doing Business Reforms, P100 million will be used in implementing the operations of SEZs.

2.18 The rest of the funds under the Doing Business Reforms are devoted to measures aimed at improving the business environment, such as the establishment of the Competition and Consumer Tribunal and the Consumer Protection Unit. However, NDP 11 is in its second year of operation; hence, the Monitoring and Evaluation (M&E) strategies to be implemented during the Plan are yet to report on progress made in the 2017/18 fiscal year. The M&E would provide an indication of whether the budgetary allocation to the SEZs project is sufficient and whether milestones are achieved on time and within budget.

2.19 Nevertheless, in addition to public funding, it is imperative that concerted effort, through deliberate policies, be directed at devising viable financing options for a sustainable and inclusive industrialisation drive that would boost exports and transform Botswana into a high-income country. These efforts would involve a critical analysis of the current model of financing industrialisation in targeted sectors, industries and locations in Botswana, which is heavily dependent on government incentives and available alternative funding methods, some of which were discussed in the Bank of Botswana 2017 *Annual Report*. Section 3 below considers some of the options and approaches.

3. EVALUATION OF FINANCING OPTIONS IN BOTSWANA

3.1 Generally, financing options for industrialisation fall under three broad categories, namely; government, development finance institutions (DFIs) and private sector financing, with relative sizes influenced by the national development priorities, policies and market maturity. To this can be added external options such as multilateral funds and arrangements targeted at industrialisation and supportive infrastructure. In general, direct government financing mostly involves infrastructure projects and social amenities that facilitate economic activity, business processes and welfare enhancements. This is more so in a developing country context, where the size and maturity of the financial sector may be inadequate to manage relatively large and long gestation infrastructure and social projects. In addition, at a relatively small scale, governments or designated agencies engage in funding and enterpreneurial development for small scale businesses and targeted cohorts of society, such as youth, women, rural community and low income segments of society.

3.2 In turn, various forms of private sector financing options are available for general economic activity, including for businesses and households. However, in several instances, it is considered that there is, for various reasons, market failure (beyond larger projects and micro and low return activity) that militates against desired development objectives and private sector needs. This is mostly the case for developing countries and where there is an urgent need for rapid industrialisation. In the circumstances, development finance institutions are established to address the market failure and close the funding gap, in particular. Elements of these funding options and track record for Botswana are discussed below.

(a) Government Financing and Entrepreneurship Development Programmes

(i) Large Scale Infrastructure Development and Service Provision Financing

3.3 Availability and continuous modernisation of infrastructure and public and social services is key to the industrialisation strategy, as these are inputs, as well as facilitative of business operations (although often the welfare accruing to people dominates discourse compared to emphasising the impact on business/industry operations and performance). For Botswana, there has been continuing commitment in this regard in terms of funding of infrastructure and social projects, including those dedicated to specific industrialisation projects. Significant aspects include:

(a) a medium-term planning process (National Development Plans) that identifies and allocates funding to build infrastructure and social services according to development objectives and need;

(b) a fiscal rule that incorporates the allocation of mineral revenue to the development budget (physical infrastructure, education and health), which is targeted at 30 percent of total expenditure and net lending;

(c) average annual growth in development expenditure of 13.6 percent in the last five years and, on average, amounting to 25 percent of government spending;

(d) evident growth and improvement in coverage of infrastructure and services, for example, roads, electricity, water, internet and mobile connectivity and related services;

(e) development of urban infrastructure to support the mining and tourism economic hubs in Orapa, Jwaneng, Selebi-Phikwe, Sowa and Maun/Kasane; and

(f) direct equity participation and partnerships in major production and export activities, including mining (diamonds, copper and soda ash) and beef production.

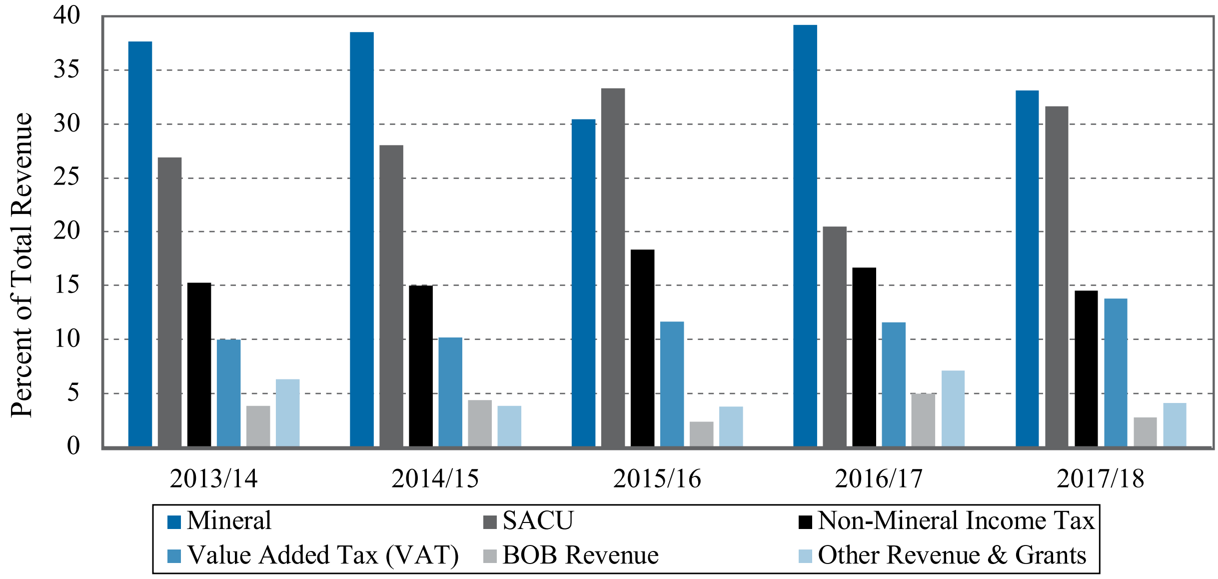
3.4 Government funding in Botswana is mostly backed by revenue comprising mainly mineral and SACU receipts (33.1 percent of total revenue in 2017/18), while income, property and consumption taxes play a lesser role (Chart 1). Additionally, government has, over the years, relied on concessional debt to augment financial resources or fund specific projects. Where necessary, the goverment also withdraws savings to support spending. Up to 2000, the fiscal budget was almost always perennially in surplus, while deficits have been common since 2001. Even then, fiscal policy and rules focus on medium term budget balance, involving the accumulation and saving of surpluses that are then available for countercyclical policy (deficit financing) when needed.

3.5 Going forward, there is scope to expand tax coverage and cost recovery, which could also be a derivative of enhanced industrialisation and broad-based improvement in living standards. For example, as highlighted in the International Monetary Fund (IMF) 2015 and 2018 Article IV Reports, there is significant scope to improve collections through reforms to improve value-added-tax collection, reviewing tax exemptions and reforms to property taxation. Moreover, privatisation and, where feasible, user charges for government infrastructure and services, could contribute to revenue while at the same time reducing the fiscal burden involved in funding state-owned enterprises and the provision of social services.

(ii) Sovereign Wealth Funds as a Potential Source of Government Financing

3.6 In certain circumstances, Sovereign Wealth Funds (SWFs) may be a source of funding for long-term investments. However, it should be recognised that SWFs must have 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

Chart 1: Government Revenue Components



Source: Ministry of Finance and Economic Development

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 public investments must be consistent with this framework, rather than on an ad hoc basis to bridge funding shortfalls. For this reason, SWFs typically include clear guidelines for withdrawals.

3.7 Botswana's Pula Fund (akin to a SWF) is a long-term fund that forms part of the country's foreign exchange reserves. The Pula Fund has increased substantially in value since its establishment in 1994 due to accumulation of budget surpluses and success of the investment strategy. 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. In turn, this would have implications for its management and subsequent withdrawals from the Fund. Foreign SWFs are also generally available as part of FDI, inward portfolio investment and private equity financing.

(iii) Small to Medium Scale Government Financing Options

3.8 For Botswana, the need to close the financing and managerial constraints to business growth and success has long been recognised by government, and this has, over the years, led to the establishment of several support institutions, schemes and/or policies. Thus, the Government's small to medium scale financing arrangements encapsulated, to varying degrees, funding, entrepreneurship development and business support. These arrangements have evolved over time, with notable examples being the now defunct Botswana Enterprises Development Unit (BEDU), Financial Assistance Policy (FAP), Tswelelo (Pty) Limited and Botswana Cooperative Bank. The demise of these institutions was mostly due to failure to meet the objectives of generating sustainable businesses; thus continuous/endless allocation of financial resources with no tangible results in terms of viable businesses and entrepreneurs. In this regard, the limited success of these institutions and schemes was mainly because of a combination of the institutional shortcomings (limitations with respect to project evaluation and monitoring) and sub-optimal performance by beneficiaries (including weak management and misdirection of funds). Thus, despite the availability of funding, clear industrialisation objectives and support initiatives, as well as business opportunities, governance and entrepreneurship (the key success factors) deficiencies appear to have been the significant constraints to business success and industrialisation.

3.9 Even then, several development finance institutions remain, having survived through successive restructuring and renewal of their respective mandates or being newly established. Below is a broad generalised assessment of their impact on industrialisation and prospects/potential going forward.

Botswana Development Corporation (BDC)[56]

3.10 The Corporation (BDC) provides financial assistance to investors with commercially viable projects and offers both debt and equity financing to pioneer new industries; unlock value in existing industries; stimulate private sector growth; and foster linkages with local industry. It also seeks to drive diversification, growth of exports and create employment opportunities. To this end, BDC can be credited with early industrialisation efforts in manufacturing, property, air transport, financial services and agriculture. In a number of instances, there has been successful divestments to private ownership and sustained good performance and growth of individual firms. Moreover, the property development function, in terms of factory shells, office and retail space, as well as residential property, was facilitative of industrialisation. At the same time, there have been missed opportunities, most notably the failure of the glass project in Palapye, Seleka horticultural farms and delayed uptake of the leather park project in Lobatse, where there could be potential for value-adding industry linkages and employment.

3.11 The recent consolidation and rationalisation efforts have been beneficial in terms of improvements in governance, financial performance and beneficial engagement in revitalisation and rationalisation of subsidiary companies. The key consideration going forward would be whether the level/scale of operation of the BDC can be commensurate with the envisaged cluster and SEZ industrialisation strategy and the sectoral/industry growth aspirations. In addition, while the diversification into foreign investments makes business sense in terms of an inward-looking business viability and profit/return perspective, it may be that there is a resource loss from the domestic industrialisation dimension with respect to reduced local funding and managerial/strategic focus on growth of the domestic industries. Overall, there is need for focused consideration on whether the BDC is integral to the cluster and rapid industrialisation or its focus is deliberately diluted to include foreign ventures (with the attendant benefits). It is notable, in this regard, that resource diversification into foreign markets already exists in the form of foreign exchange reserves (managed by the Bank), pension and other wealth management funds, as well as private investors.

National Development Bank (NDB)

3.12 The NDB[57] focuses on lending to various industries and agriculture, and has more recently covered the household sector and is mostly funded by Government, augmented by borrowing from domestic banks and external entities (i.e., bonds and other wholesale credit facilities). It is possible that access to funding from NDB has contributed to business development and (beneficial) economic activity over time. However, perennial lacklustre performance of the institution and the funded businesses/projects (evidenced by the number, value and persistence of non-performing loans and capital erosion) broadly suggests sub-optimal contribution and value addition to the country's economic performance. There is, therefore, a concern that the performance of NDB has been well below expectations and its potential not fully exploited; hence sub-

[56] Sentsho J. *et al*., (2007). "Performance and Competitiveness of Small and Medium Sized Manufacturing Enterprises in Botswana." Bay Publishing, Gaborone.

[57] Pansiri J., and Yalala, A.T., (2017). "The Evolution of Entrepreneurship and Small-to-Medium Business Development in Botswana." Botswana Journal of Business Vol 10 No 1.

optimal contribution to the industrial effort. In addition to availing funding, the development and welfare benefits of financial intermediaries include infusion of business viability and value addition through professional project/proposal evaluation, disciplined monitoring of use of resources and business activity, guidance and performance support. Moreover, there is a need for inculcation of discipline and the consequences of venture or business failure are allowed to be impactful, therefore, induce appropriate learning and response. These aspects are evidently lacking in the case of the NDB, hence the lacklustre performance of funded projects, weak loan recovery and a recurrence of financial losses which, ultimately, are borne by the Government. Among the reasons for low achievement by NDB are the weak enforcement of loan recovery and apparent acquiescence by Government in facilitating recurring recapitalisation, not conditioned on demonstrable effective managerial performance and a viable and sustainable recovery strategy.

3.13 In the circumstances, it is clear that a refocus is needed to enable the bank to play a meaningful role in the execution of the industrialisation strategy. This is achievable to the extent that resources continually availed to NDB add to economic expansion and vibrant activity. Evidence, in this regard, should be easily demonstrated by viability of the NDB funded projects and businesses that generate positive returns and are able to pay back loans; facilitating going concern for the bank and less need for recapitalisation to cover for losses (indeed any recapitalisation should be to contribute resources for additional business and economic activity).[58]

Botswana Savings Bank (BSB) and Botswana Building Society (now BBS Limited)

3.14 The BSB and BBS Limited are essentially retail financial institutions. Their contribution to industrialisation is indirect through facilitating household demand (and contribution to aggregate demand). For BSB, the potential role is with respect to spreading financial inclusion and harnessing the opportunities provided by financial technology; thus enhanced geographical coverage, savings mobilisation and payments and remittance platforms. Regarding BBS Limited, there is significant scope to increase mortgage financing supported by land registration reforms, internal product development and strategy, as well as consumer awareness.

Citizen Entrepreneurial Development Agency (CEDA)

3.15 The establishment of CEDA followed evaluation of the Financial Assistance Policy (FAP), which, in the 1980s, was a key element of the Government's industrial development policy, and operated for about two decades. The policy, which covered small-medium to large scale businesses, was intended to address sluggish growth in employment opportunities; lack of citizen participation in non-agricultural productive activities; and lack of access to finance by citizen-owned small- and medium-scale enterprises. With a focus on economic diversification, the policy was meant to support new business ventures or expansion of existing ones and was mainly targeted at the industrial, agricultural and tourism sectors. While there are indications that FAP did address some problems faced by enterprises and helped create some employment, the policy had some limitations, including uneven geographical coverage and skilled labour constraints. In addition, some enterprises needed more than just financial assistance; they required managerial development, training and technological development in order to catapult them out of infancy. Hence, FAP was replaced with CEDA in 2001 and, subsequently, LEA was established in 2004 to provide mentorship and guidance in business skills and entrepreneurship development, as well as incubation of start-ups. LEA, in turn, collaborates with research organisations, including the Botswana Institute for Technology, Research and Innovation (BITRI), National Food Technology Research Centre, Botswana International University of Science and Technology and the University of Botswana, to enhance delivery of these services.

3.16 CEDA provides funding in the form of loans, equity, factoring and invoice discounting and, also, offers credit guarantees and supplier guarantees, as well as performance bonds. It

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58 A consultancy engaged by the Government with assistance of the African Development Bank (AfDB) has started work on evaluating prospects for transformation of NDB.

caters for citizen entrepreneurship across all sectors of the economy, but its portfolio reflects support for mainly agribusiness, property and manufacturing, trade finance and services. With low-interest rate loans payable up to 15 years, the agency allows businesses to mature. In 2018, its total loan book amounted to P1.4 billion, compared to commercial bank business lending (excluding parastatals) of P22 billion. CEDA has assisted more than 6 000 businesses with 57 000 jobs created since its inception. However, CEDA's lending has been relatively unsustainable, as evidenced by high NPLs (37.6 percent NPL/total loans ratio in 2012) and many foreclosures (about 9.2 percent of total loans in 2012). This occurs despite the collaboration with business, product and market development and skills development and mentoring institutions, such as LEA, intended to enhance viability and prospects for business proposals.

3.17 There is, therefore, need to reassess prospects for enhanced contribution by CEDA to industrialisation, particularly in relation to the identified sectors and related value chains. Among the key considerations, in this regard, is the potential for the CEDA set up to be integrated with the cluster industrialisation strategy and the Special Economic Zones. Along with NDB, there is an option to outsource development and industrialisation funds (especially short-term elements) to commercial banks, where there are better project evaluation, monitoring and loan recovery processes.

Lending by DFIs

3.18 An assessment of direct funding of industry by DFIs in Botswana shows a relatively small contribution compared to commercial banks, for example, P6 billion in 2018; for the same period, lending to businesses by the commercial banks was P23.2 billion. From this perspective, the apparent absence of crowding out of the private sector could be welcome. However, such a level of resource commitment and performance over time need to be evaluated against the envisaged impact of the DFIs, especially given the level of resources availed by Government. Going forward, any assessment needs to consider alignment with the industrialisation strategy. Incidental thereto is a consideration of whether the scale of funding for individual projects is sufficient for large-scale industrialisation.

3.19 Lending by DFIs tends to be sector-specific, based on the individual institution's mandate. In that regard, lending by BBS is concentrated on mortgages and real estate, while NDB is more geared towards agriculture. BDC, on the other hand, has equity investments and loan exposures across various sectors. Of the total lending by NDB, BBS and BSB a large proportion (67.3 percent in 2018) is mortgage loans, mostly from BBS. Borrowing by the agriculture, mining and tourism sectors accounted for only 9.5 percent of advances by the three institutions (Chart 2), with the relative shares stagnant or falling over time (for example, from 14.4 percent in 2013), as the volume of lending generally fell (Chart 3). Clearly, this is not commensurate with the performance and development/industrialisation aspirations for both the individual institutions and government (nation). Industry funding by BDC, as at the end of September 2018, amounted to P631 million in loans spread across agriculture, property and services sectors and P1.6 billion equity investment in several industries. However, the recent performance by BDC has to be viewed against the background of rationalisation and divestment programme intended to refocus and reenergise the corporation.

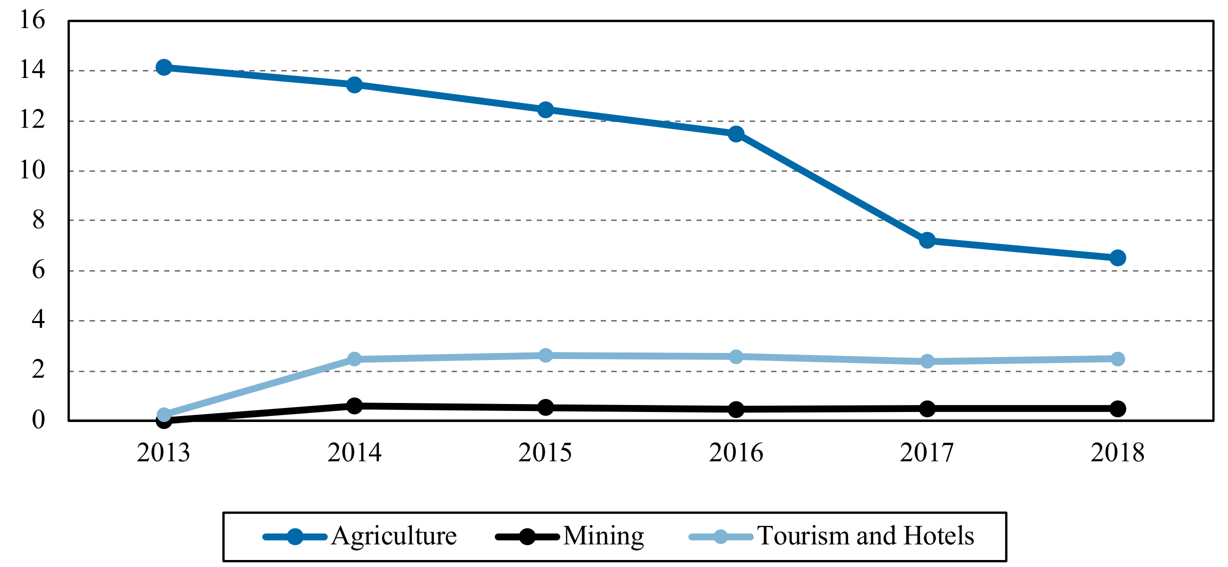
(iv) Other Government Financing Options

Women's Grants and Youth Development Fund

3.20 Government also provides finance to selected sectors of the economy, through various ministries. These are usually for social welfare development and skills training in selected career paths. For example, the Women's Grant, provided through the Ministry of Nationality, Immigration and Gender Affairs, is an initiative meant to assist women with funds up to P250 000 for income-generating projects. The grant is available to groups of at least five people (men may access these funds as part of a women's group).

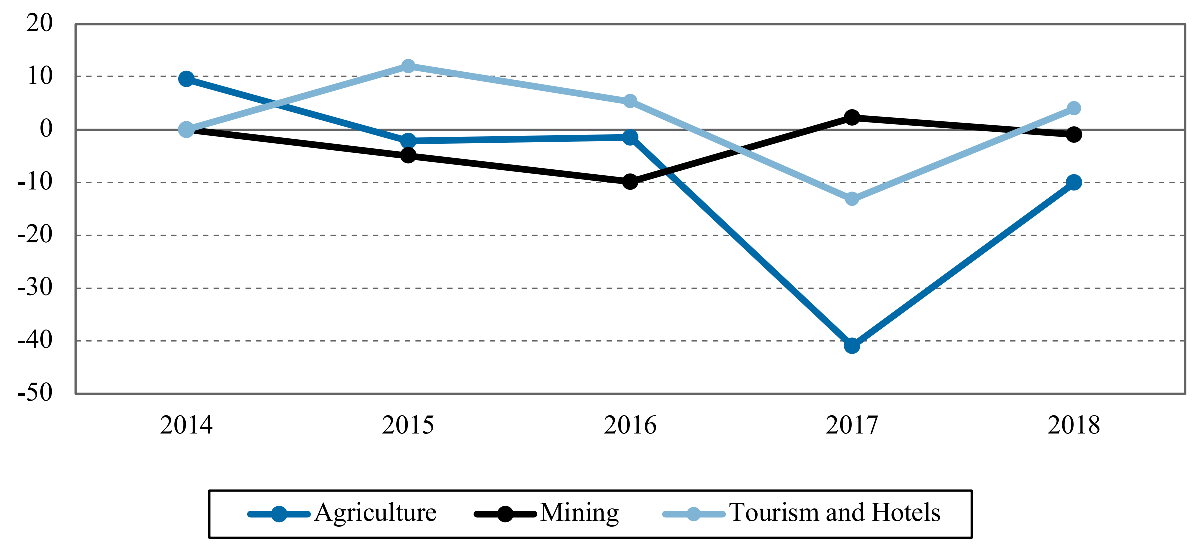
3.21 Another initiative, introduced in 2009/10 through the Ministry of Youth Empowerment, Sport and Culture Development, is the Youth Development Fund (YDF) and is allocated P120 million annually. The Fund is aimed at promoting active youth participation (particularly the out-of-school, marginalised and unemployed youth) in the socio-economic development of the country.

CHART 2: DFIS' LENDING TO SELECTED SECTORS (SHARE OF TOTAL CREDIT IN PERCENT)



Source: Bank of Botswana

CHART 3: ANNUAL GROWTH RATES IN DFIS' LENDING TO SELECTED SECTORS (PERCENT)



Source: Bank of Botswana

Financing is in the form of a 50 percent grant and 50 percent interest-free loan, with a ceiling of P100 000. In the 2015/16 financial year, 1 061 youth enterprises were approved at a cost of over P102 million. Disbursements amounted to about P59 million for 566 projects, creating 1 002 employment opportunities. Beyond this, it is difficult to ascertain the success of the Fund, as it is owed over P400 million, in part due to lack of capacity at the Ministry to collect loan repayments. Going forward, the Fund will cover youth cooperatives and consortia in identified sectors (with potential for success), possibly from the 2019/20 financial year.[59]

59 State of the Nation Address (2018). Botswana Government..

Construction Industry Trust Fund (CITF)

3.22 The CITF is also a special fund that was established by Government to address the need for semi-skilled and skilled artisans during the implementation of national development plans, particularly in the construction industry; and to fill the skills gap in the mining industry. CITF has been in operation since 1991 and major developments projects, such as the Jwaneng Cut 8 and the Kazungula Bridge, have benefitted from artisans trained under the Fund.

Public Debt Service Fund (PDSF)

3.23 The PDSF is one other Fund, which government established in 1973 for ensuring that Government would have a source of funds to service public debt. At the same time, since the domestic capital market was not well developed, the PDSF made long-term loans to parastatals and other official agencies. In the 1990s, with the development of the domestic capital market, parastatals were encouraged to seek funding on the domestic capital market, and in 2001, the PDSF temporarily stopped making new loans. Much of the existing loan book was sold to further the development of the domestic capital market, while raising revenues for the Government. A special purpose investment company, Debt Participation Capital Funding Limited, the issued capital of which is held by Government, was incorporated in 2004 to purchase from Government the rights to receive the future principal and interest payments on 72 outstanding loans owing to the PDSF and to issue bonds to the public to finance the purchase of the 72 PDSF loans. However, Government has, in the intervening years, issued new loans from the PDSF, for example, P570 million was lent to De Beers in 2009/10.

(v) Domestic Capital Market and Role in Financing Industrialisation

3.24 A vibrant domestic capital market should be one of the key financing and support options for industrialisation, meeting the needs of government, parastatals and the private sector in their various roles in this regard, viz., infrastructure, social services, utilities and long-term capital for businesses. In the main, the capital market is underpinned by a securities trading platform (a stock exchange to facilitate issuance and trading of equities and fixed income securities (bonds)), market makers as well as a government securities (bond) issuance programme to guide the market and provide liquidity and requisite vibrancy.

Botswana Stock Exchange (BSE)

3.25 In this regard, the BSE, which operates and regulates the equities and fixed income securities market, continues to be pivotal to Botswana's financial system, and, in particular, the capital market, as an avenue on which government, quasi-government and the private sector can raise debt and equity capital for financing industrialisation projects. The BSE has recently demutualised, a move that is expected to potentially lead to growth and development of the capital market and ultimately contribute to economic expansion. A demutualised stock exchange ensures access to greater amounts of capital, which is necessary for economic development and industrialisation.

3.26 The BSE has the necessary infrastructure and capability to support the listing and trading requirements for various securities. There are ongoing efforts to introduce a single central securities depository to provide a centralised platform for trading of all securities and settlement of trades using central bank money, which should improve integrity, market integration and alignment to the monetary policy stance and monetary operations by the central bank. There is, therefore, significant scope for the stock exchange to enhance the support for the industrialisation strategy. Market capitalisation (including domestic and foreign board) of the stock exchange has been over P40 billion in the last five years.

3.27 The BSE has had good performance across several indicators (including market depth, access to foreign exchange and capacity of local investors, among others), compared to peer countries.[60] As shown in Chart 4, the financial sector dominates the domestic stock market

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60 The Absa Africa Financial Markets Index 2018 provides country comparisons and highlights opportunities and challenges for the region's financial markets. Botswana ranks second in 2018, improving from position 3 in 2017, on account of stable performance across the index's six pillars and efforts made to improve the local investor base. .

capitalisation. This, to some degree, reflects the capital structure of domestic firms, where businesses mainly rely on internal resources (retained earnings) and short-term debt for financing operations, which, notably, is the preferred financing option by the mining sector.

3.28 With regard to shares traded (as a percentage of the number of shares listed in a particular sector), the financial services sector has contributed the most over the years, except in 2017, when property made the largest contribution. Chart 5 indicates that, while most of the funding has gone to the financial services sector and property, over time, the tourism sector's share has been growing (although it declined in 2017).

3.29 The bond market continues to grow, with noted improvements in both the government and corporate bond markets. Chart 6 shows some selected sectors' bonds that have been listed on the domestic stock exchange. A total of 49 corporate bonds with a market value amounting to P2.2 billion were listed on the BSE in 2018. As a proportion of GDP, the value of these corporate bonds is very small at 1 percent, an indication that there is tremendous room and scope to grow the bond market as a source of long-term financing. BBS Limited and BDC are the only two DFIs that have listed bonds on the BSE. BBS Limited has listed bonds amounting to P225 million while BDC listed P82 million.

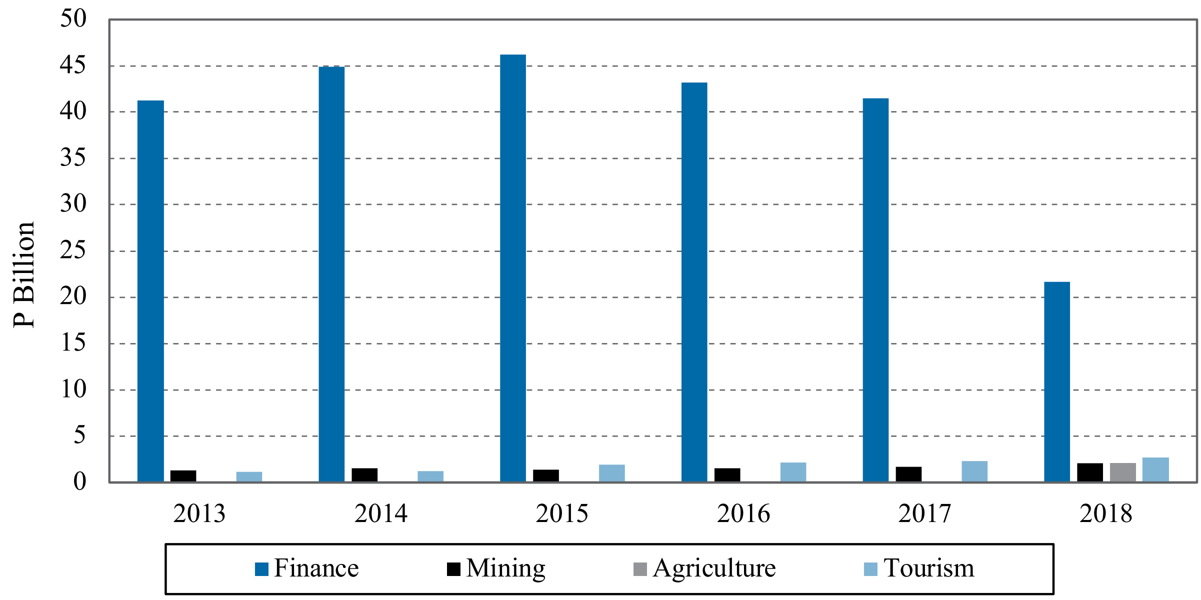
Government Bond Issuance Programme

3.30 A significant contribution of Government to development of the domestic capital market is the Government Bond Issuance Programme, initiated in 2003 and restructured to encompass a legislated amount (P15 billion) and regular issuance calendar in 2011. The programme provides a benchmark yield for private issuers and also contributes to development of related systems, infrastructure and market capabilities; thus the potential for fixed income securities to support real sector economic activity and industrialisation. While funds raised by the Government are available to facilitate support for industry development, ultimately an important benefit of the Programme is the potential to facilitate mobilisation of funds by the private sector, thus, ease the long-term financing constraint.

3.31 In terms of government financing needs and complementary to the bond issuance programme, there is an option to float infrastructure bonds for financing specific infrastructure projects of public interest. A potential benefit is that this could be linked to project evaluation in relation to viability, which could also align development costs to cost recovery and user charge options. This type of bond would also increase the diversity of products on offer. However, it requires a well-developed capital market; robust legal system and trained personnel in project finance and risk management, aspects which Botswana is yet to attain. Kenya and South Africa have been pioneers in the region in the issuance of infrastructure bonds. The government of Kenya issued a 12-year infrastructure bond valued at KSh35.85 billion in 2011 to fund specific new and on-going projects, while in South Africa municipal bonds for infrastructure development amounted to R34.8 trillion in 2016.[61]

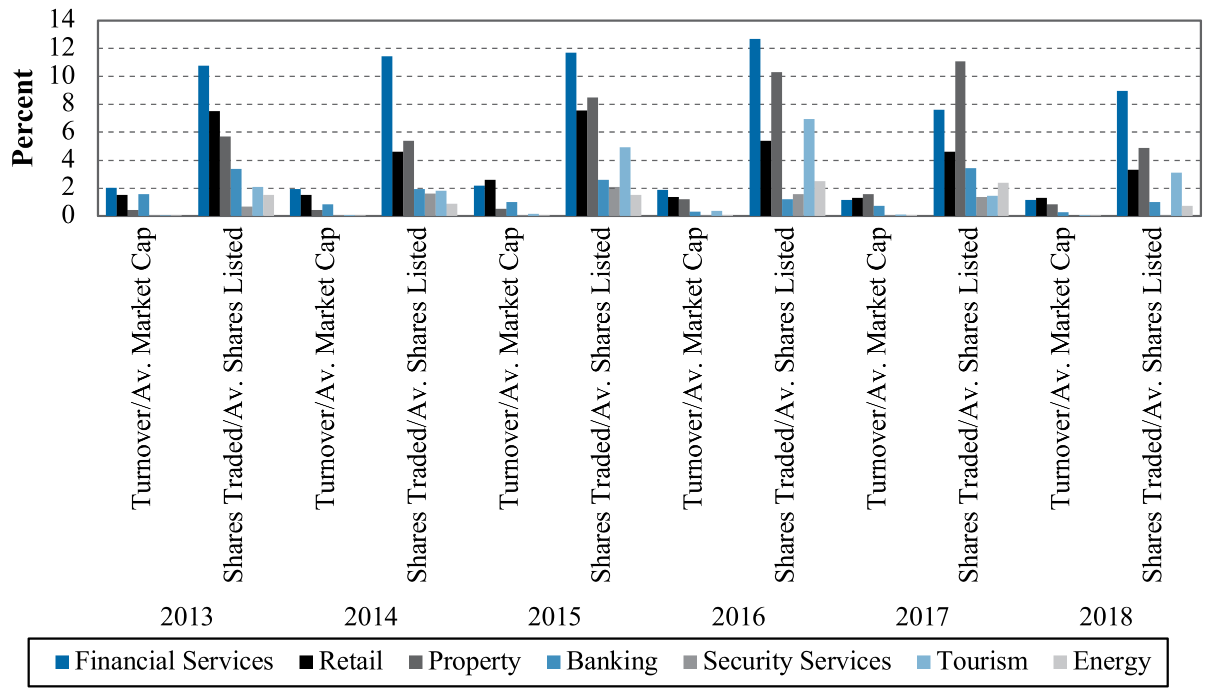
[61] Ministry of Finance and Central Bank of Kenya (2011). "Infrastructure Bond with Kenyan Diaspora Component - General Information Supplement," and the South African Reserve Bank's 2017/18 Annual Report.

Chart 4: BSE Market Capitalisation - Selected Sectors



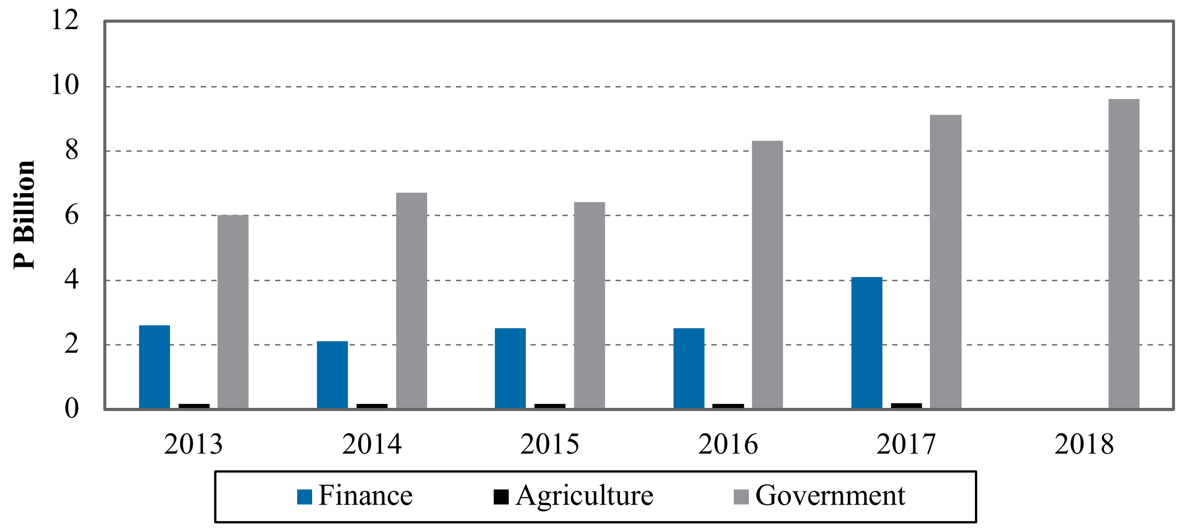
Source: Botswana Stock Exchange Limited

Chart 5: Shares Traded on the Domestic Board - Selected Sectors



Source: Botswana Stock Exchange Limited

CHART 6: TOTAL VALUE OF BONDS LISTED IN THE BSE - SELECTED SECTORS



Source: Botswana Stock Exchange Limited

(b) The Role of Regional Development Banks

3.32 Regional development banks present potential opportunities for financing large-scale projects. These include the Development Bank of Southern Africa (DBSA) and the African Export-Import (Afrexim) Bank. The DBSA plays a key role in the preparation, funding and building phases of the infrastructure development value chain. In the region, the bank finances state-owned enterprises and public-private partnerships. The DBSA has handled several regional projects, including SADC's Regional Fund for Water and, in particular, the Kazungula Water Supply Project, which comprises the construction of water treatment works, bulk water supply works and a water reticulation network. Afrexim Bank, on the other hand, was established for the purpose of financing, promoting and expanding trade within and outside Africa. In 2018, the bank availed a USD 500 million facility to Zimbabwe to help it stabilise its foreign currency position. As a participating state with shareholding, Botswana is eligible for Afrexim Bank finance and assistance, which include project and export development, structured trade finance, syndication and specialised finance and advisory services.

(c) International Financial Institutions and Bilateral Relations

3.33 Several multilateral organisations have operations that support development efforts and industry growth, while bilateral arrangements with individual countries can also involve various support elements. Commonly, these revolve around policy and structural transformation advice, operational expertise, funding and guidance on compliance aspects, especially with respect to environmental, social and governance issues. Botswana has benefitted meaningfully in this regard, notably from the IMF, World Bank, the AfDB and bilateral arrangements with several countries. Such support involves government, parastatals and private development initiatives. Going forward, to the extent that such relationships are maintained, the key to sustained success would be alignment with the industrialisation strategy and enhanced attention to governance and delivery of mandates.

3.34 Among the international financial institutions, the International Financial Corporation (IFC) is potentially more relevant with direct funding of the private sector in support of the industrial agenda. The IFC programmes include loans, investment in equity, trade and supply-chain finance, syndication, blended finance and venture capital, among others. These are across various industries including agribusiness, oil, gas and mining, infrastructure, financial markets and global manufacturing services.

(d) Private Sector Financing Options

(i) Foreign Direct Investment (FDI)

3.35 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, long distance and economic instability. 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.

3.36 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.

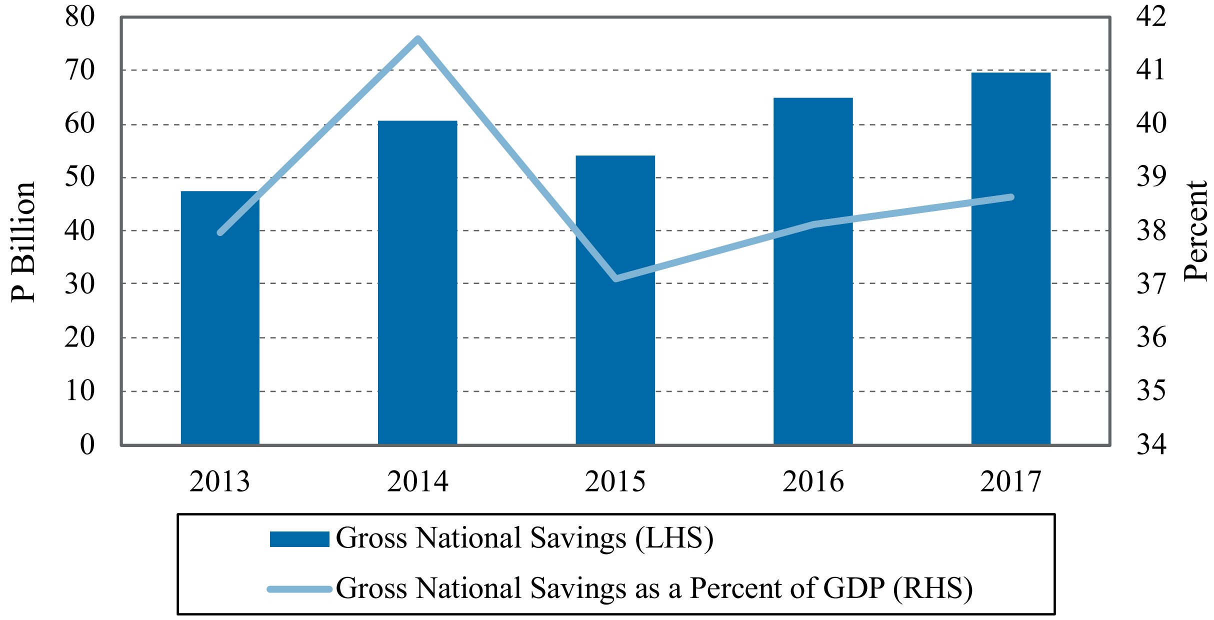
3.37 Portfolio flows involve short-term investments that mainly come through the stock and bond markets focused on portfolio diversification, trading on volatility and expectations of arbitrage and high returns in the short-term. The main influences are, therefore, macroeconomic policy performance and 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. Hence other countries develop tax rules (incentives) for mitigating volatility.

3.38 Even though Botswana has no exchange controls and is an open economy, 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. Also, policy consistency and congruence is necessary to attract FDI.

(ii) Commercial Banks and Other Non-Bank Financial Institutions

3.39 Commercial banks are traditionally the primary source of private sector finance. In terms of structure, commercial bank lending is dominated by household borrowing (mostly unsecured loans), followed by credit to the trade, real estate and manufacturing sectors. These cumulatively accounted for 82 percent of commercial bank loans as at December 31, 2018. Thus, the sectors earmarked for driving industrialisation (mining, agriculture, tourism and finance) do not make up much of commercial bank loan portfolios. Key constraints, in the Botswana context, are that domestic banks are over-reliant on volatile short-term deposits; there are limited stable long-term sources of funds; the inter-bank market is inefficient and hence limited optimal use of deposits. In addition, while Botswana has high levels of national savings, averaging 46 percent as a proportion of GDP over the last five years (Chart 7), financial intermediation is fragmented, with inadequate risk management tools to meet

Chart 7: Trends in Gross National Savings



Source: Statistics Botswana

the requirements of both providers of funds (pension funds and insurance companies) and the demand for infrastructure financing by firms such as Water Utilities Corporation; Botswana Housing Corporation and others.

3.40 The financial assets of non-bank financial institutions (NBFIs) have grown steadily over the years, reaching P86 billion in 2018, with the larger share attributable to pension funds. The pension funds industry continues to grow, supported by growth in pension membership and investment returns, and could possibly serve to bridge the finance gap.

3.41 Commercial banks and pension funds have largely been successful in providing funding for businesses, both having large pools of funds. Commercial banks remain profitable, with modest levels of non-performing loans relative to total loans. However, they continue to have a limited product range. In addition, bank credit to GDP and other financial deepening indicators point towards a shallow banking system, and savings deposit mobilisation remains low. On the other hand, pension fund assets have grown significantly over the years driven by an increase in income on investments, most of which are in equities. While regulation requires that no less than 30 percent of the total pension assets could be invested locally, about 41.4 percent was actually invested locally by November 2018.

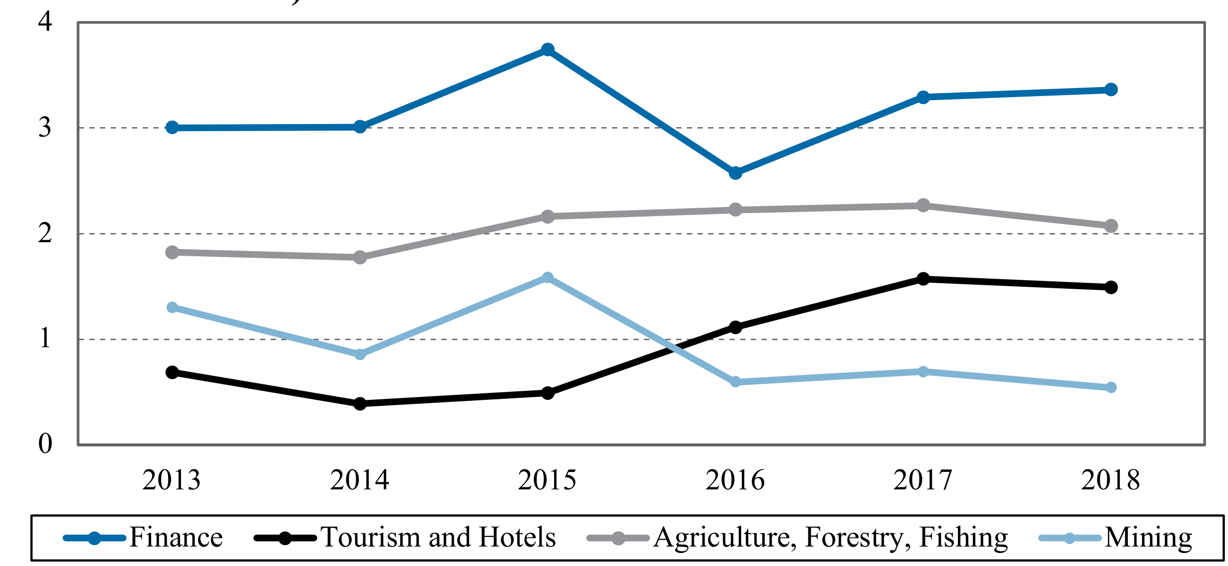
Financing by Commercial Banks

3.42 Commercial bank credit has, over time, been characterised by significant fluctuations (beyond baseline developments) with the main influences being a strategic focus on household credit and idiosyncratic demand by large corporates and parastatals. Significantly, the household sector has been the more malleable to product development and marketing efforts by the commercial banks while, in contrast, the same efforts focused on the small and medium scale enterprises have been less successful; thus the limited traction in relation to the desired areas for industrialisation. Even if it is rightly argued that a significant amount of household lending is for wealth creation and small businesses, the project evaluation and monitoring is not aligned to assuring value-adding returns, thus resulting in marginal contribution to economic activity.

3.43 Overall, most of the business credit is allocated to trade and short-term working capital requirements for various businesses. While this is important and growth enhancing, there is need to support the prospects for other areas, in particular those relating to focus areas for industrialisation. As evident from

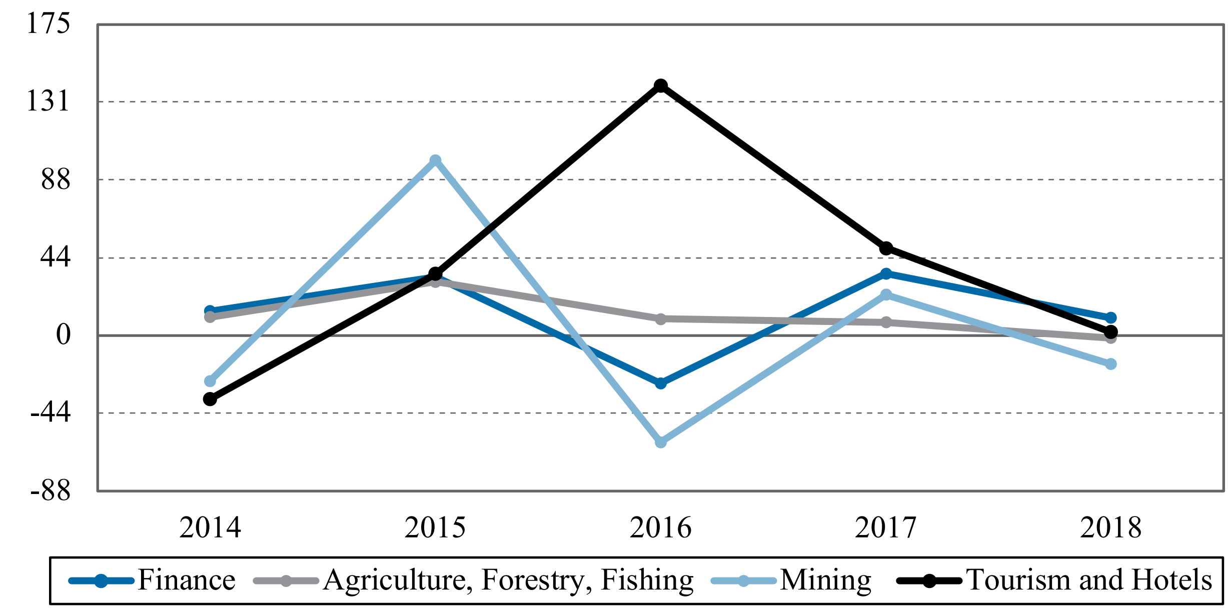
Charts 8 and 9, the allocation of credit to sectors identified for cluster development and advancement of industrialisation is a relatively small proportion of funding, which at the same time is stagnant or declining. Evidently, in the context of low commercial bank credit to GDP (by global standards), there is a role for enhanced funding support by commercial banks for the industrialisation strategy. In the first instance, this is with respect to growth of credit generally in a disciplined operational and governance environment supported by enhanced savings/funding mobilisation. There is, in this regard, potential for consideration of a differently structured range, risk profile and maturity of both liabilities and assets. Incidental thereto would be additional resources to current sectoral and levels of credit, as well as strategic refocus.

Chart 8: Commercial Bank Lending to Selected Sectors (Share of Total Credit in Percent)



Source: Bank of Botswana

Chart 9: Annual Growth Rates in Commercial Bank Lending to Selected Sectors (Percent)

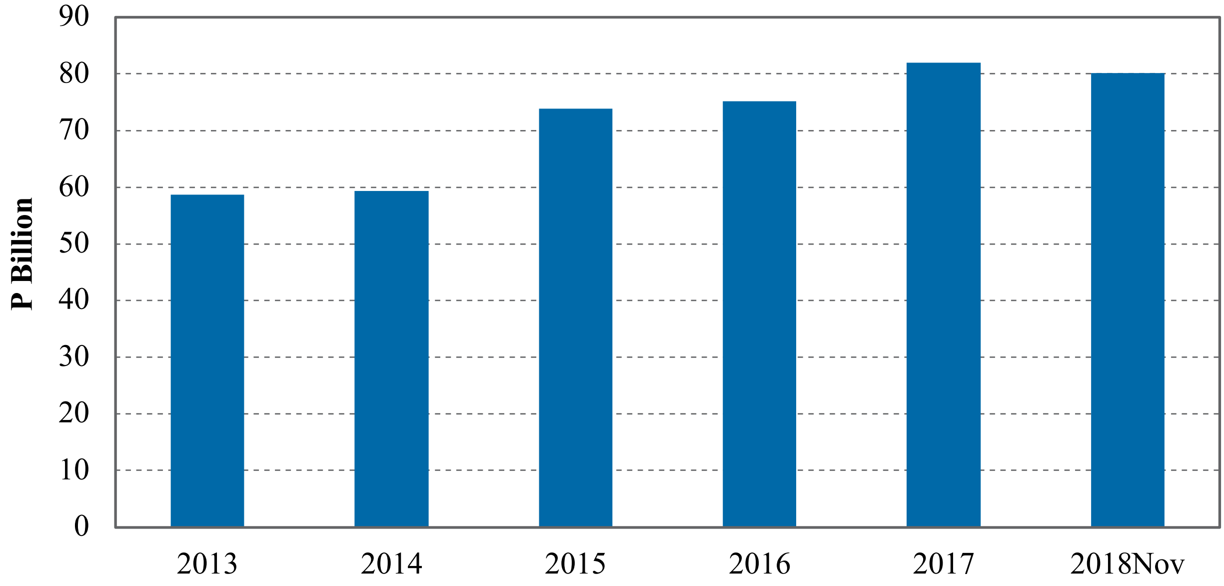


Source: Bank of Botswana

NBFIs Financing

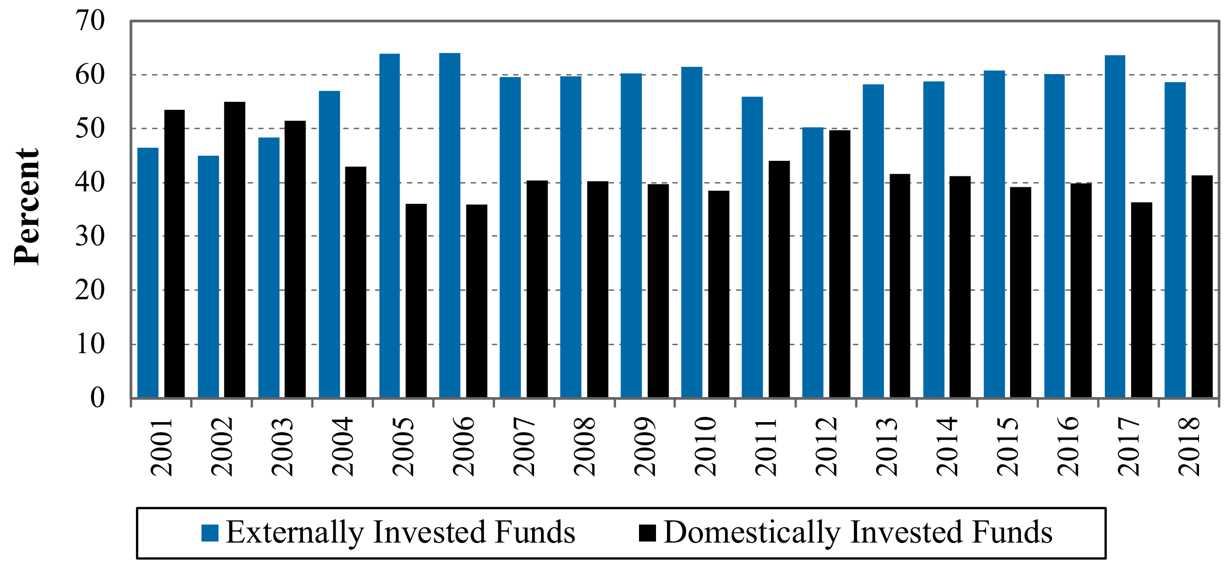
3.44 Chart 10 shows the size of pension fund assets between 2013 and 2018. In terms of the targeted sectors, pension funds invest mostly in equities and bonds in the financial services sector. However, as discussed in the 2017 *Annual Report*, the need for diversified investment portfolios and a shortage of high-return, low-risk and liquid domestic investment opportunities results in the funds being invested externally (Chart 11).

Chart 10: Pension Fund Assets



Source: Bank of Botswana

Chart 11: Pension Fund Externally and Domestically Invested Assets



Source: Bank of Botswana

(iii) Other Private Sector Financing Options

3.45 Other private sector financing options include Kgalagadi Breweries Limited (KBL) Kick-Start Finance, Debswana's Peo Fund and micro-lenders. In the period between 2015 and 2017, the P36 million Peo Fund, which provided venture capital loans and equity financing, funded more than 60 businesses, creating over 1300 sustainable jobs. In the same way, Kick-Start Finance, a youth entrepreneurial development programme, benefited over 70 small medium enterprises (SMEs) before being suspended due to lack of funds. The programme is set to be revived in 2019, with an annual budget of P1.5 million, which is expected to fund 15 new businesses each year. The potential for this type of financing option is significant, as has been the experience in countries such as South Africa. Micro-lenders are an equally viable option, with a loan portfolio of above P3.4 billion in 2018.

(e) The Impact of the Various Financing Options on Economic Activities

3.46 The impact of these various financing options varies across countries. However, the consensus appears to be that government funding for infrastructure and social projects remains appropriate and impactful, especially for developing countries, notwithstanding that this is increasingly being mixed or privatised (in various forms) in the developed and emerging economies. In addition, the micro and social support segments continue to be an imperative for governments to support poverty alleviation, inclusive growth and entrepreneurship development programmes. Mandate-specific development finance institutions also continue to be involved in a wide spectrum of economic and development/inclusion-focused activity, but with mixed results specific to countries, depending on the governance culture. Overall, it is considered that the private sector has better promise in terms of productive and high return funding allocation, given better project/business proposal evaluation, monitoring and support capacity.

3.47 Periodic reviews of initiatives meant to support enterprise development are an important exercise for ensuring that such initiatives remain relevant to their objectives. In cases where initiatives have been found to be underperforming, some have either been abandoned completely and replaced with new options or restructured accordingly.

(f) Challenges and Obstacles to Access to Finance in Botswana

3.48 As earlier discussed, Government has long recognised the financing needs for enterprise development and, to a large extent, implemented appropriate measures to bridge the financing gap. However, despite the efforts made by Government, the private sector and non-governmental organisations, access to finance remains a challenge. These range from the short-term nature of banking sector financing to lack of a collateral registry, the land tenure system,[62] as well as the shallowness of Botswana's capital markets. The 2007 Botswana Institute for Development Policy Analysis study on SMMEs also cited limited access to finance as one of the key constraints to business growth in Botswana. Other studies, including the 2011 one by the World Bank Group, the Doing Business 2018 (Table 2) and the World Economic Forum's Global Competitiveness Report (Table 3), also cite limited access to finance as one of the key constraints to business growth in Botswana. The report ranked Botswana 90th out of 140 countries in 2018.

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[62] Under the current system, tribal land cannot be used as security for commercial or mortgage loans. However, Government has initiated a project, named Improvement to Land Administration Procedures, Capacity and Systems (LAPCAS), which is still ongoing. Once complete, this project will enable landowners to access financing from banks using their land as security.

Table 2: Country Comparisons - Rankings in Doing Business 2018

Economy	New Zealand	Mauritius	Rwanda	Kenya	South Africa	Botswana
Global rank	1	20	29	61	82	**86**
Regional rank	N/A	1	2	3	4	**5**
Starting a business	1	21	51	126	134	**157**
Dealing with construction permits	6	15	106	128	96	**31**
Getting electricity	45	34	68	75	109	**133**
Registering property	1	35	2	122	106	**80**
Getting credit	1	60	3	8	73	**85**
Protecting minority investors	2	15	14	11	23	**83**
Paying taxes	10	6	35	91	46	**51**
Trading across borders	60	69	88	112	143	**55**
Enforcing contracts	21	27	78	88	115	**134**
Resolving insolvency	31	35	58	57	66	**81**

Source: Doing Business 2018, World Bank

Table 3: Botswana's Global Competitiveness Rankings for 2018 Relative to Selected African Countries

	Countries	Botswana	Mauritius	Seychelles	Namibia	South Africa	Kenya	Rwanda
	Overall rank 2018 (140 countries)	**90 (85)**	**49 (49)**	**74 (84)**	**100 (99)**	**67 (62)**	**93 (93)**	**108 (107)**
I	**Enabling Environment**							
1	Institutions	**62**	38	52	51	69	64	29
2	Infrastructure	**108**	67	70	91	64	105	115
3	Information and communication technology (ICT) adoption	**98**	47	63	105	85	113	120
4	Macroeconomic stability	**1**	43	64	100	57	104	92
II	**Human Capital**							
5	Health	**115**	83	82	117	125	110	106
6	Skills	**92**	74	43	100	84	95	123
III	**Markets**							
7	Product market	**95**	19	48	80	74	79	65
8	Labour market	**57**	74	23	39	55	60	49
9	Financial system	**69**	25	93	47	18	73	84
10	Market size	**111**	17	139	121	35	71	128
IV	**Innovation Ecosystem**							
11	Business dynamism	**103**	35	74	121	56	63	60
12	Innovation capability	**101**	62	49	77	46	69	118

Note: The figures in brackets are revised rankings for 2017, after adjusting the original rankings based on the new methodology.

Source: The Global Competitiveness Report 2018

3.49 Given their role of financial intermediation, banks provide most of the finance needed for investment. Some of the major challenges with accessing finance from banks include the maturity mismatch between loans and deposits, which limits the extent to which banking sector lending can bridge the long-term financing needs; and low returns on financial assets, which weakens core deposit mobilisation. These challenges can be addressed by exploring options, such as loan syndication and bond issuance by banks. In addition, banks, given their interlinkages with pension funds, have the potential to access pension funds to bridge liquidity shortages.

3.50 With regard to the capital markets, it is widely recognised that well-developed capital markets are important in mobilising capital, and are able to harness a pool of savings to meet long-term investment needs. 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. However, capital markets in Botswana are shallow and illiquid, even with the marked improvements noted in recent years, in part, as a result of limited supply of government and corporate bonds.

3.51 The credit infrastructure is also a major challenge in Botswana due to the absence of well-functioning credit bureaux or collateral registry. While lenders may be justified in seeking collateral for credit extended, the lack of a formalised collateral registry means that often new firms are unable to meet these demands and this limits access to finance for start-ups and firms wishing to expand. It is worth noting that the drafting of the Credit Information and Secured Transaction Bills is at an advance stage. Once approved by Parliament, the Credit Information Act will provide for a legal framework for the establishment and regulation of a credit information reporting regime and to appoint a supervisory authority to oversee the use of credit information, including for monitoring of risks and trends in the market, while the Secured Transaction Act will provide legal structures through which movable assets can effectively be used as collateral.

3.52 DFIs face several challenges. These include the small size of their portfolios; inability to utilise equity funding to improve local ownership of companies by citizens; the high number of non-performing assets; and limited government funding following the decision to decrease subventions. Some of these challenges have led to most of these DFIs making losses. The privately owned financial institutions are performing better than DFIs and they have various sources of funding they could tap into. However, their strategic objectives are not always fully aligned with government policy; hence, they may not necessarily provide funding to the target sectors without any explicit incentives.

3.53 Financing industrialisation, therefore, requires government to play a larger facilitative role in the allocation of financial resources in the domestic economy, either through providing private financial institutions with incentives or adequately resourcing DFIs. This calls for government to reform state-owned financial institutions by allowing them to source funding from both domestic and foreign markets; relieving them of non-performing assets;[63] and to develop policies that will encourage privately owned financial institutions to partner with DFIs in funding major industrial projects. There should also be incentives to ensure that the return on major industrial sector projects is better than prevailing interest rates on loans and advances.

3.54 Another challenge impeding industrialisation efforts is limited funding for Research and Development (R&D). At a nascent stage, businesses can ill-afford the high cost of R&D, and, as such, there is a need to establish funding for R&D and transferring the R&D outcomes to businesses to help improve their technological capabilities and production of high value goods, which could drive the country's industrialisation. Government provides limited research grants to the Botswana Institute for Technology, Research and Innovation (BITRI) and other similar local institutions to conduct needs-based research and development in focussed areas. The Botswana

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63 Relieving state-owned financial institutions of non-performing assets could be in the form of setting up asset management companies. However, caution is advised regarding the moral hazard such a decision could pose, and credit-underwriting standards would have to be raised.

Innovation Hub is another institution which gives cash grants for R&D. The Botswana Innovation fund had P12 million for the 2018/19 financial year. While it is expected that both BITRI and Botswana Innovation Hub should to do more to achieve their mandate of promoting research, technology and innovation-based entrepreneurship, there is need for government to develop patent laws to facilitate more funding for R&D in a secure investment environment.

3.55 A review of measures taken by other countries to address these challenges in their journey towards industrialisation provides practical experiences, which could form the basis of Botswana's policy reforms towards financing for industrialisation. The section that follows addresses these issues.

4. Cross-Country Experiences and Comparisons

4.1 To follow up the discussion in the preceding Section on the resource mobilisation for financing prospects in Botswana, the experience of other countries that have pursued rapid industrialisation is germane for drawing lessons and guiding policy considerations.

4.2 Literature highlights the varying impact of alternative financing options in different settings, direct government funding, private sector led financing and private-public-partnerships. That is, whereas some governments took the lead by spending more of their budgets on industrial projects, including providing credit, others mainly relied on the private sector. For example, in Singapore and India, government set up state-funded financing institutions, which were mandated to support certain industries by offering loans at below-market interest rates; in other instances the government partnered with private financial institutions to provide funding. Notably, in Brazil, the Republic of Korea and South Africa, state-owned institutions have been key in financing industrial developments. Most of these institutions have a diverse funding base, including resources from other financial institutions and government transfers. Furthermore, mandates of these institutions are broad, covering a wide range of sectors and activities and supporting both big and small businesses. Another successful variation is the liberalisation of domestic markets and deliberate attraction of foreign investment in high technology sectors by using tax incentives and subsidised credit. Overall, a common success factor appears to be the attention, in terms of funding, to both targeted sectors and industries and the support infrastructure, services and resources, including research.

4.3 Traditionally, the Government has been responsible for funding and managing infrastructure development through accumulated fiscal savings from diamond sales (Section 3), augmented by state-owned enterprises established to provide utilities and targeted services. While some of these were designated as commercial, the Government has, on a net basis, been a financier of these institutions (including through the provision of subsidies and/or suppressed user charges). In addition, as discussed in Section 3 and indicated in Table 4, state-owned enterprises, such as the BDC, NDB and CEDA, were set up to bridge the financing gap for industrialisation. However, over time, there is a recognition that public funding alone may not be enough to finance the country's industrialisation process, especially considering the complementary resources required for successful and return-generating value-adding funding. Recently, the IMF Article IV Mission (2018) concluded that, "In recent years, sizable buffers and prudent policies have kept the economy stable. However, the diamond/public sector development model has reached its limit as evidenced by lower economic growth, slow job creation, and high income inequality." The IMF, therefore, suggested "prudent financial policies and a focused set of reforms" towards an improvement in performance and outcomes. These reforms include the identification of alternative sources of funding for industrial development.

(a) Development Finance Institutions

4.4 DFIs played a crucial role in industrialisation of most economies. Typically, they are state-owned and provide subsidised, long-term financing for industrial development. Unlike in Botswana where the focus for DFIs is on business financing, the initial mandate for these institutions in some jurisdictions was on financing infrastructure as the backbone for industrialisation (Table 4). For example, the

Brazil National Development Bank (BNDES) investments included refurbishing the national railway system and building hydroelectric power plants, while in the Republic of Korea, the Korea Development Bank (KDB) invested in power plants, express highways and also aimed to accelerate the development of science and technology. In South Africa, the Industrial Development Corporation (IDC) was established to promote economic growth and industrial development with a focus on base and strategic industries, such as fuels, as well as basic chemicals and metals. In addition, the Land and Agricultural Development Bank of South Africa (Land Bank), the leading agricultural financier in South Africa, focuses on primary agricultural production, offering tailor-made financial services to both the established and emerging farmers.

TABLE 4: DFIs - SOURCE OF INDUSTRIAL DEVELOPMENT FUNDING

	Botswana	Brazil	Chile	Mauritius	Singapore	South Africa	Korea
Current Mission	To provide sustainable value creating financial services and partnerships that support economic development of Botswana	To foster sustainable and competitive development in the Brazilian economy, generating employment while reducing social and regional inequalities	To improve the competitiveness and the productive diversification of the country by encouraging investment, innovation and entrepreneurship, in addition to strengthening the human capital and technological capabilities to achieve sustainable and territorially balanced development	To serve as a catalyst for the promotion of accelerated socio-economic development of Mauritius	Grow stronger Singapore enterprises by building capabilities and accessing global opportunities, thereby creating good jobs for Singaporeans	To achieve a range of objectives intended to improve its citizens' quality of life; enhance public service delivery; increase economic growth; improve infrastructure; and create jobs	To contribute to the development of Korea's financial industry and economy
Ownership	Government of Botswana	Government Owned	Government Owned	Government Owned	Government Owned	Government Owned	Government Owned
Early Focus	**NDB, FAP, BDC, BBS and BSB**	**Brazilian Economic Development Bank (BEDB)**	**Corporation for Promotion of Production (CORFO)**	**Agricultural Bank and Development Bank of Mauritius (DBM)**	**Economic Development Board (EDB)**	**Industrial Development Corporation (IDC), Development Bank of Southern Africa (DBSA), Land and Agricultural Development Bank (Land Bank)**	**Korea Reconstruction Bank (KRB)**
Target Sectors	• Industrial • Agriculture • Tourism • SMMEs	*Import Substitution Policy* • Focus on public infrastructure (railway and hydroelectric) • Steel industry (1960s) • Consumer goods • Technology • Increase funding towards private firms *Export-Led Growth* • Energy • Agri-business	*Import Substitution Policy* • Mining • Utilities • Agriculture • Industrial production • Trade	• Agriculture • Industries	• Industries	• Agriculture • Infrastructure • Social development	• Restoration of industrial facilities • Infrastructure: Electricity • Mining: coal • Manufacturing: steel, shipbuilding, machinery • Heavy chemicals • Intensive support for automobile and electronics industries • High-tech industries: telecommunications and information technology

	Botswana	Brazil	Chile	Mauritius	Singapore	South Africa	Korea
Current	**CEDA, NDB and BDC**	**Brazil National Development Bank (BNDES)**	**CORFO**	**DBM**	**Development Bank of Singapore (DBS)**	**IDC, Land Bank, DBSA, National Empowerment Fund (NEF)**	**Korea Development Bank (KDB)**
Target Sectors	• Agriculture • Industry • Tourism • Real estate • Mining • Finance • Manufacturing • Commerce • SMMEs	• Refocus on industrialisation • Infrastructure (44 percent of total funding in 2017) • Industry (25 percent of total funding in 2017) • Innovation • Socio-environmental development • Regional development • Manufacturing • SMMEs (30 percent of total funding between 2002 and 2016)	Export-Led Growth • Supporting SMEs and entrepreneurship • Providing incentives for innovation and technological advancement • Agriculture	• Manufacturing • Services • Tourism • Agro-business • ICT • Real estate • SMMEs	• Agricultural commodities • Palm oil • Chemicals • Oil and gas • Mining and metals • Power generation and infrastructure • Manufacturing	• Agriculture • Infrastructure • Social development • SMMEs • Service • Construction • Mining • Manufacturing	• SMMEs • Oil and gas • Power • Petrochemicals • Infrastructure • Water treatment

Source: Musacchio, A., Lazzarini, S. G., Makhoul, P., and Simmons, E. (2017), ‘The role and impact of development banks’, World Bank Working Paper; http://www.dbm.mu; Annual Report 2017, Development Bank of Mauritius; https://www.bndes.gov.br; https://www.dbs.com.sg; http://www.ndb.bw; http://www.ceda.co.bw; https://www.iadb.org; https://www.idc.co.za/; https://www.dbsa.org; https://landbank.co.za

4.5 Over time, however, there has been a transition from a primary focus on infrastructure financing to supporting SMMEs and entrepreneurship, providing incentives for innovation, technological advancement, as well as regional development. Support in this respect encompasses loans, credit guarantees, equity investments, grants and technical assistance (Table 5).

TABLE 5: PROGRAMME AND SERVICES COMPARISON

	Botswana	Brazil	Chile	Mauritius	Singapore	South Africa	Korea
Private							
Loans to large companies	✓	✓	×	✓	✓	✓	✓
Loans to SMMEs	✓	✓	✓	✓	✓	✓	✓
Loans to Individuals	✓	✓	✓	✓	✓	✓	✓
Credit guarantees	✓	✓	✓	✓	✓	✓	✓
Leasing and Securitisation	✓	✓	×	✓	✓	✓	✓
Equity for large companies	✓	✓	×	✓	✓	✓	✓
Equity for SMMEs	✓	✓	✓	✓	✓	✓	✓
Venture capital	✓	✓	✓	✓	✓	✓	✓
Grants	✓	✓	✓	✓	✓	✓	✓
Technical assistance/consulting	✓	×	✓	✓	✓	✓	×
Public							
Infrastructure	✓	✓	×	✓	✓	✓	✓
Social development	✓	✓	×	✓	✓	✓	✓

Sources: Musacchio, A., Lazzarini, S. G., Makhoul, P., and Simmons, E. (2017). 'The role and impact of development banks.' World Bank Working Paper; http://www.dbm.mu; Annual Report 2017, Development Bank of Mauritius; https://www.bndes.gov.br; https://www.dbs.com.sg; http://www.ndb.bw; http://www.ceda.co.bw; https://www.iadb.org; https://www.idc.co.za; https://www.dbsa.org; https://landbank.co.za

4.6 In Singapore, government involvement, both in debt-and equity-financing, reportedly played a significant role in reducing funding constraints. Through debt-financing schemes, government provides funding for SMMEs only once commercial banks and financial institutions had agreed to lend to these enterprises (after the relevant due diligence process); a notable variation from what transpires in Botswana. Regarding equity financing, the government matches the private sector investment (equity stake) in SMMEs. These government-backed schemes were done as an effort to create a business friendly environment and encourage entrepreneurship in Singapore. Direct government funding for SMMEs through grants or other assistance schemes often takes a targeted approach and is restricted to certain business activities that are integral to development of SMMEs, such as international expansion, workforce training and technology adoption. Over the years, the Singapore government has also encouraged the formation of credit bureaux, which offer advanced credit-scoring facilities to help banks and financial institutions improve their assessment of SMMEs' creditworthiness.

4.7 In Mauritius, the Government adopted an export-oriented strategy, starting with the establishment of the first EPZ in 1970. The aim was to attract export-oriented foreign direct investment and to rely on the potential spillover benefits and linkages effects of FDI. The Government subsidised export companies with tariff-free access for productive inputs, and with tax incentive subsidies and relaxed labour market regulations in the export sector. It established additional EPZs to export key manufactured goods, mostly apparel and textiles. As evident from Table 4.2, activity in the export processing zones also benefitted significantly from support of the development finance institutions. Thus, to the extent that the strategy was successful, the input, in terms of effective management of funding, was invaluable.

4.8 In Korea, initial efforts at industrialisation from the early 1960s focused on building up and expanding manufactured exports, and involved prioritising labour-intensive manufacturing. In the early phases of development, government control and direction of the banking sector ensured that credit went to these priority areas. Export promotion measures included subsidised credit for working and investment capital, preferential access to licences for imports and foreign exchange, direct cash payments, and duty-free access to imported inputs used in exports. Firms set specific export targets and receipt of long-term credit was linked directly with past achievements in meeting these targets. From the late 1960s, priority activities shifted to the production of intermediate industrial products and capital-intensive industries in the heavy and chemical industries. This was part of a move to diversify and upgrade the structure of exports. Six sectors (steel, petrochemicals, non-ferrous metals, shipbuilding, electronics and machinery) were prioritised. These were given short-term export targets and funds (policy loans) were channelled to these priority sectors.

4.9 Around the 1980s, Korea relaxed the highly selective measures and a more functional, but nonetheless, still interventionist government strategy was followed. Bank credit allocation at this time was still influenced by government, although the role of policy loans was scaled down. Loans continued to be channelled to identified priority areas and firms, although this shifted in the 1980s, with a new focus on SMMEs, advanced technology activities and firms in need of restructuring.

4.10 The Chilean CORFO is relatively more focused on entrepreneurship and building a knowledge-based economy. CORFO focus on the domestic market and supports the private sector, using a combination of loans, grants and equity to promote SMMEs. On the opposite end of the spectrum, the BNDES focuses on industrial development and operates extensively in both the international markets and the Brazilian market. The BNDES providing loans and equity investments for large corporations (private and public) to both aid their growth in Brazil and support their internationalisation. The BNDES also offers angel equity,[64] venture capital funding and private equity. Angel funding is directed towards SMMEs, while private equity is directed towards innovation and supply chain improvements.

4.11 Evidently, DFIs in Botswana and in all the comparator countries focus on supporting the private sector, using a combination of loans, grants, equity and guarantees to fund large companies and promote SMMEs. However, funding in Botswana is limited compared to the comparator counties. As indicated in Chart 12 below, in Botswana, the ratio of DFIs' total loans to GDP has been consistently low, averaging 3.5 percent in the period 2010 to 2017, compared to 29.2 percent in Singapore, 7.9 percent in South Korea, 6.6 percent in Brazil and 4.6 percent in Chile. To provide context, the relative size of deposit-taking institutions' lending to GDP in the respective countries is significantly higher than in Botswana (Table 6). This is clearly indicative of a significant financial resource gap in Botswana compared to other countries.

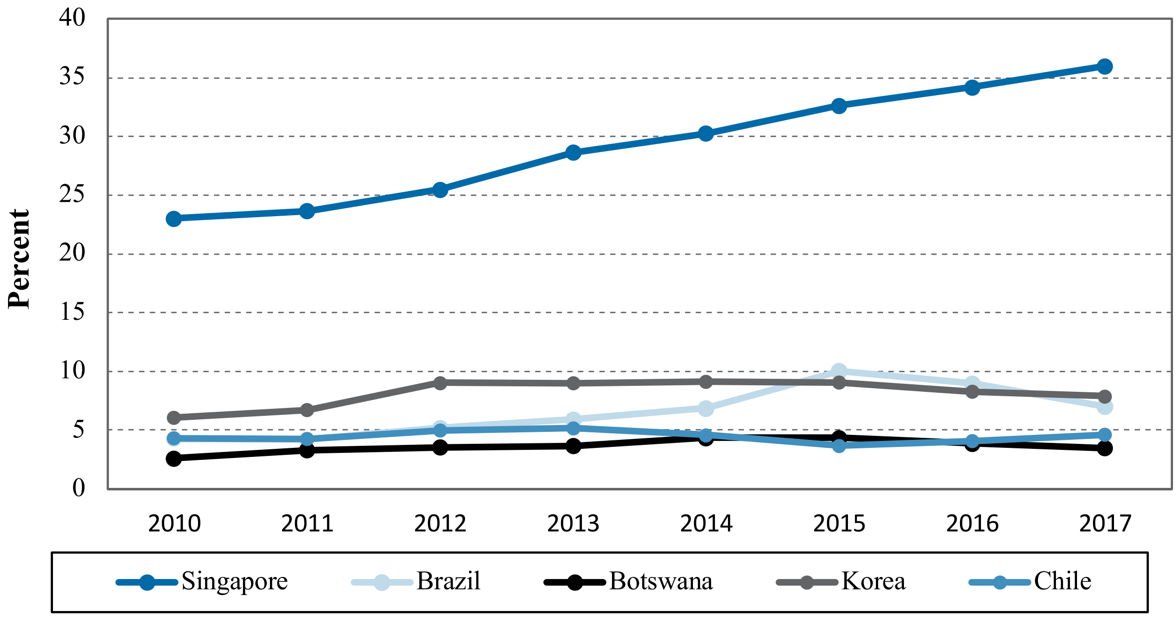
4.12 Most of the DFIs in the comparator countries also use asset securitisation as a funding alternative, an option that is not actively used in Botswana. That is, these institutions create and issue tradable securities, such as mortgage-backed securities and credit default swaps that are backed by the income generated by an asset, a loan, a public works project or other revenue source. Furthermore, credit sharing schemes, such as loan syndications for large infrastructure projects, are widely used in comparator jurisdictions.

4.13 DFIs also require an enabling environment that enhances domestic capacity, such as good corporate governance,[65] a critical component for the success of DFIs. The quality of governance and management is often the difference between the success and failure of

[64] Angel equity (sometimes referred to as angel investment) refers to funding of start-up investments in exchange for ownership equity or convertible debt. This type of equity is not based on the viability of a business but rather on helping a business to take-off; thus fosters innovation, which is vital for economic growth (https://www.forbes.com/sites/allbusiness/2015/02/05/20-things-all-entrepreneurs-should-know-about-angel-investors/#4616c2dac1aa).

[65] Corporate governance refers to the structures and processes for the direction and control of companies.

Chart 12: DFIs' Total Loans to GDP Ratio



Source: Bank of Botswana, BNDES, DBS, KDB and Inter-American Development Bank
Note: Total loans for Botswana include those of BDC, CEDA and Statutory Banks (NDB, BBS and BSB).

Table 6: Deposit - Taking Institutions' Total Credit to GDP Ratio (Percent)

	2010	2011	2012	2013	2014	2015	2016	2017	Average
Botswana	27.6	29.6	34.1	34.4	33.7	36.7	33.3	33.1	**32.8**
Chile	67.3	72.1	76.02	79.0	81.9	85.3	84.7	82.6	**78.7**
China	125.1	126.3	128.8	134.1	140.4	152.7	157.1	156.1	**125.7**
Mauritius	93.2	96.2	105.9	112.8	104.1	105.2	100.2	108.7	**103.3**
Brazil	61.8	67.5	72.6	74.8	77.7	79.9	74.4	68.2	**72.1**
Korea	155.1	157.7	158.4	157.3	162.7	166.3	169.8	171.3	**162.3**

Source: IMF

FDIs functioning in the same environment. For example, in China, the government held a tight leash on the management and governance of these institutions, while in Brazil, the BNDES was seen to be successful owing to its strong management. This contrasts with Botswana as highlighted in Section 3.

4.14 In Singapore, government-linked companies (GLCs), such as DFIs, are independently-managed; for example, unlike in Botswana, the government is not involved in the appointment of board members of GLCs. Nevertheless, there is significant involvement by Temasek Holdings Limited (THL), a company wholly owned by the Singaporean government which, in turn, owns a number of enterprises classified as GLCs. THL thus appoints board members for GLCs that operate at policy and oversight levels rather than being involved in operations and management activities.

4.15 The other difference between Botswana and the comparator countries is the quality and effectiveness of monitoring and evaluation. In Botswana, the requirement to account with respect to mandates and identification of plausible requisite remedial measures, where needed, does not appear to be strictly applied. There is, therefore, a need for a sound monitoring and evaluation framework, as the absence of such can progressively stretch the tolerance range for ineffective performance. Given its mandate, there is also a level of expectation for the Public Enterprises Evaluation and Privatisation Agency (PEEPA) to account for its impact in monitoring the performance of public institutions in meeting their objectives and targets. Notably, PEEPA also advises Government on the appointment of directors to serve on boards of public institutions and monitor their performance. Therefore, PEEPA should enhance their monitoring and evaluation efforts and encourage accountability of the DFIs and generate a performance scorecard, including for its own performance.

(i) Commercial Bank Funding

4.16 As highlighted above, the significant public sector financing of businesses does not detract from commercial bank lending. For example, for the period 2013 – 2018, the 37.2 percent average for commercial bank lending to businesses as a share of total credit in Botswana compares with average shares of 85.9 percent, 60.2 percent and 34.8 percent for Mauritius, Singapore and Brazil, respectively. This relatively low level of access to financial resources is also manifest with respect to sectoral credit for targeted sectors (Charts 13 – 16). The notable example relates to the tourism sector, where a share of one percent in total commercial bank credit in Botswana compares with 15.9 percent in Mauritius. This is a relevant focus area for Botswana, as tourism is increasingly viewed by many countries as potential platform for enhanced industrialisation and development, including in the advanced and emerging market economies. Thus the investment in requisite infrastructure and improvements in service and standards to promote development of this sector. Furthermore, tourism-friendly policies and initiatives are generally implemented to allow for a conducive environment in the tourism sector. In Botswana, the tourism sector has significant potential, with scope for both the spread of activities and value. According to the 2018 United Nations World Tourism Organisation (UNWTO) report, Botswana accounts for 1.9 percent to the international tourism receipts. Thus, the need for support for infrastructure and services and the tourism businesses/ventures. As it has been alluded to in the previous section, there is need for infrastructure development, more especially air travel infrastructure (frequency of flights, well-equipped airports), which can boost both the tourism receipts and the number of tourist arrivals in Botswana.

4.17 Another interesting example is the stipulation of an 18 percent minimum share of lending to the agriculture sector in India where, reportedly, the impact on sectoral performance has been significant.[66] However, this is in the context of substantial government ownership of commercial banks. For Botswana, the share of lending to agriculture averaged 2.1 percent for the period 2013 - 2018. The situation for the manufacturing sector, which is a target sector for economic growth in several countries, is less diverse; for instance, the respective shares in total lending for Botswana, Brazil, Mauritius and Singapore were, on average 6.1 percent, 12 percent, 7.2 percent and 4.5 percent for the period 2013 - 2018.

[66] For example, credit flow to agriculture increased from Rs695.6 billion to Rs4 682.9 billion between 2002-03 and 2010-11.

CHART 13: COMMERCIAL BANK LENDING TO THE MANUFACTUING SECTOR (SHARE OF TOTAL CREDIT IN PERCENT)

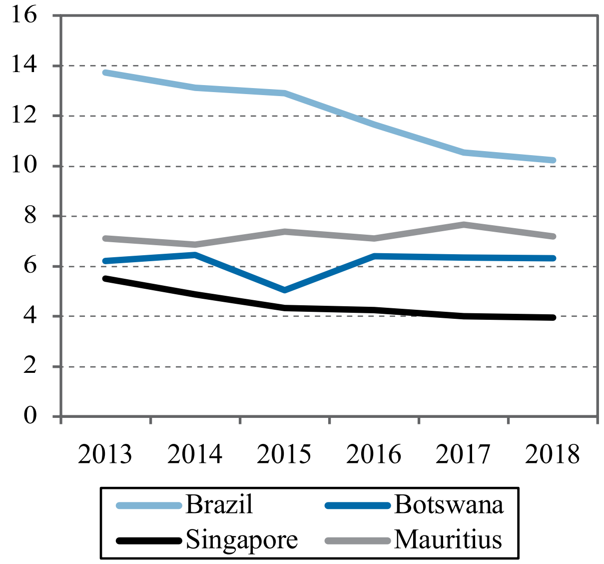


CHART 14: COMMERCIAL BANK LENDING TO THE FINANCIAL SECTOR (SHARE OF TOTAL CREDIT IN PERCENT)

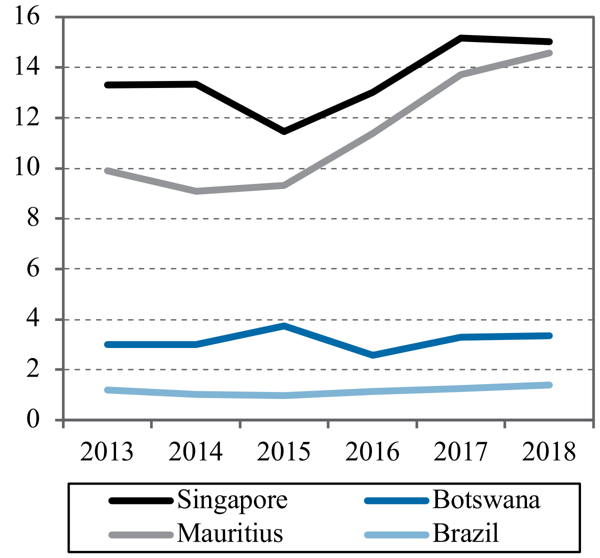


CHART 15: COMMERCIAL BANK LENDING TO THE TOURISM SECTOR (SHARE OF TOTAL CREDIT IN PERCENT)

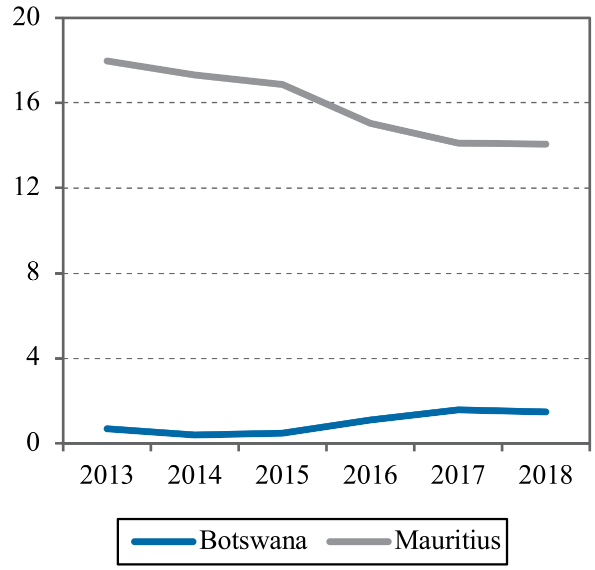
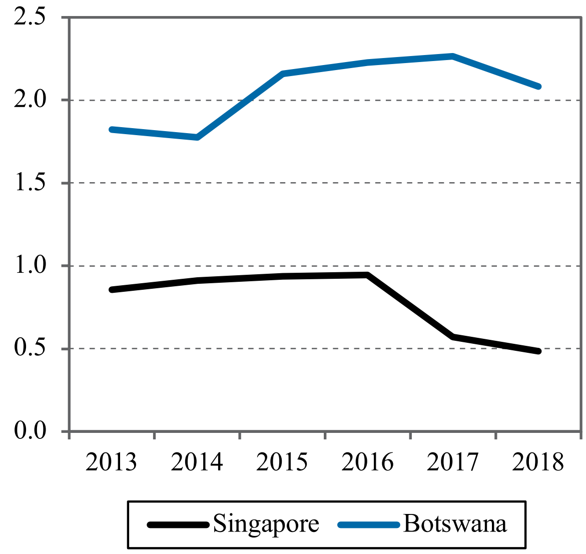


CHART 16: COMMERCIAL BANK LENDING TO THE AGRICULTURE SECTOR (SHARE OF TOTAL CREDIT IN PERCENT)

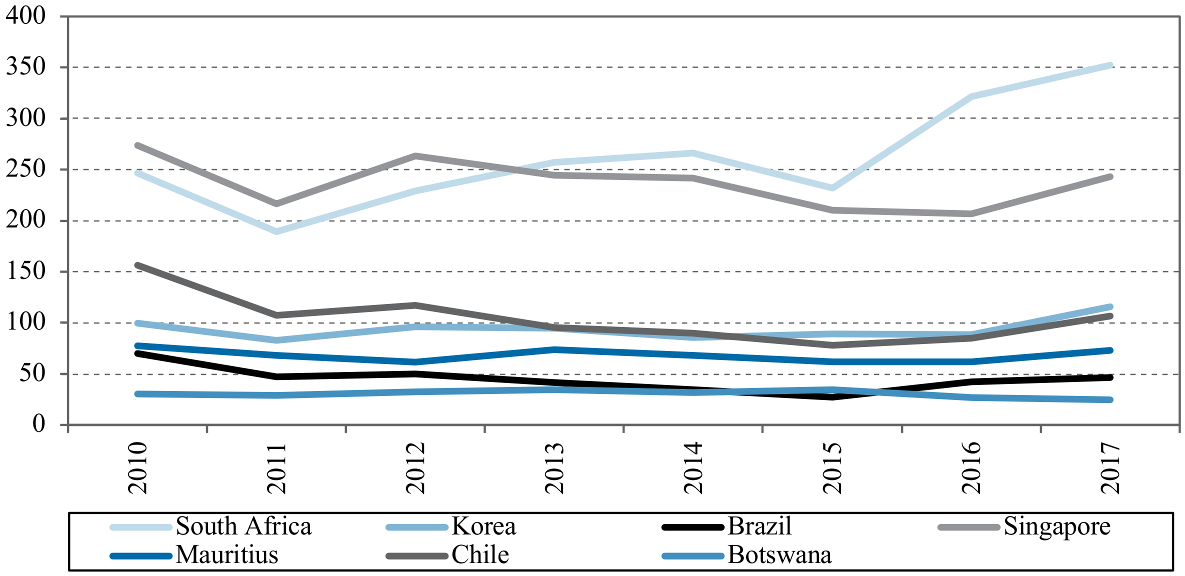


Source: Bank of Botswana, Monetary Authority of Singapore, Central Bank of Brazil and Bank of Mauritius

(b) Stock Market Capitalisation

4.18 The stock market capitalisation to GDP ratio (another indicator for financial resource mobilisation intensity) for Botswana remains very low compared to comparator countries, for example, South Africa, Singapore, Chile, Korea, Mauritius and Brazil (Chart 17); an indication that the Botswana Stock Exchange remains very small relative to the size of the economy. This is due to the small number of stocks listed and the low volumes of issued shares available for trading. The relatively small number of shares on offer constrains the mobilisation of and access to finance, limits the potential for business growth and, therefore, economic activity overall.

Chart 17: Market Capitalisation as a Percentage of GDP

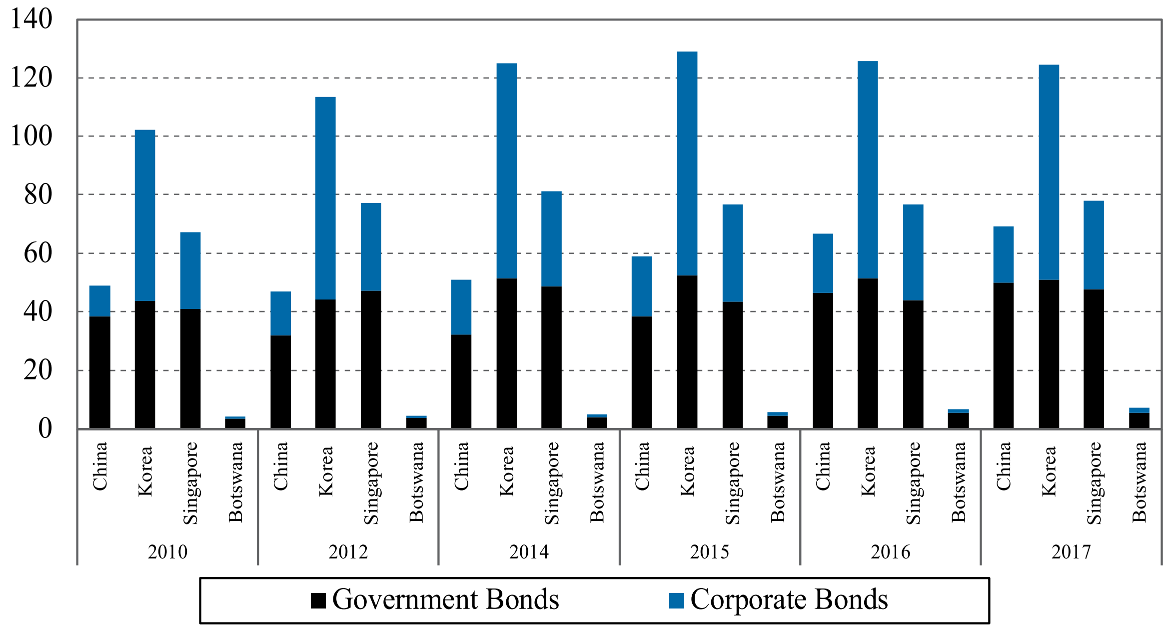


Source: Central banks of various countries

(c) Size of the Bond Market as a Percentage of GDP

4.19 The Botswana bond market (both government and corporate) continues to grow. The value of the bonds listed on the bond market amounted to 7.4 percent of GDP in 2017 compared to 4.3 percent in 2010. Despite this considerable growth, the bond market remains small compared to those in the comparator countries (Chart 18). This is due to the small number of issued bonds and the low trading volumes in the secondary market, which restricts the mobilisation of and access to finance.

Chart 18: Size of Bond Market as a Percentage of GDP



Source: Central banks of various countries

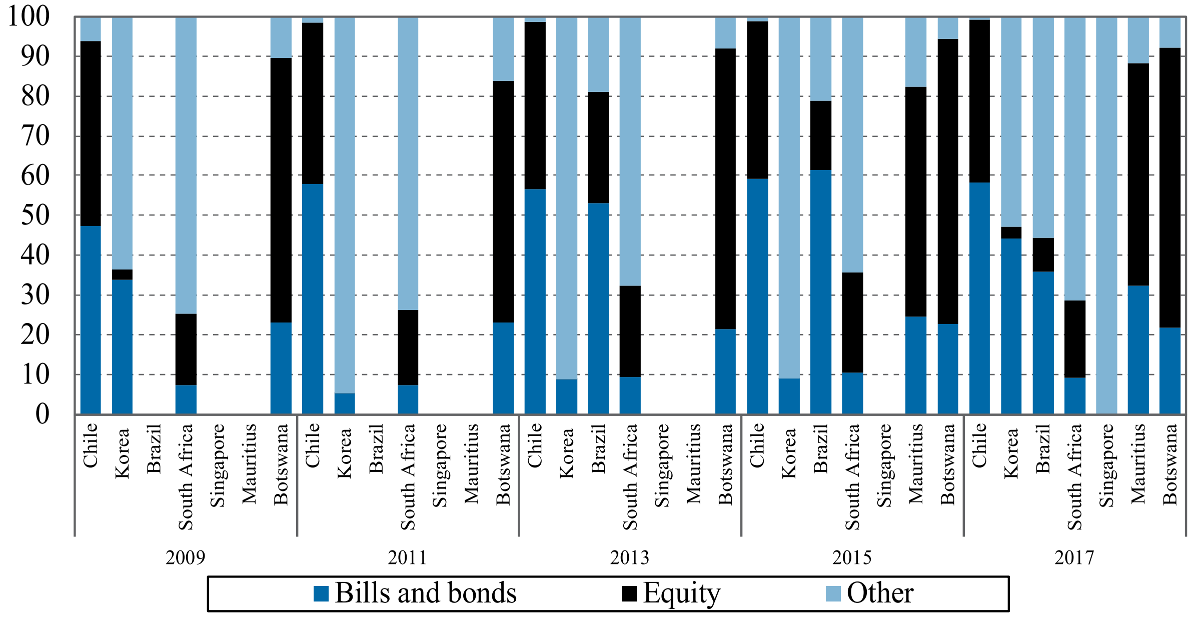
(d) Pension Fund Assets[67]

4.20 Pension funds are a common source of funds for government (including local government and municipal authorities) and corporates, given the need to fund long-term liabilities and to generate returns. As shown in Chart 19, the pension funds are mainly invested in bonds and equities, but in some instances with significant holding of cash and deposits. For Botswana, pension funds are mostly invested in equities, with an average of 68.5 percent of total pension fund assets between 2009 and 2017, and 22 percent of assets were invested in bonds (the remainder would be held in cash or near cash investments to afford liquidity). However, of the 68.5 percent invested in equities, 47.4 percent was invested offshore and only 21.1 percent was invested in the domestic equities market. Broadly, this would reflect a prudent portfolio balance with respect to risk and return, especially given the need to safeguard future earnings of pensioners. However, for Botswana, this also reflects the paucity of viable investment opportunities, despite the active pursuit in the quest for localising the availability of resources to support development and industrialisation aspirations.

(e) Key Lessons from Selected Country Experiences

4.21 Botswana, like some of the sampled comparator countries, has established state-owned enterprises (SOEs) and targeted financing schemes to support industrialisation and entrepreneurship, as discussed in Section 3. However, the financing gap continues to be significant, while there is evident resource losses and leakages associated with DFIs. Overall, the conducive business environment, openness to FDI and sound governance and accountability for the DFIs are some of key influences of successful and productive financial resource mobilisation. In this regard, the South East Asia (SEA) region provides valuable lessons for Botswana. Table 7 highlights key lessons from country experiences.

CHART 19: PENSION FUND ALLOCATION BY ASSETS (PERCENT)



Source: Bank of Botswana and Organisation for Economic Co-operation and Development

Note: Data are not available for Brazil (2009 to 2012), Mauritius (2009 to 2014) and Singapore (2009 to 2015)

[67] There is lack of data to facilitate comparison on sectoral funding with Botswana.

Table 7: Key Lessons from Country Experiences

Lessons	Remarks
Public-Private-Partnership (PPP)	• Joint public-private partnerships in China and Singapore funded their industrialisation processes. • United Nations Economic and Social Commission for Asia and the Pacific reports that between 2000 and 2016, SEA countries attracted about USD195.5 billion in private investment in 401 infrastructure projects across various sectors; 47 percent of this was in the electricity sector, followed by ICT with 38 percent. • The SEA region realised that, in order to attract more private infrastructure investments, there was a need to establish a credible regulatory and enabling environment and a sound PPP project pipeline. This required ***a clear policy orientation*** that creates a stable and long-term vision, while offering a clear perspective as regards the flow of projects to be developed under the PPP mechanism; ***a legal and regulatory framework*** that provides clarity for government actions and assurance for the private sector that its legitimate rights will be adequately protected; ***a supportive institutional arrangement*** in which internal capacity is built and responsibilities are assigned for promoting, implementing and managing PPP projects; and ***financial support measures*** that will make projects sufficiently profitable and safe for attracting private interests, while preserving fiscal stability.
Multi-National Corporations (MNCs)	• In Singapore, given the scarcity of local entrepreneurial talent and the lack of industrial technology at the time of independence, the Singapore Government decided to work with MNCs, which attracted more foreign direct investment to the country. MNCs boosted economic development by transferring technology and knowledge, as well as contributing to improved infrastructure.
Enhancing Public Expenditure Efficiency in Infrastructure	• McKinsey (2013) estimates that infrastructure spending can be reduced by about 40 percent through improvement in productivity and this could reduce pressure on the government budget significantly. This is to say that enhancing the efficiency in public spending should result in significant savings. These efficiency gains can be realised through: *(i)* ***Prioritisation of projects*** – there is a need for clear guidelines for infrastructure projects appraisal, as well as a prioritisation process to help align infrastructure development with national priorities, while providing a long-term vision for the country; *(ii)* ***Improving delivery*** – this requires streamlining permit approvals, facilitation of land acquisition, and improving public procurement and enhancing governance. It is reported that it takes 48 days and nine procedures to obtain necessary licences and permits, complete required notifications and inspections and obtain utility connections in Singapore for infrastructure projects. In that way, Singapore was able to realise significant gains without increasing public expenditure. Delays in the process of obtaining permits, which can increase costs and uncertainty, are considered as a fundamental barrier to private investment in, and speedy delivery of, needed infrastructure (United Nations Economic and Social Commission for Asia and the Pacific, 2017); *(iii)* ***Maximising the use of existing assets*** – It is reported that the SEA region, faced with an infrastructure financing gap and constraints of low revenue bases, high levels of national debt, and tight fiscal positions, makes wider use of existing infrastructure; and *(iv)* ***Reforming SOEs*** – SOEs should be held accountable for delivering high quality project management.
Capital Markets	• The SEA region offers different levels of capital market development from a financial hub in Singapore, established domestic markets of Malaysia and Thailand, emerging domestic markets of Indonesia and the Philippines, and nascent markets of Brunei, Cambodia and elsewhere. These countries have, as a result, raised infrastructure funding to varying degrees. For example, Malaysia has a more active infrastructure financing market, with bonds amounting to USD 22.6 billion in December 2016 compared to only USD 7 billion in Thailand, which was the second largest in the same period.

Lessons	Remarks
Mobilising Domestic Resources	• The 2017 *Annual Report* Theme Chapter also identified the mobilisation of domestic resources as an alternative source of infrastructure financing. Available options include prioritising public spending to free resources for infrastructure investments (for example, a gradual removal of subsidies that constitute a large proportion of the government budget and reallocating the resources to infrastructure investments) and broadening the tax base.
Movable Collateral Registry	• Love *et al*., (2016)[68] established that introducing collateral registries for movable assets increased firms' access to bank finance in countries such as Mauritius. They also found some evidence that this effect is larger among smaller firms. Therefore, there is a need to introduce the movable collateral registry to increase firms' access to finance by allowing them to leverage movable assets, such as inventory, crops and equipment, into capital for investment and growth.
Supportive Infrastructure	• The Government of the Republic of Korea invested heavily in physical infrastructure (power plants and express highways) and also aimed to accelerate the development of science and technology in order to provide a conducive environment for industrialisation. • Some of the impactful interventions by the Government of China include engineering an extraordinary boom in science and technology, research and development activities, and fuelling a massive financial investment drive aimed at enhancing China's infrastructural and human capital environment.
Guarantee Schemes	• The Republic of Korea created a guarantee scheme to facilitate borrowing abroad to support indigenous technology and industrial development, as opposed to relying on foreign technology and firms. The Korean Development Bank and other firms could borrow abroad and the Bank of Korea would issue a guarantee to the foreign lender. These guarantees resulted in lower costs of external loans.
Accountability	• The governments of Singapore and China made sure that the private sectors followed their mandates/policies. For instance, in Singapore, the government had made a commitment to and had ownership of the economic development strategy and had power to influence economic behaviour. The governments ensured proper implementation of projects they deemed crucial for their countries' development. In China, the government held a tight leash on the management and governance of the SOEs. For example, the Chinese Communist Party had the power to decide on the appointment and promotion of top SOE executives. In Botswana, PEEPA has been established to monitor the performance of public institutions in meeting their objectives and targets, as well as advise Government on the appointment of directors to serve on the boards of public institutions and monitor their performance. However, there is need for PEEPA to enhance its monitoring and evaluation efforts.

[68] Love, I., Martinez Pería, M.S., and Singh, S. (2016). "Collateral Registries for Movable Assets: Does Their Introduction Spur Firms' Access to Bank Financing?" Journal of Financial Services Research, Volume 49, Issue 1, pp 1 - 37.

Lessons	Remarks
Targeted Tourism Initiatives to SMME Financing Programmes	• In Slovenia, the programme of financial incentives for the economy includes a dedicated tourism sub-section with the goal of stimulating tourism businesses to achieve the strategic objectives of Slovene tourism. Financial resources are targeted at co-financing marketing and promotion activities and ensuring a competitive business environment through, for example, co-financing research and development and providing pre-finance for participation in European projects.[69] • In Croatia, the Croatian Bank for Reconstruction and Development has three targeted loan programmes to support the tourism industry and help businesses prepare for the upcoming season and cater to the international visitor market. Tourism businesses can also benefit from measures to promote investment, credit guarantees, grant schemes and co-financing consultancy services offered by the Croatian Agency for SMMEs, Innovation and Investments. • In Austria, a dedicated one-stop shop for all tourism financing-related issues exists. The Austrian Tourism Development Bank (OEHT) is a public-private partnership with a long history and experience in the tourism sector. The OEHT has been effective in broadening the range of financing instruments available to tourism businesses in Austria. Programmes offered by OEHT are based on direct and indirect financing and risk sharing. They also include initiatives to stimulate private financing participation. The Bank's instruments can be combined with commercial financing options, which may not fully cater for the needs of tourism SMMEs. Depending on the instrument, entrepreneurs may be required to make an equity contribution. Special programmes also target the needs of tourism start-ups and boost business innovation. • In New Zealand, public support to tourism firms is provided over two main tracks: one track supports the provision of innovative products, processes or goods, while the other targets family-owned enterprises to support regional development. Supporting local development is a strategy that contributes to reducing inequality and generates growth that is more inclusive. The Tourism Growth Partnership is a government initiative to help the tourism sector achieve greater commercial and wider returns from high value international visitors. It provides strategic, targeted funding for internationally focused projects that align with wider government tourism priorities, including increasing innovation and productivity in tourism.
Finance Inclusive Entrepreneurship	• In Canada, programmes are in place to finance tourism SMMEs that are led by women, migrants and ethnic groups, or other minorities. These programmes recognise that these groups face bigger challenges in accessing external finance and recognise that entrepreneurship is an alternative to unemployment. Public financial support offered by the Federal government, in co-ordination with sub-national governments and the private sector, also aims to promote regional tourism development, including the integration of SMMEs in the tourism value chain.
Peer-to-Peer Lending and Equity Crowdfunding	• In 2014, New Zealand introduced peer-to-peer lending and equity crowdfunding to the country's capital market. These forms of financing approaches provide businesses and individuals with a simple, low-cost way to raise capital from investors. These forms of capital raising have had a positive impact by deepening capital markets and improving the flow of growth capital to New Zealand SMMEs. The use of these instruments is well developed in China and the United Kingdom.

[69] OECD (2017). "Financing approaches for tourism SMEs and entrepreneurs", OECD Tourism Paper, 2017/03, OECD Publishing, Paris. http://dx.doi.org/10.1787/8d06572a-en

Lessons	Remarks
Agriculture Development Fund	• In Canada, the Canadian Adaptation and Rural Development Fund was established to assist the agricultural sector to deal with structural challenges and market shocks by focusing on research and innovation programs, human resource development, seizing market opportunities, environmentally-sustainable development, food quality and safety, and rural development. The fund plays an important role in enhancing the positive cycle and healthy development of the agri-food sector. It encourages market-driven innovations on the basis of food safety and environment sustainability. In addition, the Alberta Beef Development Fund and Canada Agricultural Adaptation were created to support various research initiatives, such as promoting sustainable beef production, and improving land and environment management skills and to assist with adaptation for new opportunities and challenges on the domestic and international market, respectively.[70]
Agriculture Development Bank	• In South Africa, the Land and Agricultural Development Bank of South Africa (Land Bank), a specialist agricultural bank, wholly owned by the government, was established to provide financial services to the commercial farming sector and to agri-business, as well as make available certain financial products to farmers with disadvantaged backgrounds.
Value Chain Financing	• In India, agriculture forms the resource base for a number of agro-based industries and agro-services. Therefore, agriculture is viewed not as farming alone, but as a holistic value chain, which includes farming, aggregating, processing, warehousing (including logistics) and retailing. The value chain refers to the full range of activities that are required to bring a product or service from conception, through the different phases of production, to delivery to final consumers, and final disposal after use. Some value chains in India, such as for fruits, vegetables, coffee, tea, spices, and cashew are oriented towards exports. With value chain finance, financial institutions in India support farmers by tailoring services and products to one or more points in a value chain in order to reduce the risk and cost of financing, and increase the efficiency of the value chain as a whole.

[70] African Development Bank (2015). Study on Modern Agricultural Demonstration Area Plan and Financial Support Mobilisation.

5. Policy and Institutional Considerations Going Forward to Enhance Access to Finance for Industrialisation by Identified Sectors

5.1 As discussed extensively in the 2017 Bank of Botswana Annual Report, the quality and performance of governance and effectiveness of institutions, macroeconomic policies and the country's industrialisation policies play a critical role in determining the ability of the economy to generate capital for funding investment and, hence, industrialisation. Good governance is the key to unlocking private resources and opportunities for financial flows that are essential for sustainable economic growth and development. According to the 2017 Mo Ibrahim Index of African Governance Report, Botswana ranked fifth in terms of the overall performance for governance, and the least corrupt country in Africa in the same year. However, though Botswana's ranking is impressive, it has deteriorated from second place in 2016, suggesting a need to review areas that have led to the slippage, which include safety and respect for the rule of law, and transparency and accountability. At the same time, there is need to capitalise on gains made in areas such as welfare and infrastructure, which have improved in the rankings.

5.2 According to Transparency International's Corruption Perceptions Index, Botswana ranked first in Africa and 34th in the world in 2017.[71] Similarly, Botswana's credit ratings by the sovereign rating agencies have been impressive over the years, supported by, among others, 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. Alongside these, there is also the need to ensure that macroeconomic policies, such as monetary, exchange rate and fiscal policies, play a supportive role in attracting investment to the country.

5.3 As is the case in other countries, fiscal policy in Botswana has several objectives, including revenue mobilisation, provision of public infrastructure, goods and services and redistribution of income that is biased towards vulnerable members of the society. Over the years, the country has accumulated large fiscal reserves, through fiscal discipline that has earned policy credibility and led to the accumulation of financial assets (Moody's Investors Service, October 2018). Going forward, these need to be maintained, if not improved further.

5.4 Business friendly tax policies, including tax holidays and/or reduced tax rates, among others, are among key incentives used in attracting businesses to SEZs. In China for example, companies operating in the SEZs are exempted from paying taxes for two years, followed by three years of paying half the normal tax rate. Meanwhile, in the case of Botswana, companies operating in the Selebi-Phikwe Economic Diversification Unit (SPEDU) region, are offered a five percent corporate tax for the first five years; 10 percent corporate tax thereafter; zero customs duty on imported raw material (in line with the SACU Agreement), rebates of customs duties and VAT for importation of raw materials. It is, therefore, important to ensure that tax systems, policies and administration are balanced between the need to mobilise resources for financing infrastructure development and other requirements for sustainable economic development, including providing effective incentives for private sector investment through the SEZ framework.

5.5 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. The ability of the economy to maintain low and stable inflation would complement the conducive business environment that Government is committed to supporting through measures such as the establishment of SEZs. Thus, effective monetary policy is critical in the creation and maintenance of investor confidence, which augers well for the industrialisation drive.

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71 The index ranks 180 countries and territories according to their perceived level of corruption in the public sector by experts and businesses.

5.6 Botswana has so far done very well on this front: inflation has been generally within the Bank's medium-term inflation objective range of 3 – 6 percent for a period exceeding five years and inflation expectations are well anchored. This has allowed the Bank to maintain an accommodative monetary policy stance that has so far benefitted the economy. This environment needs to be maintained going forward, for monetary policy to fully contribute towards Botswana's efforts to transition to a high-income country. This is because a low, stable and predictable level of inflation, coupled with a conducive business-friendly environment, fosters savings mobilisation, productive investment and international competitiveness of domestic producers which, in turn, contribute towards the broader national objectives of sustainable economic development and employment creation. Equally important is a sound and stable financial system, particularly the banking sub-sector (including the payments system), as it serves as the main transmission channel for monetary policy signals and facilitating economic activity through the provision of liquidity and risk mitigation.

5.7 In addition, it should be noted that national efforts to mobilise resources are interrelated with the external economic and financial 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. The current exchange rate policy framework has served the economy well; it supports broader national policy objectives and is consistent with other macroeconomic policies.

5.8 The Pula exchange rate continues to be monitored to ensure alignment with the objective of maintaining a stable real effective exchange rate considered supportive of competitiveness of domestic industry, in competing with imports and in external markets. The IMF 2018 Article IV Mission has also come out in support of the framework, noting that the exchange rate framework, based on annual reviews to the rate of crawl and basket weights, remains appropriate. Therefore, the current crawling peg system remains appropriate for Botswana, and has resulted in a stable external position that is consistent with fundamentals and is in congruence with other national macroeconomic policies, such as those relating to fiscal, monetary, trade and financial sector issues.

5.9 In general, macroeconomic policies have an influence on economic performance and economic growth and development, which are, in turn, related to the level and pace of industrialisation. Thus, the Government should continue to pursue sound macroeconomic policies, which are necessary to pave a way for the achievement of a higher level of industrialisation in the domestic economy, in order to ultimately achieve the sought-after high-income status.

6. Conclusion and Policy Recommendations

6.1 From being classified as one of the poorest countries in the world at the time of independence in 1966, Botswana transitioned to upper middle-income status in 1997, according to the Word Bank Rankings. However, since then, the country has been unable to escape the so-called "middle-income trap". This is despite the relatively conducive environment characterised by a stable macroeconomic environment, full liberalisation of the capital account, good governance and resource commitments aimed at facilitating diversification of the economy and promoting inclusive economic growth. Indeed, the ideals for diversified and inclusive economic growth and transition to high-income status are espoused in successive National Development Plans and Visions 2016 and 2036, *'Prosperity for All.'* The stagnation mirrors the trend decline in the GDP growth rates (from an average of 4.7 percent between 1997 and 2007 to an average of 3.9 percent in the next ten-year period from 2007); thus the pace of industrialisation and economic expansion has not been enough to raise employment and income generating opportunities to high-income status.

6.2 In the earlier years after independence, especially following discovery of the lucrative diamond mines, growth was propelled by infrastructure development and expansion of government services against the background of a stable macroeconomic environment, conducive to private economic activity. Moreover, it was considered that given a conducive environment, active intervention by Government to "choose winners" for purposes of accelerating industrialisation was unwarranted. Even then, there has, over time, been sustained support for vulnerable areas, such as agriculture, enterprise development and small and medium scale businesses and, for some time, active encouragement of export-oriented manufacturing given the employment potential. Increasingly, however, constraints with respect to inputs (enabling infrastructure, utilities, skills and productivity), competition from imports (goods, services and labour), slow adaptation of modern production methods (especially in agriculture), as well as modest effectiveness of support institutions, moderated industrialisation and growth prospects, as well as income generating opportunities. The results of continued active support for agriculture and entrepreneurship development have also been modest.

6.3 In the circumstances, Botswana has now adopted an industrialisation strategy anchored on cluster/hub approach which seeks to harness the country's economic potential aligned to natural endowments and in areas where the country has a comparative advantage. This involves beneficiation and enhanced extraction of economic value with respect to natural endowments such as diamonds, beef production and tourism, as well the creation of SEZs, industrial clusters and hubs, which available literature suggests have been successful in several countries, including China, India and Mauritius. The anchor Ministry of Investment, Trade and Industry has also developed a three-pronged strategy to support SMMEs, investment and export development. The potential to execute this economic transformation agenda will clearly derive from the dedication of resources towards effective implementation. Second, it will be imperative to sustain a conducive and stable macroeconomic environment, including policy transparency and predictability. Third, the envisaged industrialisation needs to be adequately supported in terms of key inputs, among which are financial resources as discussed in this Theme Chapter. Even then, to be effective, the allocation of financial resources, in particular, by Government and related entities, needs to be in the context of judicious evaluation of prospective returns and involving good governance and effective operational processes to afford circulation and perpetual growth of funds (engendered by successful recipients of funds).

6.4 For its size and prima facie, Botswana is sufficiently endowed with financial resources as reflected in the relative levels of both private and government savings; while given its debt profile and credit rating, there is considerable scope to augment financial resources through domestic borrowing and other capital flows. The evidence, nevertheless, suggests existence of a funding gap in the country, thus stultifying prospects for industrialisation.[72] The partial allocation of financial resources domestically is justifiable to the extent that there is no effective demand; that is, viable funding proposals that will ultimately contribute to an increase or, at the minimum, preserve the real value of resources.

6.5 However, in an environment where there is capacity under-utilisation; for example unemployment and unproductive land, partial deployment of resource could imply foregone or loss of resource potential. Indicators of dynamism of the financial sector in intermediation (financial sector variables relative to output) also show weaker performance by Botswana. At the same time, even in the instance of partial allocation of resources, there is evident loss of financial resources, especially those intermediated by the development finance institutions, where funding has not been matched by successful business ventures and projects; thus high non-performing loans and continuous capital erosion (for example NDB and CEDA).

6.6 The challenge appears to be effective harnessing of the financial resources to support industrialisation, including financing and facilitation of the requisite inputs. Four dimensions of effectiveness are, therefore, projected/highlighted for active consideration going forward, namely optimising domestic resource mobilisation; funding of

[72] The World Bank Group's Ease of Doing Business and the World Economic Forum's Global Competitiveness Report consistently list lack of access to finance, especially by SMMEs, as one of the constraints to doing business in Botswana. Likewise, the BES of local firms conducted by the Bank of Botswana also highlight access to finance as one of key challenges to successful business operation and, in particular, entrepreneurship.

(industrialising) businesses and economic activity by households; financing of related infrastructure, utilities and research and development; and governance, as well as process and operational efficiency and effectiveness of financial intermediaries.

6.7 Ostensibly, resource mobilisation is about increasing the quantum of financial resources to support a broad range of economic activity. However, to the extent that it involves transition from sub-optimal mobilisation, there could be added benefits such as enhanced economic value of resources, spread of benefits (across the economy and over time), as well as improvements in governance and accountability. There are two pertinent examples. First, the increase in non-discretionary saving (pension) helps in pooling a larger quantum of long-term funds, where governance and fiduciary rules and responsibilities inspire and assure investment in viable, high return projects and businesses that potentially contribute to industrialisation. Moreover, there is reduced fiscal responsibility and contingent government liability associated with social safety nets.

6.8 Second, evidence from literature suggests that extension of tax coverage and responsibility beyond natural resource rents engenders demand for accountability, on the part of government, by tax payers; thus potentially better resource use (less wastage) for long-term benefit of the economy.[73] Therefore, for Botswana, steps need to be taken to increase tax coverage, in particular, for property, unused land (to encourage direct use or leasing)[74] and, subject to cost/benefit consideration effective means of taxing the informal sector and small to medium scale businesses.[75] Furthermore, it is also warranted to actively consider a national pension scheme to low-income earners, especially in the private sector, contract employees and the self-employed (although the insurance industry is active in this regard). Aligned, thereto, there continues to be a need to accelerate development and popularisation of the capital market to facilitate the raising of funds through the stock market and issuance of debt securities by various entities. The envisaged improvements in trading and settlement infrastructure and systems at the BSEL should be helpful in this regard. There is, furthermore, scope to make improvements to the Government Bond Programme; for example, introduction of a lower maturity Treasury bill, increasing the frequency of auctions and the amount of issuance. But also longer-dated government bonds/inflation-linked bonds to meet investment requirements of annuity providers.

6.9 Regarding the funding of economic activity, the preceding discussion has demonstrated that there is considerable scope to enhance the deployment of financial resources. In particular, there is need to align the allocation of financial resources to the focus areas for industrialisation. Regarding the private financial institutions, the transition towards enhanced involvement in industrialisation would be influenced by pace and diversity of deposit/funding mobilisation (for example, a larger retail component and non-deposit liabilities), policy posture and guidance, competition and effective demand. Therefore, respective policy and regulatory authorities need to assess the impact of policy, legislation and regulation on prospects for productive deployment of financial resources to support the industrialisation strategy. As well as assessment of other areas, there are evident prospects for financial technology that need to be embraced and harnessed under appropriate conditions. Overall, and fundamentally, maintenance

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73 For example, Moore M., (2007) "How Does Taxation Affect the Quality of Governance?" Institute of Development Studies; and Martin L., (2013). Taxation and Accountability: Experimental Evidence Taxation's Effect on Citizen Behaviour, Yale University.

74 To some extent, also address concerns about "hoarding" by absentee landowners and perceptions about denial of access by locals.

75 A common argument against taxing the informal sector is that revenue yields are low, administrative costs high, tax incidence is likely to be regressive, and tax enforcement exposes vulnerable firms to harassment. However, research highlights the potential benefits. For example, with respect to revenue, the informal sector forms a large and, in many countries, growing share of GDP, and thus represents a potentially significant source of tax revenue. Moreover, taxing the informal sector may could be essential to sustain "tax morale" and tax compliance among larger firms. There is also some evidence that formalisation may accelerate growth for some informal sector firms, and may have broader benefits for existing formal sector firms. Furthermore, the payment of taxes by firms in the informal economy may be a method of engaging firms with the state, and thus promoting legitimacy, good governance, and political accountability (Joshi A., Prichard W., and Heady C., (2014). *Taxing the Informal Economy: The Current State of Knowledge and Agendas for Future Research.* The Journal of Development Studies).

of a sound and stable financial system is key to unfettered and productive conduct of economic activity; sound financial institutions are more likely to be amenable to the financial inclusion agenda, effectively transmit policy and innovation, as well as respond to effective demand.

6.10 Beyond the private financial institutions, there is evidence from the experience of other countries that development finance institutions can be effectively harnessed to drive the industrialisation agenda. However, for Botswana, the overall performance of the development finance institutions has been lacklustre, evidenced by recurring episodes of restructuring, refinancing and closures (Section 3). Given the desire to support the industrialisation objective and the positive experience of other countries, a reassessment of the potential for the local development finance institutions is warranted.

6.11 Broadly, there are three areas for consideration going forward. First, is evaluating the prospects for integration and alignment of the operations and deliverables of the key development finance institutions with the cluster/hub/SEZA industrialisation strategy. This will also entail a domestic focus for all the development finance institutions to ensure the concentration of resources and effort towards execution of the strategy. Second is a reconsideration of the scale of operations and, therefore, resource allocation and access. It is considered that, to be effective and have the desired impact, the scale of operations and resources availed should be much larger than current levels; a higher level of funding is needed to support large-scale industrial projects and businesses, which might also involve infrastructure development. Conceiving and allocating finance to projects with no access to infrastructure contribute to failure (or at best inordinate delay – for example the milk and leather projects in Lobatse), as operations and viability are inevitably constrained.[76]

6.12 As highlighted in Section 3, Government has a well-established fiscal policy that supports the development and propagation of infrastructure and utilities to support economic activity and welfare. Indeed, the extensive involvement of Government in the initial development of mining locations essentially amounts to execution of a hub or special economic zone strategy. Viewed in this light, the same approach to supporting the current industrialisation strategy could lead to successful execution; thus facilitating the development of basic infrastructure, as well as the provision of utilities and funding by the development finance institutions (this applies in particular to agriculture where constrained access to inputs is more debilitating). It is, therefore, notable, in this regard, that Government has committed to making budgetary provisions to ensure the success of the SEZ initiative. Funds under the Doing Business Reforms will also be made available to implement measures aimed at improving the business environment.

6.13 Third, a comparison of experience of various countries shows that governance approaches and accountability frameworks matter significantly in the prospects for success and positive impact of development finance institutions on industrialisation. Thus, in general autonomous institutions are more successful compared to those that are run with active government involvement in governance; for example, through Board and Executive appointments and mandate execution approaches. There is also a strong case for outsourcing development and industrialisation funds to commercial banks, where there is better project evaluation, monitoring and loan recovery, which is an option for CEDA and NDB (allocated funds). Even then, sustained operational viability of development finance institutions could be improved by selling non-performing loans at a discount to firms with resources to recover and rehabilitate delinquent assets; thus generating a complementary industry.

6.14 External sources of funds remain a viable option to support industrialisation. The added benefits include scale, potential to support infrastructure development, expertise in project execution, transfer of skills and technology, access to markets and integration into the value chain of regional and global businesses. In particular, there is need to propagate locally the

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[76] For example, conditions for lending in most instances involves assurance with respect to access to land, buildings and utilities, but the same does not apply for lending for farming by NDB. While this may be contextually reasonable, a dedicated and aligned approach that involves supporting and ensuring access to infrastructure could yield better and quicker results for the funded activities.

potential for funding of local industry by the DBSA, Afrexim Bank and the IFC, part of the World Bank Group. Various financing options from these institutions exist, including advice raising finance that could address various needs of local industries. Thus, given a conducive policy and macroeconomic environment, strong governance, operational soundness of the local industry and development finance institutions, Botswana could attract and benefit from such funding. The country could also benefit from funds from private financial institutions and those provided under initiatives such as the G20 Compact with Africa, which seeks to promote private investment in Africa, with a focus on policy design and governance structures for execution.

6.15 It also critical that the policy environment continues to encourage foreign direct investment with the attendant benefits, as well as portfolio investments that add to innovation, vibrancy, beneficial price discovery (reasonableness of cost of funds) and liquidity of the capital markets. At sovereign level, multilateral financial institutions such as the World Bank and the AfDB, as well as bilateral arrangements, remain available for project and infrastructure financing.

6.16 Overall, there is potential for the industrialisation strategy and prospects to accelerate employment and income opportunities, thus the transition to high-income status. Successful execution in this regard is premised on policy and structural transformation in key areas and access to inputs, among which is finance. From the discussion, it is clear that the financing gap is not necessarily due to the quantum of funds, but is fundamentally due to paucity of innovation and deficient governance and operational processes in intermediation. It is, therefore, important to address the policy and administrative aspects in order to engender enhanced resource mobilisation, alignment of productive resource allocation with the industrialisation strategy and a transition towards more autonomy for development institutions, but balanced with a domestic focus and a clear accountability framework for deliverables.