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## Botswana's Monetary Independence – Real or Imagined ?

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### **Introducing the Pula**

Until August 1976 Botswana used the currency of South Africa, the Rand, waiting 10 years after political independence in 1966 before introducing its own currency, the Pula. Botswana had the opportunity of being a party to the Rand Monetary Agreement, which would have provided cash compensation for the interest free loan from Botswana to South Africa, implicit in the use of the Rand in Botswana. However, it withdrew from the negotiations, having decided to set up an independent central bank and monetary system, with a separate currency.

The economic reasons for Botswana's decision were to obtain a greater degree of control over the country's economy by acquiring some new policy weapons. To a considerable extent this amounted to taking a step away from dependence on South Africa and on decisions taken by the South African Government.

Before August 1976 Botswana was for most purposes a monetary province of South Africa. Money was able to flow freely and legally between the two countries; Botswana was subject to South African exchange controls on transactions with all other countries except South Africa itself, Lesotho and Swaziland; the external value of Botswana's currency was decided by the South African authorities (in South Africa's interests); interest rates in Botswana were the same as those in South Africa, with effectively no powers to change this situation; the cash reserves of the government and of the private sector were held almost entirely in Rands (with the exception of some Sterling balances of the government at the Crown Agents in London); the commercial banks were not subject to any control by the Botswana authorities, except to the very minor extent that the Botswana Government had once managed to sell them small amounts of medium-term stock.

There were some advantages for Botswana in the old arrangements. Much small and large-scale investment in Botswana comes from South Africa and was encouraged by the complete absence of controls or of an exchange rate risk between the two countries. In the case of large-scale investment (for example, by the De Beers Anglo-American Group)

withdrawal from the Rand Monetary Area (RMA) made little difference since such companies are used to investing across monetary borders, although the increase in trouble and risk may result ultimately in a higher price being paid by Botswana for such investments. In the case of some smaller-scale investments, the changeover could be significant; although probably not for very long since people quickly get used to a new system.

Tourism was also encouraged by the common currency, both because of the greater convenience and because of the exchange control limits on foreign currency for travel abroad that operate in South Africa. However, tourism in Botswana is very small-scale and much less significant than in Lesotho and Swaziland.

In the absence of a central bank in Botswana, the commercial banks naturally invested their surplus liquid funds in Johannesburg. In addition, other residents in Botswana were free to invest funds in South Africa, in financial institutions or with associate companies. At first sight this appears to have denied use of the funds to Botswana. But in fact bank lending in the years prior to Pula Day grew very fast (five-fold in four years). Furthermore, one of the two commercial banks was allowed to 'overdraw' its account with the associate company in Johannesburg; and 'bought' additional funds by offering the government a higher rate of interest to attract money from the other bank. Meanwhile, the surplus funds of the other bank were, by 1976, more than accounted for by government deposits, so that the main beneficiary of the relatively high rate of interest being offered in Johannesburg on liquid funds was the Botswana Government itself, which also benefited from the demand for loans in Botswana as the banks competed for government balances. The outflow of funds from Botswana, to financial and other institutions in South Africa, does not seem, therefore, to have prevented any lending in Botswana; meanwhile, the Botswana Government derived some direct financial benefits.

The absence of local short-term government paper, usually Treasury Bills, did not deny credit to the government in the years immediately prior to Pula Day in 1976, for the same reasons, namely, that government had large net positive balances with the

banking system and so had no need to borrow short-term.

The creation of a central bank, in creating new policy instruments, also brings new dangers. The most important is that government is able to 'borrow' from the central bank and so, probably, impose inflationary pressure on the domestic economy and create a balance of payments problem. Without a central bank, government spending was limited to revenue and loan receipts, plus any short-term credit the government could squeeze out of its suppliers. The government could, of course, have got into financial difficulties by, for example, borrowing excessively on harsh terms for non-productive purposes; but the problem of converting domestic currency into foreign exchange in order to make foreign payments did not exist – unless the South African Reserve Bank refused to make foreign exchange available for a Botswana Government liability, an unlikely event which never in fact occurred. The creation of a national currency and central bank removed the domestic currency constraint: the Botswana Government could now create domestic money by borrowing from the Bank of Botswana, but it could not create foreign exchange, and it no longer had access to South Africa's foreign exchange reserves.

The legislation setting up the Bank of Botswana<sup>1</sup> tried to prevent excessive government borrowing from the new central bank, but such legislative safeguards have always been pushed aside, in Africa and elsewhere, when governments have been determined to overspend. Governments can create more domestic money than is prudent if they are determined to do so, but this is not a sufficient reason for remaining a monetary province of another country. The point is strengthened in Botswana's case by the divergence of interests, economic and political, between its government and that of South Africa. In any case, refusal to create an independent monetary system is by no means a sufficient condition for preventing problems – New York City is a useful illustration or, perhaps more relevantly, Liberia, which still uses the US Dollar as its currency.

Quite apart from any other policy instruments acquired when a new and independent monetary system is created, the ability to borrow from the central bank can be as useful in some circumstances as it is damaging in others. Thus if the private sector is running a surplus with the overseas sector, as has been the case in Botswana as a result mainly

of very profitable diamond mining, this will be reflected in positive net balances in the banking system, unused in the form of bank lending – and possibly unusable for the time being. It is quite possible to imagine circumstances in which the government could make use of such surpluses: with an independent monetary system, and exchange controls against the holding of foreign bank balances by the private sector, the government acquires the use of the funds quite simply, through their investment in Treasury Bills or their deposit at the central bank, with no need to alter taxation or indeed any other action.

The justification for creating the Bank of Botswana lay, therefore, in the immediate acquisition of new policy instruments, in their careful use, and in the hope that new expertise, institutions and markets would be of long term benefit in the country's development.<sup>2</sup> These are discussed in turn below.<sup>3</sup>

### Exchange Rate Policy

The importance of being able to change the external value of the domestic currency is well illustrated by the circumstances surrounding the revaluation of the Pula in April 1977, some seven months after it had been first issued.

In March and April 1977, South Africa introduced a number of measures which were expected to have adverse effects on the cost of living in Botswana, especially for the poor. Part of the consumer subsidy on South African maize was removed (imported maize is a staple food in Botswana). Railway tariffs were sharply increased, and South Africa imposed a 15 per cent surcharge on most imports, including many essential goods.

Botswana was severely constrained in its possible responses. An increase in the minimum wage would have helped only those in employment within the country. But only 60,000 or so<sup>4</sup> are recorded as employed, and not all of these would be reached by an increase in the minimum wage. Nor would such a move reach the poorest families who are found more in informal employment and in rural areas.

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<sup>2</sup> See the Government White Paper setting out its reasons for withdrawal from the RMA, 'A Monetary System for Botswana', Government Paper no 1, 1975.

<sup>3</sup> The creation of the new monetary system was described in the Bank of Botswana Annual Reports for 1976 (pp 2-20) and 1977 (pp 1-5).

<sup>4</sup> 62,700 in 1977, including formal sector self-employed (working proprietors and family workers), *Statistical Bulletin*, December 1978.

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<sup>1</sup> Bank of Botswana Act, 1975; see also the related legislation setting out regulatory powers over commercial banks: Financial Institutions Act 1975.

A second possibility was to subsidise the consumer price of maize. Administratively this would have been difficult because of the scattered population and the decentralised import and distribution system. It would have been exceedingly difficult to administer a subsidy to small stores obtaining maize supplies from over the border in remote areas, or to farmers doing the same in order to supply their workforce. Even more important, the government could not afford to subsidise the Western Transvaal's maize consumption: this was believed to be a real risk for the same reasons of geographic remoteness and lack of administrative capacity to control the country's border trade.

Revaluation on the other hand, was simplicity itself. It required merely an administrative decision at the centre and the ironing out of some subsequent complications, mainly concerning the deferred pay of Batswana working in South Africa.

Revaluation<sup>5</sup> could not, given the structure of the Botswana economy and external trade, make much difference to the income of the country as a whole. It could, however, re-distribute income in an almost wholly benign way. Botswana is not only heavily dependent on imports; poor people depend more heavily on imports than rich people. The poor spend a higher proportion of their income on essentials, which are mainly imported, than the rich, who spend more on services which are produced locally such as housing, electricity and car repairs. The poorest spend about 70 per cent of their cash incomes on imports, the richest only about 40 per cent. Many of the poorest families derive a significant proportion of cash income from the remittances of family members working in South Africa. However, survey results showed that the poorest households only received about one-third of their cash income from abroad in this way, so that while revaluation would reduce the Pula equivalent of one-third of income, it would reduce the Pula cost of some two-thirds of spending – provided that imports passing through the distribution sector were in fact sold at a lower price than would otherwise have been the case.

About 60 per cent of imports into Botswana are for the use of the importer – who thus benefited from the revaluation directly. But there was some doubt about the other 40 per cent, as it was feared that traders would allow a revaluation to increase their profit margins rather than pass it on to consumers. Subsequent investigation showed that these fears were unjustified: retailing, at least of basic neces-

sities, seems to have been sufficiently competitive for revaluation benefits to have reached the consumer. Price rises on a 'basket' of foods, accounting for 50 per cent of the low income consumer price index, were 'about five to seven percentage points less in Botswana than the average price rise on the Witwatersrand and Kimberley' [Bank of Botswana Annual Report 1977: 16].

If consumers gained, who lost? Somewhat surprisingly, the government turned out not to be a loser. Government revenue does indeed depend quite heavily on the taxation of exports and exporters' profits, which in turn are reduced in Pula value by a revaluation; but government is also a major importer, and the savings on imports turned out to match the loss of revenue closely enough for the effect of revaluation to be ignored.

Revaluation turned out, therefore, to be a way of re-distributing income from exporters to consumers. Exporters consist of:

- the diamond mining company (31 per cent of commodity exports);
- cattle owners (30 per cent);
- the copper-nickel mining company (26 per cent);
- others (13 per cent).

The diamond mine's profits – apart from the large proportion paid to government as royalty, tax and dividend – are paid abroad; the diamond market was at the time exceptionally strong, and potential new mines were profitable enough to be considered for exploitation after a revaluation.

Cattle products are exported by the Botswana Meat Commission (BMC), which is de facto a buyer's cooperative. Although the BMC is government owned, it is obliged by statute to pass on changes in sales prices to producers, and has only very limited scope for building up or running down its own financial reserves. The effective losers from a revaluation are therefore cattle owners. Cattle ownership is extremely unequally distributed in Botswana, so that the main impact of revaluation fell on large-scale owners of cattle. The political impact on the cattle owners, who enjoy a well-organised lobby was, however, lessened by BMC's ability to maintain producer prices after the revaluation, as a result of strong beef prices abroad.

The copper-nickel mining company is foreign-owned and was, in 1977, running at a large loss consisting almost entirely of interest payments on its debt. Losses were made up by inflows of capital from the foreign shareholders, who have also guaranteed the government's large foreign debt

<sup>5</sup> These paragraphs are based on the Bank of Botswana Annual Report 1977, pp 13-16.

which had been undertaken to build the public infrastructure needed for the mine and township. Revaluation increased the mine's losses but, provided it did not close the mine, the immediate net effect was small because the losses were matched by increased capital inflow. The mine did not close.

The revaluation, at five per cent, was small, and its impact was therefore also small. But, as far as it went, it achieved its objective in reducing the rate of inflation below what it would otherwise have been, and may have had a further beneficial effect in reducing later wage and salary awards which are much influenced by the rate of inflation. It could not have taken place before 1976<sup>7</sup> and no other policy weapon was available to achieve the same results.

### Interest Rates<sup>8</sup>

The creation of a new monetary system meant that some new interest rates had to be decided upon: bank rate (the rate at which the Bank of Botswana lends to the commercial banks), Treasury Bill rate, and deposit rates for commercial bank and government deposits at the Bank of Botswana being the main ones. At first the new rates were designed to fit roughly into the existing structure. Since then, rates have twice been lowered, opening up a small gap between rates in Botswana and rates in South Africa. The structure has been altered slightly, mainly to encourage depositors to place money on longer term at commercial banks.

Formally the exchange control regulations do not allow residents of Botswana to hold liquid assets abroad,<sup>9</sup> so that interest rates should only be relevant to decisions as to where to borrow – for those borrowers who have a choice. With adequate and rising foreign reserves, and excess bank liquidity within the country, Botswana would have been happy to see some switching of borrowing to domestic banks: hence the gap in the relative cost of borrowing in Botswana and South Africa (which supplies 85 per cent of imports and presumably substantial trade credit). At the same time the high ratio of trade to GNP and to the foreign exchange reserves has caused the Botswana authorities to move cautiously, since the country could not afford large-scale switching.

So far, the differential in favour of borrowing in Botswana (not more than one-and-a-half percentage points between prime borrowing rates) has had no effect – even though the commercial banks have had so much excess liquidity as to refuse at times to accept further large deposits at advertised interest rates.

The other reason for lowering interest rates was to take advantage of a falling rate of inflation to bring nominal rates down. Although in theory a high nominal borrowing rate may be zero or negative in real terms, a borrower is certain about having to pay the nominal rate, but highly uncertain about whether inflation will affect his own sales prices in line with other prices, or even whether inflation will continue. The Botswana authorities have had the opportunity, therefore, to react more quickly than South Africa in bringing down nominal rates.

### Bank Lending and Money Supply

The Bank of Botswana has conventional powers to influence bank lending and the money supply directly, by means of primary reserve and liquidity ratios, and by forbidding the two commercial banks to hold significant foreign currency balances. As a result the full operations of the two banks come under Bank of Botswana jurisdiction.

In fact, economic and monetary conditions since 1976 have led the Bank of Botswana to use unconventional means to manage the money supply – and have illustrated the relative impotence of central banks in encouraging expansion, compared with their very considerable powers of restraint if expansion is occurring too fast.

By 1976 the Botswana economy was between mining booms. Bank lending, having expanded from P14 mn in 1972 to P73 mn in the first quarter of 1976, remained at or about that level until the time of writing (mid-1979). Such expansion as continued was generated by the government and the diamond mining company, neither of which needed domestic credit. On the contrary: they both had increasing net positive deposits with the banking system. The credit needs of the copper-nickel mine were supplied from abroad. Many other factors played a part, but the net result was static bank lending and steadily rising bank deposits.

The Bank of Botswana reacted at first by removing government balances from the commercial banks to the Bank of Botswana, and later by opening an account for 'one large company' [Bank of Botswana Annual Report 1978: 25], both of which had the effect of reducing the excess liquidity of the commercial banks. The aim was not to prevent

<sup>7</sup> 1st December 1976 was the first possible date, as the Rand/Pula rate was guaranteed at 1 : 1 until 30th November.

<sup>8</sup> For a general discussion of the role of interest rates in Botswana and of the reduction in rates of August 1978, see *Statistical Bulletin*, September 1978. See also successive Bank of Botswana Annual Reports.

<sup>9</sup> With minor exceptions, related to convenience not interest rates.

increases in bank lending. Indeed the Bank of Botswana made it clear, by lowering interest rates and by offering to move official balances back to the commercial banks if they were needed, that increased lending would receive every official encouragement. The reason for taking money out of the commercial banks was to prevent further refusal of deposits: 'the authorities in Botswana are unwilling for businesses in Botswana to be unable to place their spare cash at the banks at reasonably attractive rates of interest', no doubt because otherwise depositors would have an incentive to try and evade exchange control regulations by placing deposits abroad.

The Bank of Botswana also tried to encourage longer-term lending by the commercial banks. Institutional credit is dominated by the two commercial banks; at the end of 1978 bank lending was P75 mn compared with only P4 mn by the National Development Bank and the same amount by the Botswana Building Society. The two smaller institutions have only four offices between them, whereas the banks are represented in all major and some minor centres. Thus, although the growth of the locally-owned financial institutions is an important long-term objective, any significant increase in longer-term lending must come from the commercial banks.

The Bank of Botswana had from the outset increased the incentive to lend, by widening the gap between the rate of interest on lending and the rate of interest on marginal liquid assets. This gap, representing the marginal earnings on additional lending, had increased by three percentage points by the end of 1978; the banks were forced to place marginal liquid funds at the Bank of Botswana at a low rate of interest compared with those obtainable in Johannesburg.

In addition, the authorities tried to encourage longer-term lending by placing some government money (and offering to place more) on three year deposit with a commercial bank and by altering the rules so that no low-yielding liquid assets needed to be held against such a deposit.

However, the Bank of Botswana commented in its 1978 Report that 'the rather stagnant economic conditions of 1978 curtailed lending of this type'. It remains to be seen whether the banks will increase their longer-term lending when the economy starts growing rapidly again, or whether foreign-managed British-style banks are simply unwilling or unable to fill this particular gap.

## Financial Expertise

One of the benefits of creating a central bank is that a certain amount of financial expertise is concentrated in one institution. This is not simply a matter of hiring a few people with the right knowledge and experience, for in performing their normal duties, central bank employees acquire new expertise, which could in principle have been acquired anyway, but in practice is usually not.

For example, the Bank of Botswana had to invest the country's foreign reserves in foreign currencies. In so doing, it developed some knowledge of foreign currency markets and exchange rate risks. The Bank was also obliged by statute to advise government and parastatals on their borrowing. The concentration of these two functions in one institution created a new awareness of the currency risks of external borrowing. In addition, policy on domestic borrowing by parastatals from central government gradually became more coherent as the Bank was asked for advice on a succession of proposals. That advice was formulated by officials with the particular points of view acquired in a central bank.

More generally, financial policy as a whole should improve, or even be formulated for the first time, as the result of the creation of a new monetary system and central bank. The opportunity may not of course be taken, and is not absolutely dependent on new institutions. But in Botswana, at least, something of the sort did occur, not only in the central bank, but as a side effect in other institutions such as the Ministry of Finance and the planning units of other ministries.

The changes described do not amount to a remedy for the many forms of economic dependence from which Botswana suffers. As the President summed up in his speech at the official opening of the Bank of Botswana:

*no amount of monetary wizardry, no central bank, however well run, can prevent people being worse off if their cattle get foot-and-mouth disease, if we suffer drought or if we suffer from any of the many other crises that could occur in a small land-locked country such as ours. But by the careful building up of foreign exchange reserves, by keeping a watch over the country's financial institutions, and by being willing to lend to the banks or the government at the right moment, a central bank can make it easier for the government and people to cope with crises and to go ahead with their affairs in normal times with greater confidence.*

[Bank of Botswana Annual Report 1978: 1]