Bank of Botswana

ANNUAL REPORT

2002

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BANK OF BOTSWANA

Governors' Office
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Private Bag 154
Gaborone
Botswana

Ref: RD 10/1/1

March 28, 2003

Honorable B. Gaolathe
Minister of Finance and Development Planning
Private Bag 008
Gaborone

Honourable Minister

In accordance with Section 57 (1) of the Bank of Botswana Act, 1996, I have the honour to submit, herewith, the Annual Report of the Bank of Botswana for 2002, which covers:

(i) a report on the operations and other activities of the Bank during 2002;

(ii) a copy of the Bank's annual accounts for the year ended December 31, 2002 certified by the external auditors and approved by the Board on March 21, 2003; and

(iii) a review of the economy in 2002, a theme chapter on "Botswana's External Sector: Policies and Contribution to Economic Diversification, 1991–2001", and a statistical section.

Yours sincerely

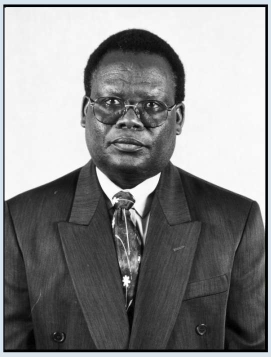
Linah K. Mohohlo
GOVERNOR

17938 Khama Crescent, Gaborone; Tel: (267) 360-6000; Cables: botbank; Telex: 2448 BD/2405 BD
Website: www.bankofbotswana.bw

Board Members

as at December31, 2002

L. K. Mohohlo
Governor and Chairman of the Board



S. S. G. Tumelo
Board Member

G. K. Cunliffe
Board Member

R. G. M. Mmutle
Board Member

D. N. Moroka
Board Member

J. Sentsho
Board Member

T. C. Moremi
Board Member

Deputy Governors

O. A. Motshidisi

K. R. Jefferis

Board Members
as at December 31, 2002

L. K. Mohohlo
Governor and Chairman of the Board

S. S. G. Tumelo
Board Member

G. K. Cunliffe
Board Member

R. G. M. Mmutle
Board Member

D. N. Moroka
Board Member

T. C. Moremi
Board Member

J. Sentsho
Board Member

Contents – Part A

Statutory Report on the Operations and Financial Statements of the Bank in 2002

CONTENTS – PART B

Box, Charts, and Tables

Abbreviations Used in the Report

AACB	Association of African Central Banks
AB	Air Botswana
ACP	African Caribbean and Pacific
AGOA	African Growth and Opportunity Act
ATM	Automated Teller Machines
BAMB	Botswana Agricultural Marketing Board
BCL	Bamangwato Concessions Limited (former)
BDC	Botswana Development Corporation
BECI	Botswana Export Credit Insurance and Guarantee Company
BEDIA	Botswana Export Development and Investment Authority
BHC	Botswana Housing Corporation
BIS	Bank for International Settlements
BLS	Botswana, Lesotho and Swaziland
BMC	Botswana Meat Commission
BNLS	Botswana, Namibia, Lesotho and Swaziland
BoB	Bank of Botswana
BoBCs	Bank of Botswana Certificates
BOTASH	Botswana Ash
BPC	Botswana Power Corporation
BSB	Botswana Savings Bank
CEDA	Citizen Entrepreneurial Development Agency
CFU	Cash Flow Unit
CPI	Consumer Price Index
CSO	Central Statistics Office
ECH	Electronic Clearing House
EDF	European Development Fund
EEC	European Economic Community
EFT	Electronic Funds Transfer
EU	European Union
EU-ACP	European Union - African Caribbean and Pacific
FAP	Financial Assistance Policy
FDI	Foreign Direct Investment
FMD	Foot and Mouth Disease
FTAs	Free Trade Areas
GATT	General Agreement on Tariffs and Trade
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
GSP	Generalised System of Preferences

HSBC	Hong Kong and Shangai Banking Corporation
IFSC	International Financial Services Centre
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
LDCs	Less Developed Countries
MFDP	Ministry of Finance and Development Planning
MFN	Most Favoured Nation
MICR	Magnetic Ink Character Recognition
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
NBFIs	Non-Bank Financial Institutions
NCSS	National Clearance and Settlement System
NDB	National Development Bank
NEER	Nominal Effective Exchange Rate
NPS	National Payments System
NSWC	North South Water Carrier
PEEPA	Public Enterprise Evaluation and Privatisation Agency
PMP	Privatisation Master Plan
REER	Real Effective Exchange Rate
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAM	Social Accounting Matrix
SDR	Special Drawing Rights
SIP	Special Investment Package
SLF	Secured Lending Facility
SMME	Small Medium and Micro Enterprises
SPRP	Selibe-Phikwe Regional Development Programme
TDCA	Trade Development and Cooperation Agreement
TEBA	The Employment Bureau of Africa
TIPA	Trade and Investment Promotion Agency
TRIMS	Trade Related Investment Measures
TRIPS	Trade Related Intellectual Property Rights
UNDP	United Nations Development Programe
USA	United States of America
VAT	Value Added Tax
WTO	World Trade Organisation
WUC	Water Utilities Corporation
ZAR	South African Rand

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Part A

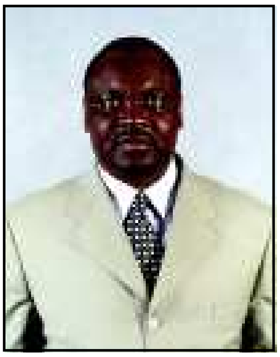
Statutory Report on the Operations and Financial Statements of The Bank, 2002

Bank of Botswana

Heads of Department

as at December 31, 2002

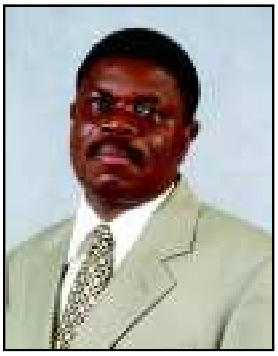
O. Mabusa
Banking Department



R. H. Nlebesi
Administration Department

M. D. Pelaelo
Banking Supervision Department

N. A. Mabe
Accounting Department



A. M. Motsomi
Research Department

F. K. Ntsayagae
Information Technology Department

O. Modisa
Financial Markets Department

STATUTORY REPORT ON THE OPERATIONS OF THE BANK IN 2002

1. AN OVERVIEW OF THE BANK

Objectives of the Bank

1.1. The primary objective of the Bank, as stated in the *Mission Statement*, is to promote and maintain monetary stability. The Bank also ensures that the payments system is efficient and that the banking system is sound. These functions of the Bank support the broad national macroeconomic objectives, including the promotion of sustainable economic diversification. The Bank's main responsibilities, its organisational structure and the framework for its activities are described below.

The Bank's primary objectives are to promote monetary stability, and to ensure an efficient payments system and a sound banking sector

Functions of the Bank

1.2 As prescribed by the Bank of Botswana Act, 1996, the major responsibilities of the Bank include the conduct of monetary policy; provision of banking services to the Government, banks and selected public sector organisations; regulation and supervision of banks and other financial institutions; issuance of currency; implementation of exchange rate policy; management of foreign exchange reserves; and provision of monetary and financial policy advice to the Government.

Primary responsibilities are prescribed by legislation

(a) Monetary Policy Implementation is directed mainly at achieving the primary responsibility of the Bank, which is the promotion and maintenance of monetary stability. This requires the achievement of low and sustainable inflation, which contributes to the promotion and maintenance of domestic and external monetary and financial stability. This objective, together with fiscal, wage, trade and exchange rate policies, fosters macroeconomic stability, which is a crucial precondition for achieving sustained development, high rates of employment and rising standards of living for Batswana.

(b) Central Banking and Payments System Services are mainly provided for the Government, commercial banks and other selected institutions. The Bank also operates a clearing system for the banking sector.

(c) Issuance of Currency (banknotes and coin) of high quality is an essential ingredient of an efficient payments system as it fosters confidence in the legal tender which, in turn, facilitates transactions and economic activity in general.

(d) Supervision of Banks and Other Financial Institutions is conducted in accordance with the Banking Act, 1995 and other relevant statutes. The purpose of prudential regulation and supervision is to ensure the safety, solvency and efficient functioning of the banking system and the overall financial sector.

(e) Exchange Rate Policy is implemented on behalf of the Government in the overall context of sound macroeconomic management. The objective of the policy is to promote export competitiveness without compromising macroeconomic stability. The Bank buys and sells foreign exchange at rates determined in accordance with the exchange rate policy.

(f) Official Foreign Exchange Reserves are managed by the Bank on behalf of the Government. The Bank ensures their safety, liquidity and return by diversifying the investments within a framework of acceptable risks.

(g) Economic Analysis and Policy Advice are covered in periodic reports, published research papers and statistical documents. Most of the materials are distributed to other institutions and the public. The Bank is also represented on a number of relevant Government committees and task forces.

Structure of the Bank

Minister of Finance reports to Parliament on the Bank's operations

1.3 The Bank of Botswana falls under the purview of the Minister of Finance and Development Planning, who appoints members of the Board, except the ex-officio Chairman (Governor), who is appointed by the President. The Minister reports to Parliament on the Bank's operations and financial performance.

The Board

The Board has overall responsibility over the Bank's operations

1.4 Under the Bank of Botswana Act, 1996 and the Bank's Bye-Laws, overall responsibility for the operations of the Bank is vested in the Board of the Bank. The Board is responsible for ensuring that the principal objectives of the Bank, as set out in the Act, are achieved. It also ensures that appropriate policies, management and administrative systems as well as financial controls are in place at all times in order for the Bank to achieve its objectives in an efficient and effective manner. Accordingly, the Board has a direct role in the strategic planning of the Bank, and in determining the broad policy framework. In this regard, the Board approves the annual budget, monitors the financial and operational performance, reviews reports of the external auditors and may call for any policy review.

The Board is required to meet at least once each quarter

1.5 The Board comprises nine members and is chaired by the Governor as required under the Bank of Botswana Act, 1996. As at the end of 2002, seven members were in place and there were two vacancies. The Permanent Secretary of the Ministry of Finance and Development Planning is an ex-officio member; the other members are drawn from the public service (statutorily not more than two), the private sector and academia in their individual capacities.

1.6 The Board is required to meet at least once each quarter, although in practice it meets more frequently. The Audit Committee of the Board is chaired by a non-executive Board member, and its main responsibility is to ensure that accounting policies, internal controls and financial practices are based on established rules and regulations. The Governor submits a report, after approval by the Board, on the operations and the audited financial statements of the Bank to the Minister of Finance and Development Planning within three months of the end of the Bank's financial year.[1]

The Governor

The Governor is the Bank's chief executive officer, supported by the Executive Committee

1.7 In addition to chairing the Board, the Governor is the chief executive officer of the Bank, and is responsible for the prompt and efficient implementation of the decisions

[1] The Bank's financial year coincides with the calendar year.

or resolutions of the Board. The Governor manages the Bank on a day-to-day basis, and represents the institution in its relations with the Government, domestic financial and other institutions as well as external organisations.

The Executive Committee

1.8 The Executive Committee, which is chaired by the Governor, comprises the Deputy Governors and Heads of Department. Its responsibility is to advise the Governor on the day-to-day management of the Bank as well as the development of the Bank's medium and long-term plans.

Departments and Divisions

The Bank has seven Departments and three Divisions

1.9 In order to carry out its functions and supporting activities, the Bank is organised into Departments and Divisions. At the end of 2002, the Bank's seven Departments were Administration, Accounting, Banking, Banking Supervision, Financial Markets, Information Technology and Research, while the three Divisions were the Board Secretariat, Security and Internal Audit. The Heads of Department report through the Deputy Governors to the Governor, as do the Heads of Security and the Board Secretariat; the Internal Audit Division reports directly to the Governor.

Strategies

Maintaining monetary stability and a sound and efficient financial system are key objectives

1.10 In pursuing its principal objectives of maintaining monetary stability as well as ensuring the soundness and efficiency of the financial system, the Bank has regularly reviewed and adapted its strategies to deal with the changing conditions prevailing in the financial sector. The Bank's activities are mainly in the following areas:

Monetary Operations, Reserve Requirements and the Bank Rate

1.11 Monetary stability is mainly reflected in low and stable inflation. Since inflation is fundamentally influenced by monetary and credit factors, the Bank's anti-inflation strategy focuses on the control of banking system credit as an intermediate target. However, controlling inflation in a small open economy, such as Botswana, with trading partners that have often experienced high and unstable levels of inflation, is a major challenge.

1.12 In implementing monetary policy, the Bank uses indirect policy instruments, particularly open market operations and the Bank Rate. The Bank may also use banking regulations and moral suasion to achieve monetary policy objectives. However, the use of Bank of Botswana Certificates (BoBCs), in both the primary and secondary markets, to control the liquidity of the financial system and influence short-term interest rates, plays a prominent role in maintaining monetary stability.

1.13 In addition to the Secured Lending Facility (SLF), the Bank also uses Repurchase Agreements (Repos) to manage short-term and overnight liquidity fluctuations in the banking system.

1.14 The Bank incorporates data on fiscal and other policies of the Government in the design of a monetary policy framework and its implementation strategy in order to ensure macroeconomic stability. Therefore, whenever necessary, monetary policy may need to be restrictive in order to counteract expansionary fiscal and wage policies that may erode monetary stability and, therefore, the nation's prospects for sustainable economic development. The broad framework of monetary policy is presented to the public in the annual *Monetary Policy Statements*.

Banking Services to the Government and Commercial Banks

1.15 The Bank serves as the banker to the Government, commercial banks as well as certain other institutions, and provides a payment, clearing and settlement system for the financial sector. In this regard, the Bank has promoted, coordinated and successfully implemented a programme that enhances the efficiency and security of the payments system. It is also a lender of last resort to the financial institutions under its supervisory purview.

Implementing the Banking Act and Regulations

Supervision and regulation of financial institutions are necessary for confidence and stability

1.16 Through ongoing banking supervision and regulatory activities, the Bank seeks to achieve a sound and stable financial system. Accordingly, the Bank ensures that the mechanisms for sustaining the safety and soundness of licensed financial institutions are appropriate and that the institutions are managed in a prudent and safe manner. To that end, the Bank enforces prudential standards with respect to capital adequacy, liquidity, asset quality and corporate governance of the banks.

1.17 In addition to its focus on the safety and soundness of licensed financial institutions, the Bank is responsible for ensuring that banks maintain high professional standards in their operations in order to provide efficient customer service in a transparent manner. The Bank also has a surveillance responsibility with regard to breaches of the Banking Act, 1995, by the public, especially in the form of activities that involve unauthorised deposit taking and use of banking names.

The Bank has responsibility for anti-money laundering policy and regulation of international financial services

1.18 Under the provisions of the Banking Act, the Bank has specific responsibilities relating to money laundering. Accordingly, banks are required to adhere to "know your customer" provisions when opening accounts, retain appropriate records, report suspicious activities and cooperate fully with law enforcement agencies in an effort to combat financial crimes and, in particular, money laundering.

1.19 The Bank is also responsible for the regulation and supervision of the International Financial Services Centre (IFSC) entities as well as the administration of the Collective Investment Undertakings Act, 1999.

1.20 The Bank monitors commercial banks' compliance with primary reserve requirements and ensures that clearing and settlement activities are conducted safely and efficiently. As the volume and value of financial transactions managed by the financial system increases, and Botswana's linkages with international financial markets expand, the Bank has to guard against systemic risks that may arise. It is for this reason that the Bank continually collaborates with private sector institutions, international organisations and the Government in introducing improvements to the safety and efficiency of the payments system.

Implementing Exchange Rate Policy

1.21 The Bank acts as the Government's agent in implementing exchange rate policy. Under the Bank of Botswana Act, 1996, the President, on the recommendation of the Minister of Finance and Development Planning, and after consultation with the Bank, sets the framework for the determination of the external value of the Pula. At present, the Pula is pegged to a basket of currencies comprising the South African rand and the Special Drawing Rights (SDR - the unit of account of the International Monetary Fund). Based on the basket, the Bank calculates the exchange rate for each business day, and quotes the buying and selling rates for major international currencies to the banks. The Bank monitors the Pula exchange rate developments regularly with a view to advising the Government on maintaining export price competitiveness of domestically produced goods.

The Bank implements exchange rate policy on behalf of Government

Managing Foreign Exchange Reserves

1.22 As Botswana's foreign exchange reserves have continued to grow, the Bank has subdivided the reserves into two portfolios to meet different objectives. A proportion of the reserves is invested in long-term assets (Pula Fund) with a view to maximising long-term return, while the remainder of the reserves form the Liquidity Portfolio, which is invested in money market instruments and short-term bonds.

Foreign exchange reserves are managed to meet specific objectives

Advice on Economic Policy, Provision of Statistics and Public Education

1.23 In addition to its responsibilities of formulating and implementing monetary policy, the Bank serves as economic and financial advisor to the Government on a wide range of issues. These include exchange rate policy, financial sector development, taxation, industrial development and trade.

The Bank serves as advisor to Government

1.24 The Bank conducts annual briefings on economic trends and publishes macroeconomic statistics and a research bulletin. The Bank has also formulated and is implementing a public education programme on banking and financial matters.

Meeting the Needs for Banknotes and Coin

1.25 The availability of a safe and convenient currency is essential for an efficient payments system. For this reason, the Bank routinely ensures that there is an adequate supply of high quality notes and coin in circulation by withdrawing soiled and damaged currency and replacing it with new notes and coin. The Bank maintains stringent standards in the design and production of both notes and coin to ensure their acceptance as a medium of exchange and to deter counterfeiting and other forms of debasement.

The Bank is the sole supplier of notes and coin

2. REPORT ON THE BANK'S OPERATIONS

Introduction

2.1 This section contains highlights of the main activities of the Bank during 2002. It covers developments relating to the Bank's progress in implementing its annual work programme.

External Relations

External relations strengthened

2.2 The Bank's relationships with external organisations continued to strengthen during 2002. In this regard, the Bank participated in regional and international meetings, conferences and seminars. These included those organised by the Southern African Development Community (SADC) Committee of Central Bank Governors, the Association of African Central Banks and the Bank for International Settlements (BIS). In addition, the Bank's relationship with the International Monetary Fund (IMF) continued to be strong. Apart from representing the Africa Group 1 Constituency on the International Monetary and Financial Committee (IMFC) for part of the year, the Bank hosted an IMF Regional Surveillance Mission and a Needs Assessment Mission on banking supervision, anti-money laundering and combating the financing of terrorism. The Bank also benefited from the presence of one long-term advisor and two regional advisors under the auspices of the IMF. Annual economic briefings were held for a range of stakeholders, including the Cabinet, Members of Parliament, senior government officials, representatives of the private and parastatal sectors, diplomats and the press.

Management and Administration of the Bank

Planning and budgeting system to be improved

2.3 The Board held six meetings during the year, including three Audit Committee meetings. Other important activities included management seminars and a senior management retreat. At the senior management retreat, a decision was taken to strengthen the planning and budgeting framework to improve the effectiveness of the Bank in that area. The new arrangement, which builds on what the Bank already has, provides a planning model that incorporates the latest thinking on planning while at the same time reflecting the many unique aspects of the Bank's circumstances and needs. During 2003, each of the Bank's Departments will be closely involved in making the new planning framework operational.

2.4 The Bank's authorised establishment increased during 2002, from 558 to 562. As in past years, the Bank had an active training programme, and a large number of staff members participated in both short- and long-term training programmes at local, regional and overseas institutions.

Finance, accounting and auditing procedures improved

2.5 Continued attention was given to improving finance and accounting procedures. Important achievements included the automation of the processing and payment of salaries, and their electronic dispatch to the banks; the automation of interest benefit tax computation; and the revision of the operating manual for the accounting system, ACCPAC; as well as the Francistown Branch Accounting Procedures.

2.6 In the area of corporate governance, the Bank continued to pursue the use of modern auditing techniques, namely, risk-based auditing, proactive auditing, performance auditing and the rating of reports according to the significance of findings. These techniques provided a means to continuously assess internal controls and improve on the ways of communicating findings while ensuring that the Departments achieved their objectives in the most efficient, effective and economic manner. A total of 42 audits was conducted by the Internal Audit Division.

The Bank is active in the fight against HIV/AIDS

2.7 The HIV/AIDS Coordinating Committee continued to spearhead the campaign against HIV/AIDS by carrying out a number of activities, which included public seminars and a sponsored walk. The Bank continues to encourage voluntary HIV testing among staff. For staff who are HIV positive, the Bank, together with the Botswana Medical Aid Society (BOMAID), provides financial and other support to enable suitable treatment, and the programme is succeeding in improving the quality of life and sustaining a productive workforce.

2.8 The Bank produced a wide range of publications during the year, including the 2001 *Annual Report,* the 2001 *Banking Supervision Report* and a *Research Bulletin.* The publication procedures for the Research Bulletin were revised, with the objective of producing at least two issues per year and sourcing contributions widely across the Bank. The project to upgrade the Bank's website made good progress, and this should come on line in the first half of 2003.

Development of external communications

2.9 A number of public education activities were undertaken during the year, including briefings for primary and secondary school students, dissemination of information to the general public during trade fairs and through radio, TV and the press. Among major activities in 2002 was the production of a comic booklet on "Money Matters" and the "Know Your Banknotes" video.

Monetary Policy Implementation

2.10 In the area of monetary policy, the most important development during the year was the decision to publicly announce, for the first time, a numerical range for the Bank's inflation objective. The inflation objective stated in the 2002 *Monetary Policy Statement* was 4 to 6 percent. The announcement generated considerable public discussion and debate and began to achieve the desired objective of changing inflation expectations.

Range for inflation objective made public

2.11 Monetary policy decisions are taken by the Bank's Monetary Policy Committee, which met six times during the year. The Open Market Auction Committee managed 52 auctions of Bank of Botswana Certificates during the year, which were used for the implementation of monetary policy and, more generally, for the management of liquidity in the financial system.

2.12 The Bank also made good progress in following up the recommendations of the IMF's "Report on Standards and Codes" which followed a mission to Botswana towards the end of 2001. Botswana is well advanced in its efforts to improve data provision and dissemination to the quality required by the Fund's General Data Dissemination System (GDDS). Information on Botswana data has recently been added to the GDDS page of the IMF's website.

Botswana advanced in introducing GDDS standards for statistics

2.13 In the area of exchange rate policy, the fixed exchange rate peg was maintained, which contributed to anchoring inflation expectations and stabilising the impact of external inflationary developments on domestic prices.

Reserve Management

2.14 Due to unfavourable developments both at home and abroad, 2002 was a difficult year for the Bank in performance terms. First, global financial markets were undermined by sluggish economic growth, ongoing political tensions in the aftermath of the tragic events of September 11, 2001 and corporate accounting

Managing reserves under unfavourable international market conditions scandals at several major US corporations. Second, the funding of the Civil Service Pension Fund by Government resulted in an increased demand for foreign exchange as a large portion of the funds was invested abroad. Both factors had the effect of reducing official reserves.

Banking Supervision

Banking system continues to grow in sustainable manner

2.15 On the supervision side, 2002 was a varied and interesting year for developments in the financial sector. The banking system continued to grow in a sustainable manner, in terms of banking assets, deposit liabilities and provision of credit to the economy. The banks were financially sound, solvent and highly liquid. The foregoing notwithstanding, perceptions about the cost and quality of delivering banking services remain unfavourable. Efforts are underway to address this matter.

2.16 A number of on-site examinations of banks, covering both prudential performance and consumer compliance issues, were conducted. Also, a number of bureaux de change were inspected for compliance with the policy and procedural guidelines for their business. Except for minor transgressions (for which appropriate supervisory action was taken), the examinations found that banks were prudently managed and operating in accordance with the banking laws.

2.17 African Alliance Management Company (Pty) Limited and African Alliance International (Pty) Limited were licensed under the Collective Investment Undertakings Act, 1999 to manage domestic investment funds and offshore funds, respectively. The Bank approved the inward marketing of sub-funds of Hong Kong and Shanghai Banking Corporation (HSBC) International Ltd-Capital Secured Growth Fund Plc, an Irish-registered umbrella fund.

2.18 As at the end of the year, the IFSC Certification Committee had considered and approved 13 project proposals. In all cases, approval was granted on condition that the proposed projects were issued with either a banking licence or an exemption certificate. Out of the 13 project proposals approved by the IFSC Certification Committee, five applied for and were issued with either licences or exemption certificates by the Bank.

Two more banks issue bonds

2.19 Standard Chartered Bank and Barclays Bank issued Floating Rate Notes of P170 million and P150 million, respectively, to reduce Tier I capital and utilise the proceeds of the bonds as Tier II capital, for meeting capital adequacy requirements. In 2001, Stanbic bank had also issued a long-term debt instrument to augment its capital base.

Banking and Currency Issues

2.20 Issuing and maintaining the nation's confidence in the national currency is an important function of the Bank. In keeping with its objective of promoting an efficient payments system and reducing fraud, the Bank restocked the P20 and P10 currency notes with enhanced security and other features that, for example, facilitate identification of the notes by the visually impaired.

Electronic clearing house established

2.21 The Bank devoted considerable efforts to the establishment and successful implementation of an Electronic Clearing House (ECH). The new system is running smoothly; and it has made it possible to reduce the clearing cycle of all up-country cheques to four days. More recently, the project has been extended by incorporating the processing of credit transfers electronically via an Electronic Funds Transfer (EFT) system which became fully operational in October. This new element of the payments system has made it possible for the Government and other commercial bank customers to post payments directly to suppliers' accounts and to post salaries into their employee accounts.

2.22 Other important developments with regard to the national payments system included the release of the first issue of the *Botswana National Payments System Newsletter "Tsa Tuelano",* and the approval of the National Clearance and Settlement System Bill. Besides establishing a clear legal framework for the operation of payments systems, the Bill seeks to criminalise the bouncing of cheques.

Agency Role

Investment grade credit ratings maintained

2.23 In terms of Section 43 of the Bank of Botswana Act, 1996, the Bank acts as financial advisor to Government. It was in this capacity that discussions were held during 2002 with the two international credit rating agencies, (Moody's Investors Service and Standard and Poor's) in the review of Botswana's sovereign credit rating. The credit ratings, first assigned to Botswana in 2001, remain unchanged. In addition, the Bank was requested to handle arrangements for the implementation of the Government Bond issue programme announced in the 2002 *Budget Speech.* The first bond was issued in March 2003.

Information Technology

2.24 A major achievement this year has been the upgrading of the Bank's connection to the Internet. The upgrading has made it easier and faster for all Departments to communicate with the Bank's clients and with each other, as well as more quickly access information needed to discharge the Bank's functions. Other major achievements included support for the establishment of the Electronic Clearing House (ECH).

Protective Services

Protective services receive growing attention

2.25 As far as protective services are concerned, staff development continued through the provision of general in-house courses for relevant staff and management of the Security Division. In addition, the Bank has been active this past year in working with the Financial Institutions Security Managers Forum to address security related issues. Along with the Bank, the Forum developed a comprehensive fraud investigation course, developed a detailed strategy to detect fake notes and collect them at a central point.

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ANNUAL FINANCIAL STATEMENTS

2002

BANK OF BOTSWANA

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CONTENTS

The Annual Financial Statements set out on pages 29 to 42 were approved by the Board on March 21, 2003 and signed by:

Linah K. Mohohlo
Governor

Nozipho A. Mabe
Director, Accounting Department

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Deloitte & Touche

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the accompanying financial statements of Bank of Botswana as set out on pages 29 to 42 for the year ended December 31, 2002. These financial statements are the responsibility of the Bank's Board. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion:

(i) the Bank has kept proper books of account with which the financial statements are in agreement; and

(ii) the financial statements give a true and fair view of the state of the Bank's affairs as of December 31, 2002 and of the result of its operations, its changes in shareholder's funds, and cash flows for the year then ended in the manner required by the Bank of Botswana Act, 1996.

Deloitte & Touche

Deloitte & Touche
Certified Public Accountants

GABORONE
March 21, 2003

Deloitte
Touche
Tohmatsu

BALANCE SHEET

December 31, 2002

	Notes	2002	2001
		P'000	P'000
ASSETS			
Fixed Assets	1	126 638	129 313
Foreign Exchange Reserves			
Liquidity Portfolio	2.1	4 872 251	8 343 336
Pula Fund	2.2	24 473 529	32 175 924
International Monetary Fund			
Reserve Tranche	3.1	175 527	194 900
Holdings of Special Drawing Rights	3.2	241 842	277 434
Administered Funds	3.4	163 219	190 438
Total Foreign Exchange Reserves		29 926 368	41 182 032
Other Assets	4	55 600	29 556
TOTAL ASSETS		30 108 606	41 340 901
LIABILITIES			
Notes and Coin in Circulation	5	759 075	701 095
Bank of Botswana Certificates	6	7 663 457	5 147 704
Deposits	7	1 180 764	761 068
Allocation of Special Drawing Rights (IMF)	3.3	32 146	38 136
Liabilities to Government (IMF Reserve Tranche)	8	175 527	194 900
Dividend to Government	9	257 225	266 500
Other Liabilities		25 446	30 082
Total Liabilities		10 093 640	7 139 485
SHAREHOLDER'S FUNDS			
Paid-up Capital	10	25 000	25 000
Government Investment Account		15 940 124	27 571 718
Currency Revaluation Reserve		2 449 842	4 893 980
Market Revaluation Reserve		–	110 718
General Reserve	11	1 600 000	1 600 000
Total Shareholder's Funds		20 014 966	34 201 416
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		30 108 606	41 340 901

INCOME STATEMENT
Year ended December 31, 2002

	2002 P'000	2001 P'000
INCOME		
Interest	1 132 746	1 455 246
Net market gains on disposal of securities	–	203 098
Dividends	167 532	161 450
Commissions	19 837	25 367
Realised currency revaluation gains	–	25 098
Unrealised market revaluation gains – Liquidity Portfolio	17 487	–
Other income	7 231	3 820
	1 344 833	1 874 079
EXPENSES		
Interest	94 161	578 261
Net market losses on disposal of securities	318 118	–
Administration costs	141 075	137 091
Realised currency revaluation losses	35 793	–
Depreciation	11 267	11 883
Unrealised market revaluation losses – Liquidity Portfolio	–	4 624
	1 300 414	731 859
NET INCOME FOR THE YEAR	44 419	1 142 220
TRANSFER FROM GOVERNMENT INVESTMENT ACCOUNT	722 119	32 326
NET INCOME AVAILABLE FOR DISTRIBUTION	766 538	1 174 546
APPROPRIATIONS		
TRANSFER TO MARKET REVALUATION RESERVE	(302 619)	–
DIVIDEND TO GOVERNMENT FROM PULA FUND	(1 028 900)	(1 066 000)
TRANSFER FROM/(TO) GOVERNMENT INVESTMENT ACCOUNT	564 981	(108 546)

CASH FLOW STATEMENT

Year ended December 31, 2002

	Notes	2002	2001
		P'000	P'000
OPERATING ACTIVITIES			
Cash generated by operations	13	2 896 802	2 347 649
INVESTING ACTIVITIES			
Net proceeds from disposal of investments		3 612 025	82 372
Proceeds from disposal of fixed assets		4	232
Purchase of fixed assets	1	(8 820)	(10 087)
NET CASH FROM INVESTING ACTIVITIES		3 603 209	72 517
FINANCING ACTIVITIES			
Dividend to Government	9	(1 038 175)	(1 321 222)
Government Withdrawals		(5 519 816)	(1 193 550)
NET CASH USED IN FINANCING ACTIVITIES		(6 557 991)	(2 514 772)
NET INCREASE IN CURRENCY IN CIRCULATION		(57 980)	(94 606)
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(701 095)	(606 489)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(759 075)	(701 095)

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS

Year ended December 31, 2002

	Paid-up Share Capital	Currency Revaluation Reserve	Market Revaluation Reserve	General Reserve
	P'000	P'000	P'000	P'000
Balance at January 1, 2001	25 000	2 423 138	305 592	1 600 000
Unrealised currency gains for the year	–	8 454 895	–	–
Unrealised market losses for the year	–	–	(1 070 464)	–
Transfers to/(from) Government Investment Account:				
Unrealised market losses for the year	–	–	875 590	–
Unrealised currency gains for the year	–	(5 984 053)	–	–
Government withdrawals	–	–	–	–
Net gains/(losses) not recognised in the Income Statement for the year	–	2 470 842	(194 874)	–
Net Income for the year	–	–	–	–
Dividend to Government from Pula Fund	–	–	–	–
Transfers to/(from) the Income Statement for the year:				
Excess of Government Pula Fund income over Pula Fund Dividend	–	–	–	–
To cover residual deficit	–	–	–	–
Balance at December 31, 2001	25 000	4 893 980	110 718	1 600 000
Unrealised currency losses for the year	–	(6 204 053)	–	–
Unrealised market losses for the year	–	–	(1 478 100)	–
Transfers to/(from) Government Investment Account:				
Unrealised market losses for the year	–	–	1 064 763	–
Unrealised currency losses for the year	–	3 759 915	–	–
Government withdrawals	–	–	–	–
Net gains/(losses) not recognised in the Income Statement for the year	–	(2 444 138)	(413 337)	–
Net income for the year	–	–	–	–
Dividend to Government from Pula Fund	–	–	–	–
Transfers to/(from) the Income Statement for the year:				
Deficit of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
Deficit on Market Revaluation Reserve	–	–	302 619	–
To cover residual deficit	–	–	–	–
Balance at December 31, 2002	25 000	2 449 842	–	1 600 000

1. The Government Investment Account represents the Government's share of the Pula Fund and the Liquidity Portfolio, which was established on January 1, 1997.
2. Net income retained in the Government Investment Account and available for future distributions amounted to P310 570 378 (2001 – P1 597 670 521).

Government Investment Account	Accumulated Profit	Total	
P'000	P'000	P'000	
23 580 585	–	27 934 315	**Balance at January 1, 2001**
–	–	8 454 895	Unrealised currency gains for the year
–	–	(1 070 464)	Unrealised market losses for the year
			Transfers to/(from) Government Investment Account:
(875 590)	–	–	Unrealised market losses for the year
5 984 053	–	–	Unrealised currency gains for the year
(1 193 550)	–	(1 193 550)	Government withdrawals
3 914 913	–	6 190 881	**Net gains/(losses) not recognised in the Income Statement for the year**
–	1 142 220	1 142 220	Net Income for the year
–	(1 066 000)	(1 066 000)	Dividend to Government from Pula Fund
			Transfers to/(from) the Income Statement for the year:
108 546	(108 546)	–	Excess of Government Pula Fund income over Pula Fund Dividend
(32 326)	32 326	–	To cover residual deficit
27 571 718	–	34 201 416	**Balance at December 31, 2001**
–	–	(6 204 053)	Unrealised currency losses for the year
–	–	(1 478 100)	Unrealised market losses for the year
			Transfers to/(from) Government Investment Account:
(1 064 763)	–	–	Unrealised market losses for the year
(3 759 915)	–	–	Unrealised currency losses for the year
(5 519 816)	–	(5 519 816)	Government withdrawals
(10 344 494)	–	(13 201 969)	**Net gains/(losses) not recognised in the Income Statement for the year**
–	44 419	44 419	Net income for the year
–	(1 028 900)	(1 028 900)	Dividend to Government from Pula Fund
			Transfers to/(from) the Income Statement for the year:
(564 981)	564 981	–	Deficit of Government Pula Fund Income over Pula Fund Dividend
–	(302 619)	–	Deficit on Market Revaluation Reserve
(722 119)	722 119	–	To cover residual deficit
15 940 124	–	20 014 966	**Balance at December 31, 2002**

ACCOUNTING POLICIES

December 31, 2002

Basis of Presentation of Financial Statements

The financial statements are prepared on the historical cost basis as modified to include the revaluation of investments in foreign assets and liabilities and the result of the activities of the Pula Fund. The financial statements comply with International Accounting Standards, except as noted below.

Foreign Exchange Balances and Transactions

Assets and Liabilities

Assets and liabilities denominated in foreign currencies are translated to Pula using the middle rate of exchange ruling at the close of the financial year. The resulting exchange gains and losses are taken to the Currency Revaluation Reserve.

Foreign Currency Transactions

Transactions denominated in foreign currencies are translated to Pula using the middle rate of exchange ruling at the transaction date.

Exchange gains and losses arising on disposal of foreign denominated financial assets are transferred to the Currency Revaluation Reserve in so far as the proceeds of disposal are re-invested in foreign assets. This treatment, which is described in more detail in Note 17, does not comply with International Accounting Standard No. 21 – The Effects of Changes in Foreign Exchange Rates.

Investments

Short-term and long-term investments in foreign treasury bills, securities and equities are stated at their market value at year-end. Unrealised market revaluation gains and losses on Liquidity Portfolio and profits and losses on realisation of all investments are taken to the income statement in the year in which they arise.

Any changes in the value of the Bank's long-term investments held in foreign currencies as a result of any change in the market values of such investments are transferred to the Market Revaluation Reserve.

Bank of Botswana Certificates

As one of its tools for maintaining monetary stability in the economy, the Bank of Botswana issues its own paper, Bank of Botswana Certificates (BoBCs), to absorb excess liquidity in the market and thereby to influence the rate of monetary growth, and also interest rates. BoBCs are issued at a discount to counterparties.

The Bank's liability in respect of BoBCs is stated at market value with movements in matured and unmatured discount recognised in the Income Statement.

Income and Expense Recognition

Interest income and expense and dividend income are recognised in the Income Statement on an accrual basis.

ACCOUNTING POLICIES (continued)

General Reserve

Under Section 7(1) of the Bank of Botswana Act, 1996 the Bank of Botswana is required to establish and maintain a General Reserve sufficient to ensure the sustainability of future operations of the Bank. The Bank may transfer to the General Reserve funds from other reserves, which it maintains, for the purposes of maintaining the required level of the General Reserve.

Currency Revaluation Reserve

Any changes in the valuation, in terms of Pula, of the Bank's assets and liabilities in holdings of Special Drawing Rights and foreign currencies as a result of any change in the values of exchange rates of Special Drawing Rights or foreign currencies are transferred to the Currency Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

Market Revaluation Reserve

Any changes in the value of the Bank's long-term investments held in foreign currencies as a result of any change in the market values of such investments are transferred to the Market Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

Fixed Assets and Depreciation

Fixed assets are stated at cost less related accumulated depreciation.

No depreciation is provided on land. All other fixed assets are depreciated on a straight line basis at the following annual rates:

		Percent
Buildings		2.50
Furniture, fixtures and equipment		20.00
Computer hardware		33.33
Computer software		100.00
Motor vehicles	– Commercial	25.00
	– Bullion Truck	5.00

Retirement Benefits

Pension benefits are provided for employees through the Bank of Botswana Defined Contribution Staff Pension Fund which is governed in terms of the Pension and Provident Funds Act (Chapter 27:03). Contributions are at the rate of 21.5 percent of pensionable emoluments of which pensionable employees of the Bank pay 4 percent. Other than the contributions made, the Bank has no further commitments or obligations to this Fund.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

December 31, 2002

1. FIXED ASSETS

	Free-hold Land	Lease-hold Land	Buildings	Capital Work in Progress	Other Assets	Total
	P'000	P'000	P'000	P'000	P'000	P'000
Cost or Valuation						
Balance at the beginning of the year	607	3 486	122 489	485	54 267	181 334
Additions	–	–	–	5 236	3 584	8 820
Disposals	–	–	–	–	(80)	(80)
Adjustments	–	–	–	–	(225)	(225)
Transfers		–	5 309	(5 309)	–	–
Balance at the end of the year	607	3 486	127 798	412	57 546	189 849
Accumulated Depreciation						
Balance at the beginning of the year	–	–	21 507	–	30 514	52 021
Charge for the year	–	–	3 068	–	8 244	11 312
Disposals	–	–	–	–	(77)	(77)
Adjustments	–	–	–	–	(45)	(45)
Balance at the end of the year	–	–	24 575	–	38 636	63 211
Net book value at December 31, 2002	607	3 486	103 223	412	18 910	126 638
Net book value at December 31, 2001	607	3 486	100 982	485	23 753	129 313

2. FOREIGN EXCHANGE RESERVES

2.1 Liquidity Portfolio

The portfolio is invested in money market instruments and bonds. It is meant to facilitate payments for regular transactions. This comprises:

	2002 P'000	2001 P'000
Bonds	1 783 324	3 874 491
Cash and Cash Equivalents and other	3 088 927	4 468 845
	4 872 251	8 343 336

2.2 Pula Fund

This is a long-term fund intended to maximize return; it is invested in the following foreign financial instruments with a long-term duration. This comprises:

	2002 P'000	2001 P'000
Equities	7 990 002	12 795 465
Bonds	16 237 283	20 283 838
Cash and Cash Equivalents and other	246 244	(903 379)
	24 473 529	32 175 924

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (continued)

Pula Fund Balance Sheet

	2002 P'000	2001 P'000
Capital Employed		
Government	15 553 489	27 565 268
Bank of Botswana	8 920 040	4 610 656
	24 473 529	32 175 924
Employment of Capital		
Investments	24 473 529	32 175 924
Investments expressed in US dollars ('000)	4 476 208	4 607 592
Investments expressed in SDR ('000)	3 318 610	3 677 708

Pula Fund Income Statement

	2002 P'000	2001 P'000
Income		
Interest and dividends	1 066 331	1 254 248
Net realised market gains	–	218 586
Sundry income	88	10
	1 066 419	1 472 844
Expenses		
Net realised market losses	(332 091)	–
Administration charges	(61 196)	(70 769)
	(393 287)	(70 769)
Net Income available for distribution	673 132	1 402 075
Appropriations		
Distribution to Government	(463 919)	(1 174 546)
Dividend to Government	(1 028 900)	(1 066 000)
Transfer from/(to) Government Investment Account	564 981	(108 546)
Bank of Botswana's share of net income	209 213	227 529

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (continued)

	2002 P'000	2001 P'000
3. INTERNATIONAL MONETARY FUND (IMF)		
3.1 Reserve Tranche		
This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is its membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holdings of Pula by the IMF, which initially were equal to 75 percent of the quota, have changed from time to time as a result of the use of Pula by the IMF in its lendings to member countries.		
Quota (SDR 63 000 000)	464 602	551 181
Less IMF Holdings of Pula	(289 075)	(356 281)
Reserve Position in IMF	175 527	194 900
The IMF Holdings of Pula are represented by a Non-Interest Bearing Note of P165 324 035 (2001 – P165 324 035) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in current account held at the Bank (included in other deposits in Note 7).		
3.2 Holdings of Special Drawing Rights	241 842	277 434
The balance on the account represents the value of Special Drawing Rights allocated and purchased less utilisation to date.		
3.3 Allocation of Special Drawing Rights	32 146	38 136
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.		
3.4 Administered Funds		
(i) Poverty Reduction Growth Facility (PRGF) Trust	51 359	60 927
The amount represents the equivalent of SDR6 893 680 (and interest accrued thereon) lent on July 1, 1994 to the Poverty Reduction Growth Facility (formerly Enhanced Structural Adjustment Facility Trust), a fund administered in trust by the IMF.		
(ii) Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust	111 860	129 511
The initial amount of SDR 14 607 060 lent on April 30, 1997 to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries Trust Fund administered in trust by the IMF was repaid on its maturity on April 30, 2002.		
The balance represents SDR 15 065 760 (and interest accrued thereon) lent to the same Trust on August 31, 2002, on the same terms and conditions.		
	163 219	190 438

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (continued)

	2002 P'000	2001 P'000
4. OTHER ASSETS	55 600	29 556

Other assets consist of staff loans, sundry debtors, advances and special memorandum accounts.

5. NOTES AND COIN IN CIRCULATION

	2002 P'000	2001 P'000
Notes	710 738	657 429
Coin	48 337	43 666
	759 075	701 095

Notes and coin in circulation held by the Bank as cash in hand at the end of the financial year have been netted off against the liability for notes and coin in circulation to reflect the net liability to the public.

6. BANK OF BOTSWANA CERTIFICATES

	2002 P'000	2001 P'000
Face Value	7 782 650	5 220 692
Unmatured Discount	(119 193)	(72 988)
Market Value	7 663 457	5 147 704

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

7. DEPOSITS

	2002 P'000	2001 P'000
Government	604 226	308 895
Bankers	290 603	268 399
Other	285 935	183 774
	1 180 764	761 068

These represent current accounts lodged by Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free.

The Government balance includes P1 848 932 (2001 – P1 589 446) in respect of the Letlole National Savings Certificate Scheme, which was launched by the Bank on behalf of the Government in 1999 as a means of encouraging savings. This is analysed as follows:

	2002 P'000	2001 P'000
Issues of National Savings Certificates	3 763	2 580
Redemptions	(1 884)	(976)
Net issues	1 879	1 604
Amounts awaiting collection from agents	(31)	(15)
Amount due to Government on behalf of the Scheme	1 848	1 589

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (continued)

	2002 P'000	2001 P'000
8. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)	175 527	194 900

This balance represents the Bank's liability to the Government in respect of the Reserve Tranche position in the IMF (Note 3.1)

9. DIVIDEND TO GOVERNMENT

	2002 P'000	2001 P'000
Balance due at the beginning of the year	266 500	521 722
Dividend to Government from Pula Fund	1 028 900	1 066 000
Paid during the year	(1 038 175)	(1 321 222)
Balance due at the end of the year	257 225	266 500

The final instalment of the pre-set dividend of P257 225 000 unpaid at December 31, 2002 was provided for in accordance with Section 6 of the Bank of Botswana Act, 1996 which requires that all profits of the Bank be distributed to the shareholder, the Government.

10. CAPITAL

	2002 P'000	2001 P'000
Authorised and paid-up capital	25 000	25 000

The paid-up capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act, 1996.

	2002 P'000	2001 P'000
11. GENERAL RESERVE	1 600 000	1 600 000

In the opinion of the Board, the General Reserve, taken together with other reserves which the Bank maintains, is sufficient to ensure the sustainability of future operations of the Bank.

12. CASH FLOW STATEMENT

This has been prepared under International Accounting Standard No. 7 – Cash Flow Statements (Revised 1992). The definition of cash in the Standard is not wholly appropriate to the Bank. Due to its role in the creation and withdrawal of currency in circulation, the Bank has no cash balances on its balance sheet (also see Note 5). However, it has the ability to create cash when needed.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (continued)

	2002	2001
	P'000	P'000
13. CASH GENERATED BY OPERATIONS		
Income from operations	44 419	1 142 220
Adjustments for:		
Depreciation of fixed assets	11 312	11 883
Loss/(Profit) on disposal of fixed assets	179	(201)
Operating cash flows before movements in working capital	55 910	1 153 902
Increase in Deposits – banks and other	124 365	18 024
Increase/(Decrease) in Deposits – Government	295 331	(329 021)
Increase in Bank of Botswana Certificates	2 515 753	1 435 306
Increase in other assets	(26 226)	(6 767)
(Decrease)/Increase in other liabilities	(68 331)	76 205
Cash generated by operations	2 896 802	2 347 649
14. CAPITAL COMMITMENTS		
Approved and contracted for	8 891	860
Approved but not contracted for	9 475	22 948
	18 366	23 808

These capital commitments will be funded from internal resources.

15. RECLASSIFICATION OF PREVIOUS YEAR BALANCES

Prior to January 1, 2002, the Government Investment Account was presented in the balance sheet as part of liabilities. This has since been reclassified to Shareholder's Funds. The balances reported in the 2001 annual financial statements have been restated to reflect the change. The effect of this change is to increase shareholder's funds at the beginning of the year by P27 571 718 000 and reduce liabilities by the same amount.

16. COMPARATIVES

Where necessary, comparative figures have been restated to conform with changes in presentation in the current year, as a result of the reclassification of previous year balances as per Note 15.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (continued)

17. REALISED CURRENCY REVALUATION GAINS AND LOSSES

Exchange rate gains and losses relating to investments denominated in foreign currencies that are sold and proceeds reinvested in foreign currency assets are treated as unrealised and are credited directly to a Currency Revaluation Reserve. This treatment does not comply with International Accounting Standard No. 21 – The Effects of Changes in Foreign Exchange Rates, which requires recognition as income, of exchange rate gains and losses realised on the sale of the investments and arising from translation of short-term investments. Compliance with IAS No. 21 would have required an amount of P548 294 150 (2001 – P3 870 216 595) to be recognised in the Income Statement before appropriation to the Currency Revaluation Reserve.

18. RISK MANAGEMENT POLICIES IN RESPECT OF FINANCIAL INSTRUMENTS

The risk management policies of the Bank regarding financial instruments are dealt with in regular reviews of the Bank's reserve management policies. The main risk areas are market, currency, credit and interest rates. The Bank invests in investment grade currencies (AA/Aa2) and above. Interest rate risk is managed by using modified duration, while credit risk is controlled by dealing with the best quality institutions or counterparties, as determined by international rating agencies.

19. RELATED PARTY TRANSACTIONS

The Bank provides several services to its shareholder, the Government, and to other Government owned institutions. The main services during the year to December 31, 2002 were:

(i) Provision of banking services, including holding of the principal accounts of the Government.

(ii) Management of the notes and coin issue, including printing and minting of notes and coin, respectively.

The aggregate balances in Government and other public sector accounts are disclosed in Notes 7 to 9.

No charges are made to the Government for provision of these services, except for commissions charged on domestic foreign exchange transactions. These are included in 'Commissions' in the income statement.

PART B

THE BOTSWANA ECONOMY IN 2002 AND THEME CHAPTER

BANK OF BOTSWANA

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Chapter 1

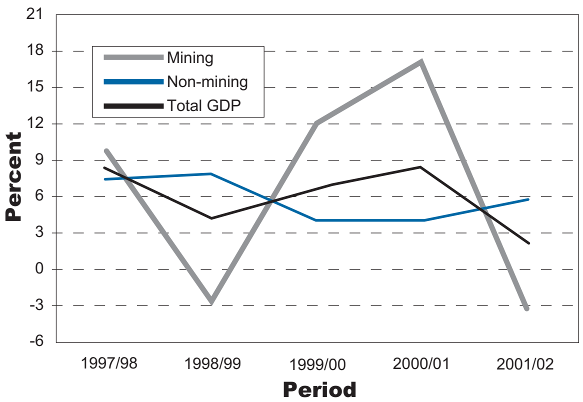
The Botswana Economy in 2002

1. Output, Employment and Prices

(a) National Income Accounts

1.1 Real gross domestic product (GDP) growth was 2.3 percent in 2001/02[1], less than half the earlier estimate of 5 percent, and considerably lower than the 8.4 percent growth achieved in 2000/01[2] (Chart 1.1). The reduced rate of GDP growth in 2001/02 was a result of a 3.1 percent decline in mining output. However, the performance of the non-mining sector improved, with most economic sectors recording higher growth in 2001/02 than in the previous year.

Chart 1.1 Growth in Real Domestic Product, 1997/98-2001/02

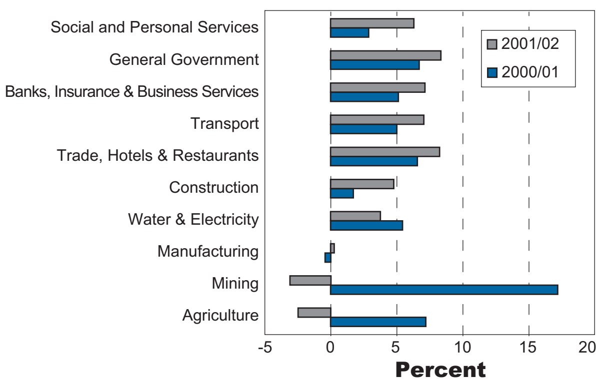


Source: Central Statistics Office.

1.2 The contraction in mining output largely reflected a 4.4 percent reduction in diamond production. A sharp reduction in the growth of diamond production had, however, been expected following the rapid growth of 17.2 percent recorded in 2000/01 as new capacity came on stream. Reduced production of copper/nickel and coal also contributed to the decline in mining sector output.

1.3 The output of the non-mining sector grew by 5.5 percent, up from 4 percent in the previous year. Excluding government, output in the non-mining private sector rose by 4.5 percent, which was also better than the previous year's performance of 3.1 percent. General government expanded by 8.3 percent, largely due to the rapid increase in government recurrent and investment expenditure, both of which grew by nearly 20 percent each in nominal terms.

Chart 1.2 Economic Growth by Sector, 2000/01 – 2001/02



Source: Central Statistics Office.

1.4 Output in other non-mining sectors, except agriculture, water and electricity, also rose at faster growth rates than in the previous year. The highest growth of 8.2 percent occurred in the trade, hotels and restaurants sector; trade expanded by 8 percent while output in hotels and restaurants rose by 9.7 percent, more than triple the growth rate in the previous year.

1.5 Value added for banks, insurance and business services rose by 7.1 percent while that for transport and communications grew by 7 percent,

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1 The national accounts year runs from July each year to June the following year.

2 The GDP growth rates for 1999/00 and 2000/01 have been revised downward, considerably so for the former, following an adjustment of some of the 'adjustment items', specifically, a reduction in taxes on imports and subsidies on products and production for both years and a slight increase in Financial Intermediation Services Indirectly Measured (FISIM) for 2000/01. The revisions have also had the effect of raising growth for 2001/02 because of the now lower base from which it is calculated.

compared to 5.1 percent and 5 percent, respectively, in the previous year. The high profitability of some of the banks, which was partly a result of interest income, contributed significantly to the improved growth rate of the banking sub-sector while the expansion in business services reflected general business buoyancy.

1.6 The strong performance of the transport and communications sector was due to cost savings as well as an increase in air traffic volumes and mobile telephone services compared to last year. Despite the difficult operating environment for the international aviation industry, domestic air traffic rose by 11 percent while regional services grew by 2 percent. The demand for mobile telephone service continued to increase rapidly while that for fixed-line services increased relatively slowly. There was also a significant expansion in road transport services, which was underpinned by a sharp 22 percent growth in new vehicle purchases, especially for commercial purposes. In contrast, rail transport services weakened. Although there was an improvement in rail traffic, which signalled a gradual return to more normal operations, goods moved per kilometre declined for the third successive year. However, the 4.3 percent decline in tonnage per kilometre was far less than last year's fall of 28 percent. In contrast, the number of passengers per kilometre increased moderately by 8.5 percent, compared to a rise of 41 percent in the previous year.

1.7 Output in the construction, social and personal services sectors expanded at rates of 4.7 percent and 6.2 percent, up from the previous year's growth rates of 1.6 percent and 2.8 percent, respectively. For the water and electricity sector growth declined for the third successive year, falling to 3.7 percent from 5.5 percent in 2000/01 and 11.3 percent in 1999/00. The modest growth in 2001/02 was, however, wholly due to a 5 percent rise in water consumption. In contrast, electricity generation fell by 8.2 percent due to a 7.9 percent decline in demand for electricity by the mines while usage by the rest of the economy slowed down considerably to a 2.4 percent growth from over 20 percent growth in the previous year.

1.8 Output in the manufacturing sector reversed the previous year's decline and grew marginally by 0.2 percent. The rate of expansion would have been faster were it not for a 35.6 percent reduction (against a growth of 70.6 percent the previous year) in cattle slaughtered by the Botswana Meat Commission (BMC), due to the outbreak of the foot and mouth disease (FMD) and the prevailing drought. Both these factors affected the supply of cattle to the abattoirs which were closed for some time. Moreover, manufacturing output growth was also negatively affected by the closure of a number of companies during the year including Flowtite Botswana and Liontex.

1.9 Agricultural production declined by 2.5 percent, reversing the previous year's 7.3 percent growth, due to insufficient and poorly distributed rains during the 2001/02 rainy season and the outbreak of the FMD, which led to the slaughter of thousands of cattle.

1.10 Although the overall GDP growth rate was the lowest since 1993/94, economic performance in 2001/02 was reasonably encouraging, given the healthy growth of the non-mining private sector, which is the basis for economic diversification. Within this segment of the economy, it is noteworthy that the fastest growing sub-sectors were those producing services (finance and business services, transport, trade, hotels and restaurants, and social and personal services), which compensated for the disappointing performance of the manufacturing sector. This outcome reinforces the arguments presented in the Bank's 2000 Annual Report, that diversification initiatives should support a wide range of economic activities, including services, rather than focusing specifically on manufacturing, as has been the case in the past. It is also reflected in changes in trade patterns, discussed in more detail later in this *Report*, with services accounting for an increasing share of international trade.

(b) Economic Outlook

1.11 Official forecasts[3] are that economic growth will recover from 2.3 percent in 2001/02 to around 5 percent in 2002/03. The forecast is based on expected growth rates of 4.5 percent and 7 percent, respectively, in mining and non-mining sectors, with the latter benefiting from expansion in manufacturing, construction and finance sectors. The forecast increase in mining output appears to be based on a reversal of the decline in diamond production in 2001/02, a small addition to output from the new Damtshaa diamond mine[4] and other planned increases in mineral production. While the forecast increase in mining output should be achievable, achieving 7 percent growth in the non-mining sector may be more difficult. Overall, the balance of risk around the forecast is on the downside, with growth below 5 percent more likely than growth above 5 percent, for a number of reasons.

1.12 While it is expected that domestic economic performance will benefit from improved – although still below trend – growth in the global economy, there remains considerable uncertainty surrounding the fallout of the conflict in Iraq, which may adversely affect consumer confidence. For Botswana, this could lead to reduced diamond sales and, therefore, either stockpiling or reduced diamond production. There are also domestic uncertainties. Beef production will be negatively affected by drought and the renewed outbreak of FMD in January 2003. Rainfall up to December 2002 was below average, resulting in the cultivation of only 4 percent of arable land, while the condition of livestock deteriorated due to inadequate grazing. Since beef is a significant component of manufacturing output, the sector's recovery is likely to be slow. It is nevertheless expected that the substantial increase in Government expenditure in 2002/03 will boost construction output, which traditionally is dependent on work related to government projects, and raise value added for the Government sector. The output of the transport sector is also forecast to increase on account of projected increased activity in air, rail and road services.

(c) Employment

(i) Employment Results from the 2001 Population and Housing Census

1.13 The 2001 census results show that between 1991 and 2001 employment outside the non-traditional agricultural sector (includes employee, self-employed and family business employment) grew considerably faster (3.4 percent) than the labour force (2.4 percent) and the population (2.4 percent) (Table 1.1). Simultaneously, unemployment rose nearly six percentage points to 19.6 percent, due to the sharp fall in employment in the traditional agriculture sector. Employment in this sector fell by 12.6 percent per annum, or 74 percent over the ten-year period. The moderate growth of employment elsewhere in the economy could not fully compensate for the rapid reduction of employment in the traditional agriculture sector. Hence, overall employment grew only slightly, by less than 2 percent per annum (or 18 percent over the entire period), compared with an increase of 6.1 percent per annum in the number of those looking for work.

1.14 With employment in traditional agriculture shrinking at such a rapid pace, by 2001 the sector accounted for only 3 percent of the labour force compared to 15 percent in 1991. This implies that future contributions to the unemployment problem by further labour migration out of this sector will be small[5].

1.15 However, self-employment grew at more than

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3 As set out in the *2003 Budget Speech.*

4 The amount of carats mined in the first half of the 2002/03 (July-December 2002) national accounts year was 22 percent higher than that for the corresponding period in the previous year.

5 It should be noted, however, that there could be a significant number of 'discouraged workers' who are not currently recorded as unemployed and seeking work but might start to actively search for work in the future because of improved economic prospects.

TABLE 1.1 ECONOMICALLY ACTIVE POPULATION (1991 AND 2001)

	1991		2001			
	Number	Percentage Share	Number	Percentage Share	Percentage Change 1991–2001	Annual Average Percentage Change 1991–2001
Employee	275 750	63	370 456	66	34	3.0
Self-Employed	28 647	7	54 661	10	91	6.7
Sub-total	**304 397**	**69**	**425 117**	**76**	**40**	**3.4**
Family Business	7 938	2	6 446	1	-19	-2.1
Lands and Cattle Post	67 613	15	17 630	3	-74	-12.6
Sub-total	**75 551**	**17**	**24 076**	**4**	**-68**	**-10.8**
Total Employment	**379 948**	**86**	**449 193**	**80**	**18**	**1.7**
Seeking Work	60 385	14	109 512	20	81	6.1
Total Labour force[1]	**440 333**	**100**	**558 705**	**100**	**27**	**2.4**
Unemployment Rate[2]	13.7	–	19.6	–	–	–

Notes:
1. The labour force is the sum of people employed in both the formal and informal sectors and those looking for work.
2. The unemployment rate is the number of people looking for work expressed as a percentage of the total labour force.

Source: Central Statistics Office (2001)

twice (6.7 percent per annum between 1991 and 2001) the pace of employment growth of the 'employee' category and faster than the pool of job seekers. This is encouraging to the extent that it could potentially help ease unemployment. However, the sustainability of these jobs has yet to be established.

(ii) Employment in 2001/02

1.16 For the year to March 2002 total formal sector employment is estimated to have grown at a marginally faster rate of 2.7 percent compared to the revised increase of 2.6 percent for the year ending March 2001[6]. While this rate of job creation is faster than population and labour force growth, it may not be enough to significantly reduce the unemployment rate. Employment in agriculture, water and electricity, transport and communications and the general Government sectors declined, while in the finance and business services sector it virtually stagnated. For the mining and construction sectors, employment growth was less than 2.5 percent. Total employment in the private sector expanded at a faster rate of 5 percent than in the previous year (3.9 percent) due to relatively strong growth of employment in manufacturing (8.4 percent), commerce (8.3 percent), community and personal services sectors (14.7 percent) and private education (4.5 percent)[7].

1.17 Employment in parastatals increased by 1.2

[6] The Central Statistics Office (CSO) revised employment data for the year ending March 2001, the effect of which was a reduction in the overall growth rate of employment from the original estimate of 5 percent to 2.6 percent. The major downward revisions were in mining (employment fell 15.8 percent, due mainly to retrenchment at the BCL mine, compared to the original growth estimate of 2 percent), manufacturing (a 4.6 percent decline in jobs against an initial growth of 5.4 percent) and finance and business services (growth dropped to 2.4 percent from the initial estimate of an 8.1 percent rise). In contrast, significant upward revisions were made in employment in agriculture, community and personal services; growth in the former rose to 8.2 percent from the original 3.3 percent and in the latter a higher increase of 11.6 percent from 4.5 percent.

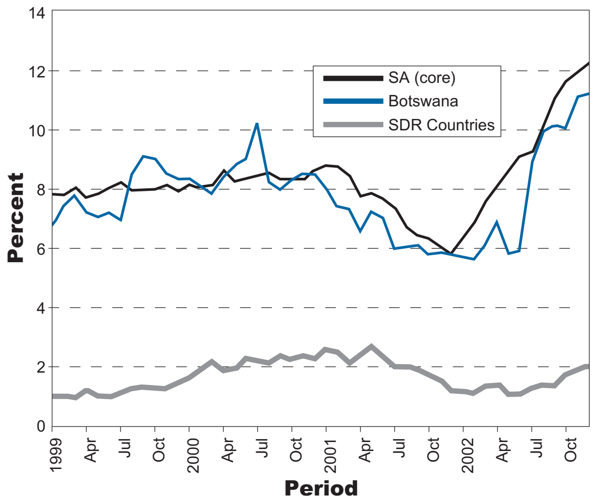
percent following two successive years of decline due to organisational restructuring and staff rationalisation in some of the institutions. For the public sector, there was a 9.9 percent reduction in the number of employees in public schools, which more than offset employment increases in other parts of central and local government[8]. As a result, employment in general government declined by 0.4 percent, against an increase of 1.5 percent in 2001.

1.18 Official forecasts for employment growth for 2002/03 and 2003/04 suggest a 5 percent increase in each year, which is expected to be driven by expansion in non-mining sectors. However, with the downside risk on the GDP growth forecast outweighing the upside risk, there is also the possibility that employment will also under-perform.

(d) Inflation

1.19 Globally, inflation rose moderately in 2002, largely reflecting higher energy prices while excess production capacity, restrained consumer demand and benign inflation expectations dampened inflationary pressures. However, inflation rose sharply in South Africa in 2002, mostly reflecting the effects of the depreciation of the rand towards the end of 2001. Domestically, there were demand pressures on inflation as reflected in higher than desirable rates of growth in commercial bank credit to the private sector and government expenditure. Commercial bank credit grew, on average, at an annual rate of 18 percent, well above the range of 12.5–14.5 percent indicated in the 2002 Monetary Policy Statement, while government expenditure is estimated to have grown by 18 percent. Nevertheless, the major impact on inflation during 2002 was the introduction of value added tax (VAT) on a wide range of goods and services effective July 1, 2002.

CHART 1.3 INTERNATIONAL INFLATION



Source: Central Statistics Office and Bank of Botswana.

1.20 It is estimated that VAT resulted in a 4–6 percent increase in the general price level spread over several months in the second half of 2002. The magnitude of the increase reflected the effects of VAT on the three groups of taxable items: those that were taxable for the first time (which did not previously attract sales tax), those for which sales tax did not cover the total value, and those that are exempt but have taxable inputs. Broadly, however, the magnitude of price increase for individual items may have been influenced by expectations of the generalised increase in prices while competitive pressures might have dampened the rate of price changes in some instances. Following the introduction of VAT, the month-on-month rate of price change rose sharply to 3.2 percent in July 2002 from an average of 0.5 percent in the preceding twelve months. However, reflecting the one-off effect of VAT on inflation, the monthly rate of price increase progressively declined to 1.1 percent in August, 0.2 percent in September and -0.1 percent in October.

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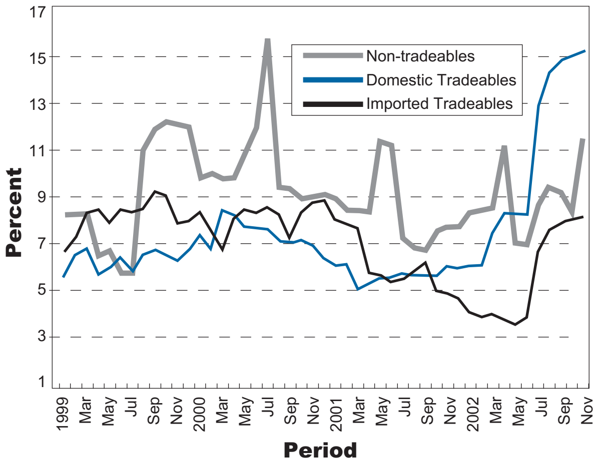
7 This is surprising given that manufacturing output increased by only 0.2 percent. It is worth noting, however, that the employment figures are very preliminary and as such the employment growth rate could change significantly once the figures are revised.

8 The decline could be indicative of previous misclassification, by respondents to the labour surveys, of the general cadre on Councils' payroll but attached to public schools. The cadre forms part of the employees of Local Authorities, but are sometimes mistakenly recorded as public school employees. It would appear that in 2001/02 these workers were correctly recorded as employees of the former and not the latter.

1.21 Consumer price inflation averaged 8.1 percent in 2002, compared to 6.6 percent in 2001 and 8.5 percent in 2000. Most of the increase in inflation in 2002 occurred in the second half of the year, from an average of 6 percent in the first half, due to the impact of VAT. Apart from the impact of VAT, the 14.3 percent increase in food prices in 2002 (compared to 4.1 percent in 2001), which was partly due to drought conditions in the Southern African region, also contributed significantly to inflation in 2002 while the change in the telephone billing system in November resulted in higher inflation at the end of the year[9]. Generally, indications are that when the effect of VAT is allowed for, underlying inflation was stable at around 6–7 percent in 2002.

1.22 By tradeability, the annual rate of increase in the cost of tradeables rose at a faster rate of 10.6 percent in December 2002 compared to 5.1 percent in December 2001 reflecting, among other factors, the sharp increase in inflation in South Africa, following the depreciation of the rand towards the end of 2001, the increase in food prices and the impact of VAT. Within tradeables, prices of imported tradeables accelerated to 8.2 percent from 4.6 percent while the cost of domestic tradeables rose year-on-year by 15.2 percent from 5.9 percent over the same period. For non-tradeables the annual price change rose to 11.7 percent in December 2002, from 7.7 percent in December 2001.

CHART 1.4 CPI INFLATION BY TRADEABILITY



Source: Central Statistics Office.

(e) Inflation Outlook

1.23 Inflation has largely been contained globally, reflecting a combination of improved credibility of monetary policy in the major economies and subdued economic activity worldwide. Despite the expected improvement in economic performance, output will remain below trend and global inflation is forecast to remain steady at around 2.5 percent in 2003. In South Africa, inflation is forecast to slow down in 2003 following a sharp increase in 2002, indicating the appreciation of the rand and the impact of the restrictive monetary policy stance on demand. The overall impact of external price developments on domestic inflation in 2003 is, therefore, expected to be benign, especially if the international oil prices remain relatively stable. However, domestic demand pressures remain, due to the high rates of growth in both commercial bank credit and government expenditure, although these are expected to be moderated in 2003 by the increase in interest rates in the fourth quarter of 2002 and the considerable slowdown in government expenditure growth announced in the 2003/04 budget. These developments are expected to reduce pressure on inflation in 2003. This positive outlook on inflation may, however, be negated by any major increases in administered prices and any Government award of salary increases to civil servants in the second quarter of 2003 following the ongoing review of the Government salary structure.

9 There was a substantial increase, of 60.7 percent, in the cost of the telephone call component of the CPI basket in November 2002 which, however, mainly reflected a change in the billing system rather than an increase in the cost of phone calls. Previously telephone calls were charged in units with a specified duration and the full cost of a unit was incurred even if only a fraction of the duration was used in making the call. The new billing system is on a per second basis. The charge will tend to make shorter calls cheaper and longer calls more expensive, but is designed to be cost/revenue neutral and is, therefore, unlikely to result in an increase in telephone bills, on average.

2. Public Finance

(a) Budgetary Performance – 2001/02 and 2002/03

(i) The Final 2001/02 Budget

2.1 The final outturn for the fiscal year 2001/02[10] was worse than forecast in both the original and revised budgets, with the overall balance in deficit compared to the significant surplus of the previous year. Total revenue fell to P12 707 million while total expenditure rose slightly to P13 671 million, resulting in a deficit of P964 million, which was higher than the original and revised estimates of P527 million and P85 million, respectively. Shortfalls in both non-mineral income tax revenue and mineral revenue, due to factors including weakness in international diamond prices explained most of the decline in total revenue. The rise in total expenditure was largely a result of a 16.1 percent increase in wage costs.

(ii) The Revised 2002/03 Budget

2.2 In the 2002/03 revised budget estimates (Table 1.2) the deficit increased (P2 216 million) and considerably exceeded the P1 619 million originally budgeted. The increased deficit was due to a reduction in total revenue to P14 426 million, following a 17.1 percent drop in mineral revenue due to continued weakness in the diamond market and the appreciation of the Pula against the US dollar.

(b) The 2003/04 Budget Estimates

2.3 In contrast to the previous year, the 2003/04 Budget is in approximate balance. This reflects the Government's effort to contain spending and projected increases in revenue through a combination of planned increases in mineral production, expansion of tax coverage and general improvement in tax collection.

(i) Revenue

2.4 Total revenue is projected to rise by 21.6 percent over the revised estimate for 2002/03 to P17 539 million. The revenue growth is expected to rise across the board from mineral revenues, non-mineral income tax, customs and excise as well

TABLE 1.2 THE GOVERNMENT BUDGET: 2001/02 – 2003/04 (P MILLION)

	2001/02			2002/03		2003/04
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	13 558	13 347	12 707	15 411	14 426	17 539
Mineral	7 953	7 463	6 996	8 492	7 040	8 140
Non-mineral	5 605	5 885	5 711	6 919	7 386	9 399
Expenditure	14 084	13 433	13 671	17 031	16 642	17 333
Recurrent	9 368	9 613	9 935	11 642	11 940	13 319
of which:						
Salaries[1]	2 944	2 966	3 447	3 884	3 903	4 132
Development	4 709	3 762	3 698	5 187	4 502	4 431
Other[2]	7	58	37	201	70	-503
Balance	-527	-85	-964	-1 619	-2 216	206

Notes:
1. Wages, Salaries and related staff costs
2. Includes FAP grants and net lending

Source: Financial Statements, Tables and Estimates of the Consolidated Development Fund Revenues 2002/03, MFDP.

[10] The fiscal year runs from April to March.

as VAT. Mineral revenue is forecast to rise by 15.6 percent to P8 140 million, due in part to an expected increase in diamond production. Non-mineral income taxes are expected to grow by 12.3 percent to P2 533 million while customs and excise revenue is projected to rise by 36.4 percent to P2 120 million, due to both an increase in the volume of imports and the Pula depreciation against the rand. Collections from VAT are expected to grow by 79.1 percent to P2 306 million, reflecting both the first full year of operation of VAT and improved collection of revenue.[11]

(ii) Expenditure

2.5 Total expenditure is forecast to increase by 4.2 percent over the revised 2002/03 estimates to P17 333 million. This is a much slower growth than in the previous year and is expected to result from a slight drop (1.6 percent) in development expenditure and a slowdown in the rate of increase of the two largest components of recurrent expenditure, 'other charges' and 'personal emoluments'. Growth for the former is forecast to decline to 14.5 percent from 24.1 percent in 2002/03, while the latter is projected to rise by 5.9 percent compared to 13.3 percent in the last fiscal year.

2.6 Development expenditure is projected to increase to P4 431 million. Just over 40 percent of the development budget is allocated to social services, within which more than half is allocated to education and health sectors; 32.5 percent was earmarked for economic services, the bulk (23.4 percent) of which will finance electricity and water supply, as well as roads; and 27.2 percent was assigned to general public services.

2.7 The sharp drop in the growth of total government spending in 2003/04 compared with double digit spending growth rates in recent years, as well as the balanced budget that compares favourably with the large deficits of the previous two years, bode well for both monetary policy and macroeconomic balance in the coming year. It is also particularly encouraging that the revised estimate of 22 percent government spending growth in 2002/03 is lower than the 27 percent growth originally forecast in last year's budget. With the easing of fiscal pressures and the fiscal balance becoming relatively less of a concern from a monetary policy perspective, monetary policy in the coming year could focus on demand pressures arising from the private sector within a more conducive environment.

(c) The 2003/04 Budget – Theme and Programmes

(i) The Theme of the Budget

2.8 The 2003 Budget Speech focused on the theme 'Improving Botswana's Competitiveness in Global Markets', and outlined measures to support the competitiveness drive. The need to maintain competitiveness derives from the fact that Botswana is a small open economy with limited influence on global trade and capital flows in the context of the ongoing globalisation process. In this competitive environment, the country can benefit from open trade and the free movement of resources if it continues to pursue prudent macroeconomic policies, foster an enabling environment for inward investment and improve service delivery.

(ii) Performance of State-owned Enterprises

2.9 It is considered that an improvement in service delivery by state-owned enterprises that provide utilities, housing, air transport and financial services would support efficiency in the broader economy and export competitiveness. For this reason, the Government has for some time encouraged state-owned enterprises to be self-sustaining and rely more on the private sector for funding. As a result, there has been some improvement in the financial performance of a

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[11] The previous year's figure includes revenue from sales tax for part of the year and for VAT subsequent to its introduction on July 1, 2002. Therefore, the growth rate should be carefully interpreted as the rapid growth projected is partly because the coverage of sales tax and VAT are not the same.

number of parastatals, including the Botswana Development Corporation (BDC), Air Botswana (AB), Botswana Housing Corporation (BHC), Water Utilities Corporation (WUC), Botswana Power Corporation (BPC), National Development Bank (NDB) and the Botswana Savings Bank (BSB).

2.10 Some key institutions, however, especially the Botswana Telecommunications (BTC), the Botswana Meat Commission (BMC) and the Botswana Agricultural Marketing Board (BAMB), have for a variety of reasons been unprofitable in recent years. Moreover, despite the profitability of some of the utility providers, there continue to be concerns about access, efficiency and the cost of services compared to other countries. To address these concerns, several projects have been initiated with the objective of widening access to, and increasing the supply of water, electricity and telecommunications services. The projects include the rural electrification programme and the expansion of rural telecommunications to cover a population of 120 000 in 147 villages. In order to prevent these high-cost projects from driving tariffs up further, part of the infrastructure costs are being met by the Government.

2.11 On privatisation, the Public Enterprise Evaluation and Privatisation Agency (PEEPA) is expected to complete the preparation of a Privatisation Master Plan (PMP) by the first quarter of 2003/04. The PMP will provide a broad strategic framework that outlines the tools and methods of privatisation together with a three-year privatisation work programme. The agency is also compiling a database of privatisation activities and opportunities, which is expected to ensure transparency, efficiency and effectiveness in its implementation.

2.12 Work on the privatisation of Air Botswana was resumed in September 2002 and will be completed by the end of 2003, following its suspension earlier due to unfavourable conditions in the international aviation industry, particularly against the background of the September 11, 2001 terrorist attacks in the USA. It is planned that 45 percent of the shares of the privatised airline will be owned by a strategic partner, 10 percent will be allocated to citizen employees of the airline and the remaining 45 percent will be retained by Government; the latter may subsequently be sold to the public. The other institutions considered for privatisation are the NDB and BSB. The Government will assess the feasibility of merging the two institutions and the possibility of privatising them either as a merged entity or separately. In order to improve its recent weak performance, the BTC is implementing a three-year organizational and financial restructuring programme subsequent to which the parastatal is expected to be privatised.

(iii) Programmes and Other Initiatives

2.13 The Citizen Entrepreneurial Development Agency (CEDA), the objective of which is to support business development and meet the financing needs of citizen entrepreneurs, had approved 792 projects worth P421.1 million as at the end of 2002. Significantly, the largest proportion of applicants financed (45 percent) was in the service sector followed by 10 percent in manufacturing, indicative of the growing importance of the services industry, which is in line with global trends. However, after the first year of operation, arrears of P3.6 million were 50 percent of expected repayments, suggesting the need for increased efforts to guard against the onset of loan repayment problems that have previously affected similar financial assistance programmes. The guidelines for the operation of the CEDA Venture Capital Fund have been finalised and the process of identifying a manager has started. The Fund is expected to be operational in the first half of 2003.

(iv) Industrial Development and Trade Issues

2.14 In recognition of the importance of domestic industry in the achievement of global competitiveness, the Ministry of Trade and

Industry, in collaboration with the United Nations Development Programme (UNDP), has introduced a programme that aims to develop investment and export promotion strategies, a modern investment law and capacity for negotiating bilateral investment treaties. The Government also intends to review administrative barriers to investment in Botswana, an area that has been of concern to industry. The investment code, which was introduced last year, will be withdrawn and replaced by a more investor-friendly one during 2003/04. Moreover, in order to improve the operational efficiency of the Ministry and therefore service delivery to industry, the reorganisation announced in the last Budget Speech is ongoing. The Local Enterprise Agency, the role of which is to speed up the delivery of training and mentoring support to local enterprises, will start operations during the 2003/04 financial year, while the Office of the Registrar of Companies will be established as an autonomous entity.

2.15 In an effort to improve market access, Botswana will actively participate in regional and international trade initiatives. Following successful negotiations for the temporary relaxation of some AGOA[12] requirements, Botswana, together with other Southern African Customs Union (SACU) countries, will enter into negotiations with the USA Government during 2003-2004 on the creation of a free trade agreement between SACU and the USA, with a view to securing uninhibited market access for SACU goods and services on a more permanent basis. Meanwhile, Botswana and other African, Caribbean and Pacific (ACP) countries will negotiate free trade arrangements with the European Union (EU), which will replace the current non-reciprocal trade arrangements in 2008 (see Chapter 2).

(v) Fiscal Legislation

2.16 A number of legislative amendments were proposed for the 2003/04 fiscal year with a view to improving tax compliance and collection, closing loopholes and easing tax administration. The amendments will be made to the Income Tax and Transfer Duty legislation while a new law is proposed for the creation of a unified revenue service. The major changes are summarised below:

2.17 *Withholding Tax on Rental and Interest Income*: Coverage of withholding taxes will be extended to rental income from immovable property (10 percent) and interest income (15 percent) received by residents. The proposal has been prompted by failure of some residents to declare their rental and interest income in their tax returns. To encourage savings, it is proposed to raise the threshold of interest income above which the withholding tax is applicable to P6 000 a year (or P500 a month), from the current P2 500 a year.

2.18 *Company Directors' Responsibility for Payment of Taxes*: The amendment seeks to hold directors personally liable for outstanding company tax on disposal of their shareholding or upon liquidation of the company.

2.19 *Transfer Duty Act*: The Transfer Duty Act will be amended retrospectively to July 1, 2002 such that the 5 percent transfer duty payable on a property transaction is waived or reduced where VAT is also payable. The taxpayer will be entitled to apply for a refund of the transfer duty paid if VAT has also been paid.

2.20 *Treatment of Bad and Doubtful Debts of Banking and Financial Institutions*: The law will be amended to allow banks and financial institutions to deduct up to a prescribed percentage of their outstanding debts or advances, for which provision for bad and doubtful debts has been made in the accounts.

2.21 *Unified Revenue Service*: Following last year's announcement, legislation is being prepared to create a unified revenue service that will take

12 The Africa Growth and Opportunity Act (AGOA) is a framework for the promotion of trade and investment between the USA and Sub-Saharan African countries. The details of this arrangement are covered in Chapter 2.

over the functions of the Departments of Taxes and Customs and Excise.

3. EXCHANGE RATES, BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION

(a) Exchange Rates

3.1 During 2002, there was considerable exchange rate volatility, although most of the movement was in the opposite direction from that experienced in 2001. The Pula strengthened against major international currencies on the back of a recovery of the rand from losses incurred towards the end of 2001. The rand appreciated by 29 percent against the SDR, reflecting prudent macroeconomic policy in South Africa, a more favourable assessment of South Africa vis-à-vis other emerging markets by international investors, a perception that the rand had become undervalued, the weakness of the US dollar, the rise in the price of gold accompanied by an improved outlook for commodities more generally, and the repatriation of export earnings by South African exporters. Given the link to the rand through the currency basket, the Pula appreciated by 18.6 percent against the SDR during the year, including a 27.9 percent appreciation against the US dollar, but depreciated by 8 percent against the rand (Table 1.3).

3.2 Botswana's exchange rate policy is based on the desire to maintain competitiveness of domestic producers by ensuring that the real exchange rate of the Pula remains relatively stable. The Pula value is linked to a basket of currencies comprising the rand and the SDR with weights that are based on Botswana's international trade and financial relations. An appreciation of the real exchange rate due to nominal appreciation and/or a rise in inflation in Botswana compared to trading partner countries reduces the competitiveness of domestic producers while reducing the cost of imports in Pula terms.

3.3 The trade-weighted nominal effective exchange rate (NEER), which reflects the weighted average of the Pula exchange rates against trading partner countries, was largely stable in 2002, appreciating marginally by 0.5 percent as

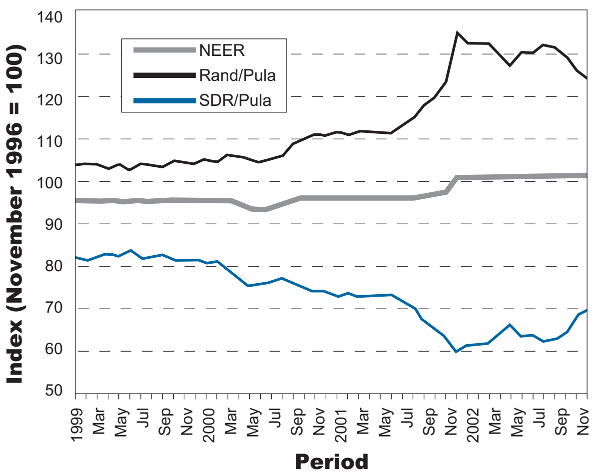
TABLE 1.3 NOMINAL AND REAL PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES

Nominal Exchange Rates (foreign currency per Pula)			
As at end of	**2001**	**2002**	**Percentage Change**
SA rand	1.7188	1.5801	-8.1
SDR	0.1143	0.1356	18.6
US dollar	0.1432	0.1829	27.7
Pound Sterling	0.0987	0.1140	15.5
Japanese yen	18.80	21.68	15.3
Euro	0.1617	0.1745	7.9
Nominal Effective Exchange Rate	**100.8**	**101.3**	**0.5**
Real Pula Exchange Rate Indices (November 1996=100)			
SA rand[1]	133.6	121.6	-9.0
SA rand[2]	144.5	129.0	-10.7
SDR	77.8	100.5	29.2
US dollar	66.2	91.7	38.5
Real Effective Exchange Rate	**110.1**	**113.3**	**2.9**

Notes:
1. Calculated using core inflation. Core inflation is the all items of consumer price inflation excluding mortgage interest costs and prices of various volatile food items.
2. Calculated using headline inflation.
Source: Bank of Botswana.

the impact of the Pula appreciation against the SDR was offset by the local currency's depreciation against the rand (Chart 1.5). Given the stability of the NEER, exchange rate developments are not expected to have any impact on inflation. The real effective exchange rate (REER), which measures Botswana's overall competitive position, appreciated by 2.9 percent in the twelve months to December 2002, indicating loss of competitiveness. This was due largely to higher inflation in Botswana compared to the average for trading partner countries. Against individual currencies, the Pula weakened in real terms by 10.7 percent against the rand (using core inflation) but appreciated by 29.2 percent against the SDR and 38.5 percent against the US dollar (see Chart 1.6).

CHART 1.5 NEER AND NOMINAL EXCHANGE RATE INDICES AGAINST SELECTED CURRENCIES

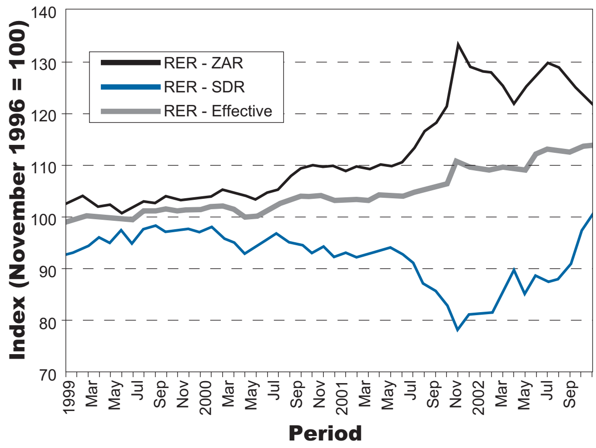


Source: Bank of Botswana

(b) Overview of the Balance of Payments

3.4 The 2002 preliminary balance of payments estimates show a surplus of P3 153 million on the current account, 14.5 percent lower than the P3 689 million recorded in 2001. The decline in the current account surplus reflected the combined effect of an increase in the income account deficit and a substantial rise in imports, which reduced the balance of trade surplus. There was a net outflow of P3 322 million on the financial account, which continued the trend of large net

CHART 1.6 REER AND REAL EXCHANGE RATE INDICES AGAINST SELECTED CURRENCIES



Source: Bank of Botswana

outflows evident since 1998; the overall balance[13] declined by 67 percent to P336 million.

(i) *The Merchandise Trade Account*

3.5 Although the merchandise trade account continued to be in surplus, the surplus declined by 6 percent in 2002 to P4 078 million from P4 346 million in 2001. Exports are estimated at P14 983 million, a 12 percent increase from P13 345 million in 2001. The increase in exports was mainly a result of the 11 percent rise in diamond exports, which continued to be the major source of export earnings, accounting for 83 percent of the total. As a result of improvements in global demand in 2002, part of the 2001 production that was stockpiled was exported alongside the entire output for 2002. Pula export revenues also benefited from the depreciation of the Pula against the US dollar as diamond exports only increased by 1 percent in US dollar terms.

3.6 Copper-nickel and soda ash exports increased by 13 percent and 29 percent, respectively. However, beef exports declined considerably, by about 40 percent, from P427 million recorded in 2001 to P257 million in 2002. The reduction was partly a result of the outbreak of the foot and mouth disease (FMD) in the north-east (Matsiloje) of the country in early 2002, which led to the closure of the Francistown abattoir during the first quarter of the year, and the

[13] Before movements in official reserves.

TABLE 1.4 BALANCE OF PAYMENTS: 1999 – 2002

	1999	2000	2001[1]	2002[2]
Current Account Balance	2 859	2 782	3 689	3 153
Visible Trade Balance	3 629	4 603	4 346	4 078
Services Balance	-721	-1 136	-1 010	-620
Income Balance	-1 213	-1 792	-801	-1 741
Net Current Transfers	1 164	1 108	1 153	1 436
Financial Account Balance	-1 127	-1 021	-2 976	-3 322
Capital Account Balance	95	194	34	99
Net Errors and Omissions	2	-15	474	405
Overall Balance	1 829	1 941	1 024	336

Notes:
1. Revised
2. Provisional
Source: Bank of Botswana.

temporary suspension of exports to the EU, the major market for Botswana beef. The future of the beef industry depends partly on the ability of Botswana to combat cattle diseases. Due to uncontrolled movements of cattle from neighbouring Zimbabwe, there was another outbreak of foot and mouth disease, again in the north-east (Matopi), in January 2003, which is likely to have similar adverse effects on beef exports.

3.7 Provisional estimates indicate that imports of goods rose to P10 905 million, an increase of 21 percent from P8 664 million in 2001. Imports of machinery and electrical appliances as well as vehicles and transport equipment accounted for the bulk of the increase. Food and beverage imports also rose due to higher prices which reflected regional food shortages and lagged effects of the previous year's depreciation of the rand. Overall, imports rose due to increased consumption as well as the ongoing construction boom.

3.8 The services account, which covers transportation as well as insurance and other professional services, had a deficit of P620 million during the year compared to P1 010 million in 2001. The net outflow was mainly in transportation, which was principally affected by an increase in freight costs. Payments for travel also rose due to the increase in the number of students on overseas training, but the rise was lower than that in 2000 and 2001 when the Government had just started sending students to South Africa in large numbers. The current transfers account, which forms part of the current account, is dominated by the South African Customs Union (SACU) payments and continued to be in surplus.

3.9 The adverse balance on the income account increased to P1 741 million in 2002 from P801 million in 2001, reflecting the decline in earnings on reserves, which resulted from the poor performance of the equity markets in which part of the reserves are invested.

(ii) Current Account

3.10 Although still at a healthy level, the 2002 current account surplus of P3 153 million was much lower than the P3 689 million in 2001 (Table 1.4). The decline was due to both the fall in the visible trade surplus and a larger deficit on the income account.

(iii) Capital and Financial Accounts

3.11 The capital account, which summarises transactions relating to migrant transfers and all other transfers of a capital nature, was also in surplus during the year, with a much larger balance of P99 million in 2002 compared to P34 million in 2001. In contrast, there were large net outflow in the financial account in 2001 and 2002. The net outflow of P2 976 million was largely a result of Debswana's increased shareholding in DeBeers. The financial account net outflow, which increased to P3 322 million in 2002, was due to increased portfolio investment outflows stemming from the new Public Officers Pension Fund. Moreover, a net outflow of P1 256 million is estimated in 'other investment' which is related to SACU transactions and bank deposits abroad as well as loans and trade credits.

(iv) Foreign Exchange Reserves

3.12 The foreign exchange reserves were P30 billion as at end of December 2002, and covered 26 months of import of goods and services. The reserves decreased by P11 billion, or 27 percent, from P41 billion in December 2001, owing mostly to the effect of the Pula appreciation, particularly against the US dollar. In US dollar and SDR terms, the reserves fell by 7.2 percent and 13.8 percent respectively, largely reflecting the fall in equity values in major international markets during 2002, combined with outgoing payments linked to the funding of the Public Officers Pension Fund.

(c) International Investment Position and Foreign Direct Investment

(i) International Investment Position (IIP)

3.13 Comprehensive International Investment Position (IIP) data are available up to the end of 2001. For 2002, preliminary estimates are derived by adding flows to the previous year's stocks, and indicate that Botswana's total foreign assets declined by P7 936 million from P51 607 million in 2001 to P43 761 million in 2002. The decrease in foreign assets was attributable to the P11 253 million fall in foreign exchange reserves in 2002, which continued to account for a large proportion (68 percent) of Botswana's foreign assets. Offsetting the impact of the fall in foreign exchange reserves was the substantial increase in portfolio assets in 2002, due to investment abroad of part of the new Public Officers Pension Fund. Foreign liabilities increased by P605 million to P17 676 million in 2002, from P17 079 million in 2001. The bulk of the increase (P357 million) was due to a rise in loans to the domestic private sector.

(ii) Industry and Country Classification of Investment

3.14 Tables 1.5 and 1.6 show Botswana's stock of foreign liabilities at the end of 2001 classified by industry and country[14] of investment origin. The liabilities are shown by categories of foreign direct investment (72 percent of total) and other investment[15].

3.15 At the end of 2001, a large proportion of foreign direct investment (81 percent) was in the mining industry, virtually unchanged from 79 percent in 2000. BCL Ltd's indebtedness for loans and accrued interest continued to dominate this category. Equity investment in the financial sector contributed to an increase in this sector's share of foreign direct investment, which rose to 7 percent in 2001 from 6 percent in 2000, becoming the second largest recipient. Wholesale and retail trade accounted for 6 percent while manufacturing, which is widely expected to be a major beneficiary, accounted for only 3 percent of foreign direct investment in 2001.

3.16 As at the end of 2001, South Africa was the largest source of foreign direct investment, accounting for 60 percent while the European Union countries had 35 percent.

3.17 Under 'Other Investment', 52 percent of the

14 Derived from the 2001 balance of payments survey conducted by the Bank of Botswana.

15 Includes all financial transactions not included under direct investment portfolio or reserve assets. In the case of Botswana, the account comprises both government and private sector loans, trade credits, currency and deposits, as well as SACU transactions.

TABLE 1.5 LEVELS OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY (P MILLION)

	Foreign Direct Investment			Other Investment			Total Investment
Industry[1]	Equity	Non Equity	Total	Equity	Non equity	Total	
Mining	2 980	5 432	8 412	10	1 206	1 216	9 627
Manufacturing	184	90	274			1	275
Finance	610	120	729	6	178	184	913
Retail and Wholesale	651	…	651	…	223	223	874
Electricity, Gas and Water	…	…	…	…	217	217	217
Real Estate and Business Services	100	14	115	…	77	77	191
Transport, Storage and Communication	48	47	96	1	51	52	148
Construction	5	18	23	…	5	5	28
Hospitality	126	9	135	…	…	…	135
Public Administration	…	…	…	…	2 102	2 102	2 102
Other	1	0	1	…	1	1	2
Total	**4 705**	**5 730**	**10 435**	**17**	**4 060**	**4 077**	**14 512**

Source: Bank of Botswana

TABLE 1.6 LEVELS OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY (P MILLION)

	Foreign Direct Investment			Other Investment			Total
Country	**Equity**	**Non Equity**	**Total**	**Equity**	**Non equity**	**Total**	**Investment**
North and Central America	45	3	48	…	340	340	**388**
of which							
United states of America	45		45	…	340	340	**385**
Europe	3 593	711	3 665	5	445	450	**4 115**
of which							
United Kingdom	546	44	591	5	218	223	**814**
Netherlands	18	3	22	…	…	…	**22**
Luxembourg	2 979	22	3 002	…	80	80	**3 081**
Other Europe	45	2	48	…	134	134	**181**
Asia Pacific	94	9	103	…	631	631	**734**
Africa	680	5 623	6 303	…	1 067	1 067	**7 370**
of which							
South Africa	662	5 613	6 275	…	939	939	**7 214**
Middle East	88	21	109	…	60	60	**169**
Other	205	3	208	11	1 517	1 528	**1736**
Total	**4 705**	**5 730**	**10 435**	**17**	**4 060**	**4 077**	**14 512**

Source: Bank of Botswana.

liabilities in 2001 were government foreign debt while the mining industry accounted for 30 percent of the total.

4. Money and Capital Markets

(a) Monetary Policy and Liquidity Management

(i) Monetary Policy

4.1 The main objective of monetary policy is to achieve sustainable low inflation, which besides contributing to macroeconomic balance and creating an environment that encourages investment, facilitates the achievement of positive real rates of interest in order to encourage savings and high quality investment. Low inflation is also essential for the maintenance of exchange rate competitiveness in relation to trading partners. For the first time, the Bank publicly specified the inflation objective of 4 – 6 percent in the 2002 Monetary Policy Statement which, given forecast trading partner inflation, was considered necessary to maintain external competitiveness. Moreover, by stating the desired range for inflation and clear indications of the policy response to inflationary developments that would push inflation away from this desired range, the Bank expected to anchor inflation expectations downwards.

4.2 The Bank of Botswana maintained a tight monetary policy stance in 2002 which was necessitated by concerns about inflationary pressures generated by the high rates of growth in both commercial bank credit and government expenditure which throughout the year were well above rates consistent with the Bank's inflation objective. Nevertheless, inflation was stable in the first half of the year, although it was at the upper end of the desired range. It was expected that following the introduction of VAT there would be a one-off increase in inflation over a few months while demand declined as prices increased. However, due to concerns about persistent higher than desirable growth in nominal demand, the Bank, in line with the policy framework outlined in the 2002 Monetary Policy Statement, increased the Bank Rate by 50 basis points each in October and November, to 15.25 percent, in order to moderate commercial bank credit growth and curtail expectations of a sustained increase in inflation.

4.3 The Bank undertook open market operations to absorb excess liquidity in the banking system, which increased substantially due to the P4.9 billion transfer of pension funds by the Government from its accounts at the Bank of Botswana to the Public Officers Pension Fund. During the year Bank of Botswana Certificates (BoBCs) outstanding rose by 49 percent to P7 783 million in December 2002, from P5 148 million at the end of 2001, even faster than the 39 percent increase in 2001. Most of the increase in BoBCs was in holdings by commercial banks' clients and other financial institutions, in particular fund managers or institutional investors for the Public Officers Pension Fund. Holdings by commercial banks' clients increased by 131 percent, and were 46 percent of total

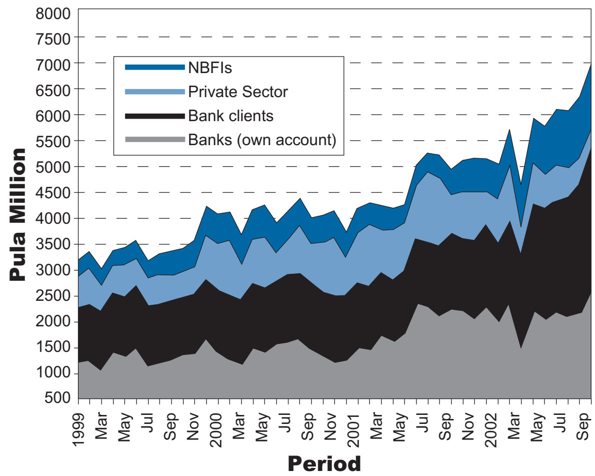
Table 1.7 Structure of Bank of Botswana Certificate Holdings

	P million		Percentage	Share of Total (Percent)	
	2001	2002	Change	2001	2002
Commercial banks	2 361	1776	-24.8	45.2	22.8
Banks' clients	1 536	3 544	130.7	29.4	45.5
Other Financial Institutions	655	1 849	182.3	12.5	23.8
Other institutions	669	614	8.2	12.8	7.9
Total	5 221	7 782	49.1	–	–

Source: Bank of Botswana.

BoBCs, while those held by other financial institutions rose by 182 percent to make up 24 percent of the total. In contrast, BoBCs held by commercial banks fell by 25 percent, as did those for the other private sector entities which declined by 8 percent.

CHART 1.7 OUTSTANDING BANK OF BOTSWANA CERTIFICATES



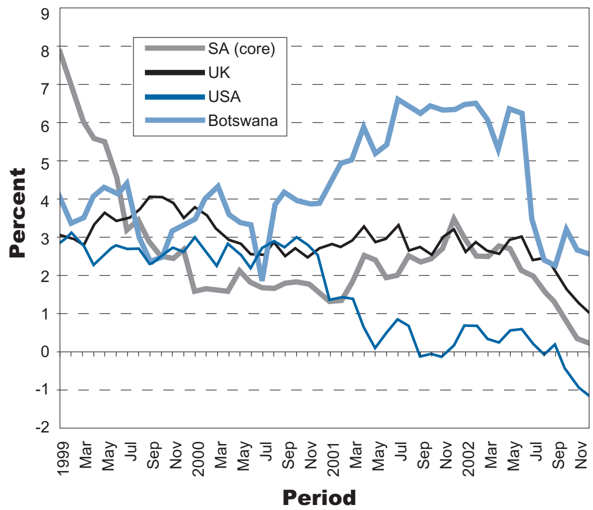
Source: Bank of Botswana.

4.4 Secondary market trading for BoBCs was sluggish, as the value of total certificates traded during the year declined by 2.4 percent to P5 202 million. It is notable that secondary market activities continued to be dominated by the Bank of Botswana (88 percent) compared to trading between primary counterparties. The value of BoBCs traded in the secondary market between the Bank of Botswana and counterparties was P4 572 million, 10.4 percent less than P5 105 million traded over the same period in 2001. The value of transactions among counterparties more than doubled to P630 million in 2002 from P223 million in 2001. The Bank seeks to encourage increased activity in the secondary market and trade among the primary counterparties and is, therefore, reviewing the relevant operating rules.

(b) Interest Rates

4.5 Interest rates were largely unchanged during the first nine months of 2002, but rose following the increase in the Bank Rate in the last quarter of the year, to 15.25 percent from the 14.25 percent that had prevailed since October 2000. The nominal three-month BoBC mid-rate fluctuated in a narrow range of 12.51 percent and 12.54 percent between January and September, but rose in the last quarter of the year to 14.03 percent in December, reflecting the increase in the Bank Rate. Following the increase in the Bank Rate, commercial banks increased the cost of borrowing by raising the prime lending rate to 16.75 percent from 15.75 percent. However, the spread between lending rates and deposit rates increased, as the deposit rates generally rose by less than the prime lending rate; the 88-day deposit rate was increased to 10.15 percent from 9.81 percent prior to the Bank Rate increase.

CHART 1.8 INTERNATIONAL REAL INTEREST RATES



Source: Bank of Botswana.

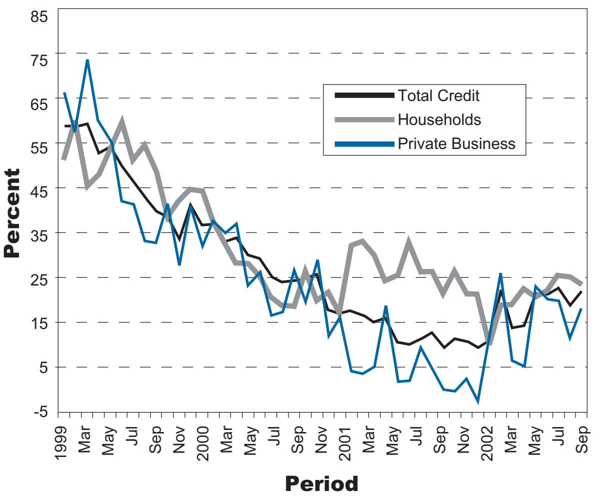
4.6 Real money market rates, which exclude inflation from nominal interest rates and which had been stable at a relatively high level, declined sharply in the second half of 2002 as a result of the increase in inflation following the introduction of VAT in July 2002. The real three-month BoBC rate fell to 2.5 percent in December 2002 from 6.3 percent in December 2001, but continued to be higher than comparable rates in the UK, USA and South Africa.

(c) Banking System

(i) Domestic Credit

4.7 The average annual rate of growth of commercial bank credit was 18 percent in 2002, higher than the 13.2 percent growth rate in 2001, while the year-on-year credit growth rate was 21.3 percent in December 2002, compared to 10.7 percent in December 2001. The 2001 credit growth rate was, however, understated because of the impact of the extension and subsequent early repayment of loans, using offshore funds, by certain large borrowers. If these loans are excluded, the rate of credit growth in 2002 was more or less the same as the average for 2001. The rate of credit expansion, however, was well above the target range of 12.5 percent to 14.5 percent[16], and was a major influence on the decision to increase interest rates during the fourth quarter of 2002. It is expected that the increase in interest rates will lead to a slowing in the rate of credit growth and reduce pressures on inflation. Lending to businesses fell as a proportion of total credit, as its rate of growth was lower than for the household sector. The average annual rate of growth of commercial bank credit to businesses was 14.4 percent in 2002 compared to 21.5 percent for the household sector.

CHART 1.9 GROWTH RATES OF CREDIT

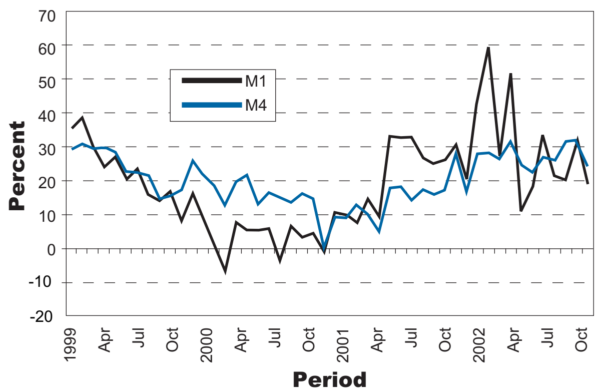


Source: Bank of Botswana

(ii) Monetary Aggregates

4.8 Money supply (M4) grew year-on-year by 24 percent in December 2002 compared to 28 percent in December 2001. The main influence on monetary growth during the year was the 41 percent reduction in government deposits at the Bank of Botswana reflecting the funding of the Public Officers Pension Fund and the sharply increased budget deficit in 2002 compared to the previous year. The 21 percent annual increase in commercial bank credit also contributed to the increase in money supply, while the 28 percent decrease in net foreign assets was contractionary. Rapid money supply growth led to an increase of 110 percent in BoBCs held by non-banks, compared to a rise of 16 percent in 2001. Deposits at commercial banks grew at a slower rate in 2002 with demand deposits up by 23 percent compared to 38 percent in 2001, and savings, notice and time deposits falling by 2 percent during the year, compared to an increase of 23 percent in 2001. Due to the appreciation of the Pula against major international currencies, the Pula value of foreign currency deposits declined by 22 percent in 2002 compared to a 67 percent expansion in 2001. The 9 percent growth rate of currency outside banks was also lower than the increase of 13 percent in 2001.

CHART 1.10 ANNUAL GROWTH RATES OF MONETARY AGGREGATES



Note: Refer to statistical section for definition of the aggregates.
Source: Bank of Botswana.

(iii) Bank of Botswana

4.9 Total assets/liabilities of the Bank of Botswana decreased by 27 percent in 2002, to P30 109

16 The target range was derived from the expected annual capacity for growth (aggregate supply) of the non-mining sector of the economy, as presented in the eighth National Development Plan (NDP 8), and desired inflation for the year, with an allowance for the process of financial deepening as the economy develops.

million as at the end of December 2002, following an increase of 22 percent in 2001. The fall in liabilities was mainly attributable to the 41 percent decrease in Government deposits at the Bank of Botswana, largely reflecting the P4.9 billion funding of the new Public Officers Pension Fund during 2002. The release of these funds into the banking system resulted in a substantial increase of 49 percent in the Bank's liability with respect to BoBCs. On the assets side of the balance sheet, the foreign exchange reserves declined by 27 percent in 2002. The long-term investment fund (Pula Fund), decreased by 24 percent during the year while the short-term Liquidity Portfolio fell by 42 percent. The reduction in the reserves partly reflected the purchase of foreign exchange during the year to finance offshore investments made by pension fund managers, as well as developments in international financial markets and exchange rate movements (see paragraph 3.12).

(iv) Commercial Banks

4.10 There was no change in the number of banks during 2002, although established banks continued to expand their branch networks, service points and the range of services offered[17]. Total assets of commercial banks grew year-on-year by 2 percent in 2002, to P11 183 million compared to the much higher growth rate of 29 percent in 2001. Although outstanding loans and advances grew by 21 percent, this was offset by substantial reductions in foreign currency balances and in balances due from foreign banks.

4.11 On the liabilities side, total deposits at commercial banks decreased by 15 percent in 2002 to P8 925 million, compared to a faster increase of 35 percent in 2001. Of the deposits, 16 percent was held in foreign currency accounts compared to 21 percent at the end of 2001. Commercial banks' capital and reserves rose by 6 percent, largely reflecting the capitalisation of profits.

(v) Merchant Banks

4.12 During 2002, the two merchant banks, Investec Bank and ABC (Pty) Ltd, increased their total assets/liabilities by 30 percent, to P846 million at the end of the year, from P651 million as at the end of 2001. Most of the growth in assets was due to a 28 percent increase in loans and advances, to P351 million, raising their share of the total loans and advances of the consolidated banking sector to 5 percent. Their holdings of BoBCs increased by a substantial 51 percent in line with an overall increase of 49 percent in the total value of outstanding BoBCs. With regard to their sources of funds, they increased deposit liabilities by 35 percent.

(d) Non-Bank Financial Institutions

4.13 Most non-bank financial institutions (NBFIs) experienced slower growth in their lending and financing activities in 2002 compared to the previous year. The National Development Bank (NDB) managed to expand its loan book by 17 percent, to P402 million, a much slower growth than the 36 percent expansion in 2001. In addition, NDB has in the past derived considerable income from agency activities carried out on behalf of the Government, such as the Financial Assistance Policy (FAP) and the Small, Medium and Micro Enterprises (SMME) loan scheme. As these incentive schemes have now been wound up, and their successor, the Citizen Entrepreneurial Development Agency (CEDA), operates independently, NDB has been seeking to develop new revenue sources and restructure its operations appropriately. One of NDB's main challenges is to continue to increase its lending in the face of competition from the newly-established CEDA, which provides highly subsidised loans to part of the NDB's potential client base. The Botswana Building Society (BBS) increased its mortgage lending to P359 million, but the growth of 7 percent in 2002 was below the 11 percent growth experienced in the previous year and mark a standstill in real terms. A similar situation prevailed at the Botswana Savings Bank (BSB), which expanded its lending, mostly in the form

[17] Including card-based payment services such as credit and debit cards.

of vehicle and housing loans to Government employees, by 10 percent to P85 million, lower than the 14 percent lending growth experienced in 2001. As mentioned in the 2003 Budget Speech, the Government is considering the possibility of merging the NDB and the BSB, and has earmarked the two institutions for privatisation, either individually or as a merged entity.

4.14 By contrast, the Botswana Development Corporation (BDC) managed to grow rapidly in 2002, with assets up by 42 percent to P1 089 million, compared to a growth of only 4 percent in 2001. In recent years BDC had experienced many problems, with losses from investments in the Hyundai motor assembly plant and various textile projects. However, the Corporation is now recovering and, during 2002, it made new investments in the Gaborone International Conference Centre, the Riverwalk Shopping Complex and Lobatse Tiles.

4.15 The performance of the stock exchange was lacklustre during 2002. The share index of the domestic component of the Botswana Stock Exchange rose by 2 percent to 2 497 in the year to December 2002, far below the growth of 69 percent recorded in 2001. Market capitalisation also rose at a slower rate than in the previous year. The foreign companies index fell sharply by 27 percent, largely on account of the decline in the share price of Anglo American Corporation, which accounts for the bulk of the value of listed foreign sector companies.

4.16 As regards activity in the market, a total of 71.1 million shares valued at P345 million, including two new listings, were traded during 2002 compared to 65.4 million shares valued at P400 million in 2001. The number of domestic companies listed on the Botswana Stock Exchange increased from sixteen in 2001 to eighteen in 2002 following the listing of Turnstar Holdings, a property management company, and Letshego, a micro loan finance company. The number of foreign listed companies was unchanged at seven, while companies in the venture capital market increased from one to two as Turnstar Holdings joined Gallery Gold, a foreign listed company. In the bond market, the total number of bonds increased to six with new issues by Barclays Bank of Botswana Ltd (P150 million) and Standard Chartered Bank Botswana Ltd (P50 million) in 2002.

(e) Credit Rating

4.17 After the initial assignment of sovereign ratings in the 'A' grade by Moody's Investors Service and Standard and Poor's in 2001, the subsequent review in 2002 by both rating agencies maintained the 'A' rating. The investment grade rating reflects the strong external position and a development strategy that successfully balances the provision of social services with prudent fiscal and monetary policies. These ratings enhance Botswana's competitiveness and the country's profile as an investment destination which, in turn, supports the process of economic diversification and economic development.

(f) Other Financial Sector Developments

4.18 There continued to be improvements in the domestic financial system that accord with global technological developments and innovations in the delivery of financial services. Progress was made in 2002 in the implementation of the National Payments System (NPS) reform project, with the Bank of Botswana as a key player. The National Clearance Settlement System (NCSS) Act was approved by Parliament while the regulations for the NCSS were submitted to the Attorney General's Chambers. The Bank of Botswana commenced a review of all other legislation related to the NPS.

4.19 To facilitate improvements in the payments system, new standards for cheques and debit vouchers were introduced. With effect from May 2002, only cheques printed with Magnetic Ink Character Recognition (MICR) numbering format can be used in the clearing system. The introduction of MICR printed vouchers and cheques was an important element in the automation of cheque clearing through the Electronic Clearing House (ECH), linking the Bank of Botswana and the commercial banks. Automated cheque clearing was complemented by the establishment of the Electronic Funds Transfer (EFT) module of the ECH, to facilitate the electronic transfer of bulk payments, including salaries.

4.20 The banking system continued to be stable and sound, with banks maintaining prudential ratios in excess of statutory requirements. The banks continued to invest in up-to-date infrastructure to provide customers with a range of products and services, such as ATM connectivity across banks, Pula credit cards, telephone banking and internationally accepted visa-badged debit cards.

Chapter 2

Botswana's External Sector: Policies and Contribution to Economic Diversification 1991–2001

1. Introduction

1.1 Botswana's economic policies are outward-looking and predicated on the small size[1] of the economy and the benefits that normally derive from international trade and financial relations. The economic and financial relationships between Botswana and the rest of the world comprise trade in goods and services as well as short- and long-term financial transactions[2]. Export sales provide domestic producers with opportunities to benefit from economies of scale that may not be possible with reliance on the domestic market only. Similarly, imported goods and services widen the range of consumer choices in the domestic market and encourage a more efficient allocation of resources through enhancing competition. Among financial relationships, foreign direct investment (FDI) permits technological transfer while also relieving a country of the domestic saving and foreign exchange constraint to development.

1.2 The outward-looking approach is evident from several key components of the economic policy framework, especially the import tariff structure, exchange rate policy and a variety of trade protocols, including the Southern African Customs Union (SACU), the African, Caribbean and Pacific (ACP)–European Union (EU) trade agreement and the Southern African Development Community (SADC). Additional impetus has recently been given to international trade following the establishment of the World Trade Organisation (WTO) and the passing of the United States African Growth and Opportunity Act (AGOA), which provides Botswana with access to the large US market for a number of products. However, despite the existence of these international trade arrangements, Botswana's export destinations and sources of imports remain highly concentrated in a few countries. For instance, in 2001 South Africa accounted for more than three quarters of Botswana's imports while the UK was a leading export destination with a share of over 80 percent (mostly diamonds and beef).

1.3 The country's impressive economic performance over the years is largely a result of the performance of the export sector. However, this sector is dominated by diamond mining, which during the 1990s contributed on average 35 percent to Gross Domestic Product (GDP), 82 percent of export earnings and 53 percent of government revenue. The external sector affects the rest of the economy in a number of ways, but most importantly in Botswana through the revenues that accrue to Government and its impact on demand for domestically-produced goods and services as inputs, including employment. A further stimulus to the rest of the economy is through the sector's relative productivity, since its products face international competition. This latter factor has an important long-run effect on resource allocation.

1.4 While recognising the overall importance of the export sector, the high level of dependence on the diamond sector is a source of policy concern. It has, therefore, been Government policy to reduce the vulnerability arising from the heavy reliance on diamond mining by diversifying the export base. In pursuit of this objective, the Government has, over the years, designed and

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1 The concept of size as applied here refers to population and Gross Domestic Product.

2 The interactions with the rest of the world are recorded as the balance of payments accounts (See Appendix for a more detailed discussion of these accounts and their compilation in Botswana). These accounts have counterparts in the national income and expenditure accounts. For instance, a surplus on the current account is equivalent to net national savings (a surplus of domestic savings over investments). The stock of inward and outward investment (international assets and liabilities) is represented in the international investment position (IIP).

implemented a number of policies to promote the growth and development of the non-mining component of the external sector.

1.5 The external sector and related policies have been discussed and analysed in several previous annual reports. The *1994 Annual Report*, which had the theme *'Botswana and the International Economy',* highlighted the benefits of the outward-looking development strategy that had been followed since the attainment of political independence in 1966, contrasting it with an inward-looking approach. The theme also reviewed the policies required for promoting export growth, especially exchange rate and foreign investment policies. The importance of appropriate external sector policies was also stressed in the *1996 Annual Report*, which emphasised the need to maintain external sector viability and stability in order to guard against adverse effects of external shocks on the domestic economy. More recently, the coverage of the *2000 Annual Report* theme, *'The Challenge of Economic Diversification',* again recognised the key role of trade policy in promoting economic diversification. It was pointed out that although transitional adjustment problems may arise as the economy becomes increasingly open to external competition, the long-run resource allocation efficiencies arising from the openness were seen as beneficial to economic diversification.

1.6 Notwithstanding the coverage that has been given to the external sector in recent years, it is considered important to devote further attention to the external sector by making it the theme of this year's *Annual Report*, in recognition of the sector's central role in economic growth and diversification. Section Two of the Theme Chapter covers the characteristics of the external sector especially with respect to its structure and trends, as well as the commodity composition and geographical patterns of trade. This is followed by a review of external sector policies and strategies that have been pursued during the past decade, especially trade agreements at global, regional and sub-regional levels as tools of trade policy implementation. Section Three also discusses export promoting initiatives in support of economic diversification more generally. The role of the external sector in economic diversification is covered in Section Four, which highlights the degree to which the sector is linked to the rest of the domestic economy, focuses on employment, the extent to which sectoral output depends on external demand and the sector's contribution to government revenue. In the concluding section, it is noted that although there has not been significant export sector diversification during the past decade, except in the case of services, there have been gains in various sub-sectors with respect to employment. However, challenges remain in achieving export diversification. These include the need for sustained pursuit of appropriate policies, vigilance with regard to possible adverse aspects of, and potential conflicts between, various provisions of different trade agreements, and the need for a mechanism for regular reviews of the effectiveness of existing programmes and policies for the achievement of export sector diversification.

2. STRUCTURE AND TRENDS, 1991–2001

2.1 This section analyses the structure and trends of goods and services transactions during the 1991-2001 period[3], as well as the recent trends in flows of FDI to various sectors of the economy.

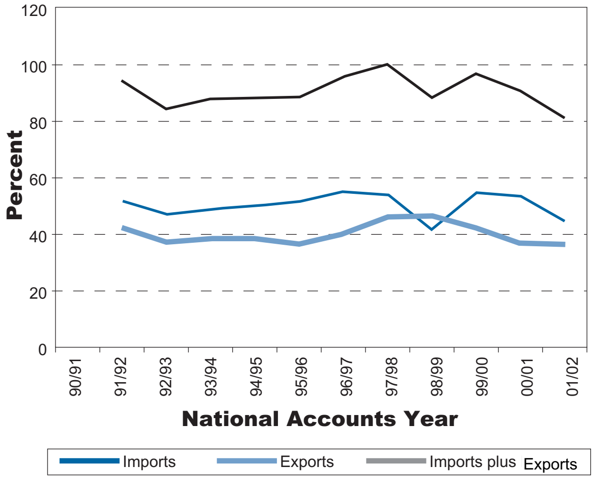
(a) The Size of the External Sector

2.2 Botswana's openness to external trade is evident from Chart 2.1 and Table 2.1. The total share of imports and exports of goods and services in GDP has consistently exceeded 80 percent, and has been close to 100 percent in some years. Exports have generally exceeded imports,

[3] Balance of Payments data is reported annually on a calendar year basis. Unless otherwise stated, data refer to calendar years, or the end of the calendar year as appropriate. However, national accounts data run from July to June, and therefore where references to GDP are included, the relevant national accounts year is used.

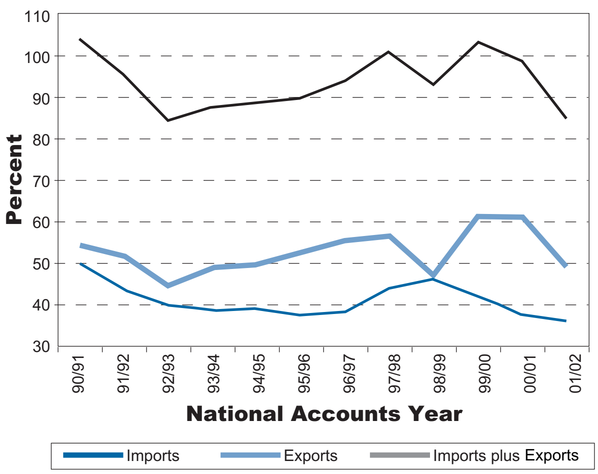
yielding large surpluses on the current account of the balance of payments; these surpluses averaged about 9 percent of GDP during the decade 1991–2001. As a result of these surpluses, and notwithstanding deficits on the financial account, there has been an accumulation of foreign exchange reserves over the years, which amounted close to 130 percent of GDP as at the end of 2001. The current account surpluses are mainly due to the good export performance of diamonds together with the choice of a fixed exchange rate policy, while more broadly pursuing prudent fiscal and monetary policies. The resulting accumulation of foreign exchange reserves reflects the fact that the country overall is a net saver, which has in turn been due to a combination of substantial surpluses in the government budget and private sector savings and investment decisions in the context of a fixed exchange rate regime.

CHART 2.2 IMPORTS AND EXPORTS OF GOODS AND SERVICES, PERCENT OF GDP (CONSTANT 1993/94 PRICES)



Source:Central Statistics Office

CHART 2.1 IMPORTS AND EXPORTS OF GOODS AND SERVICES, PERCENT OF GDP (CURRENT PRICES)



Source:Central Statistics Office

2.3 The overall positive current account performance has been accompanied by significant changes in the relative importance of imports and exports of goods and services, as might be expected as the economy undergoes transformation. These structural changes are examined further in the following sections.

TABLE 2.1 IMPORTS AND EXPORTS OF GOODS AND SERVICES, 1990/91 – 2001/02[1] (PERCENTAGE OF GDP, CURRENT PRICES)

	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/00	00/01	01/02
Imports	**49.8**	**43.6**	**39.8**	**38.6**	**38.9**	**37.3**	**38.2**	**44.0**	**46.3**	**41.8**	**37.5**	**35.8**
Goods	43.7	37.7	34.2	33.8	33.3	31.9	33.4	38.5	39.8	35.5	31.3	29.7
Services[2]	6.2	5.8	5.6	4.8	5.6	5.4	4.8	5.5	6.5	6.2	6.3	6.1
Exports	**54.3**	**51.9**	**44.8**	**49.0**	**49.5**	**52.2**	**55.7**	**56.5**	**46.7**	**61.4**	**61.2**	**49.1**
Goods	48.1	45.7	40.1	43.5	43.6	47.6	51.6	51.1	39.8	54.7	54.8	42.1
Services[2]	6.2	6.2	4.7	5.5	5.9	4.5	4.1	5.4	6.9	6.7	6.4	6.9
Imports Plus Exports	**104.1**	**95.4**	**84.5**	**87.6**	**88.4**	**89.5**	**93.9**	**100.5**	**93.0**	**103.2**	**98.7**	**84.9**

1. Year running from July to June.
2. The major services categories are transport, trade, financial and business services.

Source: Central Statistics Office

(i) Imports of Goods and Services

2.4 During the ten-year period 1990/91-2000/01, the share of imports of goods and services in GDP has generally shown a slight downward trend, albeit with some volatility due to the influence in some years of the implementation of specific large projects with high import content. As shown in Table 2.1, the ratio of imports of goods to GDP declined steadily from 43.7 percent in 1990/91 to 31.9 percent in 1995/96, before rising during the next three years to a peak of 39.8 percent in 1998/99, and then resuming its earlier downward trend to reach 29.7 percent in 2001/02. The rise in the ratio in the late 1990s was explained mainly by three major development projects: the Orapa diamond mine expansion; the North South Water Carrier (NSWC); and, the establishment of the Hyundai vehicle assembly plant. The modest underlying decline in dependence on imports may reflect increasingly developed backward linkages in the economy, which reduce the need to import inputs to production. However, in constant price terms, the ratio of imports to GDP has been less stable, suggesting that the trend identified above is due more to prices than changes in import volumes. The share of imports of services has, however, remained relatively constant over the same period, at around 6 percent of GDP.

2.5 The composition of imports (Table 2.2 and Chart 2.3) has varied during the period; due to volatility in the data series, however, caution must be exercised when interpreting this as evidence of structural change. The share of machinery and electrical equipment in total imports has risen progressively over the years, as has that of wood and paper products. The shares of vehicles and transport equipment as well as fuels and chemicals have remained stable. Imports of food, beverages and tobacco, metals and metal products as well as textiles and footwear have generally declined in relative importance, possibly suggesting a degree of import substitution for these products and a steady increase in the demand for other goods as the economy expands.

(ii) Exports of Goods and Services

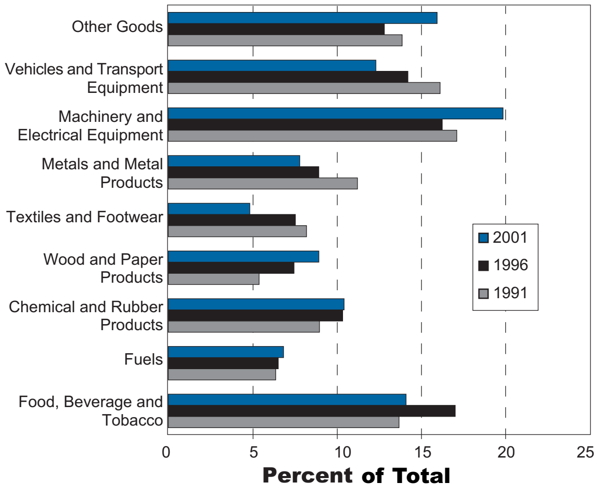
2.6 Table 2.2 shows that while there has been a declining trend in the ratio of imports of goods to GDP, the ratio of exports of goods to GDP has shown a slight upward trend between 1990/91 and 2001/02. When measured in constant prices (Chart 2.2), however, the share of exports of goods in GDP has fallen marginally, implying that the

TABLE 2.2 IMPORTS BY PRINCIPAL COMMODITIES (PERCENTAGE DISTRIBUTION)

Period[1]	Food, Beverages and Tobacco	Fuels	Chemicals and Rubber Products	Wood and Paper Products	Textiles and Footwear	Metals and Metal Products	Machinery and Electrical Equipment	Vehicles and Transport Equipment	Other Goods	Total Imports
1991	13.6	6.3	8.9	5.3	8.1	11.1	17.0	16.0	13.8	100
1992	18.7	5.5	9.4	5.7	7.0	10.8	18.8	10.0	14.1	100
1993	17.8	6.4	9.2	5.5	7.2	10.1	17.3	13.3	12.8	100
1994	17.6	6.0	9.7	5.8	8.9	9.3	17.6	12.0	13.2	100
1995	15.9	5.1	9.2	7.6	7.5	8.7	15.7	18.6	11.6	100
1996	16.9	6.4	10.2	7.3	7.4	8.8	16.1	14.1	12.7	100
1997	13.1	5.6	9.1	6.2	6.5	10.7	17.6	20.0	11.3	100
1998	13.1	4.6	8.9	6.9	6.0	10.1	21.2	16.3	13.1	100
1999	13.9	4.9	9.3	8.1	5.9	8.6	21.1	13.5	14.8	100
2000	14.1	4.9	9.7	7.7	5.8	7.2	22.2	12.4	15.9	100
2001	14.0	6.7	10.3	8.8	4.7	7.7	19.7	12.2	15.9	100

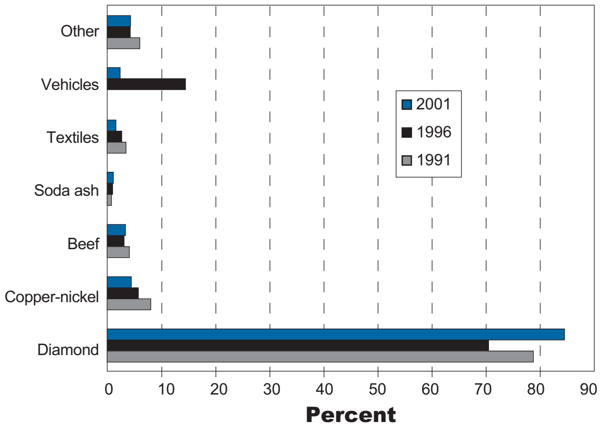
1. Calendar year.
Sources: Based on data from the Central Statistic Office and Bank of Botswana

CHART 2.3 IMPORTS BY PRINCIPAL COMMODITIES



Source: Central Statistics Office

CHART 2.4 PERCENTAGE DISTRIBUTION OF EXPORTS BY TYPE



Source: Bank of Botswana and Central Statistics Office

TABLE 2.3 PERCENTAGE DISTRIBUTION OF EXPORTS BY TYPE

Year	Diamond	Copper- nickel	Beef	Soda ash	Textiles	Vehicles	Other
1991	78.7	7.9	3.8	0.6	3.3	–	5.7
1992	78.9	7.2	4.1	1.2	2.1	–	6.5
1993	78.2	5.1	4.3	1.2	2.2	2.1	6.9
1994	74.9	5.2	4.3	0.7	3.6	6.1	5.3
1995	67.0	5.5	3.7	0.4	2.5	16.1	4.8
1996	70.4	5.5	2.9	0.8	2.4	14.1	4.0
1997	73.8	4.6	2.6	1.1	2.4	11.4	4.2
1998	69.5	5.0	3.9	1.1	3.5	11.1	6.0
1999	79.4	4.6	2.0	0.9	2.0	5.5	5.7
2000	82.3	6.0	2.2	0.7	1.8	2.0	5.1
2001	84.5	4.2	3.2	0.9	1.3	2.1	4.0

Sources: Bank of Botswana and Central Statistics Office

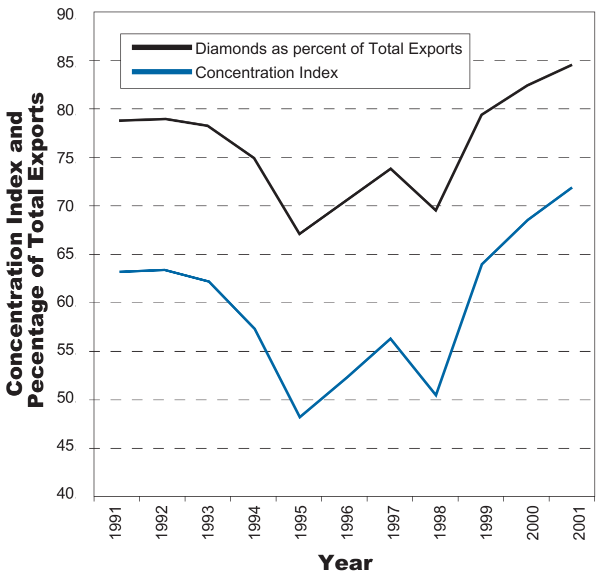
increased importance of merchandise exports to GDP is due to price rather than volume effects, and in particular to a rise in diamond prices. Also of significance is the upward trend in the relative contribution of exports of services, which implies progressive gains made by services including tourism, transport, financial and business services over the years.

2.7 There have also been important changes in the composition of exports during this period, as shown in Table 2.3 and Charts 2.4 and 2.5. During the first half of the 1990s, the share of diamonds in total exports fell, and exports became more diversified, due largely to the rapid increase in exports of motor vehicles. Between 1995 and 1998 diamonds accounted for less than 75 percent of exports, which was reflected in greater export diversification, as shown in the lower values of the Herfindahl index[4] in Chart 2.5, which measures the overall concentration of exports. From 1999 onwards, however, as the motor vehicle assembly operations encountered problems and eventually ceased production[5], the share of diamonds increased and

[4] The relative size of diamond exports in total is expressed by the Herfindahl Index calculated using the following formula: Index= $\Sigma(X_i/X)^2$ x 100, where X_i is the share of ith commodity in total exports, for i=1 to 7 (for diamonds, copper-nickel, beef, soda ash, textiles, vehicles and other commodities, respectively).

[5] The Hyundai plant closed in March 2001.

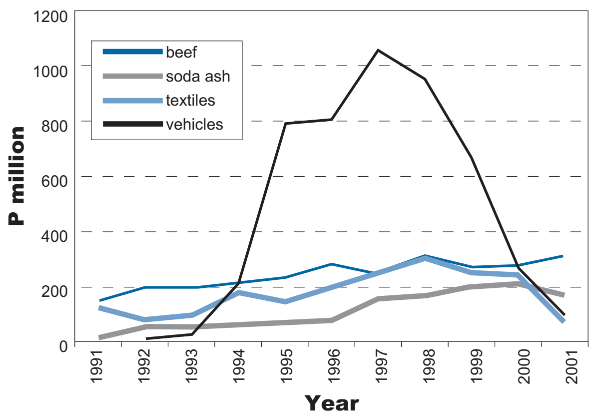
CHART 2.5 MEASURE OF CONCENTRATION OF EXPORTS



Source: Bank of Botswana using data from Central Statistics Office

Botswana, and reinforces the point made in the *2000 Annual Report* that export diversification should encompass services as well as goods, and that for a variety of reasons, the development of services exports may be more suited to Botswana's conditions.

CHART 2.6 NON-DIAMOND EXPORTS (P MILLION)



Sources: Bank of Botswana and Central Statistical Office

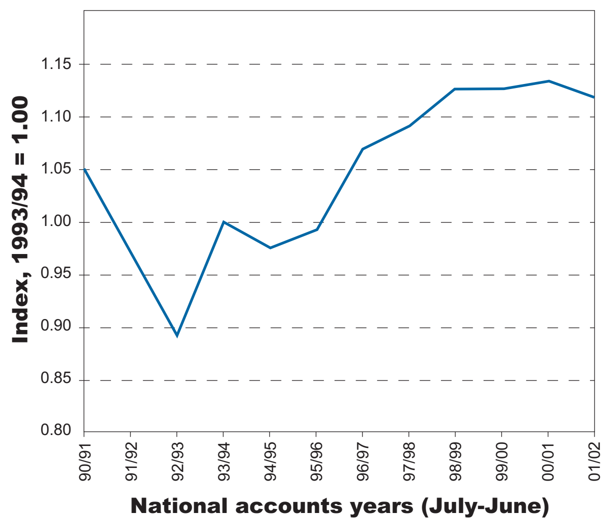
correspondingly, the relative degree of export diversification fell. As a result, by 2001 exports were less diversified than they were in 1990, whether measured by the share of diamonds in the total or the Herfindahl index. While the rise and subsequent decline of vehicle exports is an important factor explaining the trend in export diversification during the 1990s, it is also significant that several other important export commodities, notably copper-nickel, beef and textiles, experienced declining export shares over the period.

2.8 As indicated earlier, exports and imports of services have followed somewhat different trends to exports and imports of goods. Imports of services have been stable as a proportion of GDP while imports of goods have declined slightly; exports of services on the other hand have increased faster than exports of goods. As a result, trade in services has increased as a proportion of total trade, from 12 percent in 1990/91 to over 15 percent in 2001/02. This is in line with international trends which show services becoming increasingly important in international trade flows. It is also encouraging from the perspective of diversification in

(iii) Terms of Trade

2.9 The importance of rising export prices, especially diamond prices, in accounting for the rising share of exports of goods in GDP was noted earlier. The impact of rising export prices can also be seen in the terms of trade. As Chart 2.7 shows, the commodity terms of trade[6] have

CHART 2.7 TERMS OF TRADE



Source: Central Statistics Office

6 Calculated from the ratio of the export price deflator to the import price deflator.

risen over the period, with the increase particularly pronounced between 1992/93 and 1998/99. This may largely reflect an exchange rate effect, given that the Pula had appreciated against the rand (the main currency of import payments) and depreciated against the US dollar (the main currency of export receipts). Nevertheless, rising commodity terms of trade have contributed to increased national income over the period.

TABLE 2.4 DIRECTION OF TRADE – EXPORTS (PERCENTAGE SHARE IN TOTAL)

Year	SACU Region	Zimbabwe	Other Africa	Europe	USA	Other
1991	5.0	6.8	1.5	86.4	0.3	0.0
1992	6.9	4.5	1.5	86.7	0.3	0.1
1993	8.9	3.2	1.3	86.2	0.3	0.1
1994	13.9	2.7	1.0	81.5	0.7	0.2
1995	21.5	3.1	0.8	73.6	0.9	0.2
1996	18.3	3.1	0.6	76.8	1.0	0.3
1997	14.3	3.7	1.1	79.7	1.0	0.2
1998	17.2	2.9	1.3	77.1	1.0	0.6
1999	10.4	2.4	1.1	84.7	0.7	0.7
2000	6.7	3.9	0.9	87.2	0.6	0.7
2001	6.5	2.6	0.8	89.0	0.2	0.9

Source: Central Statistics Office

(b) Direction of Trade

2.10 In terms of overall indicators the Botswana economy is very open. However, there is currently a concentration on a limited range of exports as well as countries of export destination and sources of imports. The economy relies heavily on diamond exports to Europe, and in particular the UK, and on South Africa as the main source of imports.

2.11 Over the period 1991 to 2001, the major destination for Botswana's exports was Europe, accounting for an average of 82.9 percent of total exports, reflecting mainly rough diamonds and beef to the European Union (EU) (Table 2.4). Zimbabwe was an important export destination in the early 1990s, but its share has progressively declined since then. The share of exports to the Southern African Customs Union (SACU) region (mostly South Africa), increased between 1993 and 1998 and then declined sharply from 1999 to 2001. These movements were mainly a result of the initial rapid increase in exports of vehicles following the establishment of the Hyundai vehicle assembly operation and its subsequent closure. Although South Africa has been the principal destination for non-traditional exports[7], it is hoped that other markets will open in Europe and the USA as a result of trade liberalisation initiatives (see Section 3).

2.12 For imports, the SACU region accounted for an average of 78 percent of the total between 1991 and 2001 (Table 2.5). However, there has been a decline in the share of imports from the SACU region and a rise in the share for Europe, indicating some diversification of imports by source. In general, however, the direction of Botswana's trade indicates that there is very limited diversification of imports and exports, and this has not changed much over the past decade.

(c) Trends in Foreign Direct Investment

2.13 The current economic development strategy for Botswana emphasises the advantages of

7 Exports of goods and services other than minerals and beef.

TABLE 2.5 DIRECTION OF TRADE – IMPORTS (PERCENTAGE SHARE IN TOTAL)

Year	SACU Region	Zimbabwe	Other Africa	Europe	USA	South Korea	Other
1991	83.8	5.3	0.3	7.5	1.2	…	1.9
1992	85.0	4.9	0.4	7.1	1.0	…	1.7
1993	82.6	4.6	0.4	7.1	3.3	…	2.0
1994	78.0	5.9	0.5	8.4	1.9	2.1	3.3
1995	74.0	5.5	0.3	8.6	2.0	7.1	2.5
1996	78.0	5.7	0.4	6.8	1.3	4.4	3.4
1997	72.5	4.5	0.5	9.0	1.1	9.5	3.0
1998	74.8	3.9	0.6	10.1	1.4	4.8	4.4
1999	76.6	3.9	0.3	9.2	1.8	2.6	5.6
2000	73.9	3.5	0.3	16.5	1.6	0.2	4.0
2001	77.6	3.2	0.3	12.3	1.8	0.2	4.5

Source: Central Statistics Office

attracting foreign direct investment (FDI) to the country. Recent figures for FDI by economic sectors are shown in Table 2.6 below. The data show that from 1997 to 2001, total FDI increased by 196 percent, with the mining sector accounting for the largest share (81 percent) as well as the bulk of FDI growth. Non-mining FDI grew more slowly, by 145 percent over the period. Within the non-mining sector, the most important recipients were the finance sector (7 percent of total FDI) and the trade (retail and wholesale) sector (6.2 percent). Manufacturing experienced relatively slow growth of FDI, while FDI in the construction sector declined.

(d) Foreign Exchange Reserves

2.14 One of the major features of Botswana's external sector is the relatively high level of official foreign exchange reserves[8]. Several factors have

TABLE 2.6 FOREIGN DIRECT INVESTMENT BY SECTOR (P MILLION)

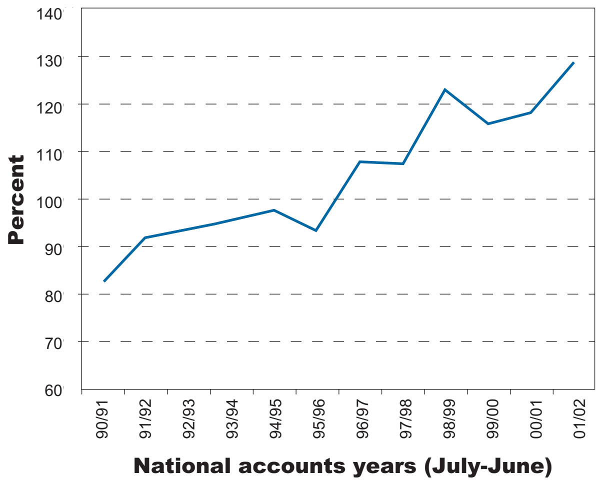
Sector	1997	1998	1999	2000	2001
Mining	2705	4903	5524	7792	8412
Manufacturing	246	333	273	344	274
Finance	228	226	523	619	729
Retail and wholesale trade	157	392	670	773	651
Electricity, Gas & Water	7	8	…	…	…
Real Estate and Business Services	65	112	144	161	115
Transport, Storage & Communication	31	47	43	105	96
Construction	31	30	8	16	23
Hospitality	44	60	83	75	135
Public Administration	…	…	…	…	…
Other	17	50	77	…	1
TOTAL	**3530**	**6160**	**7348**	**9885**	**10435**

Source: Bank of Botswana

8 Official reserves are defined as non-domestic financial assets acquired through external transactions by government or the monetary authorities. In addition to official reserves, foreign currency financial assets may be held by the banking sector and other economic agents. Such assets which are not under the direct control of the monetary authorities are not included for the purpose of this Section.

contributed to this. As noted earlier, exports have grown faster than imports, leading to rising current account surpluses. While these have been partly offset by capital outflows and deficits on the financial account, the overall balance[9] of the balance of payments has continued to record surpluses. This is in turn largely due to the maintenance of a fixed exchange rate, which has prevented the appreciation of the exchange rate that would have tended to eliminate such surpluses on the balance of payments under a floating rate regime. Between 1991 and 2001 the reserves have grown faster than the economy as a whole, and hence the ratio of reserves to GDP has increased steadily, from around 92 percent in 1990 to nearly 130 percent in 2001 (Table 2.7 and Chart 2.8).

CHART 2.8 THE LEVEL OF FOREIGN EXCHANGE RESERVES[1] (PERCENT OF GDP): 1991 – 2001



1. Foreign exchange reserves are as at end of each calendar year divided by GDP for corresponding national accounts years.

Sources: Bank of Botswana and Central Statistics Office

2.15 Although it is useful to look at the level of foreign exchange reserves in relation to the size of the economy, the adequacy of the level of reserves is more often measured by months of import cover, the ratio of short-term external debt to foreign reserves, or the ratio of a combination of imports and debt servicing measures to foreign reserves. In the case of Botswana, the indicator used is months of import cover of goods and services. This measure relates the level of reserves to the openness of the economy. The import cover focuses on the current account and is, therefore, suitable for small open economies, that have limited access to international capital markets[10]. For Botswana, import cover increased

TABLE 2.7 CURRENT ACCOUNT, OVERALL BALANCE, AND FOREIGN EXCHANGE RESERVES AS A PERCENTAGE OF GDP

Year	P million			Current account (Percent of GDP[1/])	Foreign Exchange Reserves (Percent of GDP[1/])
	Current Account Balance	Overall Balance	Foreign Exchange Reserves		
1991	612	764	7 707	7.3	92
1992	417	861	8 561	4.6	94
1993	1 035	980	10 509	9.4	95
1994	568	379	11 961	4.6	98
1995	831	591	13 249	5.9	93
1996	1 643	1 722	18 322	9.3	108
1997	2 634	2 318	19 076	13.1	107
1998	860	256	26 485	4.0	123
1999	2 859	1 929	28 852	11.5	116
2000	2 782	1 941	33 880	9.7	118
2001	3 687	1 024	41182	8.0	129

1. GDP figures are given in National Accounts years, running from July to June. Other figures are for calendar years.

Sources: Based on data from Bank of Botswana and Central Statistics Office

9 The overall balance shows the net balance on the current account, capital and financial accounts of the balance of payments. It is equal to movement in the official reserves excluding valuation adjustments.

10 See *Bank for International Settlement Review 30/2002*.

from 25 months at the end of December 1991 to 41 months at the end of December 2001. This cover is considerably higher than the conventional three-month benchmark used internationally. However, the peculiar nature of the Botswana economy, its susceptibility to balance of payments shocks and reliance on diamonds and the fixed exchange rate all appear to support the case for a relatively high level of import cover.

2.16 Botswana's foreign exchange reserves are held in order to facilitate transactions with the rest of the world including the financing of government's foreign purchases and servicing government's foreign debt. The reserves also act as insurance against unanticipated external or domestic supply shocks, while the income earned on the invested balances is a source of revenue for the government. Moreover, the reserves impart a favourable outlook to foreign investors from the perspective of the country's ability to settle its external obligations. Beyond the immediate use of foreign exchange reserves, they can be regarded as national savings from which future income can be derived following the depletion of Botswana's diamonds as a source of income.

2.17 However, while there are advantages associated with a high level of foreign exchange reserves, there may be disadvantages as well. For instance, the opportunity cost of accumulating reserves is forgoing domestic investment. Botswana, however, already has a very high investment rate, and it is unlikely that investment could be increased much further without experiencing absorptive capacity constraints. Spending the reserves in the absence of high return investments is likely to be both inflationary and wasteful, and lead to a progressive deterioration of the external accounts. Finally, holding a high level of reserves is normally associated with low or non-existent foreign borrowing. Since international lenders typically impose some discipline on a country's macroeconomic policies, whether through international financial markets or institutions, the absence of such borrowing may lead to laxity in macroeconomic policies; for example, a prolonged defence of an overvalued exchange rate. One reason that Botswana sought an international credit rating, despite not borrowing significantly in international markets, was to obtain the benefits of such external discipline.

2.18 The extent to which Botswana will continue to accumulate reserves will depend upon, *inter alia*, the soundness of macroeconomic policies and their implementation, the pace of export performance, developments in global markets and exchange rate policy.

(e) Export Intensity or Extent of Dependence on External Markets

2.19 This sub-section focuses on the extent to which the various sub-sectors of the non-mining economy depend on external demand for their activities[11]. One measure of dependence on external markets is the ratio of exports to gross sectoral output, shown in Chart 2.9. Data for the various sectors are taken from the Social Accounting Matrices (SAM), comparing 1993/94 and 1996/97 (the most recent years for which data was available). The sectors are ranked according to the size of the ratio for the latter period.[12]

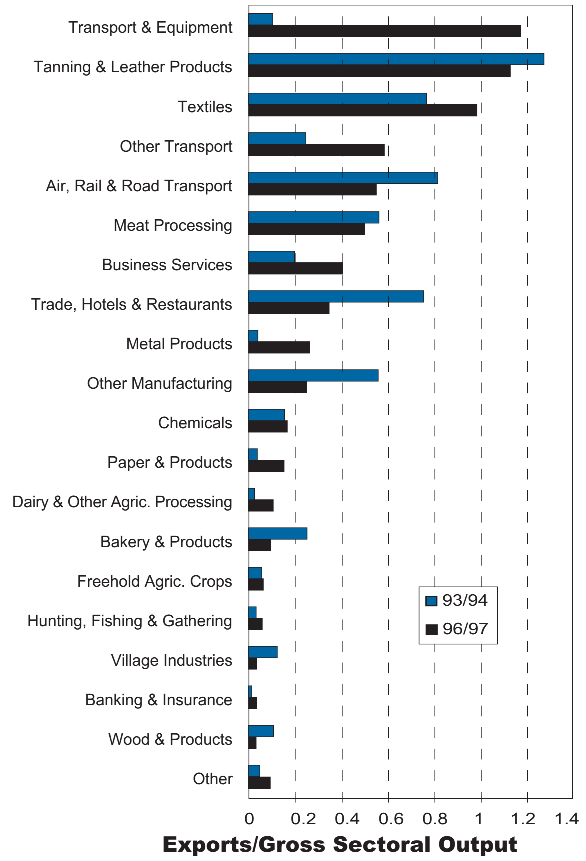
2.20 The sectoral ranking indicates that there was significant export intensity in several sub-sectors of manufacturing in 1996/97, mainly transport equipment, tanning and leather products, textiles and meat processing. The remaining manufacturing sub-sectors mainly supply the domestic market, for instance, manufacture of wood and metal products required by the construction sector, producers of bakery and dairy products, and those that supply government

11 Mining is excluded to keep the focus of interest in terms of the future development and diversification of the economy.

12 For some sectors (transport and equipment as well as tanning and leather products in 1996/97) this ratio exceeds 100 percent, reflecting a heavy export orientation together with a substantial (relative to the size of the sector) re-export trade, an effect that will also impact on other sectors.

with locally-produced products on a preferential basis. Some non-manufacturing sectors are as well highly export oriented: air, rail and road transport, trade, hotels and restaurants, and business services. Some transport sub-sectors also showed significant export orientation.

CHART 2.9 EXPORT INTENSITY BY ECONOMIC SECTOR



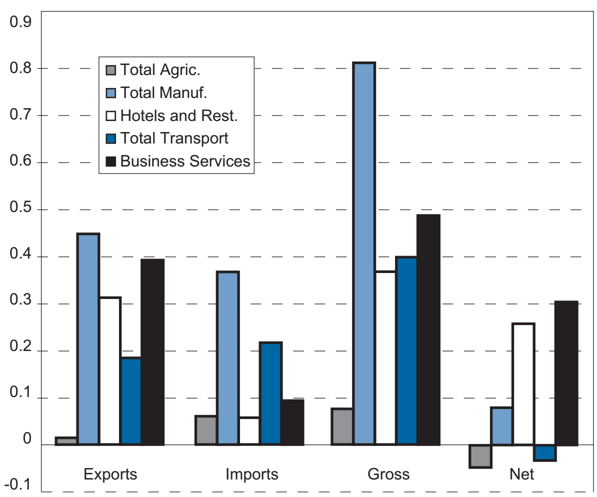
Source: Bank of Botswana using data from Central Statistics Office

2.21 Comparing the two periods, there was far greater export intensity in the latter period in the transport and equipment sub-sector. This development was explained by the commencement of the motor vehicle exports by the Hyundai production plant. For the manufacturing sector as a whole, export intensity, which was only 25 percent in 1993/94, had risen sharply to 45 percent in 1996/97. When the transport and equipment sub-sector is excluded the ratio was constant at 26 percent in both periods. There was also a considerable increase in the export intensity for business services.

2.22 The focus on export ratios ignores the role of imports in the external sector. For instance, the development of the motor vehicle export industry in the mid to late 1990s was heavily dependant on imports, with relatively low linkages with the domestic economy. It is important, therefore, to examine the degree to which an export sub-sector depends on the external markets for supplies as well as outlets for their products. These alternative measures of the degree of export orientation can be measured by the ratio of the sum of exports and imports (gross measure) or the ratio of exports net of imports (net measure) to the sectoral gross output. The former measure provides some indication of the overall extent of a sector's linkage with the external markets, while the latter suggests the degree to which the export activities of the sub-sector impact on the rest of the economy.

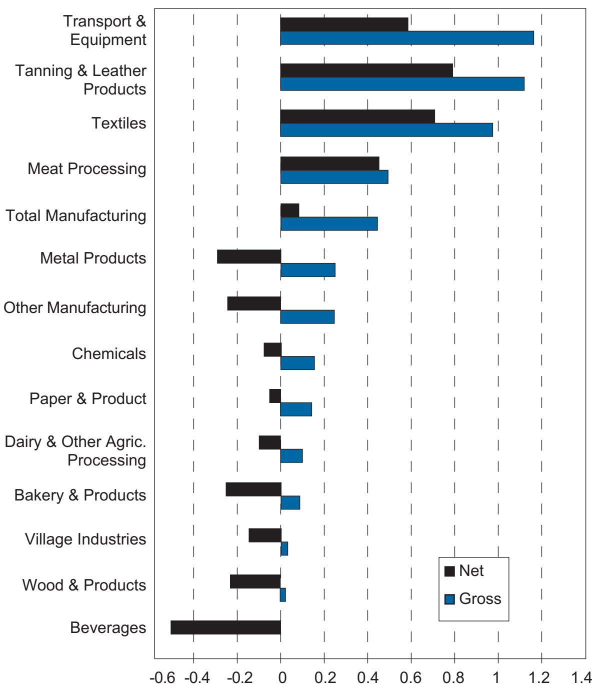
2.23 Chart 2.10 shows the various measures of the degree of external orientation of selected economic sectors in 1996/97. For the manufacturing sector the various measures present mixed results. The sector is the most export-oriented by the gross measure but one of the least ranked by the net measure due to reliance on imports in several sub-sectors. While

CHART 2.10 ALTERNATIVE MEASURES OF EXTERNAL ORIENTATION, 1996/97



Source: Bank of Botswana using data from Central Statistics Office the sector as a whole had a positive net intensity, for many of its sub-sectors, which accounted for 61 percent of manufacturing gross output, this was not the case (Chart 2.11). The overall net intensity was heavily influenced by textiles and the meat processing sub-sectors, with the latter dominated by the export-orientated Botswana Meat Commission (BMC), which has negligible imports. For the business services as well as hotel and restaurants sub-sectors, however, the degree of export intensity did not change regardless of the measure used due to their greater reliance on labour inputs rather than imports.

CHART 2.11 GROSS AND NET EXPORTS AS PORPORTION OF TOTAL OUTPUT - MANUFATURING SECTOR (1996/97)



Source: Bank of Botswana using data from Central Statistics Office

3. POLICIES AND STRATEGIES

3.1 Botswana's small market makes it imperative that the country adopts an export-oriented growth strategy, implying entering into international trade arrangements. In this regard, Botswana's trade policy is closely linked to the SACU[13] agreement, under which all other trade negotiations or agreements with third parties must be acceptable to other SACU members. In general, Botswana's trade policy seeks to 'achieve the broadest possible free and dependable access for Botswana's industrial products and services'[14]. This broad objective is pursued mostly through membership in a range of multilateral trade agreements.

(a) Trade Agreements

3.2 Botswana has, over the years, entered into a number of multilateral trade agreements and also has a bilateral trade agreement with Zimbabwe. The agreements have concentric characteristics, with the broadest trade agreement framework being of the World Trade Organisation (WTO), followed by regional agreements including those between African, Caribbean and Pacific (ACP) states, as well as the European Union (EU), and between countries in sub-Saharan Africa and the USA under the African Growth and Opportunity Act (AGOA). There are also the sub-regional arrangements such as SACU and the Southern African Development Community (SADC). The objective of Botswana participating in these agreements is to facilitate the country's export growth and, therefore, the diversification of the economy.

(i) World Trade Organisation (WTO)

3.3 The World Trade Organisation (WTO) came into being on January 1, 1995 as a result of the final round of the General Agreement on Tariffs and Trade (GATT) negotiations, the Uruguay Round. The WTO administers the implementation of a set of agreements, monitors national trade policies and deals with trade disputes. The agreements include those of the GATT, which focuses mainly on trade in goods, as well as others relating to services and property rights. The WTO agreements also contain a framework

13 The member states are South Africa, Namibia, Botswana, Lesotho and Swaziland. The provisions of the SACU agreement are outlined in Section 3(a) (ii) below.

14 World Trade Organisation, *Trade Policy Review Body, 1998.*

for the enforcement of rights and obligations of member countries, and provides for technical assistance and training to developing countries on trade-related matters.

3.4 While covering a wide range of activities, the WTO agreements are based on some fundamental principles aimed at ensuring that international trade is non-discriminatory, free, competitive, predictable and more beneficial to less developed countries.

3.5 The WTO agreements serve as the umbrella to all other trade-related agreements between WTO members to ensure their consistency with the organisation's principles. However, while the principles of WTO are generally beneficial to a developing country such as Botswana, by expanding export market access, there are problems with the practical application of those principles that are constrained by a number of other provisions that favour developed countries. For instance, although WTO agreements liberalise trade, access of some textile and agricultural products to the markets of developed countries remains restricted. This is disadvantageous to many developing countries, although in Botswana's case, the restrictive provisions are largely offset by concessions gained under various multilateral and bilateral trade agreements. Botswana is also a beneficiary of the various provisions of the WTO such as the one that grants a waiver for the ACP/EU Trade agreement, thus permitting Botswana to continue accessing the European beef market without breaching the WTO's most favoured-nation (MFN) agreement[15].

3.6 The restrictions on access of textiles and agricultural goods to markets in the developed countries contrast with the treatment of financial services and telecommunications in which developed countries have a comparative advantage, and which have been placed on a fast-track liberalisation route. The forthcoming Trade Related Intellectual Property Rights (TRIPS) Agreement protects formal innovation, which is common in the industrialised countries, while informal innovations found in most developing countries are provided with little or no protection. Nevertheless, a TRIPS agreement provides for flexibility in policies related to public health, including the sourcing of medication especially for the HIV/AIDS pandemic. Similarly, although the objectives of the Trade Related Investment Measures (TRIMS[16]) Agreement is to strengthen rules that protect weaker economies against uncontrolled foreign investment, it provides no control over the so-called 'positive' investment measures found in the investment incentive schemes utilised mostly by the industrialised countries.

3.7 Notwithstanding their numerical superiority, most developing countries have limited impact on the principal decisions of world bodies such as the WTO. With lesser economic and political power, the developing countries negotiate with little or nothing to exchange for concessions in their favour. Moreover, most developing countries lack the human resource capacity to deal with sophisticated negotiations and to bargain on the basis of research findings on crucial issues.

3.8 Although there are some benefits to be derived from the WTO, the implementation of the various provisions of the trade agreements often impose an administrative burden on developing countries which stretches their respective institutional capacities.

(ii) Southern African Customs Union (SACU) Agreement

3.9 The SACU agreement, which began in 1910, is in effect Botswana's main multilateral trading agreement[17]. The aim of SACU is:

15 WTO members are required to offer the same treatment to any other member with regard to trade.

16 The WTO agreement on TRIMS deals with investment measures that restrict and distort trade, such as the local content requirements or import or foreign exchange limits.

17 The original member states were South Africa, Botswana, Lesotho and Swaziland. Namibia joined in 1990 after attaining independence.

> '…maintaining the free trade of goods between the member countries and applying the same tariffs and trade regulations to goods imported from outside the common customs area … on a basis designed to ensure the continued economic development of the customs union area as a whole, and to ensure in particular that these arrangements encourage the development of the less advanced members of the customs union and the diversification of their economies, and afford all parties equitable benefits arising from the trade amongst themselves and with other countries'[18].

It provides for a common external tariff structure and duty-free movement of goods originating from within the Customs Union, except in specified exceptional circumstances. For example, if Botswana, Namibia, Lesotho and Swaziland (BNLS) deem any of their industries to be of major economic significance or 'an infant', then the agreement allows for additional duties to be applied after consultation, in order to afford the targeted industries the needed protection for a limited period of time. Import taxes and duties are applied on commodities originating outside of SACU, as both a protectionist and a revenue-raising measure. A common revenue pool is held and managed by South Africa in a consolidated revenue fund for distribution among the members.[19] SACU forms the basis for all agreements that SACU member countries may enter into. SACU members are free to enter into other agreements either collectively or separately, but such agreements must not be at variance with the provisions of the SACU agreement. It is SACU, therefore, that determines the nature and form of Botswana's external tariff policy.

3.10 By the time the BLS (Botswana, Lesotho and Swaziland) states gained Independence in the 1960s, it was realised that the revenue allocated to members other than South Africa was not commensurate with the imports into the respective national markets. As a result, the provisions of SACU were amended in 1969. The revised Agreement sought to compensate SACU members for various negative aspects of membership, including the following:

- The 'price-raising effect' on imports into BNLS countries resulting from the tariff that protected South African industries from international price competition;
- The 'industrial polarisation effect' that was caused by many industries' preference to locate in South Africa; and
- The 'loss of fiscal discretion' given that South Africa sets the tariff and excise duties for the entire Customs Union.

3.11 The 1969 renegotiated agreement resulted in an increase in the allocation of resources from the common revenue pool to smaller SACU members, for example, Botswana's Customs Union receipts rose from R3 million in 1967 to R50 million in 1975[20]. SACU receipts have, until recently, been the second most important source of government revenues after mineral revenues.

3.12 However, further problems emerged under the revised 1969 SACU arrangement, including the delay in distributing revenue caused by procedural issues, especially the collection and presentation of required documentation on imports; and the difficulties faced by the BLNS countries in utilising the provisions in the SACU agreement for protecting their 'infant industries'[21]. Concerns about these issues in the BNLS countries gathered momentum during the 1970s. There was also need to democratise the

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18 Davies R. 'The Southern African Customs Union (SACU): Background and possible issues for negotiation facing a democratic South Africa' in: *Reconstitution and Democratising the Southern African Customs Union,* 1994, p.29. Sisulu, Nkosi Morley, Setai and Thomas H. Rosalind (eds.)

19 The distribution was based on annual shares of imports.

20 World Bank, Reports N. 1126 BT '*Botswana Opportunities for Industrial Development in Botswana: An Economy in Transition'*, April 28, 1993.

21 Botswana, for instance, has only twice made use of this provision.

22 World Trade Organisation, *Trade Policy Review Body, 'Trade Policy Review Botswana', 1998,* and *World Bank Report N. 11267 BT, 1993, pg. 32.*

BOX 2.1 THE 1969 AND THE 2002 SACU REVENUE SHARING FORMULAE[23] – A COMPARISON

1. The 1969 Formula

S = (A+B+C)/(D+E+F+G)*H*1.42

Where:

S = share of the revenue pool accruing to a particular BLNS country

A = value of goods imported (cif) into that country

B = value of excisable goods produced and consumed in that country

C = excise and sales duty paid on B

D = cif value of imports into SACU

E = customs and sales duty paid on D

F = value of excisable goods produced and consumed in the SACU region

G = duties paid on F

H = Accumulated SACU revenue in the year

NB: A 42 percent provision is made in the formula in favour of the BLNS countries as a compensation factor for these countries. The 42 percent is deemed to account for factors noted in paragraph 3.10.

2. The 2002 Formula

$\rho_{Bot} = (\Sigma\mu_t - \phi_t) * \gamma(\varphi_t + \varepsilon_t + \delta_t)$

Where:

ρ_{Bot} = share of the revenue pool accruing to Botswana

$\Sigma\mu$ = size of the SACU pool

ϕ = Operating costs (secretariat, tariff board andTribunal)

γ = Botswana's share of the various components

φ = Customs component

ε = Excise component

δ = Development component

agreement, revise the technical formula for revenue sharing, and establish a dispute settlement mechanism[22]. Accordingly, renegotiation of the SACU agreement was started again in 1994. A draft agreement was reached on October 19, 2001, and the final agreement was signed on October 21, 2002.

3.13 The revised 2002 agreement is more democratic and provides for institutional structures for the implementation of the agreement, comprising a Council of Ministers as the supreme policy making body; a Commission consisting of senior officials from member states; a Secretariat responsible for the day-to-day administration of the agreement; the SACU headquarters to be located in Namibia; a Tribunal which will adjudicate disputes; and a Tariff Board consisting of experts from member states which will make recommendations to the Council of Ministers

23 At the time of writing, the 1969 formula was still in force and is expected to remain operational until the mechanisms and processes have been put in place for the implementation of the new 2002 Agreement.

regarding the level of, and changes in tariffs on goods originating outside the SACU area. Moreover, the new agreement incorporates a revised revenue sharing formula through which members will share the customs duty revenue in proportion to their intra-SACU imports; 85 percent of the total excise duty revenue will be proportional to each member's GDP; while the remaining 15 percent of the excise duties will accrue mostly to the less developed members. Another significant change to the earlier agreement is that South Africa will no longer be the sole custodian of the common revenue pool, the location of which will now be determined by the Council of Ministers. Member states may also now enter into agreements with third parties while adopting a common approach[24].

(iii) Africa Growth and Opportunity Act (AGOA)

3.14 Under this arrangement the US opened access for Botswana's products especially textiles, to the US market duty free and without quotas[25]. Yarns and fabrics that are not available in the USA would also be duty free. However, US imports of apparel from Africa made of African fabric and yarn, which are duty free, are subject to a limit of 1.5 percent to 3.5 percent of total apparel imports. Beyond this limit AGOA's preferential treatment will not apply. In general, AGOA provides for duty-free and quota-free entry to the US for almost all manufactured products. However, the implementation aspects of the agreement suggest that textiles and apparel are given first priority under AGOA, and are likely to be the most relevant commodity for many African countries.

3.15 AGOA also offers benefits through the Generalised System of Preferences (GSP) Programme for 8 years. As part of its implementation process for the agreement, a US-Sub-Saharan Trade and Economic Forum was established to facilitate regular trade and investment policy discussions and allow for negotiations of free trade areas (FTAs) between the US and interested Sub-Saharan countries. The agreement also promotes the use of technical assistance to strengthen economic reforms and develop the cementing of relationships between US firms and their counterparts in sub-Saharan Africa.

3.16 The benefits established under AGOA are extended only to countries which meet specific criteria. The criteria include 'best practice' policies that will ultimately help to attract trade and investment as well as foster broadly-shared prosperity. They also include protection of a market-based economy, good governance, elimination of trade barriers, appropriate labour practices, poverty reducing policies and the protection and upholding of human rights. Countries designated as eligible or beneficiaries are required to undergo annual reviews of their status. Countries can be added or withdrawn based on the findings of the reviews.

3.17 Although it failed to meet the strict definition of a lesser-developed beneficiary country, Botswana satisfied all other eligibility criteria of AGOA from its inception. Following the passing of AGOA II on August 6, 2002, Botswana and Namibia, were classified as 'lesser developed beneficiary countries' for purposes of AGOA despite having per capita GNP of over $1500. Botswana products eligible to benefit from AGOA provisions include, among others, textile and apparel goods. In 2001, Botswana's duty-free exports to the United States of America under AGOA were valued at about $ 1.2 million, all of which were shipped under the GSP provisions of the AGOA Act.

(iv) Botswana-Zimbabwe Trade Agreement

3.18 The Trade Agreement between Botswana and Zimbabwe has its origins in the 1956 Customs Agreement between the Federation of Rhodesia and Nyasaland, Bechuanaland Protectorate and

24 The operational details of the 2002 agreement such as the competition policy (which will probably include the local content requirements and/or their absence) are yet to be determined.

25 Previously, there were quotas on Botswana's exports of textiles and apparel products to the USA.

Swaziland[26]. The agreement has, however, experienced some problems, with Zimbabwe imposing import quotas and tighter local content requirements on Botswana's exports following the relocation of some of Zimbabwean enterprises to Botswana to avoid Zimbabwean foreign exchange controls[27]. Zimbabwe has also been concerned about Botswana being a possible conduit for South African goods into Zimbabwe through Botswana's membership of SACU.

3.19 In 1988 a new agreement was negotiated between the two countries. The new agreement provided for the removal of customs duties and quantitative restrictions on goods that originate from the two countries, implying emphasis on local content requirement. The local content requirement is such that manufactured goods must contain at least 25 percent value-added from within the two trading partners. This requirement, however, created administrative problems of documentation verification by customs officials.

3.20 Trade between the two countries rose in the late 1980s and early 1990s as Zimbabwe became an important market for Botswana's exports of manufactured goods. However, this trade was negatively affected following Zimbabwe's adoption of a structural adjustment programme. Recent macroeconomic problems in Zimbabwe, particularly the contraction of the economy and the shortage of foreign exchange, have continued to adversely affect trade between the two countries such that as at the end of 2001 Zimbabwe absorbed only 3 percent of Botswana's manufactured exports.

(v) African, Caribbean and Pacific–European Union (ACP–EU) Partnership Agreement

3.21 The Cotonou Agreement (formerly the Lomé Convention) is a treaty between 81 African, Caribbean and Pacific (ACP) countries and the European Union (EU). This agreement allows for tariff-free entry of ACP countries' goods into the European market subject to some generous quotas. For example, Botswana's beef quota to the EU is 18 916 tonnes per annum until 2008. At no stage has Botswana been able to fulfil this quota partly as a consequence of frequent natural disasters including drought and outbreaks of diseases.

3.22 The association between the ACP and the EU, was in the form of the Yaounde 1 (1963–1969) and Yaounde 2 (1969–1975) agreements. During this period most of the African signatories were French-speaking African nations that had gained political independence from France. When the United Kingdom joined the European Economic Community (EEC) in 1973, the wider Lomé 1 agreement was negotiated to include former British-ruled countries; it thereafter comprised 46 ACP[28] countries and 9 EEC member states. Since then the Lomé Convention has been reviewed and updated every five years.

3.23 The Lomé Convention was considered a highly innovative model of international cooperation, as it included such features as equal partnership, aid and trade, mutual obligations and joint administration. The Lomé 4 agreement expired in February 2000. Negotiations for a new agreement started in September 1998, and resulted in the signing of a new EU-ACP agreement in June 2000 in Cotonou, Benin.

3.24 The Cotonou agreement is designed to last for twenty years, with provision for revision every five years. Accompanying the agreement is a financial protocol that covers each five-year period. It indicates the total resources available to the ACP countries through the European Development Fund (EDF).

3.25 Central to the new EU–ACP agreement is the reduction and eventual eradication of poverty, while contributing to sustainable development and gradual integration of the ACP countries into the world economy. This cooperation is based on a set of fundamental principles namely;

26 World Bank, 1993, p32

27 op. cit p 32

28 Botswana joined with this group.

equality of partners and ownership of development strategies; expansion of participants; dialogue and mutual obligations as well as differentiation and regionalism.

(vi) Southern African Development Community (SADC)

3.26 In 1980, Botswana co-founded the Southern African Development Coordination Conference (SADCC), which changed its name in 1992 to SADC[29]. Institutionally, SADC comprises the Heads of State and Government, which form the supreme policy-making body, the Council of Ministers, and a Secretariat. Botswana hosts the SADC Secretariat. In 1992, SADC changed its focus from that of reducing economic dependence on South Africa to that of broadening regional economic corporation and integration. The SADC organisation emphasises the easing of trade restrictions within the community through the creation of a free-trade area with the ultimate objective of the creation of a common market. Besides the removal of trade restrictions, SADC envisages free movement of goods, services, capital and labour as well as political cooperation. In the field of development, SADC promotes cooperation in areas of transport, communications, tourism, energy, industry and mining between member states with each country allocated the responsibility of implementing programmes in a particular sector.

3.27 The SADC member states signed a Trade Protocol in September 2000[30], which envisaged the creation of a SADC free trade area by 2004. The Trade Protocol further provides for the liberalisation of intra-regional trade in goods and services on the basis of a fair, mutually equitable and beneficial trade arrangements, complemented by protocols in other areas; ensuring efficient production within the SADC reflecting the current and dynamic comparative advantages of its Members; contribution towards the improvement of the climate for domestic, cross-border and foreign investment; and the enhancement of economic development, diversification and industrialisation of the region.

3.28 The Protocol specifically provides for a phased elimination of tariff and non-tariff barriers to intra-SADC trade. After a period of eight years, 85 percent of intra-regional trade is expected to be free from tariff barriers, with the eventual elimination of all trade restrictions by 2012. Under the agreement SACU members are expected to liberalise their trade barriers relatively faster than other less-developed SADC members.

3.29 Subsidies are prohibited under the Protocol so as to avoid distorting competition, except as permitted under the provisions of the WTO. The Protocol also provides for the protection of new industries for a specific period. Safeguard measures are allowed only in situations where the imports of goods threaten to cause serious injury to a particular domestic industry, as determined by the WTO agreement on safeguards. Member states can only apply for safeguard measures for such period as is necessary to prevent or remedy serious injury, but not to exceed eight years. The Protocol also provides for anti-dumping measures consistent with WTO provisions.

3.30 Reconciling the visions of SADC, which is that of a free-trade community, and a duty-free movement of goods only within SACU members, is potentially a challenge to SACU member countries. Part of the challenge lies in the fact that the lowering or the eventual elimination of tariffs on goods imported from non-SACU SADC members carries the risk of reducing SACU revenues. Moreover, SACU members lack the ability to unilaterally change the common external tariff structure to reduce

[29] Southern African Development Community (SADC) currently comprises Angola, Botswana, the Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, the Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

[30] The Democratic Republic of the Congo, Angola and Seychelles did not sign the protocol, but have the option to sign when circumstances permit.

input costs, which would enhance the competitiveness of their exporters, while the rest of the SADC members do not face such a problem and can unilaterally change their external tariff structure. In effect, SACU members' restrictions on their tariff policy may mean loss of competitiveness to other SADC members. Botswana's acceptance of the SADC Trade Protocol would suggest that the country finds the potential loss of SACU revenues acceptable as a trade off to the expected benefits to be derived from the SADC trade agreement. However, in an environment in which revenues from diamonds are no longer expected to grow at rapid rates, the loss of SACU revenues may further weaken the Government's revenue base unless receipts from other SADC-related export earnings increase.

(vii) Other Arrangements

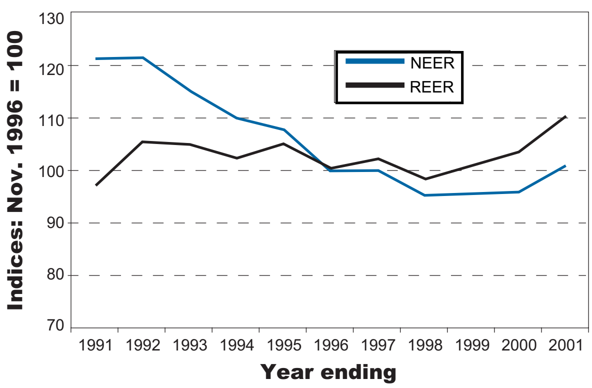
3.31 Botswana has benefited from the WTO's Generalised System of Preferences (GSP), a tariff reduction facility offered by industrial countries to designated Less Developed Countries (LDCs) on certain export products[31]. Foreign investors, especially in the textiles sub-sector, have been attracted to locate their operations in Botswana in order to utilise the country's unused GSP facility and export to the USA. Since Botswana's trade with USA is presently small, accounting for less than 1 percent in 2000, there is scope for the expansion of exports under the GSP over and above the AGOA arrangement.

(b) Exchange Rate Policy

3.32 Broadly, Botswana's macroeconomic policy aims at maintaining a stable real effective exchange rate (REER) in order to ensure international trade competitiveness. Toward this end, the exchange rate policy maintains a stable nominal effective exchange rate (NEER) of the Pula by pegging the currency to a basket of currencies comprising the Special Drawing Rights (SDR) and the South African Rand (ZAR) in proportions that reflect Botswana's trade shares. By promoting stability of the nominal effective exchange rate, the exchange rate mechanism has also acted as a nominal anchor for monetary policy.

3.33 Chart 2.12 shows the real effective exchange rate of the Pula, the movements of which are affected by changes in both the NEER and relative inflation in Botswana and trading partners. The REER has been fairly stable during the period under review, especially up to 1999, although it has appreciated somewhat since 2000. For most of the period under review, Botswana inflation has been higher than that of major trading partners. Between 1991 and 1999, this was offset by the depreciation of the NEER, leading to stability in the REER. Since 2000, however, the combination of NEER appreciation and relatively high inflation in Botswana has caused the REER to appreciate. Monetary policy is focused on ensuring that Botswana's inflation is no higher than the average inflation across trading partners, thereby supporting the stability of the REER in the context of the fixed nominal exchange rate.

CHART 2.12 REAL AND NOMINAL EFFECTIVE EXCHANGE RATES



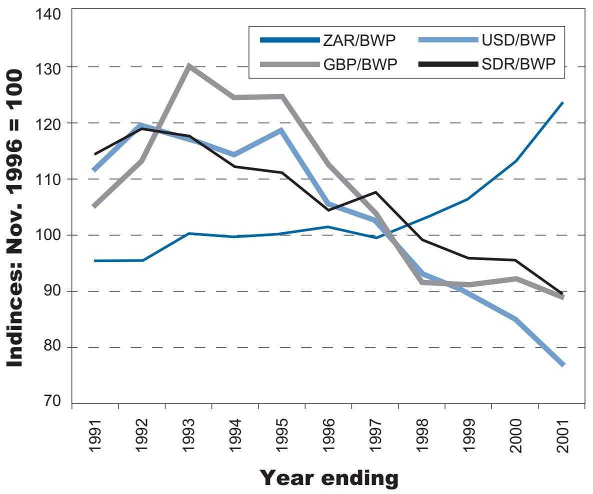
Sources: Bank of Botswana and Central Statistics Office.

3.34 To a large extent the evidence from movements in the REER points to the success of the policy objective of maintaining a stable REER. However, it should be noted that the REER is an overall measure of the movement of the Pula after allowing for relative inflation with major trading partners. As a result, it can hide major

[31] World Bank, 1993, p 33

divergences and fluctuations in bilateral real exchange rates. Chart 2.13 shows movements in real bilateral exchange rates. It can be seen that the Pula's real bilateral rate appreciated significantly against the rand over the review period, especially since 1997. However, the Pula depreciated against the currencies included in the SDR, especially the pound sterling and the US dollar. Based on the bilateral rates, exporters to the rand area may have lost exchange rate competitiveness since 1997, while suppliers to the UK and USA may have recorded gains.

CHART 2.13 REAL BILATERAL EXCHANGE RATES



Source: Bank of Botswana and Central Statistics Office.

3.35 Over the review period, movements in bilateral real exchange rates of the Pula did not induce the expected outcome on both exports and imports. As the Pula appreciated against the rand and depreciated against the SDR, the competitiveness of Botswana products was reduced vis-à-vis South African products and increased vis-à-vis those from developed countries. *A priori*, loss of competitiveness should lead to a fall in exports and an increase in imports. The expectation was, therefore, that imports from SACU would have increased as the Pula appreciated against the rand and those from Europe would have decreased against the depreciating Pula. Despite this, imports from the SACU region were on a declining trend, in relative terms, during this period while those from Europe were rising significantly. For exports, no changes in the direction of trade are discernible in response to bilateral real exchange rate developments. One possibility is that other trade-promoting factors offset the exchange rate effects during this period.

3.36 An interesting research question is whether the current level of the REER is optimal, consistent with the policy objective of fostering and maintaining competitiveness. That is, the attainment of a stable REER may not be sufficient to support competitiveness and diversification if the REER is not stable at the 'correct' equilibrium level. For example, the fact that export diversification has been slow and the economy has experienced significant unemployment may, among other things, suggest that the exchange rate is overvalued. However, the optimality of the level of REER, in the case of Botswana, is a matter that goes beyond scope of this Section.

(c) Export Diversification Initiatives

(i) The Need for External Sector Diversification

3.37 Botswana remains very much a mineral-based economy. Since the discovery of diamonds in 1967, the impressive economic growth has been partly a direct result of growth in mining, but also indirectly through development policies pursued by the Government utilising resources from the mineral sector.

3.38 The heavy dependence on diamonds has, however, been a source of concern, and over the years policy has been designed to foster economic diversification. The diversification policy has focused on a number of sectors including agriculture, tourism, manufacturing and financial services through the establishment of an International Financial Services Centre (IFSC). Such diversification aims to reduce the vulnerability of the country to external shocks[32].

3.39 Cognisant of the damaging effects of the 'Dutch

[32] See also Bank of Botswana *2000 Annual Report* on Economic Diversification.

disease' type of problem[33], Botswana has made deliberate policy choices, for instance, the nominal exchange rate peg has aimed at limiting, if not completely avoiding, this skewed development pattern. Naturally, as is evident from the definition of the Dutch disease, the policymakers' fear was that mineral-led growth could damage the competitiveness of the non-mining sectors of the economy. While the Dutch disease may not have been entirely avoided, given that economic diversification has been slower than was hoped for, it is at least encouraging that economic planning has taken into account its potential negative impact.

3.40 The major goal of successive National Development Plans (NDPs) has been the diversification of the economy away from diamonds by supporting the growth of non-mining sectors, expanding and diversifying exports, and improving labour productivity. In this regard, it is often argued that manufacturing is a more efficient engine of economic growth than other activities, because of its greater forward and backward linkages[34].

3.41 The Botswana government has been pro-active in promoting export growth and diversification through tax incentives, a liberal exchange control regime prior to its abolition in 1999, as well as various investment incentives. Some of the investment incentives include a duty drawback facility in the imports of inputs for export production (for exports outside of the SACU area), no sales tax on the imports of machinery and equipment required for export production, a stable but competitive real exchange rate, and a prudent wage policy in order to promote international competitiveness of exports. Additionally, the Government has embarked on a series of initiatives with the specific aim of encouraging economic development outside the primary sectors of agriculture and mining[35]. Some of the investment initiatives include the Financial Assistance Policy (FAP), the Citizen Entrepreneurial Development Agency (CEDA), the Trade and Investment Promotion Agency (TIPA) and the Botswana Export Development and Investment Authority (BEDIA).

3.42 *Financial Assistance Policy (FAP) and Citizen Entrepreneurial Development Agency (CEDA):* In 1982, the Financial Assistance Policy (FAP) was launched to facilitate the development of new or expanding export-oriented or import substituting enterprises as a means of employment creation and promotion of economic diversification. FAP initially took the form of labour and capital subsidies, tax holidays and training subsidies. Although the form of FAP assistance policy changed over the years, it remained centred on subsidies through the provision of grants to firms in selected activities. Many of the companies that accessed FAP funding were in textile production, although other activities in manufacturing and certain agriculture were also eligible.

3.43 The FAP was reviewed and evaluated four times (1984, 1988, 1995 and 2000). The first three reviews supported the continuation of the scheme, arguing that the programme was achieving its objectives. However, the final review identified many implementation problems and instances of abuse, as well as widespread failures among small-scale FAP-assisted projects and a number of medium and large-scale companies that could not sustain themselves beyond the five-year assistance period[36]. It was concluded that the programme was, therefore, no longer cost effective and was not achieving its objectives. FAP was abolished in June 2001, and has since been replaced by the Citizen Entrepreneurial Development

33 The Dutch Disease theory posits that in the absence of offsetting macroeconomic policies, a primary export commodity boom may result in de-industrialisation and a negative impact on the tradeable sectors of the economy through appreciation and overvaluation of the real exchange rate.

34 Backward linkage occurs when an incoming firm purchases inputs from domestic firms while the forward linkages occur when the output of an incoming firm is used as a productive input in the domestic industry.

35 *2000 Annual Report*, p 85

36 Budget Speech, 2001.

Agency (CEDA), which provides financing to citizen businesses in all sectors of the economy in the form of subsidised loans and risk-sharing, as opposed to outright grants. Because of the relative thoroughness with which the CEDA projects are evaluated, it is hoped that these projects should be more successful in comparison to those funded under the FAP programme.

3.44 Trade and Investment Promotion Agency (TIPA) and Botswana Export Development and Investment Authority (BEDIA): One export promoting initiative taken in 1984 was the establishment of the Trade and Investment Promotion Agency (TIPA), the objective of which was to provide information needed by potential investors in Botswana. TIPA's responsibilities included the provision of advisory services to potential investors, especially assisting in logistical support in communications with relevant government departments, parastatals and private organisations; hosting of foreign trade and investment missions; dissemination of investment promotional materials with emphasis on available incentives and business opportunities through national and international media; and formulating an export development strategy in order to promote Botswana's non-traditional exports by assisting manufacturers to realise their export potential[37].

3.45 In 1998, TIPA was wound up and replaced by a statutory body, the Botswana Export Development and Investment Authority (BEDIA). As was the case with its predecessor, BEDIA is in principle a one-stop investment-clearing agency that promotes, facilitates and monitors investment flows in Botswana. Its objectives include the promotion of investment and manufactured exports as well as construction of factory shells for lease to investors. Since 1998 BEDIA has assisted 13 companies from Zimbabwe, China, Mauritius and Sri Lanka to locate in Botswana.

[37] See National Development Plan 7, p 154.

3.46 BEDIA faces a range of challenges in attracting foreign investment, including the high cost of utilities, especially water, shortage of skilled labour, perceived low labour productivity and high transport costs. Notwithstanding these drawbacks, one of BEDIA's new tasks is to assist in the identification of activities that are regionally and internationally competitive.

(ii) The Selibe–Phikwe Regional Development Programme (SPRDP)

3.47 In 1988, the Government set up the Selibe-Phikwe Regional Development Programme (SPRDP), with the objective of diversifying economic activity in the Selibe-Phikwe area away from mining and into non-traditional manufactured exports. Among the incentives provided was a reduction of company tax to 15 percent, compared to 25 percent[38] elsewhere and an exemption from withholding tax on dividends from after-tax profits, in addition to FAP benefits. This special incentive package (SIP) was available to manufacturing firms in the Selibe-Phikwe area on condition that they employed over 400 workers and exported 100 percent of their output outside the SACU area. However, of all the 17 companies attracted to Selibe-Phikwe under the SPRDP, only one company utilized SIP[39], and most simply made use of FAP.

3.48 In 1992, the Government reviewed the SPRDP and decided to reallocate its sub-components. The responsibility for the industrial programme was to run for three more years following which it was transferred to TIPA while the agricultural component was to be transferred to the Ministry of Agriculture. Some of the enterprises that were established under this programme, many of which were in textiles and clothing, failed and were closed.

[38] Effective 1995, all qualifying manufacturing businesses in the country pay a tax rate of 15 percent.

[39] Cowan D, 1997, 'The Selibe-Phikwe Regional Development Project' in Salkin J. et al (eds.) *Aspects of the Botswana Economy* (Gaborone, Bank of Botswana).

(iii) Botswana Export Credit Insurance and Guarantee Company (BECI)

3.49 In order to reduce financial uncertainties for exporters, the Botswana Export Credit Insurance and Guarantee Company (BECI), a wholly-owned subsidiary of the Botswana Development Corporation (BDC), was established in 1996 to assist in the development of non-traditional exports by protecting exporters against the risk of non-payment for their exports through the default or insolvency of the buyer or inability to pay because of political problems in the importer's country.

4. CONTRIBUTION TO ECONOMIC DIVERSIFICATION

4.1 The policy of economic diversification through the development of the export sector critically depends on the degree to which this sector would be linked to the rest of the domestic economy in order to avoid enclave development such as has occurred, to some degree at least, in the mining sector.[40]

(a) Employment and Manufacturing Sector

4.2 Table 2.8 shows estimates of employment in the various manufacturing sub-sectors in 1996 together with estimates of gross output and value added per worker. The most notable feature is the distinctive characteristic of the textiles sub-sector, which has already been clearly identified as export intensive. It is both one of the largest employer and labour intensive in production, as indicated by the relatively low levels of output per employee. This points to the potential attractions for developing this sector and the need for labour to be competitive in terms of productivity and wages. It is also worth noting the low value added per worker in the metal and wood products sub-sectors. This reflects relatively labour-intensive production combined with heavy reliance on imported materials. Chemical products have a similar reliance on imports but have a higher value added per employee, indicating more capital-intensive production.

4.3 The Social Accounting Matrix (SAM) gives labour income by sector. If the simplifying assumption that wage levels in each worker

TABLE 2.8 MANUFACTURING EMPLOYMENT, GROSS OUTPUT AND VALUE ADDED PER EMPLOYEE, 1996

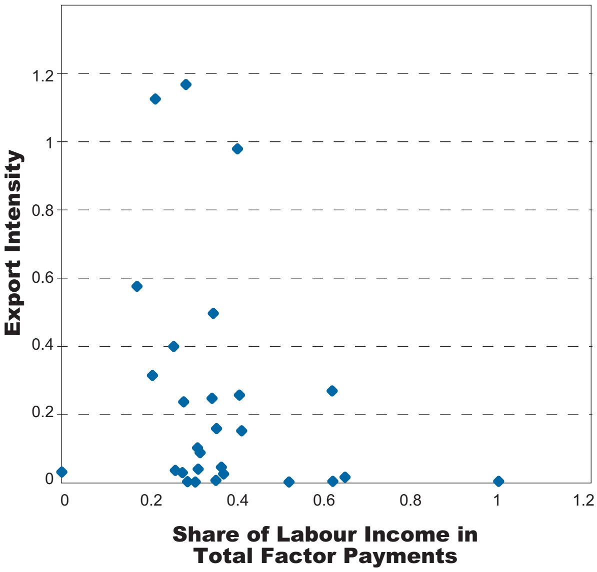
Sector	Gross Output (P'million)	Number of Employees	Gross Output Per Employee (P'000)	Value Added (P'million)	Value Added Per Employee (P'000)
Meat processing	454	2 018	225	115	57
Dairy	433	2 280	190	94	41
Beverages	407	1 150	354	97	84
Bakery	160	983	163	55	56
Textiles	209	4 268	49	77	18
Leather, Tanning, etc	268	71	378	9	127
Chemicals	302	935	323	96	103
Wood	495	1 337	37	17	13
Paper	108	1 275	85	43	34
Metal	244	4 006	61	36	9
Other	1 305	5 019	260	246	49

Source: Central Statistics Office and Bank of Botswana.

40 While mining has contributed enormously to GDP, exports and government revenues, there are few other backward and forward linkages in the economy.

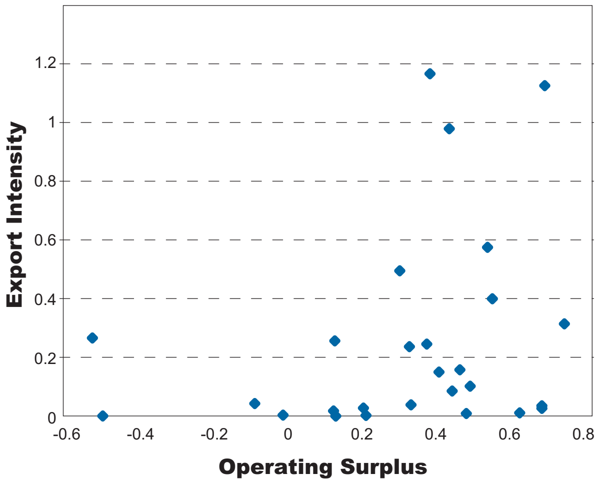
category are equal across sectors is acceptable, this can be used to analyse the labour profile of the various sectors. In particular, whether there is any meaningful correlation between export orientation and employment intensity can be investigated in more detail. This is shown in Charts 2.14 and 2.15 – the scatter diagrams that match respectively, the proportion of labour income and net[41] operating surplus in total factor

CHART 2.14 LABOUR INCOME AND EXPORT INTENSITY BY ECONOMIC SECTOR



Source: Bank of Botswana using data from Central Statistics Office

CHART 2.15 EXPORT INTENSITY AND NET OPERATING SURPLUS BY ECONOMIC SECTOR



Source: Bank of Botswana using data from Central Statistics Office

[41] That is, less depreciation.

payments with the measure of gross export intensity used in Section 2 above. For labour income, there is no clear correlation with export intensity, either positive or negative. While the highest employment percentages are in sectors with very low exports, this is largely due to the impact of the government sectors. In these sectors exports are very low, while at the same time the measure of output in the national accounts inevitably exaggerates the importance of labour compared to other sectors[42]. Nevertheless, it is clear that sectors with relatively high export intensity have a low income share for labour, which does not support the claim sometimes made that exports are particularly beneficial for creating employment. Some positive correlation exists between export intensity and net operating surplus. This in turn suggests that the resources might be expected to be moved into export activities due to their profitability. However, this result may be somewhat exaggerated. For instance, in textiles a 42 percent operating surplus is offset by 24 percent subsidy, a clear reflection of the heavy reliance of the sub-sector, at that time, on the FAP programme.

(b) Linkages with the Financial Sector

4.4 Information on lending provided by commercial banks is at the broad sectoral level and can provide only limited information on their role in supporting the development of the external sector. However, while the average maturity of bank lending has been increasing, short-term lending tends to predominate. Over the past decade, overdrafts have typically constituted the major form of lending, while lending for periods longer than ten years has been less than ten percent of the total. This structure of lending suggests that banks play the main role in meeting the operating needs of established businesses rather than in supporting the establishment of new ones. This is perhaps to be expected, as commercial banks are not generally in the business of providing the risk/venture capital that

[42] For government sectors (and others where there is no output that can be priced) there is no measure of operating surplus.

is the main source of finance for new businesses. Nevertheless, on occasion, commercial banks finance new investments. For instance, one of the local banks was heavily involved in the financing of the Hyundai motor plant. The high profile failure of this venture illustrates the high risks the banks expose themselves to in business investment lending.

4.5 The activities of BEDIA are also relevant in this respect. In the Bank's *2001 Annual Report*, it was reported that the operations that had been established with the assistance of BEDIA at that time made very limited use of domestic financial institutions. However, this observation needs careful interpretation, as it may possibly indicate a reliance on own funds rather than the reluctance of the financial institutions to provide funding to new incoming ventures.

4.6 That the private sector banking system in Botswana does not provide venture capital for the development of export-oriented business is the major justification of continued government involvement in this area through the financial parastatals. For example, the Botswana Development Corporation (BDC) is a major source of equity finance.

4.7 Nevertheless, banks support export-oriented and other businesses through the provision of banking services. Monetary stability in the form of stable prices, a stable exchange rate and lack of exchange controls can also play an important role in export promotion. Factors such as these contribute to positive credit ratings such as those awarded to Botswana by international rating agencies in 2001, and confirmed in 2002.

(c) External Sector and Government Revenue

4.8 Traditionally, revenues from import duties are an important source of Government revenue. In fiscal year 2001/02, SACU receipts were P1 732 million, the second largest source, although a distant second to mineral-related receipts. However, SACU receipts are likely to be gradually eroded as the average level of tariffs falls, due to both the general lowering of duty rates and the extension of free trade agreements involving SACU member countries[43].

4.9 There are no specific taxes on exports, and exports are subject to VAT at a zero rate. Since the mid-1990s, qualifying manufacturing companies pay a concessional rate of income tax of 15 percent; and a similar arrangement applies to participants in the International Financial Services Centre (IFSC). The main beneficial effect of export promotion on Government receipts will be the general revenue-raising effects of sustained rapid economic growth that will generate income and indirect taxes on domestic transactions from second round linkages in the production process. However, compared to the receipts from diamond mining, currently the dominant source of government revenue, the share accruing to government from this growth will be relatively low, and public spending programmes will need to be planned accordingly if they are to be sustainable.

5. SUMMARY AND OUTSTANDING ISSUES

5.1 Botswana's development strategy is outward looking. It seeks first and foremost to increase the market for and competitiveness of the country's exports, but also to widen the range and quality of goods and services available to the domestic market through imports and to attract foreign direct investment that maximises new technology and skills transfer into the country. This development strategy is supported by a variety of initiatives, including trade and multilateral agreements, macroeconomic policies and business development programmes. The evaluation of the impact of these initiatives included in the earlier sections of the chapter shows that more needs to be done to achieve diversification of Botswana's trade in both its composition and direction. Although Botswana

43 The EU has already reached a free trade agreement with South Africa, which by extension applies to the other SACU member states. In 2002, the USA declared its intention to negotiate a similar agreement with SACU.

has generally benefited from its pursuit of sound macroeconomic policies, it is important to regularly review those, such as the exchange rate policy, that might contribute to improving the performance of the external sector and enhancing its role in achieving the broader development goals. Additionally, the country will need to examine the opportunities and challenges that are presented by regional and multilateral trade agreements so as to maximise the benefits that can be derived from them. It is also necessary to continue the critical assessment of policies supporting the business sector to ensure the beneficial use of subsidies and the long-term viability of projects in which the Government is a participant.

5.2 As described in the preceding sections of this Report, the outward-looking development strategy has supported the continued openness of the economy, with external trade consistently being more than 80 percent of GDP during the review period of 1990-2001. Within that total, the share of imports of goods and services in GDP has shown a modest declining trend, partly as a result of an expansion in domestic production capacity. There has not been much change in the composition of imports over the past decade, although the share of machinery and electrical equipment has been rising, which may be a manifestation of increasing capital stock. It is also notable that, compared to exports, the range of imports is diverse, although South Africa is still the dominant source. This Report notes that considerable effort has been made to diversify exports, albeit with little success as they continue to be dominated by diamonds. There was a short-lived increase in vehicle exports to South Africa in the mid-to-late 1990s following the opening of the Hyundai plant, but it subsequently closed. Overall, the ratio of exports of goods and services to GDP has remained fairly steady during the past decade.

5.3 With continued balance of payments surpluses and the fixed peg exchange rate policy, Botswana has been able to accumulate substantial foreign exchange reserves, although the rate of growth in these reserves slowed in recent years. At the end of 2002, accumulated reserves provided around 26 months of import cover. While there are opportunity costs associated with accumulating reserves, such as foregoing the possible benefits of alternative domestic investments, there are good reasons for the present policy. Most important is the limited absorption capacity of the economy. In the circumstances, accumulating reserves is seen as the best policy option to investing in marginal and non-viable domestic activities; as investment opportunities develop, the reserves can be drawn on to fund them. Further, as a small open economy, Botswana is vulnerable and sizeable reserves provide an important buffer to absorb both internal and external shocks.

5.4 The outward-looking strategy is also supported by membership of a number of regional and multilateral trade agreements, which help to expand the market for locally produced goods and services and minimise the costs of trade. The broadest of these agreements is the World Trade Organisation (WTO). It provides Botswana with an underlying and comprehensive framework for its bilateral and multilateral trade relationships based on principles of competitive free trade, reciprocity and predictability. Section 3 of this Chapter provides detail on Botswana's other various regional and international trade arrangements that complement the WTO protocols. The most important of these is the SACU Agreement, from which Botswana receives custom revenues and unfettered access to the large South African market. Other important trade agreements cover trade with the EU and the USA. The Cotonou Agreement, which replaced the Lome Convention (ACP/EU Trade Agreement) in June 2000, allows access to the European market for a range of commodities from African and Caribbean countries. Similarly, the African Growth and Opportunity Act (AGOA) seeks to open the US market to African manufactured goods, duty free and without quotas. This is a potentially important opportunity for Botswana given that it meets the governance and economic management conditions for access. As of now, however, the country's exports under this arrangement are relatively small, although increasing.

5.5 In reviewing the various trade agreements and multilateral arrangements, it is evident that there are a number of inconsistencies among them that will need to be reconciled. This is the case especially in respect of SACU, the Cotonou arrangement, and the EU–South Africa Trade, Development and Cooperation Agreement (TDCA*)*. Although Botswana is not directly a member of this latter arrangement, it is indirectly affected through its membership of SACU, and certain provisions of the TDCA may undermine the benefits that would otherwise accrue under SACU and the Cotonou Agreement. Looking ahead, the SADC Free Trade Area (FTA) is likely to become an increasingly important trade agreement for Botswana. The long-term goal of SADC is to create a regional common market with unfettered movement of factors of production and goods and services. To this end, there are measures in place to progressively move towards a free trade area and elimination of tariff and non-tariff barriers in intra-regional trade. It will, however, be necessary to evaluate the impact of the SADC FTA on SACU and examine how the two agreements can be reconciled, as several countries are members of both. More generally, it would be helpful to have a formal mechanisms for periodic and systematic evaluation of the various trade agreements of which Botswana is a member to ascertain their effectiveness and continued relevance in meeting Botswana's development objectives[44].

5.6 The development of trade is also crucially dependent upon the nature of exchange rate policy, which, in Botswana's case, aims along with monetary policy to maintain stability in the real effective exchange rate (REER). Between 1990 and 2001 the REER of the Pula has been largely stable, although bilateral real exchange rates have been quite volatile. It was noted in the Report, however, that the REER may be relatively stable but at an uncompetitive level. Whether this is the case in Botswana needs to be continuously reviewed given the importance of the issue to the Government's diversification and development strategies. Nevertheless, it remains important also to ensure that Botswana's inflation is no higher than the average inflation of trading partner countries, so as to avoid the need to use devaluation to achieve and maintain competitiveness.

5.7 It has been hoped that the export-oriented development strategy would be supported by inflows of foreign direct investment (FDI). This is not so much because Botswana needs the capital associated with FDI inflows – with a surplus of domestic savings over investment, there is no shortage of capital at the macroeconomic level – but more because of the other potential benefits of FDI. These include technology and skills transfer, and access to markets. Although much reliance has been placed on manufacturing in recent years, FDI in the manufacturing sector has grown more slowly than in many other sectors. Even if this means that available investment opportunities have been largely financed from domestic sources, it does suggest that the other benefits of FDI, which would help to develop export potential, are not impacting on the sector in the same way that they have, for instance, in the mining sector. The policy framework therefore needs to concentrate on three areas. First, it must aim at enhancing the general investment climate for the benefit of both domestic and foreign investors. In this regard, it is expected that the SADC economic integration process and the creation of a free trade area will be supportive, as will Botswana's membership of other regional and international trade agreements. While many aspects of the macroeconomic policy environment remain supportive of investment, and Botswana remains a low-tax regime among emerging markets, with political stability and healthy economic growth rates, it is important to ensure that the necessary reforms are carried out to the microeconomic

44 There are however, a number of reviews and negotiations of multilateral trade agreements on a regional or sub-regional basis.

issues that affect the environment in which firms do business. The second policy objective should be to ensure that the potential benefits of technology and skills transfer from FDI, and marketing links, are developed in such a way as to complement and strengthen domestic investment. Joint ventures are one way of doing this, as is the raising of standards through competitive pressures. Third, it is necessary to ensure that the policy environment is supportive of FDI. The institutional support provided by BEDIA to foreign investors in the form of marketing and comprehensive information on the country, the provision of infrastructure and liaison between investors and government departments is also potentially beneficial and should contribute to growth of inward investment and economic diversification. However, it appears that, so far, BEDIA has had limited success in attracting foreign investors, and it will be necessary to continually focus on and address the constraints that inward FDI may face.

5.8 Overall, Botswana's external position remains healthy. Along with the disappointments, notably that the pace of export diversification has not proceeded as quickly as has been hoped, there are some encouraging signs. Perhaps most prominent among these is that there has been a gradual but discernible shift in trade patterns with trade in services growing faster than trade in goods, and hence becoming progressively more important in overall trade patterns. This is not entirely surprising, given that the same phenomenon is occurring on a global scale. It is, however, encouraging that Botswana is participating in this shift in trade patterns. This is especially so because services encompass several of the areas that have been identified as having important future economic potential for Botswana, particularly tourism and financial services. Further work is required in improving the quality of the trade data as it relates to services, in order to provide more reliable and faster information on trends in different categories of services trade. However, the result is consistent with arguments presented in the Bank's *2000 Annual Report*, and elsewhere, that successful diversification of production, employment and trade must be broad-based, and that Botswana is well placed to take advantage of the relatively fast growth of international trade in services.

Appendix: Balance of Payments Estimation Methodology

The balance of payments is a statistical statement that records, for a specific time period, the economic transactions of the economy with the rest of the world. It is divided into two major accounts: the current account and the capital and financial account. The current account covers trade (imports and exports) in goods and services, income and current transfers. The capital and financial account records capital transfers and financial investments (direct, portfolio and other investment). Below is a description of data sources for the major components of the balance of payments accounts.

Current Account

Trade

For merchandise trade, major exporters (Debswana, BCL, BMC and BOTASH) submit data directly to the Bank of Botswana. Data on exports of textiles and other products comes from CSO, as does information on imports. Import data is reported on a c.i.f. (cost insurance and freight) basis and is adjusted by the Bank for coverage, valuation and timing.

For services, an annual transportation survey (with individual questionnaires tailored for air, rail and road carriers) is used, in conjunction with data from other sources (such as the Department of Civil Aviation, commercial banks and Ministry of Education) to estimate freight, fares and other transportation items. The CSO compiles information on travel services from migration cards and the bi-annual visitor survey. Estimates are made using average length of stay and expenditure data for each category of visitor applied to the appropriate arrivals data. On the debit side, a number of categories of expenditure are used, including students studying abroad and air and land travellers, with separate estimation methods made for each category. Other services are compiled using data from foreign exchange forms. This applies to, *inter alia*, communication, construction, insurance, financial, computer and information services, and royalties and license fees, legal, accounting, and management fees, as well as personal, cultural and recreational services. Government transactions data are obtained from the Bank of Botswana's accounting system (as all government's international transactions pass through accounts at the Bank).

Income

Income is divided into compensation of employees and investment income. For the former, data on credit items are obtained from The Employment Bureau of Africa (TEBA), the South African Chamber of Mines and the foreign exchange forms, which mainly reflects remittances by Batswana working in South African mines. Data on debit items are obtained from the foreign exchange forms.

Investment income is divided into direct, portfolio and other investment income. Information on direct investment income is derived from the balance of payments surveys of resident companies. Data on reinvested earnings and undistributed branch profits are also collected through the surveys. Data on income on portfolio investment are obtained from the balance of payments surveys and from the balance sheets of the Bank of Botswana and pension fund managers' returns. Other investment income data are obtained from the balance of payments surveys, the Government's Cash Flow Unit (CFU) and the Bank's monetary survey.

Current Transfers

Current transfers consist of transfers that do not involve change of ownership of fixed assets, transfer of funds linked to disposal of fixed assets or debt forgiveness. The current transfer data are derived from information obtained from Ministry of Finance and Development Planning on the common customs union account. The source of remittances is the foreign exchange forms. Data on grants are obtained from the Cash Flow Unit.

Capital and Financial Account

Capital

Capital transfers are mainly migrant's transfers and the major source of data here is the foreign exchange forms. The entries cover mainly transfer of savings by Botswana emigrants. These are transfers that involve change of ownership of fixed assets.

Financial

For statistical purposes, ownership by a foreign investor of at least ten percent is treated as direct investment. The data for both direct investment abroad and in Botswana are sourced from the balance of payments surveys. For portfolio investment data, the source is the balance of payments survey as well as the pension fund managers' quarterly returns. Other investment data sources are the CFU, the balance of payments and monetary surveys. Reserve assets data are readily available from the Bank of Botswana.

Shortcomings of Data

- Untimely receipt of data is the biggest impediment to reducing a lag in production of balance of payments statistics and making them more useful as macroeconomic indicators. Data from the CSO is produced after long lags.

- For the Balance of Payments surveys, there is a problem of poor response rates, especially for the annual survey, where the response rate is around 50 percent to 60 percent.

- The adjustment factors for converting imports from c.i.f. to f.o.b. (free on board) basis are outdated; also the Bank and CSO have different methods resulting in discrepancies between their published data.

- The net errors and omissions figure, though not extremely high, suggest that there are some inaccuracies. The services account is likely to be the area where there is a lot of information missing, due principally to excessive reliance on commercial banks' foreign exchange transactions. Given the use of credit cards, there could be a lot of payments that are not recorded.

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