BANKING POLICY IN BOTSWANA: ORTHODOX BUT UNTYPICAL

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Summary

Financial sector policy in Botswana was unusual. In most other African countries, newly independent governments intervened extensively in the ownership, management and credit allocation of domestic banks. At independence in 1966, Botswana did not even create a central bank or issue its own currency. The country continued to be part of the South African monetary system, using South African currency. In 1976, the government did eventually create a new central bank and issue its own currency. The government's approach to financial policy remained untypical, however, in that it continued not to interfere directly with the commercial banks which dominated the financial sector, but opted mostly for indirect policy instruments.

Botswana did eventually introduce measures to liberalise further its already relatively liberal financial sector at the end of the 1980s. It was again untypical, however, that this was not done as a response to economic crisis, and therefore not as part of IMF or World Bank conditionality. On the contrary, Botswana wanted to increase the efficiency of the financial intermediation of the economy's large financial surpluses. Botswana was, unfortunately, rather more like other countries in having to close or rescue non-bank financial institutions. The financial sector policy changes were only partially successful. The entry of new commercial banks, all foreign, introduce some much needed competition. This improved some aspects of banking, but with some negative side effects, and did not result in any significant expansion of the type of bank finance provided. Moreover, although Botswana's banking legislation and bank supervision were adequate, no small locally-owned commercial banks were licenced; this was definitely preferable to the practice in some other countries of licencing such banks before the reform of banking law and bank supervision, but may have prevented the development in Botswana of potentially valuable finance.

1. Introduction

Financial sector policy in Botswana was unusual. In most other African countries, newly independent governments intervened extensively in the ownership, management and credit allocation of domestic banks. The underlying motive was to direct more credit to local, especially small scale, farms and businesses, at lower interest rates and with longer repayment periods. The more extensive was that intervention, the greater was the difficulty of achieving the objectives of financial sector liberalisation in the 1980s and 1990s. The latter was usually undertaken as part of a response to economic crisis, as part of IMF and World Bank conditionality.

At independence in 1966, Botswana did not even create a central bank or issue its own currency. The country continued to be part of the South African monetary system, using South African currency. This policy was pursued even though it meant being subject to South Africa's monetary, exchange rate and exchange control policies, and despite official concern that the banks in Botswana lent half or less of domestic deposits to local borrowers, placing the remainder in South Africa (Section 2).

This passive policy was not questioned until after mining development enabled the government to balance its recurrent budget without foreign aid, in 1973. In 1976, the government did eventually create a new central bank and issue its own currency. The government's approach to financial policy remained untypical, however, in that it continued not to interfere directly with the commercial banks which dominated the financial sector, but opted mostly for indirect policy instruments. The government's commitment to this strategy was demonstrated when it relied mainly on indirect policy instruments during a (short-lived) financial crisis in the early 1980s (Section 3).

Botswana did eventually introduce measures to liberalise further its already relatively liberal financial sector at the end of the 1980s. It was again untypical, however, that this was not done as a response to economic crisis, and therefore not as part of IMF or World Bank conditionality. On the contrary, Botswana wanted to increase the efficiency of the financial intermediation of the economy's large financial surpluses. Botswana was, unfortunately, rather more like other countries in having to close or rescue non-bank financial institutions (Section 4).

The financial sector policy changes were only partially successful. The entry of new commercial banks, all foreign, introduce some much needed competition. This improved some aspects of banking, but with some negative side effects, and did not result in any

significant expansion of the type of bank finance provided. Moreover, although Botswana's banking legislation and bank supervision were adequate, no small locally-owned commercial banks were licenced; this was definitely preferable to the practice in some other countries of licencing such banks before the reform of banking law and bank supervision, but may have prevented the development in Botswana of potentially valuable finance (Section 5).

2. Absence of banking reform at independence

When Botswana became independent in 1966, there were no financial sector changes. The country continued to use South African currency, and remained part of the South African monetary system with effectively no opportunities for independent monetary, exchange control or exchange rate policy, and virtually no instruments for influencing domestic financial institutions. The other two small countries using South African currency prior to their becoming independent, Lesotho and Swaziland, also continued to do so for some years. The South African authorities did not consult with its three small neighbours over financial sector policies, and therefore did not even consider modifying them where the neighbours' interests differed from those of South Africa.

There were two expatriate commercial banks in Botswana, Barclays and Standard Chartered. They were both of British origin, but were branches of those banks' subsidiaries in South Africa, and were therefore controlled from Johannesburg rather than from London. They kept the bulk of their liquid assets as deposits with their respective head offices in South Africa, the only exception being their small holdings of South African currency. Their operations were subject to regulation by the South African Reserve Bank; there were no banking regulations such as liquidity and capital requirements specific to Botswana. The Botswana bank branches applied South African exchange control regulations to transactions with countries outside the South African monetary system. There were no exchange controls on transactions between Botswana and South Africa.

In practical terms, therefore, Botswana was simply a monetary province of South Africa. Because money could flow freely between the two countries, interest rates in Botswana were bound to be more or less identical to those in South Africa. Other aspects of monetary and exchange rate policy were decided by the South African authorities, without consultation with the Botswana government, and without consideration of whether Botswana's interests differed from those of the South African economy.

Botswana government policy documents prior to and at the time of independence did not suggest that any changes should be made to these monetary arrangements. It was assumed

that the commercial banks could not be induced to provide credit to small scale farmers and businesses, nor medium term project finance, because they were regulated by South Africa and credit conditions were extremely tight at that time. Proposals regarding credit were thus confined to estimating the foreign funds that would be required by the National Development Bank (created just before independence, in 1964), mainly for financing boreholes and the purchase of farms from the government, with much smaller amounts for the newly established cooperative movement and for low cost housing in the new capital city [Republic of Botswana, 1966: 53-61].

This policy of non-interference continued for some years, despite some concern over the consequences. For example, the National Development Plan published in 1968 noted that commercial bank advances to residents, organisations and institutions in Botswana were only 48% of commercial bank deposits, and that therefore more than 50% of bank assets were invested outside the country. Moreover, residents could and did invest their savings directly in South Africa.

> "Botswana is, therefore, in this respect a creditor nation, a role that she can ill afford to play at this juncture in her development ... At the same time the country is in urgent need of finance for telecommunications, power, water supplies and housing, all of which are sound loan-worthy projects. More credit on easier terms also needs to be made available to commerce and industry to stimulate the private sector." [Republic of Botswana, 1968: 80-1]

Despite this official concern, there were no proposals to direct commercial bank credit to support the government's development objectives, the commercial banks were not nationalised, no government-owned commercial bank was created, there was no attempt to limit commercial bank lending to foreign-owned companies (in order to make more credit available to locally-owned businesses), nor were there any other measures of this type which were common after independence in so many African countries. The government continued to propose a larger role for its National Development Bank, but even if all the necessary resources could have been found, it would still have remained small in relation to the two commercial banks (its lending was about 27% of commercial bank lending in 1968). In the event, National Development Bank lending actually fell in real terms by some 27% during the following six years, while real GDP increased by more than 200%. The government proposed the creation of a development corporation, while considering the formation of a local building society (with help from established building societies abroad), and these institutions were eventually created, both in 1970. They were of course bound to be small in relation to the commercial banks for many years. It was therefore remarkable that the

government continued to leave the commercial banks alone while they controlled such a high proportion of domestic financial resources, and invested less than half of them in Botswana.

The principal reason why the newly independent Botswana government behaved so differently was probably a combination of its ideology and a pragmatic realisation of its limited room for manoeuvre.

The Transitional Plan, issued at independence in 1966, stressed the "necessity of planning the social and economic development of the nation", but went on to define the government's role as "to set forth clearly its objectives and priorities, to frame its policies accordingly, and to assist the private sector in every way consistent with the attainment of these goals" [Republic of Botswana, 1966: 7]. What this meant in practice, as became apparent from later plans and their implementation, was that the government planned its own spending carefully, but limited its economic activities to the provision of basic infrastructure and the conventional public services, while leaving the bulk of economic activity to the private sector. The government did, however, lend to parastatal utilities to finance their capital spending, which had a major impact on the financial sector. Nevertheless, Botswana is in the slightly paradoxical position of having had an unbroken series of development plans since independence, while having consistently refrained from direct planning of the private sector.

It can also be argued that the absence of a radical change of economic strategy was because of the heavy dependence of the government on British aid, and the almost complete absence of development prior to independence. Half the recurrent government budget was paid for by grant-in-aid; in these circumstances, the entire development budget had also to be financed from abroad. The urgent priority was therefore to begin to remedy colonial neglect, which required still more aid. The government wanted to reduce aid dependence in the longer term. Any prospect of this required more aid in the short term, to build the infrastructure necessary to attract private sector investment. The country could not afford, therefore, to endanger the inflow of aid by radical, especially socialist, economic policy changes. It was also significant that the political leadership was fundamentally conservative and inclined towards market-oriented economic policy. Most leaders, including President Seretse Khama himself, were cattle owners, which meant they had commercial experience and an interest in the continuation of existing economic policy.

3. Belated monetary changes, ten years after independence

Botswana's economic prospects were transformed by mining developments, and to a lesser extent by the renegotiation of the Southern African Customs Union (SACU) in 1969, which

greatly increased the customs revenue received as a consequence of imports for mining construction. As a result, Botswana balanced the recurrent government budget in the 1972/73 fiscal year without a grant-in-aid from the British government, many years before it might otherwise have been expected, and before receiving significant revenue from mining profits. This development made it appear feasible for Botswana to have its own currency and monetary system. The issue was debated at length, with the arguments set out in a White Paper [Government of Botswana, 1975]. At this time, negotiations were in process for a Rand Monetary Area Agreement, which would have given Botswana for the first time a return on the rand currency circulating in the Botswana economy. This had amounted to an interest free loan to the South African government. Nevertheless, the government decided to withdraw from the negotiations and to introduce a new currency and monetary system, with a fully-fledged central bank. Lesotho and Swaziland stayed in the negotiations, established monetary authorities which issued local currencies but had much more limited powers than a central bank, and received income on agreed estimates of the rand that continued to circulate in parallel with their local currencies.[1]

The two foreign-owned commercial banks in Botswana were incorporated locally in 1975, with direct (100%) ownership and control from Britain, although they continued for the time being to deposit their excess liquid assets with their fellow subsidiaries in South Africa. Then, in 1976, an independent monetary system was created, with a national currency (the Pula) and central bank.[2] To that extent, then, Botswana eventually followed the example of most other independent African countries, after a ten year delay.

However, there were relatively few other changes in the structure of the banking system after 1976. The Botswana authorities continued with its previous policy of not interfering directly with the allocation of commercial bank lending, and of leaving unchanged the ownership and control of commercial banks, despite their increasing dominance of the financial sector (see Table 1 below). The authorities confined themselves to using the indirect policy instruments made available by the creation of the new monetary system and national exchange control regulations. That is, Botswana chose the basic strategy which so many countries adopted only in the late 1980s and early 1990s.

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[1] The formula negotiated for estimating rand circulating in Botswana would have been somewhat generous, compared with the Pula note circulation as it in fact built up in 1976 and 1977 [Harvey, 1985: 3].

[2] Detailed descriptions of the creation of the new monetary system are in the 1976 and 1977 Bank of Botswana Annual Reports.

Table 1
Commercial bank dominance of financial institution liabilities, 1972 and 1979 (P million)

Financial institutions	1972	1979
Commercial banks	38.9	155.2 (a)
Other (b)	5.0	14.5
Share of other	11.3%	8.5%

Notes: (a) The statistic for commercial banks in 1979 could have been higher by at least P50.2, this being the non-bank deposits at the Bank of Botswana which the commercial banks refused to accept; in addition, government deposits at the Bank of Botswana were P82.2 million, which the commercial banks could have bid away.
(b) National Development Bank, Botswana Building Society, Post Office Savings Bank and (in 1979) Botswana Cooperative Bank.

Exchange controls were introduced for the first time on transactions with South Africa. There were effectively no constraints on trade, and controls on other current account transactions were extremely liberal. Exchange controls on the capital account were much more significant, and had a major impact on the commercial banks.

First, residents of Botswana were obliged to sell their holdings of rand in South Africa and hold local currency deposits instead. Although many individuals continued (illegally) to hold their rand deposits, at least temporarily,[3] large institutions had to conform with the new regulations. The commercial banks began to hold their liquid assets in Pula in Botswana, mainly in deposits at the Bank of Botswana. Other large corporations, including especially the mining companies, switched from rand to Pula bank deposits.

Second, a non-resident controlled could not borrow, from banks in Botswana, more than the amount of foreign exchange it had brought into the country, the "one-for-one" rule. The objective was to encourage foreign capital inflow. It could also have had the effect of making more credit available to local borrowers, but did not new so because commercial banks had liquid assets in excess of the new requirements set by the Bank of Botswana.

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[3] This was shown by the lack of demand for rand from the banking system to pay for imports in the months immediately following the introduction of the new currency. Clearly, residents used rand balances to pay for imports rather than selling rand for Pula and then having to go through the new procedures for buying rand. This was tolerated by the authorities, who could probably not have done much about it anyway [Bank of Botswana, 1976: 14]. This conveniently allowed the new system to be established without stress. After about three months, purchases of rand for import payments reached what appeared to be normal levels, although there was little way of knowing whether residents continued to hold rand financial assets as savings.

Indeed, so much excess liquidity developed that the commercial banks began in 1978 to refuse to accept large fixed term deposits at the advertised rates, because they would have had to be redeposited at the Bank of Botswana at a loss. Even accepting deposits at lower than advertised rates, or obliging customers to hold a higher proportion of their deposits in non-interest bearing current accounts, would have been unattractive to the commercial banks because capital adequacy requirements were based at that time on the amount of deposits.[4] "One large company" (clearly the diamond mining company, Debswana) was therefore allowed to have a call account at the Bank of Botswana, because the government was "unwilling for businesses in Botswana to be unable to place their spare cash at the banks at reasonably attractive rates of interest" [Bank of Botswana, 1978: 25]. This enabled the commercial banks to continue accepting deposits from their other customers. Over the years, as excess liquidity proved to be a lasting and growing phenomenon, the right to deposit at the central bank was extended to parastatal companies, and eventually to anyone (but with a minimum deposit large enough to exclude most individuals).

The new financial legislation gave the Bank of Botswana powers to decide all interest rates, including those on commercial bank deposits and lending. These powers were used to reduce interest rates slightly below those of South Africa, in an unsuccessful attempt to stimulate bank lending. Lowering interest rates could have led to an unwanted capital outflow, even though large corporate depositors in the commercial banks were unlikely to evade exchange control regulations. Other depositors could probably have done so. More significantly, it was perfectly legal to finance trade in Botswana rather than abroad; such a shift in sources of trade finance would have been a legitimate form of short term capital outflow. There was little evidence that it occurred. The foreign exchange reserves grew steadily, from P65 million at the end of 1976, to P255 million at the end of 1980. This made it unnecessary to be concerned about short term capital outflows, which could anyway have been reversed by raising interest rates.

The Bank of Botswana also offered much lower interest rates on its call accounts than the commercial banks and other large depositors had received previously on balances in South Africa, or than the central bank received on the foreign exchange reserves. This greatly increased Bank of Botswana profits (and therefore government revenue) at the expense of the commercial banks and, principally, the diamond mining company Debswana. Both, however, remained extremely profitable.

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[4] The legislation was changed later so that capital adequacy was based on lending, preferable because bank capital and reserves should be available to cover the risk of non-repayment of bank lending. Liquid asset requirements were also based on deposits, and remained so, correctly.

The low rate on commercial bank call accounts increased the incentive for commercial banks to convert excess liquidity into additional loans and advances. The margin between prime lending rate and the return on additional liquid assets was 3.5 percentage points in 1975. It increased to between 5.5 and 6.5 percentage points between 1977 and 1979, but there was little evidence that this affected commercial bank behaviour. Commercial bank loans and advances fell steadily in real terms from 1976 to 1980, by 23% in total in the four years. This was an example of the asymmetry of monetary policy. It can be effective in restraining an overheated economy, but is frequently ineffective in stimulating an economy where there is a lack of demand for credit from potential borrowers regarded by banks as creditworthy, even if banks have excess loanable funds and a strong incentive to lend.[5]

The authorities were also concerned about the small amount of longer term lending for fixed investment by the commercial banks; their lending was dominated by short term loans for working capital. They followed the British pattern of commercial bank lending, leaving long term loans and equity finance to other markets and institutions which of course did not exist in Botswana. The commercial banks argued that they could not make longer term loans out of short term deposits. This argument was unconvincing, given that their deposits were the economy's money supply, that the central bank stood ready to support their liquidity, and that their parent banks in Britain were at that time moving into long term mortgage lending financed by short term deposits. Nevertheless, the structure of commercial bank deposit rates was altered in favour of longer term deposits; the government also lengthened the term of some of its own deposits with the commercial banks. Neither policy instrument was successful in altering the commercial banks' policies in favour of longer term lending, then or in subsequent years.

Another policy instrument which became available in 1976 was the setting of domestic liquidity requirements for the commercial banks. This was in part a prudential regulation, but it could also have been used as a macroeconomic policy instrument. However, it is only effective if the commercial banks are pushing up against the limit and have no spare liquid assets. In such conditions, the authorities can restrict the growth of bank lending, or even cause it to contract, by increasing the liquid asset requirement. If banks have spare liquid assets, increasing the liquid asset requirement has no effect unless it absorbs all the excess liquidity; similarly, reducing the liquid asset requirement has no effect if the banks already have excess liquidity. Generating an increase in bank lending also requires that there be unsatisfied demand for credit from would-be borrowers regarded as creditworthy by the

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[5] The banks were accused at the time of lack of initiative, but lack of demand was the more likely explanation. Commercial bank lending grew quickly once the next mining construction boom began to stimulate demand.

banks. The commercial banks in Botswana had excess liquid assets ranging from 32% to nearly 60% of deposits in the five years following 1976.

The government's commitment to relying on indirect policy instruments was confirmed by the official reaction to a balance of payments crisis in 1981 and 1982. The market for large gem diamonds virtually collapsed. Although the demand for smaller gem diamonds kept up remarkably well, large gems provided a high proportion of total revenue from Botswana's diamond mines. Diamond export revenue fell by 64% in the second half of 1981, compared with the second half of 1980, and the foreign exchange reserves fell rapidly. The government decided early in 1982 to introduce stabilisation policies rather than gamble on the diamond market recovering.

Secondly, the government did not, as was common elsewhere in Africa, respond to the crisis by increasing the severity of administrative controls on imports and other uses of foreign exchange. It was believed that controls would be ineffective, while greatly damaging business confidence. Because so much investment in Botswana, other than in cattle, originated from neighbouring countries, the business community was acutely aware of the damaging consequences of severe foreign exchange and import controls, and the probability that their severity would increase continuously once government had decided to use them to cope with balance of payments deficits.

Instead, the government introduced a package of conventional stabilisation measures, including a rise in interest rates, a ceiling on commercial bank lending which was agreed with the banks (although rapidly falling excess liquidity would probably have constrained bank lending anyway), a small devaluation which offset an inadvertent appreciation in the previous year caused by rand weakness and the Pula being pegged to a basket of currencies, a tightening of fiscal policy and a government wage freeze at a time when past inflation had led to expectations of a nominal wage increase of some 20%. The government also drew down the remaining tranche of a foreign loan negotiated to pay for an increased share of diamond mining investment, but not used because government revenue grew faster than expected. The measures were almost immediately successful in reversing the decline in foreign exchange reserves.[6]

Exchange rate policy was used mainly to alleviate the inflation imported from South Africa, which supplied some 80% of imports to the extremely import-dependent Botswana economy.

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[6] The government also entered into negotiations for an IMF loan, but before the agreed Letter of Intent could be signed, Botswana became ineligible to borrow because the measures already taken had caused foreign exchange reserves to increase rapidly.

This worked quite effectively. The Pula rose to R1.37 by 1990 (from parity with the rand in 1976), while consumer prices in Botswana rose 4.3 times compared with 6.2 times in South Africa. Reduced import costs in local currency terms fed into lower inflation and lower wage increases, so that the real bilateral exchange rate with South Africa fluctuated within narrow margins and the competitive situation of Botswana producers was not eroded by the rising nominal exchange rate. The trade weighted real exchange rate index, 100 in 1980, fluctuated within a narrow range, from 106 to 88, with a slight downward trend [Harvey 1993: 17]. The real bilateral exchange rate with South Africa fluctuated even less. After 1990, this strategy was abandoned, and from 1992 Botswana's inflation was consistently higher than South Africa's (by an average of 2.6 percentage points in the four years 1992-95).

4. Government as a financial intermediary

The most significant form of government intervention in the financial sector was that the government itself became a major lender, financed partly by foreign borrowing but mostly by budget surpluses. This lending was long term, mainly to public sector borrowers, but increasingly to government-owned development banks and therefore financing to some extent the private sector as well. It is difficult to decide whether this excluded the private sector banks from valuable business, or whether it relieved pressure on them to lend to borrowers, and on terms, which they preferred to avoid.

Table 2
Government lending compared with bank lending
(Pula million at constant 1992 prices)

	1980	1992	1995
Government	125	1904	1717
of which to banks	17	463	384
Government lending to non-banks	108	1441	1333
Commercial banks	340	1363	1159
Other banks: private	7	250	44
parastatal	78	585	453
TOTAL bank lending	425	2198	16
Total Credit	533	3639	2989
Memo item: share market capitalisation	-	657	1120

Notes: statistics for different lending institutions not strictly comparable because of different reporting dates; there is a minor problem of double accounting because not all intra-bank loans and deposits are netted out; the large fall in "other private banks" between 1992 and 1995 was because the largest finance company (FSC) was taken over by a commercial bank.

By 1980, government lending was already more than a third of commercial bank lending. Government lending was entirely to parastatal corporations (including parastatal development banks) and town councils, mostly to parastatals. The Botswana Housing Corporation was the largest borrower with 66% of total government lending in 1980. Government lending in that year to parastatal financial institutions was only 14% of the total, and 4% of commercial bank lending. So government lending did relatively little to compensate for the lack of development finance from the commercial banks.

During the 1980s, government lending increased faster than commercial bank lending, to the point where government was the largest single lender in the economy, and government lending was larger than the combined total of commercial bank loans.[7] Although the real value of government lending fell from its 1992 peak, it continued to increase its share of total

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[7] The government also invested in parastatal equity, but in current Pula it was only P0.4 billion in 1994 compared with P2.4 billion of lending, if equity in the Bank of Botswana (almost entirely retained profits), the copper-nickel mining company (the government's share of the cost of keeping the loss-making mine opened), Botswana Railways (also loss-making), and the soda ash mine (bankrupt in 1995), are excluded [Bank of Botswana Annual Report 1995: S67-8].

lending (from 52% to 57% in 1995). The majority of this lending continued to be to "commercial" parastatals, selling their services to the public and servicing their debts, but the share of commercial parastatals in government lending fell from 83% in 1980, to 68% in 1992. The percentage of lending to financial parastatals rose from 14% to 24%, a rate of expansion which proved to be too fast for some of them to manage efficiently (see below).

The government lent at rates slightly below the commercial bank prime lending rate, and almost all government lending was longer term than commercial bank credit. This was a subsidy to the parastatal sector, loosely justified on the grounds that the parastatals had social as well as commercial objectives. However, most government lending was to parastatals providing urban services. Overwhelmingly, this benefited the better off, because those with low incomes did not qualify for government housing, did not use electricity, did not fly by Air Botswana, and did not have telephones.[8] Government lending to these parastatals was 74% of the total. However, the implicit subsidy was limited because some of the largest borrowers (for example, the parastatals supplying water, electricity and telephones) made positive returns on capital employed.

The commercial banks argued that government lending at sub-commercial rates of interest excluded them from a significant part of the market for loans, and partly explained their loss of market share. However, this argument was not entirely convincing. For example, when the commercial banks were offered an opportunity to participate in financing parastatal expansion, they expected the central bank to underwrite the liquidity risk by guaranteeing to discount the loans on request, and the government to underwrite the credit risk by providing formal guarantees. This would have removed the main advantage of commercial bank participation in the finance of parastatals, namely their judgment on the commercial soundness of the projects involved and any loan conditions which they would have imposed arising from their credit analysis. There would have been little point in placing government deposits in commercial banks to facilitate their lending to parastatals, if government had been obliged to underwrite all the risks.[9] The underlying problem was that commercial banks had minimal incentives to undertake longer term lending. Their managers were not trained in assessing longer term projects, nor were they rewarded for doing so. Meanwhile, throughout the 1980s the commercial banks were extremely profitable, further reducing their incentive to seek new business, particularly if it involved unfamiliar types of lending.[10]

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[8] Subsidised lending also benefited urban consumers of water, but rural water supplies (which reached an increasing proportion of rural residents) were subsidised to a very much greater extent [Harvey and Lewis, 1990: 288-9]

[9] Although the commercial banks had excess liquidity, it would not have been enough to substitute for government lending to parastatals without government deposits being shifted from the Bank of Botswana.

[10] For example, in the ten years after 1976, the two main sources of commercial bank income, lending and foreign exchange transactions, increased roughly tenfold while employment (as a proxy for costs) rose less than

Government lending to the financial parastatals grew even more rapidly than government's other lending. In addition, the private sector non-bank financial institutions, notably the Botswana Building Society and the Financial Services Company, shifted during the 1980s from relying on private sector resources to being heavily dependent on loans and deposits from government, to the point where they were de facto financial parastatals.[11] This lending had mixed success. The National Development Bank had overwhelming levels of bad debt; the Botswana Cooperative Bank had to be wound up in 1995; the Botswana Building Society and the Financial Services Corporation had problems but not on a scale to render them insolvent; and the Botswana Development Corporation was moderately successful.

The NDB remained sound in its early years, but its lending failed to grow: lending in real terms was stagnant from 1968 to 1979, although GDP grew by 379% over the same period. Then it was given a mandate to expand under a new managing director, together with the matching government finance. Thereafter it had a continuing history of bad debts being written off, and refinancing by government. Part of this could be attributed to the NDB's obligation to lend to the agricultural sector, and drought; but the rate of expansion and lack of accountability led to unsound lending and eventually corruption. Although some of these problems were quickly identified, and appropriate policy statements made, nothing effective was done throughout the 1980s. Effective action was finally taken in 1993, with new government money cut off, a new management team, and, most crucially, firm political support for reform.[12] This was an example of the extraordinary difficulty, and lengthy delays, which so often occur in government attempts to reform insolvent banks.

A second important consequence was that the availability of NDB loans on doubtful criteria, with a probability of non-repayment being forgiven, reduced any pressure there might otherwise have been on commercial banks to lend improperly. The commercial banks also remained relatively free of pressure to lend to the agricultural sector or to small-scale enterprises. There were no public accusations of undue political influence on the commercial banks to lend on non-commercial criteria. There were occasional unsubstantiated rumours, but available evidence suggests that, even if the rumours were true, such lending remained very small in relation to commercial bank profits and did not therefore threaten their solvency. It is also relevant that the central bank's Bank Supervision Department was

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50%. For much of the 1980s, the commercial banks were able to make over 50% on shareholders' funds which were themselves being increased at more than twice the rate of inflation [Harvey, 1993: 8-9].

[11] The Financial Services Company (mainly providing leasing finance) merged with First National Bank of Botswana in 1994, but retained its government finance. The latter was a major attraction to its commercial bank partner.

[12] While the NDB made a modest profit in 1995, after many years of losses, the effectiveness of management and board of directors was reported to remain problematic, with continued government and board pressure to undertake unprofitable lending.

adequately staffed, had a good reputation, and conducted regular bank inspections; this further reduce the possibility of undetected improper lending, or tolerance of non-repayment of loans, on a damaging scale.

The Botswana Development Corporation is widely regarded as a success, including being singled out as such by the World Bank [1989: 60]. However, it was nearly bankrupted in the late 1970s by a relatively large investment in an unsuccessful brewery, and although it recovered and earned respectable rates of return on capital employed, it depended for a high proportion of its profits on a small proportion of its investments. Its success, relative to the many insolvent development corporations in Africa, was attributable to being managed on commercial lines with no government interference in day-to-day management. This strategy was sustained even though it had civil servants on the board, including the chairman.[13] However, a majority of board members was from the private sector, and expatriate managers tended to be recruited from a commercial background. The Corporation's financial problems derived from genuine mistakes, in a difficult environment, so that it was not (as was the NDB) a mechanism for protecting the commercial banks from improper pressures.

5. Gradual financial sector liberalisation, in a non-crisis situation

Financial sector liberalisation in Botswana was not undertaken as a consequence of a balance of payments or external debt crisis, and was not therefore part of a structural adjustment programme sponsored by the IMF or the World Bank. It occurred gradually, being a continuous process from the late 1980s rather than being a discrete programme with stated deadlines.

Botswana's "problem" was how to manage financial surpluses. The economy recorded the fastest growth of national income per head (8.4% per annum), between 1965 and 1990, of all World Bank members with populations greater than one million, had foreign exchange reserves which rose from 6 months to over two years of import cover during the 1980s, and had a ratio of external debt service to exports of goods and services of only 4% in 1990 [World Bank, 1992: 219, 265]. The government had no domestic debt at all; on the contrary, the government had nearly two years' worth of recurrent expenditure on deposit at the central bank. This unusual record was generated in the first instance by diamond mining, which in turn provided huge revenues for government. Diamond mining was exceptionally profitable, because costs were a small proportion of revenues, and government received a substantial share (more than 75%) of diamond mining profits. Because diamond mining employed few people, the main link between diamond mining revenues and development was government

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[13] In fact, the chairmen were particularly determined that the BDC should be a commercial success.

spending and lending. Although this was much larger than bank lending, and itself generated much private sector development indirectly through the spending of the income created, there remained a role for the financial sector in lending some of the financial surpluses directly to the private sector.[14]

The realisation that financial sector reform was necessary occurred gradually. For some years, official concern was confined to the excess liquidity of the commercial banks. It could be argued that this concern was misplaced. The government's planning procedures were carefully designed to keep government spending within the physical constraints of the economy, most notably skilled labour.[15] These same physical constraints affected spending financed by bank credit in the same way as spending by government. Increased expenditure financed by commercial banks would therefore have caused excess demand for domestic resources, with damaging effects.

The National Development Plan published in 1980 did not have a chapter on the financial sector. It noted that the commercial banks had excess liquidity, but argued that the large differential between what the banks could earn on call accounts at the Bank of Botswana and what they could earn on loans, together with the new Hypothecation Act of 1978 which allowed cattle owners to use cattle as security, provided "ample incentive for the commercial banks to lend money if they can find bankable propositions" [Republic of Botswana, 1980].

Two years later, the Presidential Commission on Economic Opportunities had a chapter on banking and credit [Republic of Botswana, 1982a]. The White Paper which followed accepted three minor financial sector recommendations, none of which amounted to a change of policy.[16] For the rest of the 1980s, Bank of Botswana Annual Reports and National Development Plans contained very little on financial sector policy, apart from continuing concern about commercial bank excess liquidity. The 1985 National Development Plan, although it had a chapter on the financial sector, noted that the government itself was providing both development finance for non-financial parastatals, and substantial funding to the National Development Bank, the Botswana Development Corporation, and the Botswana Building Society, to provided long-term finance for the private sector. The Plan appeared to be satisfied with financial sector performance: it noted that total credit had grown at 11% per

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[14] For example, government recurrent and dominant spending, plus net lending, in the five years to 1994/95, totalled P18.8 billion, while commercial bank lending increased by P0.6 billion over the same period.

[15] Government lost control over its spending in the late 1980s with costly effects, for example existed increases in construction costs, but regained control in the 1990s; for more detail see Harvey, 1992.

[16] A Banking Consultative Committee was to be established, but little was heard of it subsequently; the working of the Hypothecation Act was to be reviewed (the commercial banks never used it significantly); and the National Development Bank was to link better to small enterprise extension services [Republic of Botswana, 1982b: 14].

year, more than twice the growth rate of the non-mining economy, and that the geographical coverage of the commercial banks had expanded. No policy changes were proposed [Republic of Botswana, 1985: 348-55].

In 1986, the Bank again expressed concern about "sluggish demand for bank credit accompanied by a build up of excess liquidity". This time, the Bank took action, and commercial bank prime lending rates were reached from 11.5% to 10%.[17] At the same time, the exchange control rule limiting foreign company borrowing was relaxed.[18] In 1987, the prime lending rate was again reduced, and commercial banks obliged to accept interest bearing deposits at published rates up to advertised limits (minimum P50,000) with any excess to be placed on interest-bearing call accounts [Bank of Botswana, 1987: 15-16].

In 1988, the Bank noted for the first time that interest rates were strongly negative, 10 percentage points below those in South Africa in real terms at the end of 1988, and announced that the World Bank had started on a financial sector study [Bank of Botswana, 1988: 23]. This was the first real indication that financial sector policy might change more fundamentally.

In 1989, the authorities announced that they wanted to move gradually to positive real interest rates. There were also plans for the Bank of Botswana to issue its own paper to soak up the continuing excess liquidity, and hopes for greater banking competition: the objectives were positive real interest rates, more competition among commercial banks, and for non-bank financial institutions to extend the range of services offered so as to become competitive with the commercial banks.[19]

(a) *Real interest rates and financial deepening*

Botswana did not suffer from heavily negative real interest rates to the same degree as some other African economies. The commercial bank prime lending rate was actually above inflation in half the years from 1981 to 1990. The nominal interest rate on deposits was of course lower, but was above inflation in two of those years, and never more than 6 percentage points below inflation in the other eight years. Nevertheless, there was not any financial

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[17] This reduction in the cost of borrowing was introduced at the worst possible time, as it coincided with a loss of control over government development spending which lasted for three or four years.

[18] The rule was also changed from P100,000 plus 100% of foreign funds brought into Botswana to P100,000 plus three times foreign equity in order to encourage conversion of loans to equity; there had been concerned for many years at the excessive gearing of many foreign companies which were sometimes referred to as P2 companies because they had only P2 of equity [Bank of Botswana, 1986].

[19] There were several other recommendations, but they were simply to review various aspects of the financial sector, in other words postponement of immediate action [Bank of Botswana Annual Report, 1990].

deepening, as measured by ratios of money supply or private sector credit to non-mining GDP.[20] Furthermore, the share of private business in commercial bank advances declined in the first half of the 1980s, and remained roughly constant thereafter, because so much of increased bank lending was to households [Bank of Botswana, 1993: 12-13].

The absence of financial deepening was partly because real interest rates, after allowing for taxation of deposit interest and the fact that interest paid on borrowing was tax deductible, were more negative than indicated by the difference between nominal interest rates and inflation. Secondly, the commercial banks continued to be unwilling to use their short term deposits to make longer term loans, even though their deposits were quite stable. Thirdly, the banks consistently complained of a shortage of bankable projects (despite Botswana being the world's fastest growing economy).

Nominal interest rates were increased. The commercial banks prime lending rate rose from a low of 7.5% in 1988, to a high of 15% in 1993, and remained at 14% in 1994. At first, however, rising rates of inflation kept the prime lending rate below inflation, which meant that the cost of borrowing adjusted for taxation was even further below inflation. However, rates of tax on personal incomes and company profits were reduced in 1993 and 1994, thereby also reducing the difference between real rates of interest before and after tax. As a result, the real cost of borrowing at prime lending rate in 1994, after taking account of a company tax rate reduced from 40% in 1992 to 25%, was almost exactly zero, and therefore positive for all borrowers paying more than prime rate.

Bank of Botswana Certificates were first issued in 1991, with an effective interest rate higher than that on commercial bank three month deposits. They quickly replaced Bank of Botswana call accounts. Their sole purpose was to start on the process of making short term interest rates market-determined, since the government budget was still in surplus. Their main advantage was to make interest rate policy less political. Previously, getting the government to agree to interest rate changes, especially upward changes, was a lengthy and difficult process. The interest rate on Bank of Botswana Certificates was only partially market-determined, because their supply was entirely controlled by the authorities. Demand was market-determined, however. This gave the monetary authorities greater flexibility, and made it easier for them to pursue their policy of pushing interest rates above the rate of inflation. However, the secondary objective, financial deepening, had not occurred by 1995, when the ratio of M2 to GDP was slightly lower than in 1990.

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[20] The ratio of M2 to non-mining GDP fluctuated narrowly between 25% and 35%, with no discernible trend; the ratio in 1990, at 30%, was the same as in 1981.

(b) *Increased commercial bank competition*

One new commercial bank had opened up in Botswana in 1982, Bank of Credit and Commerce Botswana, a wholly owned subsidiary of BCCI. Rather disappointingly, it did not compete significantly with the two existing commercial banks. When the parent company collapsed, it was managed temporarily by the Bank of Botswana. It was found to be reasonably sound, having apparently been insulated from the parent company's (illegal) activities, in part by Botswana's exchange controls. It was then sold to one of the commercial banks to be licenced in the 1990s (FNBB, see below).

It is difficult to establish whether the licencing of new entrants to commercial banking in Botswana in the 1990s was because of the change of policy, or whether it was simply a fortunate coincidence. Licencing policy was mostly cautious despite the admission of BCCI. It was argued that Botswana's was not large enough for additional commercial banks to operate successfully. There were periods when applications would have been welcome but were not forthcoming, but there was also a degree of complacency regarding the existing oligopoly. This included acceptance of exceptionally high commercial bank profits, on the grounds that this enabled the banks to increase their capital and reserves rapidly, which in turn increased their capacity to finance large customers without exceeding prudential limits.

The first foreign bank since BCCI to apply for a banking licence (Zimbank) posed a dilemma, as it was majority owned by the Zimbabwe government. However, it was regarded as being efficiently managed in Zimbabwe, on commercial criteria, and the application was therefore accepted. It began operations in Botswana in 1990 with a managing director who had worked previously for Standard Chartered in Botswana. However, the Botswana operation of Zimbank never operated at a profit, accumulated substantial bad debts, and was also taken over by First National Bank of Botswana, for a nominal sum.[21]

In 1991, another foreign-owned commercial bank started operations, with two more in 1992. Rather unusually, two of these banks were the ones that had owned and run the Botswana branch banks before 1975, although they had subsequently ceased to be British and had become wholly South African owned. Botswana therefore had Barclays Bank and Standard Chartered Bank, operating in Botswana since before independence and owned from Britain

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[21] The purchase price was P2, because P13 million of capital invested (in four successive tranches) was approximately offset by P13 million of losses. Unofficially, Zimbank paid the purchaser to take it over. One of the reasons for the failure of Zimbank in Botswana was that it was continually undercapitalised. Another reason was that its comparative advantage was to finance trade with Zimbabwe, but within a year trade with Zimbabwe collapsed because of the large devaluation of the Zimbabwe dollar. A third reason was that it had a high cost structure which included several highly paid expatriates.

since 1975, while two of the new banks were what had been Barclays and Standard in South Africa. They were known in Botswana as First National Bank of Botswana (FNBB) and UnionBank respectively (Union Bank later changed its name in Botswana to Stanbic). The third new bank was ANZ Grindlays, but its Africa-wide operations were bought by Standard Bank of South Africa shortly afterwards so that ANZ Grindlays and UnionBank in Botswana merged in 1992.[22]

There was some concern that the rather uncompetitive oligopoly which had long existed in Botswana would be extended to include the two new banks from South Africa, because of their previous association; however, this fear proved unfounded. Competition was vigorous, but in contrasting ways. It had a number of positive effects, but also some unexpected and possibly damaging side effects.

First National Bank of Botswana chose to compete for retail banking business through rapid expansion of branches and provision of new and better services. It was fortunate in that it was able to acquire both branches and accounts much more quickly than originally expected, by taking over not only Zimbank Botswana (as described already), but also BCCB whose parent company crashed in the period between FNBB applying for a licence and beginning operations. FNBB bid for BCCB what successful partly because it was prepared to keep branches open and retain staff (although the management was changed). In 1994, FNBB acquired Financial Services Company, which provided a large leasing business (FSC had total assets roughly half as large as those of FNBB in 1993) more than half of which were financed by long term government loans at sub-market, fixed rates of interest.[23]

Expansion of FNBB continued rapidly, including the opening of new branches ahead of the requirements imposed in the granting of a banking licence. It therefore become large enough to compete with the established banks in a very short period of time, including competition for large corporate customers from which newly established banks, being small initially, would normally be excluded by prudential limits on the percentage of capital that could be loaned to any one customer.[24]

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[22] At the time, ANZ Grindlays Botswana had only one loan on its books. It regretted its decision to set up in Botswana, not having realised that other foreign banks were setting up at the same time, and was therefore greatly relieved to be taken over so quickly.

[23] In fact, FNBB reversed into FSC because the latter had a stock market quotation. FNBB thereby became a locally quoted company. The other banks complained that the acquisition of long term government finance gave FNBB an unfair competitive advantage, including P2 million per annum attributable to the interest rate advantage on government loans.

[24] Prudential limits could be exceeded for loans with parent bank guarantees. The parent banks of Barclays and Standard Chartered were larger than the parent banks of FNBB and Stanbic, giving the former a slight advantage (although Standard Chartered's parent was at one time treated as ineligible by the Bank of Botswana because of doubtful debts arising from loans to developing countries).

An important advantage of FNBB in competing for retail banking business was its use of the computer capacity of its parent bank in South Africa, including Automated Telling Machines (ATMs) which were more user friendly and cheaper than those of its competitors.[25] FNBB paid its parent full cost for its ATMs, but the South African operation enjoyed considerable economies of scale. It also had spare capacity, whereas the other Botswana banks faced capacity constraints. It was claimed that FNBB's rate of expansion had been managed without loss of efficiency, although it had imposed great strains on senior management.

Stanbic competed in a different way, focusing on corporate finance. Although the parent company, Standard Bank of South Africa, had 1200 branches, its global strategy was to shift away from being a retail bank. In Botswana, it discouraged retail banking by imposing a P1,000 minimum savings account balance, and a minimum salary of P5,000 per month for people opening a current account,[26] regarding it as cheaper to pay interest to attract deposits in the wholesale market was cheaper than providing services to attract zero-interest current accounts. It had four urban branches and no plans to open rural branches without a government subsidy, although the opening of rural branches was one of the conditions of being granted a banking licence, and lack of branches ruled out some customers who expected to have banking facilities countrywide. Failure to meet licencing obligations to open rural branches was not expected to be a problem, even though competitor banks complained that it provided Stanbic with a cost advantage.

Overall, the entry of two new foreign commercial banks competing aggressively, made a big difference to the long established oligopoly situation.

First, some new banking services were provided, mostly but not only by the new banks. These were not limited to ATMs, but included consumer cards usable at the point of sale in shops, the replacement of passbooks for savings accounts by electronic cards, and the provision of computer terminals on employers' premises so that companies no longer had to write cheques and their employees no longer had to queue to cash those cheques on paydays.

Secondly, the quality of services improved.[27] Thirdly, the margins on some operations, notably foreign exchange transactions, were sharply reduced, and loss of market share forced both the old established banks to reduce their workforce (reportedly by between 20% and

[25] Information providing by FNBB, and confirmed by competing banks.

[26] The exchange rate at that time was \$1 = P2.7. The average monthly wage for citizens varied from P244 in agriculture to P2,300 in education.

[27] This was stated by both new and old banks; the latter statements provided convincing evidence that services had previously been low quality as would be expected in an oligopoly situation.

25%). Inevitably, their profitability was also reduced. During the 1980s, they consistently made returns of more than 50% on shareholders' capital, which in turn was increased each year by more than the rate of inflation.[28] Barclays' profits fell 39% in 1994, and Standard Chartered's fell 62% in 1995. Both made greatly increased provisions for bad and doubtful debts which was not necessarily caused by increased competition. In addition, though, both suffered from falls in operating income in real terms (of roughly 10%), while Standard Chartered provided 23% of (slightly increased) operating income against restructuring costs. Despite these effects of increased competition, both banks remained profitable. Table 3 below shows the 1994 profits of the expatriate commercial banks compared with their capital and reserves at the end of the previous year.

Table 3

Profits and capital of commercial banks in Botswana, 1994

Bank	Profits 1994	Capital 1993	Profits /Capital %
Barclays	21.2	107.6	19.7
Standard Chartered (a)	9.9	85.5	11.6
FNBB (b)	16.6	30.0	55.3
Stanbic	4.6	21.3	21.4

Note: (a) Table shows Standard Chartered's profits in 1995 compared with capital at end-1994.
(b) FNBB's profits adjusted pro rata because it changed its accounting year in 1994 so that it lasted 15 months; the rate of return may still be exaggerated because turnover and profits were rising. The bank stated that its rate of return on capital was 35% [interview 1995].
Source: commercial bank annual reports

It was to be expected that the old established commercial banks would be forced to reduce employment in response to (successful) competition from new entrants. There were also some branch closures. Both banks stated that they would no longer consider opening new rural branches. For many years, the main pressure on the commercial banks from the Bank of Botswana was for them to mobilise rural savings, mainly by extending the rural branch

[28] Legislation required the commercial banks to add part of their profits each year to reserves. The central bank may have tolerated the extraordinarily high returns on commercial banking because they enabled capital to be increased rapidly, strengthening the banking system and allowing the banks to finance large customers without exceeding prudential limits.

network. While the commercial banks were not competing, they were willing (within limits) to subsidise rural branches from oligopoly profits. It is not, of course, necessarily the case that this was the best use of these resources. Rural branches normally lend very little in their districts, so they probably provided an expensive savings mechanism which duplicated that provided by the Botswana Savings Bank (formerly the Post Office Savings Bank and still using Post Office facilities), while channeling rural savings into urban lending.[29] The old banks' reduction of branches and employment was not necessarily damaging, provided that the new banks increased their employment and opened branches to replace those closed.

On the other hand, a potentially damaging side effect was a tendency for the old banks to respond to competition for large scale corporate finance business by reducing their finance for medium scale businesses. Surprisingly, there was almost no pressure on the banks on this latter issue, in the 1980s or the 1990s. Partly, this was because the government-owned National Development Bank (NDB) and Botswana Development Corporation (BDC) were expected to fulfill this role; in this, Botswana was typical of most African countries.

More unusually, the government also provided grants through the Financial Assistance Policy (FAP), for setting up or expanding private sector businesses. Small scale businesses received initial capital grants; medium and large scale businesses received grants over 5 years.[30] Between 1983 and 1993, FAP made grants to 3600 small businesses costing P39 million, and 474 grants to medium and large scale projects costing P160 million. Of course, FAP grants took some years to build up to their current level, but by 1993 their annual flows were large in relation to other forms of project finance for the private sector (see Table 4 below). The government chose to provide FAP as grants rather than loans in recognition of the inexperience of most entrepreneurs in Botswana, and the high risk of financing new businesses, especially with loans. Grants also reduced the scheme's administrative costs. The best available estimate of the survival rate of small scale FAP-assisted projects was about 50% in 1993 [Phaleng Consultancies, 1995: 46], which compares favorably with small business survival rates in other countries but would have rendered the scheme rapidly insolvent if finance had been provided as loans.

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[29] The most rapidly growing form of lending by the commercial banks was to households, mainly for cars and and other consumer durables: the share of households in commercial bank credit rose from 16% in 1982 to 35% in 1994. Botswana Savings Bank lending, exclusively to government employees for cars with government guarantees, increased fourfold from 1986 to 1994 (figures alone unavailable before 1986).

[30] The details were complicated; the unusual feature was that grants were structured to favour the use of unskilled labour, rather than being biased to the use of (imported) capital as in so many investment incentive schemes [Phaleng Consultancies, 1995: 3-4].

Table 4
FAP grants compared to increases in other forms of project finance, 1993
(P million)

Sources of finance	1983	1993
FAP grants (a): small	0.5 (178)	10.4 (449)
medium and large	1.6 (21)	31.5 (38)
Commercial banks: total	26.8	165.2
long term (>3 years)	not available	28.5
NDB and BDC	14.9	75.3
Other non-banks (b)	5.0	35.1

Notes: (a) number of grants in brackets
(b) Botswana Building Society, Financial Services Company and Botswana Cooperative Bank in 1983; plus another leasing company (ulc) in 1993, Tswelelo (lending to small and medium scale enterprises) included in BDC of which it is a subsidiary.

Sources: Bank of Botswana Annual Reports; BDC Annual Reports; Phaleng Consultancies, 1994.

There was some evidence in the 1990s that the commercial banks were increasing longer term loans as a proportion of their total lending (see Table 5). However, this coincided with the commercial banks starting to provide mortgage finance for individual house purchases, so that it was not possible to know whether their medium and long term lending to the business sector had also increased.

Table 5
Maturity of commercial bank loans 1990-95
(percentages)

Maturity	1990	1991	1992	1993	1994	1995
Less than 12 months	60.5	56.2	54.4	55.4	49.9	46.1
1 to 5 years	32.3	34.3	33.3	31.5	33.7	35.7
Over 5 years	7.5	9.6	12.2	13.2	16.5	18.3

Source: Bank of Botswana Annual Report, 1995

Financial sector reform also included some restructuring of non-bank financial institutions. The Botswana Cooperative Bank (BCB) was established in 1974 to accept deposits from and lend to cooperative societies, which were also the bank's owners. This structure effectively obliged the bank to lend to cooperative societies, which meant that BCB "continued to incur substantial losses and [had] ... a serious incidence of bad loans" [Bank of Botswana, 1991: 29]. In 1990, the government provided resources to allow BCB to lend to public sector employees for car and housing finance, with government guarantees. The intention was to allow the Bank to diversify its lending, and to provide a safe and profitable form of income. The bank also began to accept deposits from the public. However, it never provided significant competition to the commercial banks. It did not transact foreign exchange business, which made it unattractive for almost all depositors; virtually all Botswana residents, not just the better off, transact business with neighbouring countries and therefore need to buy and sell foreign exchange. Moreover, the bank only had one branch, the head office in Gaborone. The reforms failed to save the bank, which was put into liquidation in 1995.

The Botswana Savings Bank (BSB), formerly the Post Office Savings Bank, also embarked on moves to become more like a commercial bank. Its records were a complete mess in 1982, when it separated from the Post Office and became a special department of the Ministry of Finance. For three years there had been no annual report, no audit, and no reconciliation of accounts. It was successfully reformed, and became a parastatal in 1994 with its own board of directors, which speeded up decision making. It continued to use the 90 post offices in Botswana to collect savings deposits (for a fixed fee per transaction), which reduced the disadvantage of it having only one banking office, in Gaborone. Like BCB, it began to provide government guaranteed car and housing loans. In addition, it introduced in 1996 a simple personal lending scheme: customers undertake to save a fixed amount every month for two years, by deduction from salary. After 12 months of sustaining monthly savings, the customer can borrow twice the amount saved and repay by increased salary deductions. Interest paid on BSB deposits is tax free, which would give the bank a competitive advantage if it were to attract large deposits from people wealthy enough to be liable for tax. This was probably an efficient arrangement, because it avoided taxing interest of depositors who would be entitled to reclaim the tax, while it seemed unlikely that income tax payers would be attracted to the BSB; the Botswana Building Society offered higher tax free interest on deposits. In 1994, deposits were less than 2% of commercial bank deposits.

Overall, the small size and limited services of the BSB did not add significantly to competition among commercial banks, although it did provide a service to large numbers of people who were remote from commercial bank branches and might have found it difficult to

open commercial bank accounts. This was probably a very much more efficient way of providing an institutional savings mechanism countrywide than putting pressure on commercial banks to open rural branches; it did not provide full access to institutional credit, but as argued above rural branches of commercial banks were unlikely to lend much locally either.

(c) *Banking legislation*

In most other African countries, the banking legislation in force or introduced at independence had inadequate provisions on such issues as insider lending, prudential limits on lending to large borrowers, the suitability of directors, and the definition of bad and doubtful debts. Such provisions doubtless seemed unnecessary where commercial banks were exclusively subsidiaries of large international banks. For the same reason, bank supervision was barely necessary, and was therefore neglected with the result that experience was not acquired.

Botswana was different, perhaps because banking laws were not enacted until 1975. They were largely adequate for prudential purposes, even though Botswana's two commercial banks were also subsidiaries of large international banks.[31] Among other requirements, the commercial banks had to maintain adequate capital in relation to deposits, to transfer part of their profits to reserves each year, to make adequate provisions against bad or doubtful debts to the satisfaction of the central bank, to avoid lending more than 10% of capital and reserves to any one borrower, and could not lend more than a specified amount to employees and directors.

However, the Bank of Botswana was specifically excluded from supervising building societies, the Cooperative Bank, the Post Office Savings Bank, and the National Development Bank, all of which were established under their own prior legislation. More inclusive provisions might have helped to prevent the expensive mismanagement of BCB and NDB, although remedial action would also have required the strong political support which was not forthcoming until the 1990s.

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[31] One major problem could in theory have endangered one of the commercial banks, when they were first incorporated in Botswana. It had a large loan to the copper-nickel mining company, which was invariably in financial difficulties, to finance the pipeline of matte between the mine in Botswana and the further processing in America. This loan was small in relation to the balance sheet of the South African operation of which the bank was a part until 1975, but was several times the capital and reserves of newly incorporated Botswana subsidiary. However, it seemed unlikely that the British parent company would walk away from its Botswana subsidiary if this loan became a problem. The foreign shareholders of the mining company would also probably have backed the loan, particularly as one of them was also the foreign investor in Botswana diamond mining.

As a consequence of these exclusions, Bank of Botswana supervision staff were not able to acquire first hand experience of banking crises, nor of regulating small, problem banks. Within these limitations, bank supervision was taken seriously, with regular commercial bank inspections and continuous staff training. Public sector employees in Botswana were adequately paid, so that they did not have to find second and third sources of income at the expense of their public sector duties, as in so many other African countries.

The legislation was revised in the 1980s, without however extending the range of institutions to be supervised by the central bank. Finally, in 1995, a new banking law removed the previous exclusions. For some time previously, the Bank of Botswana had been informally inspecting the non-bank financial institutions still excluded by the then existing legislation, so that the 1995 Act legalised what had already become practice.

(d) *Licencing of new commercial banks*

Somewhat perversely, given that Botswana always had reasonably effective banking legislation, there were no locally-owned commercial banks as, for example, in Ethiopia, Kenya, Nigeria, Uganda and Zambia. Those countries licenced new, small, locally-owned commercial banks before the reform of bank legislation, which was in most cases unchanged since independence and in all cases seriously inadequate, and also without adequate capacity for effective bank supervision.

Official Botswana policy was to develop "a sound and efficient banking sector ... by encouraging competition between well managed, privately-owned financial institutions ... citizen participation in the ownership and management of financial institutions is encouraged". Licencing decisions would take into account "the likely impact of any new financial institutions on the existing domestic financial sector", which could be used to protect the existing banks. On the other hand, "the Bank of Botswana does not attempt to evaluate the commercial liability of the proposed new financial institutions, in the belief that the market judgment must be made by the investors whose capital is at risk and not by the licencing authorities". There is some formal insistence on new banks "sharing" the expansion of branch networks with old banks, in other words new banks should open rural branches, but as noted above this requirement has not been vigorously enforced [Bank of Botswana, 1990].

As regards the entry of new foreign-owned banks, these principles have been applied with the balance favouring the entry of new banks, rather than the protection of old-established ones. Between 1990 and 1992, four new foreign commercial banks were licenced to add to the previous three; this may have been too many for the size of the market, as demonstrated by

subsequent mergers which (together with the closure of BCCB) left Botswana with only four.

As regards the licencing of locally-owned banks, however, the Bank of Botswana has been more cautious, so that no such banks were licenced as of 1996.[32] Although the Bank of Botswana requires a lower initial capital for local applicants (P1 million as against P5 million minimum, plus an equal amount of "back-up capital" in both cases, meaning presumably authorised but not paid up), some of its other stated criteria probably exclude small local applicants, and could certainly be used to exclude them. Most notably, new applicants must demonstrate "the ability to service the borrowing requirements of major corporations without infringing the asset concentration constraints of the Financial Institutions Act". If applied rigorously, that would rule out most foreign-owned applicants initially, and for a considerable period thereafter until profits could be used to build up capital and reserves, unless parent companies provide guarantees for local lending. It completely rules out locally-owned banks.

It could be argued that licencing local commercial banks would be extremely risky. It could also be very expensive for government, because of the (usually misguided) tendency for central banks to finance commercial banks in trouble. Local commercial banks elsewhere in Africa have had a high failure rate. Using the same evidence, however, it could be argued that some local commercial banks have survived and grown soundly, despite the absence of adequate legislation and central bank supervision. Botswana's legislation is adequate. Bank supervision is also competent, although by definition lacking in experience of supervising small new banks. However, supervision of the non-bank financial institutions, which began informally in the 1990s, and formally in 1995, began to provide that experience, and additional foreign expertise could always be acquired. In Botswana's circumstances, therefore, small local commercial banks would appear to have a better chance of surviving successfully than elsewhere.

Why should Botswana take that risk? Experience elsewhere in Africa is that new local banks could easily attract deposits by offering a more user-friendly service than the larger expatriate banks, especially where the latter had become a very non-competitive oligopoly. That description applies less to Botswana since 1990 than previously, but as elsewhere the established banks themselves admitted to weaknesses in retail banking services. Moreover, the new emphasis on competing for corporate business has made some at least of the expatriate commercial banks less willing to service smaller scale depositors and medium

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[32] Nor did it appear likely that any local commercial banks would be licenced in the foreseeable future, although it would be foolish to forecast this outcome given the usual time lag between academic writing and publication.

scale borrowers. Local banks could therefore provide a better service to more depositors, and in doing so put pressure on large commercial banks to do the same.

One of the major advantages of new, small and local commercial banks is that they would have to seek lending opportunities in the small and medium scale sector, because prudential rules would exclude them from lending large amounts to large corporations. Of course, if profitable lending opportunities to the small and medium scale business sector do not really exist in Botswana, or at least not in sufficient quantity to sustain one or more new banks, then being obliged to lend to this sector would simply lead to losses.

However, the rapid growth of the economy, although driven primarily by mining and the spending of mining revenue, also generated rapid growth in the non-mining economy. Much of this growth was in locally-owned small and medium scale businesses. The number of new local businesses registered annually, for example, grew from 364 in 1980 to 2310 in 1992. Not all of these new registrations became operational, but the rate of growth of actual businesses was probably similar. Manufacturing exports, in particular, derived initially mainly from relatively small scale businesses. Of course, the withdrawal of some of the existing commercial banks from lending to this sector was because they perceived this business to be unprofitable. New local banks could only lend to this sector of business if they were to have lower costs (or if large bank perceptions were wrong). While transaction costs would only be lower in local banks if salaries were lower or productivity higher than in larger banks, local banks should have some advantage, if locally staffed, from having better knowledge, and therefore lower information costs concerning the small and medium scale business sector.

New local banks would face all the other problems inherent in getting established, including for example acquiring good management, without having to rely on rejects from the other banks. Satisfying the Bank of Botswana on the suitability and experience of management is anyway a licencing criterion. Alternatively, a foreign partner might be able to supply expertise, although this would be expensive.

Overall, the Bank of Botswana is undoubtedly correct in being cautious about licencing local commercial banks. The failures of local banks in other African countries, and of local non-bank financial institutions in Botswana, provided plenty of evidence of the potential costs. Nevertheless, Botswana has a comparative advantage in the form of fully adequate banking legislation and a strong bank supervision capacity, which should make avoidance of bank failures relatively manageable, while the potential developmental benefits are considerable. Botswana may have been able to grow exceptionally fast, prior to 1992, without a full range

of commercial bank types, but diamond-led growth will be much less (possibly zero) in future. Financial sector reform generated greatly increased competition, and therefore better services, for the large-scale corporate sector, but far from generating the same benefits for the small and medium scale business sector, reform may have worsened the access of small and medium scale enterprises to financial services. There is therefore an argument that caution should not result in no local banks in licenced for an indefinite period.

5. Conclusions

The history and development of Botswana's financial sector was atypical in almost every way, in comparison with other African countries.[33] The lack of government intervention, after independence in 1966, or when the Bank of Botswana was created in 1976, meant that Botswana did not have to refinance or restructure large government-owned commercial banks. Nor did the government have to shift significantly from direct credit controls to indirect market-related instruments. The country's extraordinary record of economic growth and financial surpluses meant that the government was not forced into financial sector reform as part of IMF or World Bank conditionality, in response to economic crisis. On the contrary, Botswana embarked on financial sector reform in order to improve the intermediation of excess funds, at a time of macroeconomic stability.[34] This history should have meant that relatively little financial sector reform was necessary, certainly less drastic than in some other African countries, and that reform had a greater chance of success because it was undertaken in relatively favorable economic circumstances.

The objectives of financial sector reform were nevertheless only partially realised. Nominal interest rates were increased, but not to the point where they were consistently higher than inflation, and without any immediate impact on financial deepening. One o f the objectives from of increasing real interest rates, namely the attraction of more deposits into financial institutions, was not an urgent priority because of the commercial banks consistently having excess liquidity.[35] There was no evidence of improved credit allocation; indeed, the share of households in commercial bank credit continued to increase, reaching the remarkable figure of 44% in 1995, up from 30% in 1990 and 19% in 1983.

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[33] Lesotho and Swaziland were comparable to Botswana in the lack of post-independence interference with commercial banks, and in not having to introduce financial sector reform because of economic crisis and donor conditionality.

[34] It could be argued that financial sector reform was first considered during the period of overspending in the late 1980s, and while inflation was in double figures. But the budget and balance of payments were in surplus, the foreign exchange reserves were rising rapidly, and inflation was largely imported from South Africa.

[35] Commercial bank liquid assets were never less than 1.82 times the official requirement from 1983, and the banks could of course have bid for more deposits by competing for private sector cash invested in Bank of Botswana Certificates (or Bank of Botswana call accounts prior to the Certificates being issued).

It is not clear whether the licencing of additional foreign-owned banks happened to coincide with, or was a consequence of, the financial sector reform programme. Whatever the cause, it had some significant effects. Competition to supply banking services to the large scale corporate finance sector increased markedly. This was assisted by one of the new banks being able to expand exceptionally fast through acquisitions, but the same bank also enjoyed organic growth in part by introducing new retail banking services. On the other hand, there was some evidence of increasing unwillingness to lend to small and medium scale businesses, or to increase the geographical spread of bank branches. This was explicable in terms of the established banks being less willing to cross-subsidise what they regarded as uneconomic business when their oligopoly was challenged. This factor appeared to overwhelm any possible willingness, as a consequence of higher and less regulated interest rates, to lend more to borrowers perceived as more expensive to administer or more risky in terms of probability of repayment. Attempts to get the commercial banks to increase their longer term lending, which dated back to the 1970s, were no more successful in the 1990s than they had been earlier. The long-delayed reform of the National Development Bank further reduced the availability of longer term credit, but this was necessary because of the Bank's overwhelming level of bad debts. It remained to be seen whether the reform would enable it to lend successfully.[36]

There was no development of smaller commercial banks. Two local non-bank financial institutions, the Botswana Cooperative Bank and the Botswana Savings Bank, began to become more like commercial banks. However, the Botswana Cooperative Bank failed in 1995; and the Botswana Savings Bank did not lend to businesses and only started a very limited form of consumer finance in 1996. Meanwhile, the Bank of Botswana's licencing policy for new local commercial banks was conservative, in that no such banks had been licenced as of 1996.

Overall, the commercial banking system in Botswana became more competitive as a result of the entry of additional foreign-owned banks, and this resulted in some innovation in banking services which probably would not otherwise have occurred to the same degree. This improvement did not extend, however, to increased availability of longer term finance from the commercial banks, nor apparently to increased credit for small and medium scale businesses.

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[36] The Botswana Stock Exchange (formerly the Botswana Share Market) had only 12 quoted shares in 1995, and therefore had only limited significance as a medium for raising long term finance. There were some rights issues, but its main influence initially was to make possible limited localisation of the ownership of large foreign-owned companies, while also allowing domestic pension funds and life insurance companies to diversify their domestic assets.

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