Linah K Mohohlo: The role of the central bank in economic transformation - sharing experiences

Speech by Ms Linah K Mohohlo, Governor of the Bank of Botswana, to the Nigerian Economic Summit Group, Lagos, 22 March 2004.

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I am most grateful to you, Mr Chairman, and through you, the Nigerian Economic Summit Group, for inviting me to join you on this important occasion. This event and other similar activities hosted by many countries in our continent, provide meaning and substance to the objectives of the African Union.

This gathering is consistent with the many contributions that the people of this country have made towards the realisation of the African Union and all that it entails. Of particular significance to me is that this event has been put together in collaboration with the Nigerian Women in Business. I have no doubt that this is as it should be, particularly during this month when the "United Nations Women's Week" has been celebrated. In Botswana, we have followed with admiration the strides made by women in Nigeria.

The initiatives and achievements of the women of Nigeria are examples of what is possible in, not only achieving equality and fundamental human rights for more than half a country's citizens, but in advancing the economic well-being of the populace as well. Removing the many social, political and cultural barriers to the full participation of women in any economy, at all levels, will go a long way towards ensuring the success of efforts as we bring about the much needed transformation, be it social, political or economic.

What is an undeniable fact is that whatever barriers there are to women's advancement, they will not remove themselves. Women must take the initiative and avoid being tentative in their approach and apologetic in their demands. A good number of women in Nigeria, as in other parts of the world, have the requisite credentials to unlock the doors to responsible positions in all areas and sectors of the economy. You have a shining example, right here in Nigeria, in the Minister of Finance, the Honourable Okonjo Iweala, whose steadfast determination and exemplary efficiency in discharging the responsibilities of her Ministry are already evident. I want to believe that the authorities do not have to look too far for leadership at the apex of the banking field as well.

This brings me to the main theme - "The Role of the Central Bank in Economic Transformation". You will agree, Mr Chairman, that the degree to which a central bank can effectively assist in the economic transformation of any developing country depends not only on its degree of professional competence with which it carries out its mandate, but also on the environment in which it operates.

It is this latter point that marks the contours of my remarks on the theme; it is the same point that anchors the success of Botswana's socio-economic progress since Independence, which in large part enabled the Bank of Botswana to play a constructive role in the economic transformation of the country over the years, and continues to do so to this day.

The rest of my remarks will be organised to provide a brief background on Botswana's economic development, especially its transformation from a poor rural economy to a fast growing mineral-led economy. This brief survey will serve as a backdrop to the contribution of the Bank of Botswana towards realising the country's full potential in achieving sustainable economic growth and development.

As many of you know, Botswana is a landlocked country situated in the centre of Southern Africa, covering an area more or less the size of Kenya. Most of the country is not suitable for crop farming as it is semi-desert, with cattle rearing generally the only viable form of farming.

Diamonds were discovered in 1967, soon after Independence (1966) and, currently, Botswana is the world's largest producer of diamonds in value terms. The mining sector contributes approximately one third to GDP and accounts for about 80 percent of exports. The revenue from diamonds and the Government's prudent fiscal policies have generally resulted in budget surpluses and a sizeable level of foreign exchange reserves, currently equivalent to 24 months' import cover of goods, services and factor payments. Despite the dominance of the diamond sector, other sectors of the economy, including tourism and financial services, have grown in importance over the years.[1]

Several indicators suggest that the development process pursued by Botswana has been very successful. For instance, per capita income grew at an average annual rate of 8.4 percent between 1966 and 1990. Despite a slowdown in the 1990s, Botswana has registered annual GDP growth rates which few other countries have matched, particularly in the past 20 years. As a result of the good economic performance, the country has graduated from being very poor at Independence to one of the relatively rich in the region, and has achieved middle-income status. Diamond revenues have helped the Government to generate savings, hence there is no need for government borrowing. This has two implications for the business environment. First, the lack of government borrowing means that the private sector is not "crowded out" for investment resources. Second, the usually buoyant revenues have enabled the Government to reduce taxes to very low rates. Notwithstanding these achievements, problems remain. The level of poverty is at an unacceptable level, too many of our people remain unemployed, and the HIV/AIDS pandemic is raising many new social and economic problems.

Fortunately, the outside world has recognised Botswana's efforts in economic development, and this has resulted in the country acquiring an international reputation for good governance, transparency and negligible corruption. Consequently, Botswana has attained and maintained the highest sovereign credit rating in Africa, awarded by both Moody's Investors Service and Standard and Poors.[2] The rating compares favourably with several middle-income countries elsewhere in the world. The country has also scored highly in the Global Competitiveness Report for the period 2003-2004[3], and Transparency International has recently ranked Botswana 30 out of 133 countries in its Corruption Perception Index.[4] All of these scores are the highest among surveyed African countries and are higher than those of several European countries. Those of you who are familiar with the credit rating procedures are aware that they are based on a wide cross section of the institutional, political, social and policy characteristics of the country being rated and, therefore, the process of assessment is very intrusive. I hasten to add that the central bank played a pivotal role in facilitating the rating exercise.

Botswana's experience provides considerable lessons for the process of economic transformation, given that the country has successfully completed one transformation and is in the process of another. The first transformation involved managing the impact of mineral exploitation on a poor subsistence agricultural economy. The second involves managing the transition from a rapidly growing, mineral-led economy to one which is more diversified and broadly based. Let me comment on these two transformation experiences, and draw some lessons that may be useful for other countries and will no doubt be of interest to this gathering.

When diamonds were discovered in Botswana, the country had little in the way of human or physical resources. In deciding how the newly-discovered mineral resource was to be managed, the Government focused on a few principles that, with hindsight, have proved to be extremely important. These principles included securing a fair deal for the nation in terms of the income generated from mineral exploitation; ensuring the efficient exploitation of minerals and not overstretching the nation's limited resources; and sharing the revenue from minerals nationwide and not concentrating the benefits in particular areas. Interestingly, the diamond mines were never nationalised and were left to be run by a private sector company that was, and continues to be, in partnership with the Government in the project.

The Government's main concern was deciding how to best use the revenues generated by diamond exports. In doing so, it was guided by the desire to improve living standards as equitably as possible. Most of the mineral revenues were invested in physical and human infrastructure, such as roads, water supplies, telecommunications, education and health facilities. By and large, the Government avoided spending mineral revenues on what could be considered wasteful grandiose projects. Perhaps most importantly, the Government acknowledged the need to save some of the revenues and accumulate financial assets in the form of foreign exchange reserves. With these reserves, and

1 National Development Plan 9, 2003-2009, Republic of Botswana, Gaborone.

2 www.moodys.com and www.standardandpoors.com, respectively.

3 World Economic Forum, Geneva, October 2003.

4 See www.transparency.org/cpi/cpi2003.

generally prudent budgeting, Botswana has been able to avoid the volatility and disruption that typically afflicts mineral producers who are vulnerable to fluctuations in mineral prices, output and revenues. The result has been rapid economic growth, generally rising per capita incomes and, at least until HIV/AIDS came along, there were major improvements in "quality of life" indicators such as life expectancy and literacy.

Although some development experts attribute Botswana's relative success to the exploitation of diamond deposits, this is only part of the story. Natural resources, no matter how endowed and lucrative, cannot, on their own, develop a country. What is important is the quality of economic policy making, and it is in this sphere that Botswana is distinguished from many other developing countries, certainly not the good fortune of having diamonds. There are several dimensions to what I have just referred to as the "quality of economic policy making". The first key element is complementarity so far as fiscal, monetary and exchange rate policies are concerned. The second is policy consistency and achieving stability in the policy environment, given their particular importance to both domestic and foreign investors. The third element is coherence and creation of synergies in policy implementation. It is in this policy environment that the Bank of Botswana has contributed to the development of the country.

While the challenges are different, I believe that the same principles of stable, consistent and transparent macroeconomic policies, derived through a transparent process of consultation, analysis and discussion, with a leadership that is honest and unselfish, should help the second transformation to be completed as relatively successfully as the first.

Mr Chairman, with this background, it is now time that I focus on the central point of my remarks - that is, the role of the central bank, in this case the Bank of Botswana, in the achievement of Botswana's economic transformation.

The Bank's contribution to the policy environment, and the role it plays in achieving the broader national goals, is spelled out in the mandate given to it by Parliament.[5] In general terms, it is a supportive role, as it is for almost all central banks in the world. Specifically, the Bank has, as its primary responsibility, to promote, and when achieved, to maintain monetary and financial stability. While the Bank has many tasks to perform, such as, to issue the national currency, to assist the development and functioning of an efficient payments mechanism, to implement the Government's exchange rate policy, to manage the country's foreign exchange reserves, and to provide advice and banking services to the Government, all of which are important in themselves, what is of paramount importance is the achievement of monetary and financial stability goals.

This is a supportive role because none of these objectives are ends in themselves; the Bank pursues them as means towards the greater end of sustainable national economic growth and development. As I noted earlier, one of the most important elements of a successful economy is a stable macroeconomic environment, which can only be achieved by pursuing sound and consistent economic policies. It is not something the Bank can do alone; every organ of the economy has a role to play. The Bank's part is to foster monetary and financial conditions that are conducive to an orderly, balanced and sustained development or - in the language of this event - to engage in the transformation of the economy through the combined efforts of government, private individuals and businesses, both domestic and foreign.

Little of what I have alluded to should be new to this well-informed group. Not only are these underlying principles and objectives of a central bank embodied in the NEPAD initiative, it is also a message I believe you will have heard many times from your own central bank, under the able leadership of my counterpart and friend, Governor Sanusi, and most likely from every other central bank Governor who takes the time to discuss these issues in public - which these days seems to be a regular and frequent occurrence. You will agree that it is far better to hear from central bank Governors periodically, if not frequently, on these important issues rather than have the uncertainty that comes from a lack of information on what central banks do and why they do it. It is with this thought in mind that I want to share with you how we go about these specific central bank tasks at the Bank of Botswana.

Monetary stability in Botswana is pursued through a monetary policy that aims to achieve a sustainable low and predictable level of inflation. Precisely how low it should be is a subject of ongoing

5 Bank of Botswana Act, 1996.

debate, not only in Botswana but elsewhere where monetary or price stability has been recognised and accepted as the primary goal of monetary policy. Experience has taught us that high and volatile inflation works against the efficient allocation of scarce resources by creating an environment that inhibits businesses and consumers from making sound investment and saving decisions, and sustainable growth is impossible without productive investment supported by adequate long term savings. In pursuing its inflation objective, the Bank of Botswana is mindful of this fact, by setting domestic interest rates high enough to provide a positive return to savers but not so high that they discourage private sector investment.

The Bank's monetary policy must also be mindful of the international dimension in which it operates. As I pointed out earlier, Botswana is a small open economy and, like all such economies, the country is dependent on trade and foreign investment to complement its own efforts to grow and prosper. This means that there is a need to remain and, where possible, to improve Botswana's international competitiveness, but also, in Botswana's case, to diversify the economy away from its current dependence on relatively few products, especially diamonds, as the principal source of growth. Many different policies, focusing for the most part on trade and investment, contribute to these efforts. The Bank for its part contributes by pursuing a monetary policy that, in the short run, seeks a rate of inflation that is no higher than the average of its major trading partners which, if successful, implies a relatively stable real effective exchange rate, given that Botswana has pegged the nominal exchange rate of its currency, the Pula, to a basket of currencies comprising the South African rand and the IMF's Special Drawing Right (SDR). In the longer run, however, real and durable international competitiveness and export diversification must ultimately come from improvements in productivity. The Bank's focus on bringing inflation down to low and sustainable levels reflects both this fundamental national objective as well as its own statutory objective of achieving and maintaining monetary stability.[6]

The second main responsibility of the Bank is to promote and maintain financial stability through the regulation and supervision of domestic banks, by assisting in the development and operation of an efficient payments mechanism, and by maintaining confidence in the currency. These functions constitute the bulk of the Bank's activities, and they involve the licensing of commercial banks and other deposit-taking institutions, continuous monitoring of their solvency and liquidity, daily processing of cheques and other means of payment used in the hundreds of thousands of financial transactions that occur each day, and designing, printing and minting as well as distributing good quality bank notes and coin to the public.[7]

It is important to point out that the overall credibility of the Bank, and hence its effectiveness in achieving its fundamental objectives, is critically dependent on how well it performs these operational tasks. Competent and well-trained staff, high standards of efficiency and accuracy, up-to-date equipment and facilities, are required and must have the full attention of management to ensure that they are the best available for the job to be performed.

Experience has shown that financial stability and monetary stability are inextricably linked. This means that regulation and supervision of financial institutions will be most effective in an environment of macroeconomic stability. A consistent and sound macroeconomic policy environment, with complementary monetary, fiscal and exchange rate policies, is essential. Major inconsistencies inevitably lead to an increase in economic and financial risks, to the point where the financial system itself becomes vulnerable. At the same time, the absence of a well-functioning financial system will make the achievement of monetary stability more difficult.

There is one other element of a sound and efficient financial system that must be taken into account by the Bank. It is that corporate governance for financial institutions be of the highest standards, and that specialist service providers, such as accountants, auditors and lawyers, adhere to equally high professional standards and code of business ethics. You will agree that if accounting and auditing standards are weak or perverted, effective banking regulation and supervision will be seriously compromised.

That is why in addition to on-site and off-site supervision, the Bank of Botswana regularly meets commercial banks bilaterally and as a group, to ensure that good corporate governance is the order of

[6] Monetary Policy Statements 2003 and 2004, Bank of Botswana, Gaborone (see www.bankofbotswana.bw).

[7] Annual Report 2002, Bank of Botswana, Gaborone (see www.bankofbotswana.bw).

the day, and that the quality of customer service is constantly improved in line with international best practice. This level of attention to high standards of corporate governance and professional conduct has meant that there has been no bank failure in Botswana. The closure of the Bank of Credit and Commerce International (BCCI) in 1991, was due to its global problems and not its domestic operations.[8]

Mr Chairman, earlier in my remarks, I highlighted that the success of a central bank in fulfilling its mandate depends on two factors - the environment in which it operates, and its own competence in carrying out its duties. It goes without saying that there has to be a favourable and supportive environment which should facilitate the carrying out of the mandate. After all the central bank, related institutions and agencies are a means of implementing the strategies aimed at attaining an overall shared vision or goal for the country as a whole. These institutions serve a larger national goal; hence there is need to generate synergies in their activities if the overall national objective is to be achieved.

One of the synergies that crucially influences the effectiveness of a central bank's role in macroeconomic management is its relationship with government. Of necessity, this relationship must be close. The central bank is "the government's bank"; the government is typically the largest or only shareholder of the central bank; and central bank functions typically involve providing a range of services to government. What is important, however, is that the relationship is clearly defined; the central bank should be independent of the Government particularly with respect to the important central banking function of maintaining monetary and financial stability. Central bank independence has several dimensions. First, there must be a clear specification of objectives and allocation of unambiguous policy responsibilities. Second, there should be a prohibition on government intervention or interference in the formulation or implementation of policy decisions relating to the responsibilities allocated to the central bank. Third, there should be restrictions on government actions, such as borrowing from the central bank, that might compromise the Bank's ability to formulate and execute policy. Fourth, there should be a prohibition on government interference in the execution of duties by officers of the Bank.

It should be noted, however, that central bank independence is not absolute. Many central banks that have independence in the formulation and implementation of monetary policy are subject to objectives, such as inflation targets, that are specified by their respective governments. Furthermore, governments have a legitimate role in determining the broad components of the macroeconomic policy framework, such as the nature of monetary policy and exchange rate regimes. More generally, the need for central banks to be ultimately accountable to an elected authority such as Parliament, whether directly or indirectly, means that there has to be some element of constraint on independence. Operationally, however, it is important that central banks should have policy independence if they are to be effective in achieving their objectives.

In the case of the Bank of Botswana, there is a reasonable degree of independence. The Government plays no direct role in the formulation and implementation of monetary policy, and the Bank is left to set interest rates and determine other parameters of monetary policy implementation without interference. This allows the Bank to focus squarely on its objective of achieving low and sustainable inflation. The Bank is also independent with regard to the licensing and supervision of banks. Furthermore, while the Governor, Deputy Governors and Board Members are government appointees, they cannot be removed from office by the Government, except where they are incapable of performing their duties. Public officers have to be in a minority on the Bank's Board. In addition, there is no provision in the Bank of Botswana Act for the Minister of Finance to issue instructions of any kind to the Bank. The only direct way for the Government to intervene in the Bank's policy decisions is through instructions issued by the President, and it is clear from the way in which this provision is framed in legislation that it is intended to be used only in exceptional circumstances.

There are, however, indirect channels where the Government can influence the Bank's decisions. The most senior official in the Ministry of Finance is an ex-officio member of the Board, and as the representative of the shareholder, he puts the Government's views forward. And in certain areas, such as exchange rate policy, the Bank of Botswana Act specifies that the Government makes decisions and the Bank's role is advisory.[9]

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8 Banking Supervision Annual Reports, Bank of Botswana, Gaborone.

9 Bank of Botswana Act, 1996.

As you can appreciate, the Bank of Botswana enjoys a relatively high degree of independence from the Government. While there are undoubtedly areas where that independence can be strengthened, key areas of policy formulation and implementation are left to the Bank to pursue in accordance with the best professional judgment of Bank staff, and this has led to high quality policy making that has contributed to Botswana's economic success. Partly for these reasons, major policy disagreements between the Bank and the Government are very rare.

Besides its main policy responsibilities, the Bank also has a number of important statutory roles to play in providing financial services to the Government, as its financial advisor. As well as being banker to the Government, the Bank advises on any borrowing the Government may contemplate. It also carries out various ad hoc agency functions. For instance, when the Government decided to obtain a sovereign credit rating in 2001, the Bank managed the process, by selecting an advisor, hosting the rating agencies, and acting as a clearing house for data and information. More recently, the Bank handled the Government's first domestic bond issue, and this was very successful and is making an important contribution towards the development of the domestic capital markets.

I have been associated with the Bank of Botswana since its inception, and it is with pride that I am able to say it is one of the most respected institutions in Botswana; it is also an exemplar for public institutions, as appropriate. In terms of corporate governance, transparency and accountability, the Bank aspires to conduct its business in accordance with best international practice.

The fact that the Bank has a high level of credibility, both domestically and internationally, is not just an achievement of which to be proud; it also makes the Bank's policy implementation more effective, as its pronouncements are acted upon and are effective in shaping expectations.

As I conclude, Mr Chairman, I wish to suggest that the success achieved by Botswana in its macroeconomic development has been shaped by a set of mutually supportive policies motivated by a common vision. The role of the Bank of Botswana in this context was to participate and contribute its part to the larger scheme of national goals. The Bank's activities have been assisted by the mutually supportive synergies generated by the national effort at all levels. Needless to say, all the organs of any government, including the central bank, must pull together if development endeavours of bringing about appreciable socio-economic transformation are to be achieved.

With these remarks, it only remains that I commend the organisers of this Economic Summit for the initiative undertaken, and to express my heartfelt appreciation for the excellent arrangements made to facilitate my presence at this occasion in such distinguished company. For me, it will remain a memorable experience. I wish you, individually and collectively as a nation, success now and in all your future endeavours.

I thank you for your attention.