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THE IMPACT OF FINANCIAL LIBERALIZATION POLICIES: THE CASE OF BOTSWANA

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ABSTRACT

Financial liberalization enables market forces to play a greater role in mobilizing resources, allocating credit, setting financial asset prices and improving financial intermediation. Many studies have claimed that these changes enhance savings, and improve efficiency of investment, which ultimately ameliorate economic growth. This paper attempts to analyse the Botswana experience, where despite having an open economy for many decades, financial liberalization was a major policy in the recent structural change. Our analysis show that, in line with the objectives of financial liberalization program in Botswana, both the level of savings and efficiency of investment, have shown some sign of improvement.

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THE STRUCTURE OF THE FINANCIAL SYSTEM

Botswana was one of the poorest countries in the world when it achieved independence in 1966. The country emerged from 80 years of British rule but did not inherit any apparatus capable of promoting economic development. Particularly, the country had no proper infrastructure, communication systems or effective public administration, and was heavily reliant on foreign subsidies and colonial grants (Harland-Thunberg, 1978). Bechuanaland protectorate (as Botswana was previously known) had, since 1895, used various southern African currencies as a legal tender and up to 1976 been a member of Rand Monetary Area (Dahl, 1981). But such a membership in the Rand Monetary Area (RMA) did not give the state any right on monetary policy influence as the South African Reserve Bank not only managed the Rand currency, but also conducted monetary and foreign exchange policies. In this regard, Botswana was disadvantaged for being in RMA since the government had no independence over macroeconomic policies. In particular, foreign exchange rates, interest rates and exchange controls were entirely controlled by South Africa, while the Botswana government also had minimal control over domestic commercial banks as they were foreign subsidiaries having their headquarters in Johannesburg (Harvey, 1985).

Following independence, Botswana did not withdraw itself from RMA¹ but remained part of the monetary system with effectively no opportunities for independent monetary and exchange rate policies, and virtually no instruments for influencing domestic financial institutions in the absence of a national central bank (Harvey, 1996). Despite the above mentioned disadvantages, such a move was significantly important for two major reasons. First, Botswana entirely relied on external finance and, therefore, needed to continue the inflow of investment, especially from the RMA zone. Further, the country could not afford the cost of creat-

ing new financial institutions for this purpose, as there were other important national projects such as infrastructure establishment and educational enhancement that the country was in urgent need (Harvey, 1985). Similarly, Botswana did not have the capacity to run such institutions as it had a shortage of educated and skilled labour force which could be up to this task (Samatar, 1999). Second, withdrawing from the monetary union could have jeopardized the share of custom union revenue Botswana received from the South African Customs Union (SACU), which the country dearly needed for its development projects at a time when the state was facing an extreme scarcity of funds. Instead, the government renegotiated the customs union agreement in 1969, and signed a new formula where Botswana's share of customs union revenue was proportionately linked to growth in imports.²

In addition to these country's specific needs, the state was not in a hurry for radical economic policy changes. The Transitional Plan³ read at independence, as noted by Harvey (1996), emphasized not to control, but "to assist the private sector in every way" in pursuit of the attainment of social and economic development goals. This was a clear indication that the government was, unlike many other African countries, ready to allow the private sector to handle the bulk of economic activity and, hence, determined to maintain market oriented economic policy right at the start. Resultantly, individuals and institutions in Botswana were able to freely invest their liquid funds in the Johannesburg money market (Harvey, 1985).

Despite facing some pressure from some sectors of the society, as acknowledged in the National Development Plan 1968-1972,⁴ the government continued the policy of non-interference. In 1975, Botswana decided to conduct its own macroeconomic policies and hence withdrew from RMA and established its national currency "Pula" after the creation of Bank of Botswana which started operation in January 1976 (Dahl, 1981).

Table 1: Components of the GDP, 1966-2000 (%share)

| Year | Agriculture | Manufacturing | Mining | Industry |
|------|-------------|---------------|--------|----------|
| 1966 | 39.0 | 8.0 | 0.0 | 17.3 |
| 1975 | 25.4 | 6.9 | 12.5 | 32.5 |
| 1977 | 21.3 | 5.8 | 15.2 | 34.6 |
| 1979 | 13.1 | 3.7 | 31.2 | 44.0 |
| 1982 | 8.9 | 6.7 | 32.0 | 43.9 |
| 1985 | 5.5 | 5.2 | 47.2 | 56.1 |
| 1987 | 7.2 | 5.1 | 45.5 | 57.2 |
| 1989 | 4.8 | 5.0 | 51.2 | 61.1 |
| 1991 | 4.4 | 5.0 | 37.7 | 53.2 |
| 1993 | 4.4 | 4.6 | 35.7 | 47.8 |
| 2000 | 4.2 | 6.0 | 33.7 | 44.3 |

Source: World Bank, World Table and African Development Indicators

As much as it was necessary to have an independent currency and macroeconomic policy determination, the effectiveness of the new central bank was largely argued to be constrained by the small size of the market, high degree of external dependency and the country's fiscal authority as it still remained a member of SACU (Makgetla, 1982). With the discovery and expansion of copper, nickel and diamond in 1970s, Botswana's economic prospects looked brighter. As a result of increased exports of these minerals the government balanced the recurrent budget expenditure by 1973 without grants-in-aid from the British government (Harvey and Lewis, 1990). This was also enhanced by the large revenues Botswana received as a result of higher levels of imports, which greatly increased the income from the customs union under the new agreement. Indeed, the increasing importance of mining sector's contribution to GDP (reaching 12.5% in 1975), the building up of foreign reserves and the resulting increase in the government's share of the revenue (refer to Tables 1 and 2) transformed Botswana's finances and provided a greater incentives for the country to have its own

currency and monetary policies.

At independence, Botswana had two foreign owned commercial banks, Standard and Barclays. With the establishment of the Bank of Botswana, these two banks were incorporated locally but remained free to make their own lending decisions (Makgetla, 1982). The new structural changes did not alter the ownership or controls of the commercial banks, although the previously untrammelled power of the transnational banks to dictate interest rates and transfer of funds was now limited. On the other hand, the authorities opted for to use of indirect policy instruments made available by the creation of the new monetary system rather than direct market intervention policy, widely used in other parts of Africa by then (Harvey and Lewis, 1990). The Botswana's economy generally remained liberal, with no specific constraints on trade or other current account transactions. The government decided to introduce exchange controls on capital accounts for the first time. This was particularly for the purpose of forcing commercial banks and other mining companies to transfer their liquid balances, previously held outside the country to the central bank. Further, it also gave some powers to the Bank of Botswana to supervise over large loans by the commercial banks to foreign companies, to make more credit available to local borrowers (Harvey, 1985).⁵

Table 2: GDP per capita, Investment, Aid and Foreign Exchange Reserves

GDP per capita, Investment and Aid

| Indicator | 1966 | 1961-1970 | 1970 | 1971-1980 | 1980 | 1981-1990 | 1991-2000 |
|---------------------------|------|-----------|------|-----------|------|-----------|-----------|
| GDP per capita | 236 | 284 | 413 | 1062 | 1984 | 3430 | 5909 |
| Investment (Ratio of GDP) | 12.5 | 11.1 | 23.6 | 24.1 | 20.7 | 18.4 | 16.0 |
| Aid (Ratio of GDI) | 30.9 | 19.2 | 14.1 | 12.5 | 9.7 | 7.6 | 2.1 |

Debt and Foreign Exchange Reserves

| Year | Foreign Exchange (US\$) | Import Cover (No. Months) | Long-Term Debts (US\$) |
|------|----------------------------|------------------------------|---------------------------|
| 1976 | 75 | 4 | 169.1 |
| 1979 | 267 | 6 | 123.4 |
| 1983 | 396 | 7 | 230.1 |
| 1987 | 2013 | 24 | 545.5 |
| 1991 | 3719 | 24 | 613.2 |
| 1995 | 4696 | 23 | 693.2 |
| 1999 | 6240 | 29 | 454.7 |
| 2000 | 6658 | 34 | 397.6 |

Note: The GDP per capita is at constant 1996 US\$.

Source: Bank of Botswana, Annual Reports, Penn World Table and Harvey and Lewis (1990).

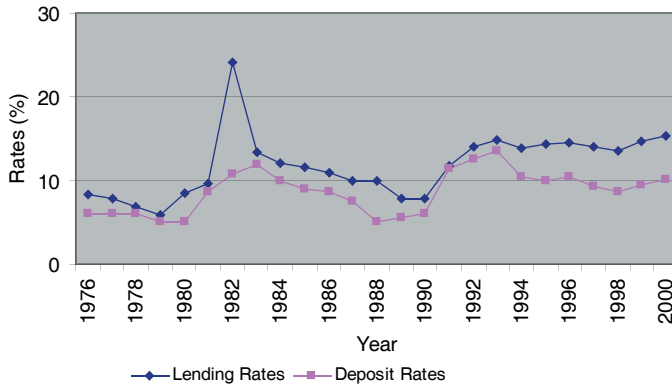
With an increase in the inflows of foreign funds (in both foreign investment and foreign aid as shown in Table 2) and mineral exports, the government income improved rapidly. Due to this, the foreign exchange reserves grew steadily, from US\$ 75 million in 1976 to US\$267 million in 1979, while the government had on deposit at the Bank of Botswana between 30% and 50% of a year's current revenue for the period (Harvey, 1985). The rapid expansion in trade (in both exports and imports) and mining extraction did not bring in the required growth in bank lending. Botswana's government believed that there was a lack of long-term finance in particular and banks were employing only a relatively minor share of their domestic deposits. It is actually hard to prove this claim, but two phenomena may suggest this to have been true; (i) Foreign Direct Investment (FDI) inflows continued despite a significant build up in the country's reserves in late 1970s and 1980s.⁶ Why did foreign capital have to come if these funds could easily be mobilized locally? Since FDI comes with technical, management and necessary market links, foreigners must have observed there were good investment projects, which local investors did not venture. This may indicate that there was long-run investment project problem. (ii) Partially,

this was also reflected in the commercial banks loans and advances as they fell in real terms by 23% from 1976-1980 and, by comparison, the growth in the credit slowed from 46% a year in 1973-1976 to only 5% a year from 1976-1979⁷ (Harvey, 1996). Makgetla (1982) observes that the rapidly increasing earnings which were deposited in commercial banks, combined with limited availability for investment, resulted in excess liquidity in the banking sector, which reached P67 million by the end of 1979.

As the commercial banks lending was dominated by short-term lending for working capital, leaving a small share for fixed investments and project lending, the government decided to remedy the situation to encourage commercial banks to make more long-term lending. The margin between prime lending rates and interest rates on marginal liquid assets was increased from 3.5 to 6.5 percent points in three years, with the aim of giving more incentive to lending (Harvey and Lewis, 1990). In addition, the government deposited some of its surpluses with commercial banks at a long-term, since the banks claimed not to make long-term lending out of short-term deposits.

Further, a law was also passed enabling the commercial banks to take improved security on cattle (Harvey, 1985). Meanwhile, Botswana's interest rates were lowered in the hope that more businesses would be established in the country, since interest differentials were significant and lending terms made easier (see Figure 1). Nevertheless, these policies were not able to change the trend, as commercial banks continued to make short-term loans than long-term project financing.

Harvey (1990) notes two main reasons for this behaviour. Firstly, the banks had been making extremely high returns on foreign exchange and loans, estimated to be in real terms almost 5% during the period of 1972-1985 when their costs increased by a margin which was less than that figure. This enabled the commercial banks to make enormous profit without undertaking any further initiatives of increasing their products or engaging in risks. Secondly,

Figure 1: Interest Rate Trends

Source: IMF, *International Financial Statistics (IFS)*, various issues

the commercial banks did not have the required expertise with the necessary experience for long-term project evaluation, which required identification of, and support for, a new range of borrowers and further risk management. On the other hand, if they were to cater for the unsatisfied demand for long-term loans they needed to train extra staff or hire foreign expatriates. In either case their costs would increase and certain levels of risk of failures were to be expected. Despite the marginal increase in commercial banks lending in 1977-1978, they had more liquid assets than otherwise required by law (Harvey and Lewis, 1990). Apparently in 1978, the commercial banks were unwilling to accept additional deposits because of the perceived lack of investment opportunities, and could only get a low rate of interest on additional deposits at the Bank of Botswana. This forced the Bank of Botswana to act as a deposit taker of last resort, opening up an account for the large mining company and a number of other parastatals, in a bid to enable the banks to accept individual and other business deposits (Oden, 1981). The problem of over-liquidity has been primarily created by the mining and government sectors, which had large savings deposits but little need for any loans while, in the other sectors of the economy, there

were few investment projects matching the requirements for the commercial banks. Since it is the role of financial institutions to transfer resources between sectors, the excess liquidity prevalent in Botswana indicated the failure of commercial banks to facilitate efficient use of resources (Makgetla, 1982).

Despite these initiatives from the government, it was observable that long-term lending remained minimal and the economy needed entirely new financial institutions. This led to the creation of a number of parastatals by the government for this purpose. Hence, the National Development Bank (NDB) and the Botswana Development Corporation (BDC) were formed, with the main aim of extending credit to parastatals and other productive urgencies as a mechanism to handle extra liquidity (Harvey and Lewis, 1990). Similarly, the government also channelled some of its funds to the development corporations to foster economic expansion, in particular, infrastructure development, industry promotion (especially agriculture and manufacturing sectors) and technical support to promote private enterprises. These institutions enhanced the availability and access of credit to locals and locally-owned businesses playing a significant financial role from 1976 onwards (see Table 4).

FINANCIAL LIBERALIZATION AND STRUCTURAL REFORMS IN BOTSWANA

It is well documented that the financial and banking sectors, to a considerable extent, contribute to the level of economic development.⁸ It is argued that financial development improves total factor productivity and ultimately enhances economic growth through the functions inherent in the financial system which include; allocating capital, mobilizing savings, evaluating and monitoring borrowers, and transforming risks (Hierro et al., 2002). From the seminal paper of McKinnon (1973) and Shaw (1973), there has been a greater belief that government interventions lead to market failures and funds can only be allocated optimally in a “free” market environment.

Financial liberalization is the freeing of the financial markets from continuous government interventions or unfavourable regulations. Typically, in this view, financial liberalization then leads to higher growth by the freeing and rising of market interest rates and/or reduction in the rates of inflation which would increase the supply of loanable funds by attracting more business and household savings to bank deposits, and increasing the efficiency of the banking system (Mlachila and Chirwa, 2002). Both these two mechanisms eventually lead to an increase in the availability of funds for investment, and hence, enhance the rate of economic growth.

Financial liberalization can be discussed in two dimensions: domestic and external liberalization. The first involves the liberalization of the domestic financial system, and the later generally refers to capital accounts liberalization, although more often than not both are closely interlinked. In achieving domestic and external liberalization the banking system plays a key role. Banks, as financial intermediaries, play an important role in transferring public deposits to financial assets and channelling funds from surplus units to deficits and, therefore, facilitating wealth creation, trade and capital formation (Mlachila and Chirwa, 2002). On the other hand, banks play a critical role of filtering and screening information and borrowers and, therefore, directing the flow of resources to the most deserved projects. In this context the success of financial liberalization which involves decontrolling of interest rates and elimination of credit ceilings highly require increased efficiency in the banking sector.

Financial systems in Africa have traditionally been characterized as having higher intermediation costs and excessive government intervention and, therefore, weak resource mobilization (World Bank, 1994). In addition the African financial systems have experienced an increasing trend of public interference in the management of both public and private banks damaging the quality of their services. Consequently, credit allocation procedures remained poor as credits are allocated through government directions (World

Bank, 1994). All these factors have weakened the financial system, especially the banking sector, decreasing competition and lowering bank profits. Due to this, in many sub-Saharan African (SSA) countries financial liberalization was a major component of structural adjustment that took off in the 1980s with the aim of improving incentives under which banks operate. It was also expected that the removal of government controls in interest rates and barriers to entry into the financial system would lead to greater competition and, therefore, lower profit margins and interest spreads (Mlachila and Chirwa, 2002).

Unlike other SSA countries, financial reforms in Botswana have occurred gradually rather than being part of a policy package externally imposed. From 1976, Botswana implemented its own macroeconomic policies independently. Since then, Botswana had liberalized-economic oriented policies than otherwise. It kept an exchange-control regime that was progressively liberalized relative to most developing countries (Jefferis and Harvey, 1995). With the exception of capital accounts, where controls remained relatively restrictive, current accounts were completely liberalized as most current account transactions were delegated to commercial banks as authorized dealers.⁹ The restrictions on capital accounts were adopted when the country introduced its own currency. Largely, they were due to the following factors; first, because of considerable uncertainty regarding the level of confidence in the new currency, there was a concern that allowing residents to hold foreign currency would undermine the Pula (Harvey, 1985). Second, the rapid rate of economic growth largely depended on capital from abroad. Hence there was a considerable danger that any immediate outflow of foreign capital would cause the country's foreign reserves to fall sharply and lead to dramatic changes in both savings and investment.

However, gradually there has been partial liberalization of capital accounts in the past. Since the establishment of the Botswana Stock Market (BSM) in 1989, overseas portfolio investments were permit-

ted to purchase shares with generous terms, while large local institutions such as the Debswana Pension Fund and Botswana Life Insurance Ltd, were permitted under exchange control regulations to invest up to 50% of their assets abroad (Jefferis, 1995). In contrast, although the Botswana economy remained very open, Jefferis and Harvey (1995) note that combination of capital control measures - particularly on purchases of foreign-currency financial assets and low domestic real interest rates - have significantly penalized local savers, as foreign financial assets generally offer higher real rates of return than those denominated in Pula, and, therefore, local investors are deprived of the opportunity to increase their wealth and diversify their risks.

Despite the rapid economic growth Botswana's financial institutions did not expand as expected, either in the capital securities market or the banking sector. Since independence, the country's financial system has been dominated by two major commercial banks, which for a long time concentrated on short-term segments of the market and offered little development to enhance long-term investments. Indeed, before the creation of BSM there were limited range financial instruments as capital market for equities and long-term and short-term debt instruments were absent (Jefferis, 1995). This constituted a serious structural weakness, as the government recognized that, although excess liquidity prevailed, there was unsatisfied demand for long-term financing. Gelbard and Leite (1999) introduced an index for measuring financial development for 38 SSA, including Botswana. Table 3 gives the extent of financial development in Botswana at two points in time (1987 and 1997) to address any specific advancement or good progress in improving and modernizing the financial system during the decade, particularly with regard to financial liberalization and the adoption of indirect monetary policies.

In overall, the financial system in Botswana improved from being minimally developed in 1987 (with an index of 49 compared to 33 for SSA average) to somewhat developed in 1997 (with an

index of 62 compared to 56 for SSA average). Botswana's financial system index scores above the SSA in both 1987 and 1997 although the level of improvement is marginal, just 27% over the decade. As at 1987 the highest ranking of the six indexes is the institutional environment and financial openness. But over the decade, the most significant improvement has been in the area financial liberalization with more than 162% increase. Further, there has been a greater diversity of financial products and substantial improvement in instruments of monetary policy as this index improved by 145% over the period.

Table 3: Financial Development index in Botswana

| Indicator | 1987 Level | Index | 1997 Level | Index |
|-------------------------------|---------------------|-------|----------------------|-------|
| Market Structure | Largely Developed | 76 | Largely Developed | 92 |
| Financial Product | Underdeveloped | 17 | Somewhat Developed | 51 |
| Financial Liberalization | Repressed | 20 | Somewhat Liberalized | 65 |
| Institutional Environment | Somewhat Supportive | 71 | Somewhat Supportive | 71 |
| Financial Openness | Somewhat Open | 54 | Minimally Open | 46 |
| Monetary Policy | Minimally Developed | 29 | Somewhat Developed | 71 |
| Overall Development | Minimally Developed | 49 | Somewhat Developed | 62 |
| Highest - Overall Development | Largely developed | 77 | Largely Developed | 87 |
| SSA - Overall Development | Minimally Developed | 33 | Somewhat Developed | 56 |

Note: Financial development indicators were calculated using six elements which were taken to represent the financial environment, product and characteristics under which a specific market system operated covering 38 SSA countries. Source: Gelbard and Leite (1999).

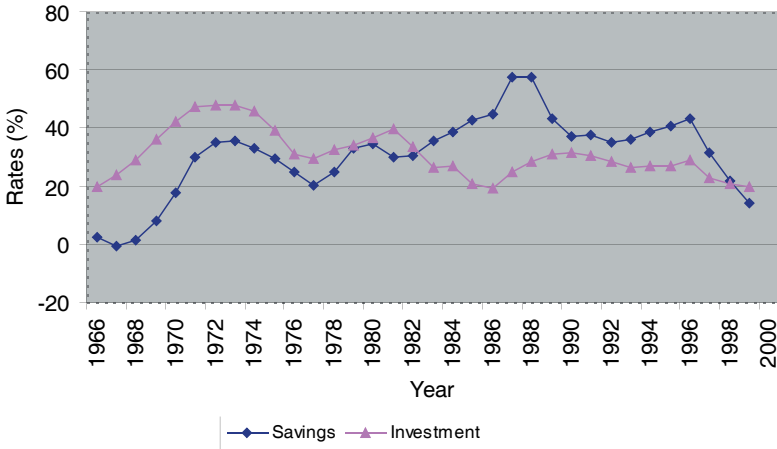
INTEREST RATE POLICIES AND FINANCIAL INTERMEDIATION

Prior to the establishment of the Bank of Botswana, the commercial banks were entirely free to determine the local interest rates. Since Botswana's commercial banks were branches of foreign owned banks, the interest rates movement closely followed the Johannesburg market while locally market conditions had a relatively little impact (Makgetla, 1982). With the new financial system, the Bank of Botswana had all the powers to determine all interest rates including the commercial banks deposits and lending rates. Despite this the government pursued a number objectives in interest rates policy. This included encouraging more lending by the commercial banks, short term capital inflows or outflows and long-term savings, and in addition avoiding interest rates being below the rate of inflation (Harvey and Lewis, 1990). But since all these objectives are hard to pursue at once, the desired policy varied from time to time.

As the economy recorded an average growth rate of 8.4% between 1965 to 1990, the real interest rates have been negative in Botswana up until 1991 (see Figure 3). Only during a brief period of 1981-1983 did the real interest rate appear to have been positive since the introduction of the new independent financial system in 1976. Between 1981-1983, the government implemented a policy package aimed to improve the deteriorating balance of payments situation. This included, raising interest rates from 10.5% to 14.5%, while other measures included an increase in the liquid assets requirements and restrictions in the growth of commercial bank lending (Harvey and Lewis, 1990). It is observable that both savings and investments fell during this period while real interest rate increased significantly (Figure 2 and 3).

In 1984, real interest rates were back to negative as interest rate structure for deposits in commercial banks and other saving institutions were altered. Harvey and Lewis (1990) observe

Figure 2: Savings-Investment analysis



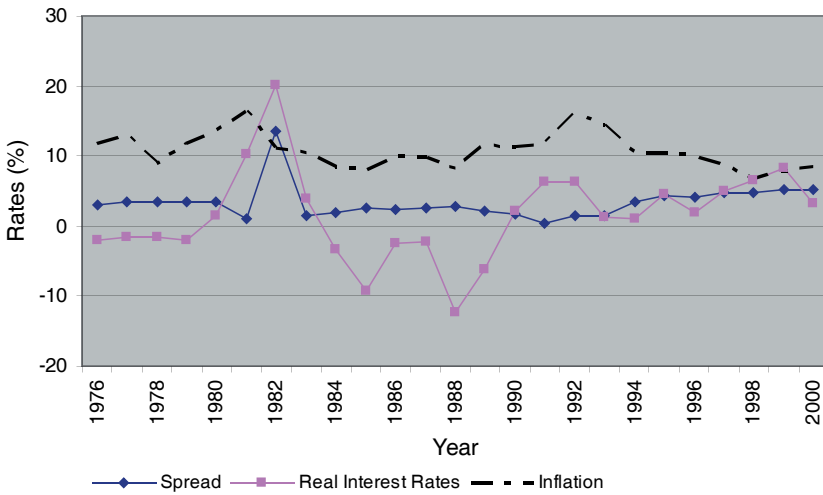
Source: World Bank, African Development Indicators

that, although interest rates were generally low, saving deposits increased steadily during the years when real interest rates were negative, noting independency of movement in either nominal or real rates of interest.

Table 4: Growth of Lending (Pula, million)

| Sector | 1966 | 1975 | 1987 | 2000 |
|----------------------------------|------|------|------|------|
| Commercial Banks | 7 | 56 | 265 | 3947 |
| NBFIs | | | | |
| National Development Bank | 1 | 2 | 47 | 50 |
| Botswana Development Corporation | n.a | 6 | 115 | 358 |
| Botswana Building Society | n.a | 2 | 36 | 212 |
| Botswana Saving Bank | n.a | 1 | 11 | 151 |
| Botswana Co-operative Bank (BCB) | n.a | n.a | 7 | n.a |
| Financial Services Company (FSC) | n.a | 1 | 19 | n.a |
| Total Credit | 8 | 68 | 500 | 4719 |

Figure 3: Inflation and Interest rates



Source: IMF, International Financial Statistics (IFS)

| | | | | |
|------------------------|-----|-----|-----|-----|
| NBFIs/Commercial Banks | 14% | 21% | 89% | 20% |
|------------------------|-----|-----|-----|-----|

Note: FSC was taken over by a commercial bank in 1994 and BCB had to be wound up in 1995. n.a means not applicable. Source: Bank of Botswana, Annual Reports and Harvey and Lewis (1990)

The government increasingly continued to finance parastatals through public financial corporations - at a lending rate below the commercial bank prime lending rates - from the budget surpluses, while commercial banks remained biased towards short-term loans as it naturally appeared that there was excess liquidity build up. Hence in 1986, the Bank of Botswana further reduced the commercial bank prime lending rates to 10% to encourage private and business borrowings from commercial banks. As shown in Table 4, the market share of commercial banks in the financial intermediation reduced significantly during this time as they fail to diversify their lending structure while the bulk of lending activities were undertaken increasingly by financial parastatals. By 1988, the real interest rates were strongly negative bypassing the -10% level.

Resultantly the Bank of Botswana took steps to change financial sector policy fundamentally (Hermes and Lensink, 1996). Following an earlier report by the World Bank (World Bank, 1989) a number of policy initiatives to address financial sector diversification were introduced. The specific measures which were taken in this regard consisted of: (i) licensing of more commercial banks to increase competition and efficiency in the banking sector, (ii) raising interest rates to reach positive real levels which will promote private and business savings and reduce household borrowings for consumption purposes, (iii) initiating capital and money market development. From 1989, Botswana real interest rates have gradually increased upwards while the Bank of Botswana started issuing government papers to curb excess liquidity and allowed Non-Banking Financial Institutions (NBFIs) to offer extended services to increase competition with commercial banks (Harvey, 1996).

Like many other African countries, Botswana's financial sector has long been dominated by oligopolistic commercial banks (Standard Chartered and Barclays) which were incorporated locally in 1975 though they existed since independence. With the establishment of the Pula and the Bank of Botswana, the government continued with its policies of non-interference into the affairs of the commercial banks, especially with the allocation of lending and change of ownership and control. Surprisingly enough, on a number of occasions, the commercial banks behaviour contradicted the government policies.¹⁰ To maintain efficiency, and enhance business confidence in the banking sector, the central bank committed itself to the use of indirect policy instruments. The financial sector remained segmented and meanwhile financial resources to finance long-term investment in much of the private sector had been specifically limited. The government became a major lender for project financing, largely to public sector but also to some extent the private sector until the late 1990s (see Table 4). Up until 1990, there were only 3 banks in the country (the third one being the Bank of Credit and Commerce Botswana, a wholly owned

subsidiary of Bank of Commerce and Credit International, BCCI), while NBFIs (which were all public owned financial institutions) increased considerably (refer to Table 5). Due to the oligopolistic structure, the banks earned high profits on the basis of relatively low risk but highly profitable activities such as foreign exchange transactions (Jefferis, 1995). Relatively, combination of these factors put the banks under no pressure for competition, innovation or much inclination to develop new sources of business or increase in the range of financial instruments. Thus, since 1990, remarkable changes have taken place to diversify and integrate the financial sector into the whole economy as it has lagged behind the country's rapid economic growth.

Table 5: Evolution of depository institution in Botswana

| Year | Commercial Banks | NBIFs |
|------|------------------|-------|
| 1966 | 2 | 1 |
| 1982 | 3 | 5 |
| 1990 | 4 | 6 |
| 1992 | 6 | 5 |
| 1995 | 4 | 5 |
| 2000 | 5 | 6 |

Source: Bank of Botswana, Annual Reports

Following the adoption of a new financial sector development policy, improving competition has been a major concern as four new commercial banks were established in 1990-1992. In the recent past, the government has taken steps to liberalize licensing requirements for banks and passed a new Banking Act to widen the regulatory powers of the central bank to include merchant banks, discount houses, and other forms of specialized financial institutions (AfDB, 2002). Consequently, two new banks were licensed in 2000 as the banking sector continues to grow to resume its impor-

tant role within the financial system. Hence, the share of lending by the commercial banks increased reasonably in the last four years as its share reached almost 84% in 2000 (Table 4).

Observably, the entry of these new commercial banks have already made a significant impact on the quality and products offered by the banking sector as noted by Harvey (1996). Firstly, customers are provided with some new banking services such as ATMs, new consumer cards usable at major shopping points and replacement of savings account passbooks by electronic cards. Secondly, the sector has had considerable improvement in the quality of services as the number of bank branches has increased over time and banking services have become widely available. Thirdly, although banks remained profitable, the margins on major operations such as foreign exchange transaction have sharply decreased. A number of authors have also related banking efficiency with interest rate spread (for example, Mlachila and Chirwa (2002), Gelbard (1999), and Fry (1995)). The difference between lending and deposit rates which is generally taken to represent the level of intermediation is often characterized to measure banking efficiency. Mlachila and Chirwa (2002) cite that, even after undertaking financial liberalization, many countries in the SSA have had high intermediation margins and, hence reported significant spread. Similarly, in the case of Botswana, spread remains high (see Figures 1 and 3) and if one assumes this type of definition, in principle there has not been a significant fall in the interest rate spread to indicate a significant improvement in the efficiency of the financial system.

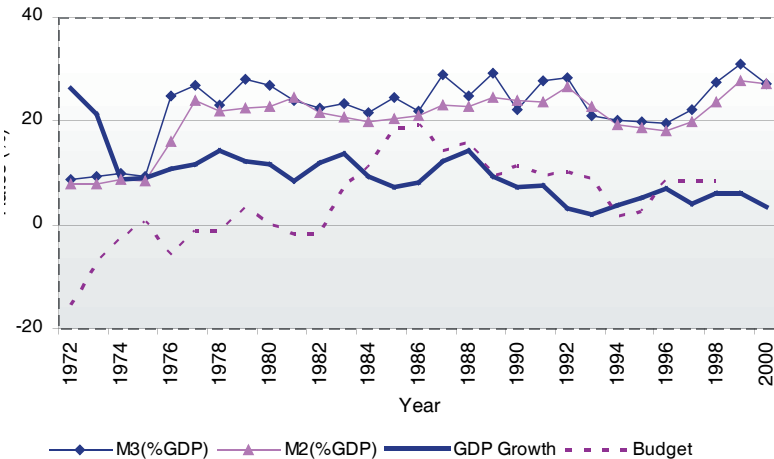
SAVINGS, INTEREST RATES AND INTERMEDIATION

Likewise, in an effort to enhance financial sector developments BSM was established in 1989 with the aim of filling the gap in the commercial bank dominated financial system where money and capital markets were absent and, hence, the availability of long-term finance was minimal. It was hoped that the existence of a market for

corporate equities would encourage companies to make greater use of equity finance and ultimately lower the general financial risks (Jefferis, 1995).

In the past, the government itself acted as a financial intermediary since it provided on a large scale, all forms of loans, while commercial banks remained cautious in expanding credit for long-term projects (Harvey and Lewis, 1990). In the era of financial liberalization (since 1991) real interest rates have generally been positive (Figure 3). It is expected that this will influence the pace of financial intermediation as well as financial deepening. Scholars have argued that for a country to successfully develop, the ratio of financial assets should increase faster than GDP, commonly referred to as “financial deepening” (Harvey and Lewis, 1990). In this respect, Figure 4 gives movement of broad money (M2) and liquidity level (M3) both as a percentage of GDP. The absence of financial deepening is visible as both M2 and M3 fluctuate narrowly between 20% and 25% in the period prior to financial liberalization. An upward trend is observable especially from 1995 indicating that there has been an increase in the accumulation of financial assets and liabili-

Figure 4: Performance Analysis



Source: African Development Indicators and International Financial Statistics (IFS)

ties in the economic system, reflecting growth in the monetarization process.¹¹

In examining savings and investment trends, savings exceeded investment since 1984. Although the saving rate has been declining in the last two years, domestic savings were generally high for the last one and half decades, most of it generated by the government (public sector) through budget surpluses and foreign exchange reserves (Table 2 and Figure 4). Private savings have been improving in the last decade reaching 19%, on average, for 1996-2000 compared to 13% in 1991-1995 (Table 6). In line with financial liberalization, the share of private sector credit has shown some signs of improvement. The credit to the private sector has improved on average from 13.2% in 1991-1995 to 15.1% in the 1996-2000 period. In contrast, it is also important to look at the sectoral distribution of credit in the private sector itself. Surprisingly, the household sector received the largest share of credit in the recent years. The proportion of total credit to the household increased from 7% in 1976 to 49% in 1997 while trade and business share remained stable at 13% each in the same period (Maipose and Matsheka, 2002). Between the years 1998 and 1999 credit to the household and the private business sector grew in real terms by 34.8% and 17.9% respectively. Similarly, among the other economic sub-sectors, credit to the agricultural sector declined as it accounted for 2% in 1997 compared to 17% in 1976, while the share of credit to the manufacturing sector marginally increased from 6% in 1976 to 8% in 1997.

Maipose and Matsheka (2002) highlighted that the share of private sector, excluding households has declined from 66% in 1976 to 47% of the total credit in 1997. This presents a potentially serious long-term problem, given that the bulk of lending to the household sector goes to consumption, squeezing the required resources to finance long-term investment. The business sector has, in the past, expressed concern that higher interest rates following financial liberalization, together with the past continuous growth in the government spending, were crowding out private sector spending,

Table 6: Saving-Investment-Growth trend indicators

| Variable | 1971 -1975 | 1976 -1980 | 1981 -1985 | 1986 -1990 | 1991 -1995 | 1996 -2000 |
|----------|---------------|---------------|---------------|---------------|---------------|---------------|
| GDI | 49.2 | 39.8 | 34.3 | 25.0 | 27.9 | 24.4 |
| PUB-INV | n.a | 14.4 | 15.9 | 13.9 | 11.8 | 12.9 |
| PRI-INV | n.a | 14.1 | 19.1 | 11.2 | 14.5 | 9.8 |
| GNS | 19.0 | 16.0 | 23.0 | 42.0 | 34.0 | 29.0 |
| PUB-SAV | 15.0 | 15.0 | 25.0 | 33.0 | 20.0 | 10.0 |
| PRI-SAV | 6.0 | 1.0 | -1.0 | 8.0 | 13.0 | 19.0 |
| CRED-PRI | 13.7 | 14.3 | 11.6 | 7.6 | 13.2 | 15.1 |

Note: GDI is gross domestic investment, PRI-INV is private investment, PUB-INV is public investment, GNS is gross national savings, PRI-SAV is private savings, PUB-SAV is public savings, CREDPRI is the credit to the private sector as a % of GDP, and n/a means not available. Source: World Bank, World Tables and World Saving Database.

especially for business investment (IMF, 2002). More unusually in the other SSA countries, Figure 2 indicates that investment has been lower compared to savings for more than a decade now. This can only be explained by a possible real shortage of visible and profitable projects especially in the manufacturing sector. In addition, the past inefficient intermediation in the financial system may have greatly contributed to the situation, as financial instruments and instruments for risk management and maturity transformation were absent.

CONCLUSION

Our analysis above shows that the objectives of financial liberalization were partially achieved considering the time framework so far. As growth in the GDP declined in the last five years, leading to a government budget closer to deficit, one of the major objectives of increasing interest rates remained to mobilize more savings,

especially from the household sector. On average, the pace of private savings has been increasing in the last decade, recording a higher level of 19%, on average, for the last 5 years (1996-2000), relative to 13% in the previous half a decade (1991-1995). Further, development of organized capital markets have benefited institutional and business savers and, therefore, contributed to the improvement in the efficiency of investment.

ENDNOTES

¹ With Botswana, the other two countries who used rand currency issued by South Africa were Lesotho and Swaziland.

² For an extended discussion of the renegotiation of the new custom union agreement, see Harvey and Lewis (1990) pages 189-192.

³ This refers to the Transitional Plan for Social and Economic Development, 1966.

⁴ Of specific concern was the behaviour of the commercial banks where, despite taking deposits from Botswana, they invested more than 50% of their funds outside the country when these funds were seriously needed to finance many development projects in the country.

⁵ This was also meant to further increase foreign direct investment, as foreign companies were not allowed to borrow more than they brought in the country and discourage large capital expatriations.

⁶ Refer to Harvey and Lewis (1990) for discussion of FDI trends.

⁷ But partly, this reduction in the banks lending was contributed by the completion of Selebi-Phikwe copper and nickel project, which entered into its production phase.

⁸ See, for example, Goldsmith (1969), Schumpeter (1911) and Bagehot (1873).

⁹ It was part of the government policy to keep the economy open. Botswana has never implemented other forms of foreign trade restrictions such as import licensing. For further discussion on this,

refer to Jefferis and Harvey (1995).

¹⁰ A good example is the failure of the commercial banks to venture into long-term lending although the government provided the required incentives.

¹¹ The ratio of financial assets to the GDP is showing an increasing trend and, hence, predicting financial deepening. Technically, an increase in the M2 or even M3 might not mean financial deepening has taken place, but rather, this could be a shift of liabilities from one institution to another. In our assessment, the Botswana experience suggest a general case of improvement in financial deepening as most of the banking and NBIFs still remain active in the market (see Table 5).

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