Bank of Botswana

Annual Report
and
Economic Review
2000

BANK OF BOTSWANA

Governors' Office
Tel: (267) 360-6371/67/79
Fax: (267) 371231

Private Bag 154
Gaborone
Botswana

Ref: RD 10/1/1

March 28, 2001

Honourable B. Gaolathe
Minister of Finance & 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 2000, which covers:

(i) a report on the operations and other activities of the Bank during 2000;

(ii) a copy of the Bank's annual accounts for the year ended December 31, 2000 certified by the external auditors and approved by the Board on March 16, 2001; and

(iii) a review of the economy in 2000, a special feature on the challenges of economic diversification 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 December 31, 2000

L. K. Mohohlo
Governor and Chairman of the Board

S. S. G. Tumelo
Board Member

G. K. Cunliffe
Board Member

D. N. Moroka
Board Member

T. C. Moremi
Board Member

N. H. Fidzani
Board Member

C. S. Botlhole-Mmopi
Board Member
(December 1999 - February 2001)

DEPUTY GOVERNORS

J. Majaha-Järtby
(February 1996 - January 2001)

K. R. Jefferis

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as at December 31, 2000

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Board Member

C. S. Botlhole-Mmopi
Board Member

The Governor's 25th Anniversary Message

A Silver Jubilee has a special significance in the life of any institution as it signifies a coming of age and maturity. The occasion also provides the opportunity to reflect on challenges and achievements. During the past quarter of a century, the Bank has, against seemingly insurmountable challenges, developed a strong organizational structure to buttress the fulfillment of its mission of meeting the needs of the Botswana economy through efficient service and dedication to duty.

At the behest of the Bank, the infrastructure of the financial sector has expanded, its products have been diversified, the quality of service improved and the volume of financial business has risen by leaps and bounds in response to the needs of a fast growing modern economy. More financial institutions are expected to enter the market in the near future, particularly under the auspices of the recently launched International Financial Services Centre (IFSC). The IFSC, which reflects Botswana's commitment to regional economic and financial integration, will attract highly reputable international and local financial institutions.

While the financial sector continued to expand, the Bank consistently applied stringent standards in its supervision of the banking system during the past 25 years. As a result, the country has maintained a high standard of financial sector soundness and stability in an environment of rapid advances in information technology and the increased pace of integration of the global financial sector. Of equal significance, is the fact that the commercial banks, which operate under international supervisory and regulatory standards, have continued to record levels of profitability that compare favourably internationally.

The expected rapid growth of the economy implies future increases in the volume and complexity of the responsibilities of the Bank. Alongside strong economic performance, the country's foreign exchange reserves have risen considerably, as a result of which the management of the foreign exchange reserves has become progressively more sophisticated and complex. The fast growing economy has also necessitated the development of an efficient domestic and international payments system as well as the effective implementation of a market-based monetary policy.

Since 1998, public confidence in Botswana's macroeconomic management has been strengthened further by annual public announcements of monetary policy objectives. The policy statements are intended to forestall inflationary expectations by disseminating information to the public about policy intentions. In so doing, the statements influence market expectations and encourage the formation of appropriate economic and financial decisions. For this reason, public statements of monetary policy have contributed significantly to the maintenance of a stable macroeconomic environment, which is a basis for sustained economic diversification and development.

Besides the requirement of a sound financial sector and effective implementation of monetary policy, the proper functioning of a modern market economy needs a reliable and stable external value of the domestic currency. In order to achieve this objective, the Bank has implemented, on behalf of the Government, the Pula exchange rate mechanism. Under this mechanism, the Pula is pegged to a basket of currencies comprising the South African rand and the Special Drawing Rights (SDR). The mechanism has minimized fluctuations of bilateral rates, prevented the appreciation of the currency which would result from balance of payments surpluses if the exchange rate were freely floating and, in the process, maintained the competitiveness of the currency, which in turn promotes non-traditional exports.

Regionally, the Bank has worked closely with other central banks in implementing various initiatives under the aegis of the Southern African Development Community (SADC), including the Eastern and Southern African Banking Supervision Group. The objective of this and other regional efforts is to promote a harmonized and sound financial sector as well as develop an efficient payments system in the region. Internationally, the Bank has, on behalf of the Government, continued to be a very active participant in the activities of the International Monetary Fund (IMF), the Bank for International Settlements (BIS), the World Bank and other multilateral institutions.

Simultaneously, the Bank has maintained a network of very productive and mutually beneficial relationships domestically with the Government, the private sector and other stakeholders in the economy. Since policy formulation and effective implementation depend on feedback, these relationships are indispensable to the Bank and will continue in the years ahead.

I wish to take this opportunity to pay tribute to all past and present leaders of Botswana and all other stakeholders, for their foresight back in the early 1970s in laying a solid foundation for one of the most important institutions of the country. The achievements made since the founding of the Bank 25 years ago, are a vindication of the soundness of their vision for the country and a source of justifiable pride for all Batswana. However, a fitting tribute to the founders of the Bank is for the Board and the staff of the Bank to maintain a tight grip on the baton that has been passed on to us, so that when our turn is over, we too, will hand over the baton, in one piece, to the next generation. If we succeed in doing so, the next generation will honour us because they too, will celebrate anniversaries of a well founded central bank.

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CHAPTER 1

Recent Economic Developments in Botswana

THEME CHAPTERS

Theme: The Challenge Of Economic Diversification

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TABLES

Abbreviations Used in the Annual Report

ACP	African, Caribbean and Pacific
ATMs	Automated Teller Machines
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BEDIA	Botswana Export Development Investment Authority
BEDU	Botswana Enterprise Development Unit
BMC	Botswana Meat Commission
BNPC	Botswana National Productivity Centre
BoB	Bank of Botswana
BoBCs	Bank of Botswana Certificates
BOTEC	Botswana Technology Centre
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
BTC	Botswana Telecommunications Corporation
CEDA	Citizen Entrepreneur Development Agency
CEMAEF	Citizen Entrepreneur Mortgage Assistance Equity Fund
CIT	Communications and Information Technology
CIUs	Collective Investment Undertakings
CPI	Consumer Price Index
CRSA	Control Risk Self Assessment
CSO	Central Selling Organisation
DTC	Diamond Trading Company
EU	European Union
FAP	Financial Assistance Policy
FCAs	Foreign Currency Accounts
FCI	Foreign Companies Index
FNBB	First National Bank Botswana
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
HIES	Household Income and Expenditure Survey
IDP	Industrial Development Policy
IFC	International Finance Corporation
IFSC	International Financial Services Centre
IIP	International Investment Position
IMFC	International Monetary and Financial Committee
IMF	International Monetary Fund
IT	Information Technology
MFDP	Ministry of Finance and Development Planning
MTR	Mid-Term Review
NACA	National AIDS Coordinating Agency
NAMPAD	National Master Plan for Agricultural Development
NBFIs	Non-Bank Financial Institutions
NDB	National Development Bank
NDP	National Development Plan
NPH	National Policy on Housing
NSCs	National Savings Certificates
OECD	Organisation for Economic Cooperation and Development

Abbreviations Used in the Annual Report *(cont)*

OMO	Open Market Operations
PDSF	Public Debt Service Fund
PEEPA	Public Enterprise Evaluation and Privatisation Agency
Repos	Repurchase Agreements
RIIC	Rural Industries Innovation Centre
RNPE	Revised National Policy on Education
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAM	Social Accounting Matrix
SDR	Special Drawing Rights
SLF	Secured Lending Facility
SMMEs	Small Medium and Micro Enterprises
SNA	System of National Accounts
TEC	Total Estimated Cost
TIPA	Trade and Investment Promotion Agency
USA	United States of America
VAT	Value Added Tax
WTO	World Trade Organisation

PART A

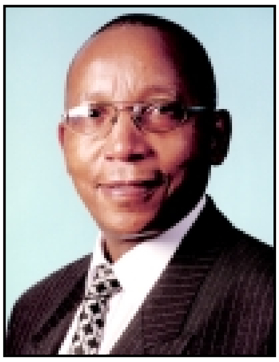
STATUTORY REPORT ON THE OPERATIONS OF THE BANK 2000

BANK OF BOTSWANA

HEADS OF DEPARTMENT

as at December 31, 2000

O. Mabusa
Banking Department

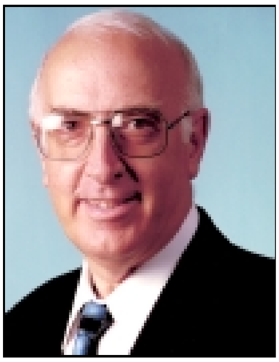


S. M. Kgosi
Finance Department

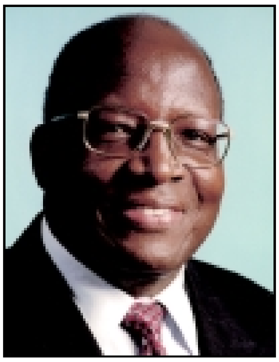
M. D. Pelaelo
Financial Institutions Department

R. H. Nlebesi
Human Resources Department

O. A. Motshidisi
International Department



J. G. Caldwell
Management Systems Department



H. P. Bandawe
Research Department

N. A. Mabe
Support Services Department

PART A: STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK

1. AN OVERVIEW OF THE BANK

Objectives of the Bank

The primary objectives of the Bank are to promote monetary stability, ensure efficient payments system and a sound financial system

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 the efficiency of the payments system and soundness of banking institutions. In performing its functions, the Bank fosters broad national macroeconomic objectives, including sustainable economic diversification. The Bank's main responsibilities, its organisational structure and the framework for its activities are described below.

Functions of the Bank

Primary responsibilities of the Bank

1.2 As prescribed by the Bank of Botswana Act, 1996, the primary responsibilities of the Bank include the conduct of monetary policy, provision of banking services to Government, banks and selected public sector organisations, regulation and supervision of the 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 Government.

(a) The Conduct of Monetary Policy is directed mainly at achieving the primary responsibility of the Bank, the promotion and maintenance of monetary 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 Services are mainly provided for the Government, commercial banks and other selected institutions. The Bank also operates a clearing house for the banking system.

(c) Supervision of Banks and Other Financial Institutions is conducted in accordance with the Banking Act, 1995. The purpose of prudential regulations and supervision is to ensure the safety, solvency and proper functioning of the monetary, credit and financial system.

(d) Issuance of Currency (banknotes and coin) of high quality is an essential ingredient of an efficient payments system, which in turn, facilitates economic activity.

(e) Exchange Rate Policy is implemented with a view to promoting export competitiveness without compromising macroeconomic stability. The Bank, acting as Government's agent, buys and sells foreign exchange at rates determined in accordance with the exchange rate policy. The Bank implements an appropriate exchange rate policy in the overall context of sound macroeconomic management.

(f) Official Foreign Exchange Reserves are managed by the Bank on behalf of the Government. The Bank ensures their safety and liquidity, while minimising risk without sacrificing return.

(g) Economic Analysis and Policy Advice includes the production of research and statistical reports, the distribution of economic and statistical materials to other institutions and the Botswana public at large. The collection and dissemination of reliable statistics as well as the production of policy oriented research, ultimately assists in informed policy decisions.

The Structure of the Bank

1.3 The Bank of Botswana falls under the purview of the Minister of Finance and Development Planning, who appoints all members of the Board of the Bank except its Chairman, who is the Governor. The Minister reports to Parliament on the Bank's operations and financial performance.

The Board

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 the policies, management capabilities, administrative systems and financial controls necessary to achieve the Bank's objectives, in an efficient and effective manner, are in place at all times. 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 of the Bank, receives reports of the external auditors and may call for policy reviews.

The Board has nine members and is required to meet at least once each quarter

1.5 The Board comprises nine members and is chaired by the Governor. The Permanent Secretary of the Ministry of Finance and Development Planning is an ex-officio member and the other seven members are drawn from the Government, the private sector and the academia.

1.6 The Board is required to meet at least once each quarter of a year, although typically, it meets more frequently. An Audit Committee of the Board is chaired by a non-executive Board member. Its main responsibility is to ensure that accounting policies, internal controls and financial practices are based on established rules and regulations. The Board submits a report 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 (calendar year).

The Governor

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 or resolutions of the Board. The Governor manages the Bank on a day-to-day basis, and represents the institution at official meetings with the Government, domestic financial and other institutions, external organisations and the media.

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-term and long-term plans.

Departments and Divisions

The Bank has eight Departments and three Divisions

1.9 In order to carry out its broad functions, the Bank is organised into various Departments and Divisions. At the end of 2000, the Bank's Departments were Banking, Finance, Financial Institutions, Human Resources, International, Management Systems, Research and Support Services. The three Divisions were the Board Secretariat, Security and Internal Audit. Seven Heads of Department reported through the Deputy Governors to the Governor, while one Department (International) and the Internal Audit Division reported directly to the Governor.

Strategies

Monetary stability and a sound and efficient financial system

1.10 In pursuing its principal objectives, the Bank has regularly reviewed and adopted its strategies to deal with the changing conditions prevailing in the financial sector. Maintaining monetary stability and ensuring the soundness and efficiency of the financial system, are major objectives of the Bank. The commitment to the attainment of these objectives is reflected in ongoing developments in the following areas of the Bank's activities:

Open Market 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, its control is a major objective of the Bank's monetary policy. However, controlling inflation in a small open economy, such as Botswana, with trading partners that sometimes have been experiencing high and unstable levels of inflation, is a major challenge.

1.12 The Bank implements monetary policy through the use of indirect monetary policy instruments, particularly open market operations, the Bank Rate and primary reserve requirements. 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 manage 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) and Reverse Repurchase Agreements (Reverse Repos) to deal with short-term and overnight liquidity shortages in the banking system.

1.14 The Bank incorporates fiscal and other policies of Government in its design of a monetary policy framework and 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 form of annual *Monetary Policy Statements*.

<u>Banking Services to Government and Commercial Banks</u>

1.15 The Bank serves as the banker to the Government, commercial banks and other selected institutions, as well as providing a payment, clearing and settlement system for the financial sector. The Bank is promoting and coordinating a programme that will enhance the efficiency and security of the payments system. The Bank also provides a lender of last resort facility to the financial institutions under its supervision.

<u>Implementing the Banking Act and Regulations</u>

Supervision and regulation of financial institutions

1.16 Through its routine banking supervision and regulatory activities, the Bank seeks to achieve a sound and stable financial system. The Bank ensures that the mechanisms for sustaining the safety and soundness of licensed financial institutions are strengthened and that those institutions are managed in a prudent and safe manner. In this regard, the Bank enforces prudential standards with respect to capital adequacy, liquidity, asset quality and management of banks.

1.17 The Bank also monitors commercial bank compliance with primary reserve requirements and ensures that clearing and settlement activities are conducted efficiently. As the level and value of transactions flowing through the financial system increases, and Botswana expands its linkages with international financial markets, the Bank has to guard against systemic risks which may arise. In general, the Bank continually collaborates with private sector institutions, international organisations and the Government to introduce a more efficient and safer payments system.

1.18 In addition to its supervisory role which focuses on the safety and soundness of licensed financial institutions, the Bank is responsible for ensuring that the banks conduct their operations in a professional and transparent manner in providing customer service. The Bank also takes a lead in investigating breaches of the Banking Act, 1995, especially activities such as unauthorised deposit taking and improper use of banking names.

1.19 Under the provisions of the Banking Act, the Bank has specific responsibilities relating to money laundering. Accordingly, the banks are required to identify customers 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.

Administration of anti-money laundering policy

1.20 The Bank has assumed the responsibility for the regulation and supervision of the International Financial Services Centre (IFSC) entities as well as administration of the Collective Investment Undertakings Act, 1999.

Regulation and supervision of IFSC and collective investment schemes

Meeting the Need for Banknotes and Coin

1.21 The availability of a safe and convenient currency is an integral part of 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, withdraws from circulation and destroys soiled and damaged currency, and replaces it with new notes and coin. The Bank adheres to 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 of the currency.

Implementing Exchange Rate Policy

1.22 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 Special Drawing Rights (SDR - the unit of account of the International Monetary Fund) and the South African rand. 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 authorised dealers. The Bank monitors the Pula exchange rate developments regularly with a view to advising the Government on maintaining competitiveness of domestically produced goods.

Managing Foreign Exchange Reserves

1.23 As Botswana's foreign exchange reserves have continued to grow, the Bank has split 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 return; the Liquidity Portfolio is invested in short-term money market instruments and bonds.

Advice on Economic Policy, Provision of Statistics and Public Education

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

1.25 The Bank collects and disseminates macroeconomic statistics, especially those relating to the financial sector and international transactions. The statistics are regularly provided to the public, along with research reports and press releases, on broad macroeconomic developments. The Bank has also taken the lead in formulating and implementing a public education programme on banking and financial matters.

2 REPORT ON THE BANK'S OPERATIONS

Introduction

2.1 The main activities of the Bank during 2000, including the celebrations of the 25th Anniversary, are highlighted below. The activities relate mainly to the Bank's implementation of its annual work programme.

Governor's Office

Governor's first full year in office

2.2 During her first full year in office, the Governor, Ms Linah K. Mohohlo, was engaged in a wide variety of activities both within and outside the Bank. Among the major activities of 2000, the Governor presented the Bank's *2000 Monetary Policy Statement* in February and played an active role in ensuring the development of the Bank of Botswana's inflation forecasting capacity. She officiated at the Bank's Silver Jubilee Celebrations in July 2000.

Botswana assumes membership of International Monetary and Financial Committee

2.3 The Governor also assumed membership of the 24-member International Monetary and Financial Committee (IMFC), on behalf of Botswana, for a two-year period effective October 2000, representing the Africa Group 1 Constituency[1] of the International Monetary Fund. The IMFC is an advisory body to the Board of the IMF.

2.4 Besides his supervisory responsibilities over the Departments of Research, Banking and Human Resources, Deputy Governor Jefferis made presentations at both the UNCTAD/UNDP Workshop on Globalisation, Liberalisation and Sustainable Human Development and at the annual Bankers Conference organised by the Bank of Namibia.

2.5 Deputy Governor Majaha-Järtby continued to carry out her regular supervisory responsibilities for the Financial Institutions, Management Systems and Support Services Departments. She participated as a

[1] The Africa Group 1 Constituency comprises 21 Sub-Sahara African countries, namely: Angola, Botswana, Burundi, Eritrea, Ethiopia, The Gambia, Kenya, Lesotho, Liberia, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe.

resource person in a banking supervision course in Abidjan, Cote d'Ivoire, organised by the IMF and the Joint Africa Institute.

2.6 The Board held six meetings during the year (which included three Audit Committee meetings). The Board Secretariat continued to provide secretarial services to the Board and to other Bank committees as necessary. The Division also made logistical arrangements for seminars and other Bank functions, which included the launching of the 2000 *Monetary Policy Statement*, the Bank's economic briefings, the Senior Management Retreat and Seminars. The Secretariat published the Bank's periodic newsletters and coordinated the implementation of the Bank's community welfare activities through the Bank's donations policy.

The Board met six times

2.7 A biannual three-day Senior Management Retreat was held in August 2000 and it focussed on the formulation of three-year strategic plans for each Department. The aim of the strategic plans is to bridge the gap between the annual Work Programmes and the Bank's Vision 2021.

2.8 On behalf of the Government, the Bank undertook the sovereign credit rating initiative for Botswana under the advice of JP Morgan. Two rating agencies, Moody's and Standard and Poor's, were appointed for the exercise[2].

Bank co-ordinates Sovereign Credit Rating

2.9 The Bank celebrated its 25th Anniversary on July 6, 2000. His Excellency, President Festus Mogae, who was the guest of honour at the main function, delivered a speech to mark the occasion. Other guests included cabinet ministers, members of the diplomatic corps, heads of parastatals, financial institutions, private sector business leaders, media representatives as well as former Governors and Deputy Governors. The celebrations were also attended by the Governors of SADC Central Banks, while the International Monetary Fund, the Bank of England and the Deutsche Bundesbank were represented by senior officials. Other overseas guests included Professor Jeffrey Sachs, Director of the Centre for International Development at Havard University in the USA, and representatives of the Bank's international counterparties.

Silver Jubilee celebrations

2.10 There were three events to mark the two-day celebrations. In addition to the main event at which His Excellency, President Mogae and the Governor delivered their respective speeches to mark the occasion, Professor Sachs presented a seminar paper on "The Next 25 Years in African Economic Development" and Dr Jürgen Stark, Deputy Governor of the Deutsche Bundesbank, delivered a dinner speech on "Future Trends in Central Banking". The celebrations were concluded with a cultural show, which included a play focused on the history of the Bank.

2.11 A commemorative booklet, *Bank of Botswana, 1975-2000*, was issued to mark the occasion. The illustrated booklet reviews the main activities of the Bank and the progress made during the past 25 years.

2 See page 62, footnote 21

Financial Affairs and Auditing

Internal Audit introduces Control Risk Self Assesment

2.12 The Internal Audit Division continued to play its role in monitoring and evaluating the various controls in the Bank through the use of modern auditing techniques such as proactive auditing, risk based auditing, performance auditing and rating of reports according to their significance. In addition, the Division coordinated the Control Risk Self Assessment (CRSA) programme.

2.13 Apart from carrying out the 2000 routine accounting activities, the Bank successfully implemented an automated cheque writing project.

New Insurance Strategy

2.14 A comprehensive review of the Bank's insurance strategy was undertaken during the year. The new strategy places emphasis on high value assets and potential high-risk areas.

Banking Services

2.15 The provision of banking services to commercial banks, Government and other selected institutions was successfully carried out during the year.

National Payments System

2.16 A draft National Payment Systems Strategic Framework was produced towards the end of 2000. The framework brought Botswana's payment modernisation programme closer to developments in other SADC member countries.

Bank Notes and Coin

2.17 New P50 and P100 notes and a P5 coin were introduced.

Banking Supervision

Banking system remained sound

2.18 During 2000, the banking system remained healthy, stable and profitable. The Bank conducted on-site examinations for the four commercial banks, and was satisfied that the banks were adequately capitalised, prudently managed and had good asset quality.

Annual Banking Supervision Report produced

2.19 In addition to the statutory report to the Minister of Finance and Development Planning on the state of the banking industry in 1999, the Bank also produced an *Annual Banking Supervision Report* (1999) for the first time and undertook a comprehensive review of statutory returns.

2.20 The Bank conditionally approved one off-shore banking licence for ABC Holdings Limited, and granted an Exemption Certificate to Seed Company International Limited to operate in the International Financial Services Centre (IFSC). A banking licence was granted to Bank of Baroda (Botswana) Limited, which is expected to start operations in

March 2001. Approval was given to ulc (Pty) Limited to extend its banking licence from a credit institution to a merchant/investment bank. First National Bank of Botswana Limited (FNBB) was authorised to hold a 40 percent stake in a micro-lending company on condition that FNBB was the approving body for such loans. In addition, the bank was granted permission to acquire shares in Premium Credit Botswana (Pty) Limited, an insurance financing company, subject to stipulated conditions.

Pyramid Schemes

2.21 There was a re-emergence of pyramid schemes throughout the country during the year. Accordingly, and in accordance with Section 3 of the Banking Act, 1995, the Bank issued "cease and desist orders".

Pyramid schemes re-emerge

Bureaux de Change Operations

2.22 There were 19 licensed bureaux de change in 2000, of which 14 were operational by year-end.

Human Resources Administration

2.23 The Bank's establishment during 2000 was 550, and the Human Resources Department continued to enhance the strategic planning process and technical input in human resources policy formulation. As usual, an active training programme comprising short and long duration courses was implemented during the year.

Strategic planning enhanced

Reserves Management

2.24 A new asset allocation framework was implemented during the year, which included minor changes to a number of portfolio mandates. The Bank also continued to monitor, manage and control the various financial risks in line with approved investment guidelines.

New asset allocation framework implemented

Open Market Operations

2.25 The Bank continued to implement monetary policy through the use of open market operations. Eleven auctions of Bank of Botswana Certificates (BoBCs) were conducted during the year, and the Bank Rate was increased twice, by 50 basis points each time, to 14.25 percent.

Eleven auctions conducted

Management Systems

2.26 The Bank undertook a number of projects during the year, especially the following:

A number of IT projects undertaken

- selection of the dbs financial systems software for the National Electronic Clearing House project;

- acquisition of the CA Unicenter TNG system for administering the network; and

- implementation of the Lotus Collaborative Software system which has modules for document and automated workflow management.

Research and Publications

2.27 During 2000, the Bank continued its work in the areas of economic analysis and policy advice.

2000 Monetary Policy Statement launched

2.28 The Bank launched the 2000 *Monetary Policy Statement* in February and published the *1999 Annual Report*, the December 1999 *Research Bulletin* and the monthly issues of the *Botswana Financial Statistics*. In addition, the Bank updated the SADC central bank database, the IMF *International Financial Statistics* and the IMF *Exchange Arrangements*. The Bank also participated in a seminar on trade in services and a workshop on the SADC trade protocol.

Economic briefings conducted

2.29 Six economic briefings were conducted on the *1999 Annual Report* to a diverse inter-sectoral audience, which included His Excellency, President Mogae and Cabinet Ministers. The theme of the *Report* was "A Sectoral Review of Botswana's Economy Over the Last Decade". In addition, the Bank conducted a number of seminars on a variety of topics.

PART A

ANNUAL FINANCIAL STATEMENTS
2000

BANK OF BOTSWANA

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The Annual Financial Statements set out on pages 30 to 40 were approved by the Board on March 16, 2001, and signed on its behalf by:-

Linah K. Mohohlo
Governor

Nozipho A. Mabe
Director, Accounting Department

KPMG

Certified Public Accountants

Gaborone Office
Plot 50364B
Fairground Park
Gaborone

Mail Address
P.O.Box 1519
Gaborone

Telephone +267 312 400
Telefax +267 375 281

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers
Plot 50371
Fairground Office Park
Gaborone
P O Box 1453
Gaborone, Botswana
Telephone: (267) 352011
Fascimile: (267) 373901

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 30 to 40 for the year ended December 31, 2000. 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 statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion:

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

- the financial statements give a true and fair view of the state of the Bank's affairs as of December 31, 2000 and of the result of its operations for the year then ended in the manner required by the Bank of Botswana Act, 1996.

PricewaterhouseCoopers

PricewaterhouseCoopers
Certified Public Accountants

KPMG

KPMG
Certified Public Accountants

GABORONE
March 16, 2001

BALANCE SHEET
December 31, 2000

	Notes	2000	1999
ASSETS			
		P'000	P'000
Fixed Assets	1	131 140	122 008
Foreign Exchange Reserves			
Liquidity Portfolio	2.1	4 681 319	3 936 492
Pula Fund	2.2	28 711 638	24 453 690
International Monetary Fund			
Reserve Tranche	3.1	123 962	143 607
Holdings of Special Drawing Rights	3.2	211 148	180 128
Administered Funds	3.4	152 119	138 375
		33 880 186	28 852 292
Other Assets	4	22 576	16 352
TOTAL ASSETS		34 033 902	28 990 652
LIABILITIES			
Notes and Coin in Circulation	5	606 489	606 817
Bank of Botswana Certificates	6	3 712 398	4 230 167
Deposits	7	1 072 065	1 049 653
Government Investment Account	8	23 580 585	19 222 667
Allocation of Special Drawing Rights (IMF)	3.3	30 461	27 711
Liabilities to Government (IMF Reserve Tranche)	9	123 962	143 607
Dividend to Government	10	521 722	300 000
Other Liabilities		32 490	22 763
Total Liabilities		29 680 172	25 603 385
SHAREHOLDER'S FUNDS			
Paid-up capital	11	25 000	25 000
Currency Revaluation Reserve	12	2 423 138	1 343 958
Market Revaluation Reserve	13	305 592	418 309
General Reserve		1 600 000	1 600 000
Total Shareholder's Funds		4 353 730	3 387 267
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		34 033 902	28 990 652

INCOME STATEMENT
Year ended December 31, 2000

	Notes	2000 P'000	1999 P'000
INCOME			
Interest		1 257 677	1 046 786
Net market gains on disposal of securities		817 510	430 049
Dividends		145 600	130 419
Commissions		24 481	23 547
Unrealised market revaluation gains - Liquidity Portfolio		-	7 820
Other income		5 498	4 372
Realised currency revaluation gains		3 650	-
		2 254 416	1 642 993
EXPENSES			
Interest		500 909	383 470
Administration costs		127 562	105 468
Depreciation		7 164	6 430
Unrealised market revaluation losses - Liquidity Portfolio		681	-
Realised currency revaluation losses		-	6 716
		636 316	502 084
NET INCOME FOR THE YEAR		1 618 100	1 140 909
TRANSFER FROM GOVERNMENT INVESTMENT ACCOUNT	8.1	-	59 091
NET INCOME AVAILABLE FOR DISTRIBUTION		1 618 100	1 200 000
APPROPRIATIONS			
DISTRIBUTION TO GOVERNMENT		(1 166 722)	(1 200 000)
Dividend to Government from Pula Fund		(860 000)	(1 149 414)
Share of residual net income		(306 722)	(50 586)
TRANSFER TO GOVERNMENT INVESTMENT ACCOUNT	8.1	(451 378)	-

ACCOUNTING POLICIES
December 31, 2000

BASIS OF ACCOUNTING

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 in so far as they are appropriate for a Central Bank.

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.

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 counterparties in the financial sector. The aim of issuing BoBCs is 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 generally 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 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:

Buildings	2.50%
Furniture, fixtures and equipment	20.00%
Computer hardware	33.33%
Computer software	100.00%
Motor vehicles	25.00%

RETIREMENT BENEFITS

Pension benefits are provided for employees through the Bank of Botswana Staff Pension Fund which is governed in terms of the Pension and Provident Funds Act (Chapter 27:03). This is a defined contribution plan under which pensions are based on the actual performance of the fund. Contributions are at the rate of 21.5 percent of pensionable emoluments of which pensionable employees of the Bank pay 4 percent.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS
December 31, 2000

1. **FIXED ASSETS**	**Freehold Land**	**Leasehold Land**	**Buildings**	**Capital Works in Progress**	**Other Assets**	**Total**
Cost or Valuation						
	P'000	P'000	P'000	P'000	P'000	P'000
Balance at the beginning of the year	607	3 486	118 306	7 406	27 550	157 355
Additions	-	-	-	9 011	7 381	16 392
Disposals	-	-	-	-	(838)	(838)
Adjustment	-	-	-	-	(90)	(90)
Transfers		-	1 597	(2 308)	711	-
Balance at the end of the year:	607	3 486	119 903	14 109	34 714	172 819
Accumulated Depreciation						
Balance at the beginning of the year	-	-	15 499	-	19 848	35 347
Charge for the year	-	-	2 958	-	4 206	7 164
Disposals	-	-	-	-	(845)	(845)
Adjustments	-	-	-	-	13	13
Balance at the end of the year	-	-	18 457	-	23 222	41 679
Net book value as at December 31, 2000	607	3 486	101 446	14 109	11 492	131 140
Net book value as at December 31, 1999	607	3 486	102 807	7 406	7 702	122 008

2 **FOREIGN EXCHANGE RESERVES**	2000	1999
	P'000	P'000
2.1 **Liquidity Portfolio**	4 681 319	3 936 492
2.2 **Pula Fund**	28 711 638	24 453 690

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

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

The financial information of the Pula Fund is given below:-

	2000 P'000	1999 P'000
Pula Fund Balance Sheet		
Capital Employed		
Government	23 080 585	18 073 628
Bank of Botswana	5 631 053	6 380 062
	28 711 638	24 453 690
Employment of Capital		
Investments	28 711 638	24 453 690
Investments expressed in US dollars ('000)	5 354 720	5 279 552
Investments expressed in SDR ('000)	4 108 635	3 846 466
Pula Fund Income Statement		
Income		
Interest and dividends received	1 165 939	1 049 215
Net realised market gains	810 412	438 329
Sundry income	46	11
	1 976 397	1 487 555
Administration charges	(63 934)	(52 559)
Net Income for the year	1 912 463	1 434 996
Transfer from Government Investment Account	-	59 091
Net Income available for distribution	1 912 463	1 494 087
Appropriations		
Distribution to Government	(1 311 378)	(1 149 414)
Dividend to Government	(860 000)	(1 149 414)
Transfer to Government Investment Account	(451 378)	-
Bank of Botswana's share of net income	601 085	344 673

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.

	2000 P'000	1999 P'000
Quota (SDR63 000 000)	440 252	400 509
Less IMF Holdings of Pula	(316 290)	(256 902)
Reserve Position in IMF	123 962	143 607

3.2 Holdings of Special Drawing Rights	211 148	180 128

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	30 461	27 711

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 and Growth Facility (PRGF) Trust	48 662	44 267

The amount represents the equivalent of SDR6 893 680 (and interest accrued thereon) lent on July 1, 1994 to the Poverty Reduction and Growth Facility (formerly Enhanced Structural Adjustment Facility Trust), a fund administered in trust by the IMF.

(ii) Poverty Reduction and Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust	103 457	94 108

The amount represents SDR14 607 060 (and interest accrued thereon) lent on April 30, 1997 to the Poverty Reduction and Growth Facility/Heavily Indebted Poor Countries Trust, a fund administered in trust by the IMF.

	152 119	138 375

	2000 P'000	1999 P'000
4. OTHER ASSETS	22 576	16 352

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

5. NOTES AND COIN IN CIRCULATION

	2000 P'000	1999 P'000
Notes	565 876	577 330
Coins	40 613	29 487
	606 489	606 817

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

	2000 P'000	1999 P'000
Face Value	3 893 080	4 442 476
Unmatured Discount	(180 682)	(212 309)
Market Value	3 712 398	4 230 167

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

7. DEPOSITS

	2000 P'000	1999 P'000
Government	637 916	676 712
Bankers	250 781	201 066
Other	183 368	171 875
	1 072 065	1 049 653

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 035 108 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:

	2000 P'000	1999 P'000
Issues of National Savings Certificates	1 656	1 020
Less: Redemptions	619	249
Net issues	1 037	771
Less: Amounts awaiting collection from agents	2	80
Amount due to Government on behalf of the Scheme	1 035	691

8. GOVERNMENT INVESTMENT ACCOUNT

8.1 Pula Fund

Balance at the beginning of the year	18 073 629	18 233 257
Transfer to Income Statement	-	(59 091)
Transfer from/(to) Government Investment Account - Liquidity Portfolio	3 159 841	(500 000)
Excess of share of Pula Fund income over distribution	451 378	-
Share of unrealised currency gains (Note 12)	1 641 651	150 535
Share of unrealised market (losses)/gains (Note 13)	(245 914)	248 928
Investment by Government in the Pula Fund at the end of the year	23 080 585	18 073 629

8.2 Liquidity Portfolio

Balance at the beginning of the year	1 149 038	91 140
Transfer (to)/from Government Investment Account - Pula Fund	(3 159 841)	500 000
Net Transfers from Government Deposit Account	2 510 803	557 898
Investment by Government in Liquidity Portfolio at the end of the year	500 000	1 149 038
Total Government Investment Account	23 580 585	19 222 667

The Government Investment Account represents the Government's share of the Pula Fund and the Liquidity Portfolio which were established on January 1, 1997.

During the year ended December 31, 1999, the distribution to the Government included an amount of P59 091 443 transferred to the Government Investment Account.

	2000 P'000	1999 P'000

9. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)

	2000 P'000	1999 P'000
	123 962	143 607

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

10. DIVIDEND TO GOVERNMENT

	2000 P'000	1999 P'000
Balance at the beginning of the year	300 000	257 386
Dividend to Government from Pula Fund	860 000	1 149 414
Government share of residual net income	306 722	50 586
Paid during the year	(945 000)	(1 157 386)
Balance at the end of the year	521 722	300 000

The final instalment of the pre-set dividend of P215 000 000 and the residual dividend of P306 722 232 unpaid at December 31, 2000 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.

11. CAPITAL

	2000 P'000	1999 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

12. CURRENCY REVALUATION RESERVE

	2000 P'000	1999 P'000
Balance at the beginning of the year	1 343 958	1 254 177
Pula Fund currency gains for the year	2 394 121	192 069
Transfer to Government Investment Account (Note 8.1)	(1 641 652)	(150 535)
	2 096 427	1 295 711
Liquidity Portfolio currency gains for the year	326 711	48 247
Balance at the end of the year	2 423 138	1 343 958

	2000 P'000	1999 P'000
13. MARKET REVALUATION RESERVE		
Balance at the beginning of the year	418 309	322 454
Unrealised market (losses)/gains for the year	(358 631)	344 783
	59 678	667 237
Transfer to Government Investment Account (Note 8.1)	245 914	(248 928)
Balance at the end of the year	305 592	418 309

14. CAPITAL COMMITMENTS

Approved and contracted for	2 540	7 908
Approved but not contracted for	18 928	16 926
	21 468	24 834

These capital commitments will be funded from internal resources.

15. RISK MANAGEMENT POLICIES IN RESPECT OF FINANCIAL INSTRUMENTS

The risk management policies of the Bank regarding financial instruments are dealt with in Part A of the Annual Report on the Bank's operations.

PART B

RECENT DEVELOPMENTS
IN THE
BOTSWANA ECONOMY

BANK OF BOTSWANA

CHAPTER 1

RECENT DEVELOPMENTS IN THE BOTSWANA ECONOMY

1. OUTPUT, EMPLOYMENT AND PRICES

National Income Accounts

1.1 Preliminary estimates of national income accounts for 1999/00 indicate that real growth of gross domestic product (GDP) was 7.7 percent.[1] The growth rate was considerably higher than in the previous year, for which the revised estimate is 4.1 percent. It was, however, lower than the 10 percent that had been forecast by Government at the time of the 2000 Budget Speech.

1.2 There were also revisions to GDP estimates for earlier years, which took into account new information and reclassification of certain activities. Another development was that quarterly GDP estimates have been made starting in 1995/96. These innovations and improvements are described in more detail in Box 1.1.

(i) Output

1.3 The principal reason for the acceleration in growth in 1999/00 was increased activity in the *mining* sector. The sector grew by 11.9 percent, contrasting with a 2.9 percent decline in the previous year. The coming on stream of the Orapa expansion project during the first half of 2000 explained most of the rapid growth of output for the sector. Due to some technical problems, the project did not reach full capacity until later during the year. As a result, growth was less than the 15 percent forecast initially and, consequently, the rise in mining output during 2000/01 is likely to be higher than originally anticipated.

Box 1.1: Revisions to the National Accounts Estimates

National accounts estimates provide important data that help assess the performance of the economy. The data are presented as both aggregate measures, such as GDP, and disaggregated into important sub-components. The three major breakdowns are by sector of output, type of expenditure and source of income.

Most countries produce national accounts guided by the System of National Accounts (SNA), a set of international standards compiled under the auspices of various organisations including the United Nations, the IMF and the World Bank. Meeting all the standards set by the SNA requires significant resources. For this reason, many countries are unable to fully comply with the requirements. However, adoption of the basic guidelines of the SNA is essential for the reliability and comparability of data.

In recent years, the Botswana national accounts statistics have been revised on several occasions. The objectives of the revisions have included the introduction of improved methods of statistical estimation and improvements in the consistency of the accounts with the most recent (1993) version of the SNA. The changes introduced at the time of the publication of the provisional estimates for 1999/00 were the most far-reaching, since they involved significant elements of reclassification. In particular, and very important for Botswana, the treatment of mining activities has been altered, with prospecting activity being redefined both as a business service (in line with related activities such as surveying) and as investment rather than as intermediate consumption activity. As a result, both total output and its sectoral allocation have been revised.

The estimates of household consumption in the expenditure account have been improved through the introduction of annual surveys to estimate this item directly. Previously, household consumption was measured as a residual after the estimates of other items had been determined. The annual surveys will be supplemented by the more comprehensive information contained in the Household Income and Expenditure Surveys (HIES) that are undertaken periodically. The next HIES is currently scheduled for 2002.

A further innovation is the production of quarterly GDP estimates. The estimates will enable the seasonal variations in output and expenditure to be observed directly and should be of great benefit to economic analysis. However, for the estimates to be useful, it is important, particularly for policy makers, that the quarterly data are produced on a timely basis, preferably with only a short lag after the end of each quarter. Users must also be aware that these data should be used with some caution since, by necessity, they are based on only partial information and, as such, are likely to be subject to subsequent revisions.

[1] The national accounts year runs from July to June. This coincides with the tax year, but is different from both the calendar year and the Government's financial year (April to March).

1.4 The non-mining economy expanded by 5.7 percent. A major contributing factor was continued growth in the *general government* sector, which rose by 6.0 percent. Excluding both mining and government, output in the rest of the economy expanded by 5.6 percent compared to 8.3 percent in 1998/99.

1.5 Within the lower average growth rate, sectoral performances varied considerably. Some sectors showed higher growth: *water and electricity* (8.0 percent) and *trade, hotels and restaurants* (6.1 percent) and *general government* (6.0 percent). Other sectors, however, generally expanded at slower rates.

1.6 Growth in *manufacturing* was 3.2 percent (5.7 percent in 1998/99), the lowest since the early 1990s. Some slowdown of the sector was expected in view of the closure of the Hyundai vehicle assembly plant in early 2000. That the sector still showed overall positive growth despite the setback, is an indication that manufacturing in Botswana is more robust and well established than is sometimes presumed to be the case.

1.7 *Transport and communication* showed a sharply slower growth of 1.7 percent (16.2 percent in 1998/99). This out turn was not surprising since both sub-sectors experienced difficulties. Rail transport continued to be negatively affected by the slump in transit traffic while the technical problems at Botswana Telecommunications Corporation (BTC) impacted on the communications sub-sector, offsetting the strong growth in the operations of mobile phones.

1.8 *Construction* grew by only 2.4 percent (11.5 percent in 1998/99). However, that this sector showed positive growth at all suggested that there was no recession in the sector in 2000, contrary to some expectations.

1.9 The slow growth of 3.7 percent, against 9.0 percent in 1998/99, in the output of the *bank, insurance and business services* reflected the differing performances of the institutions comprising the sector. While banking activity continued to grow at a healthy pace, poor performance elsewhere in the sector held the overall growth rate down. In particular, business services, which account for around a quarter of sectoral value added, did not perform well. *Inter alia*, this may reflect a reduction in the rate at which new Government projects have been getting underway. In the circumstances, the pace of project implementation might be seen as a leading indicator that some slowdown in construction, and therefore business services, is in the offing. However, given the rapid increase in Government development spending announced in the 2001 Budget Speech (see below), such a dip, if it occurs at all, is likely to be only temporary.

1.10 During 2000, a slowdown of activity in the local property market was reported by real estate analysts. In particular, there was increased availability of good-quality office space. While this may have impacted negatively on the operations of some businesses and may have been a further contributory cause of the reduced growth in business services, for the economy as a whole, such a slowdown in real estate development was beneficial. Offices were being vacated not because of a decline in economic activity but due to mature businesses increasingly moving to their own purpose built premises, a sign of confidence in the prospects for the economy. As a result, office space was available for new businesses to Botswana for immediate occupation and at more reasonable prices. Since availability of affordable office space has been seen as a constraint on economic development in Botswana (for example, it has been cited as a potential impediment to the rapid growth of the International Financial Services Centre (IFSC)), this turn of events is to be welcomed.

1.11 *Agriculture* continued its sequence of poor performances, with a decline of 8.7 percent (a decrease of 7.6 percent in 1998/99). The serious floods in early 2000, which significantly disrupted both arable and livestock farming activities, contributed to the poor agricultural performance. Early signs are that 2000/01 will also be a poor year, as the drought conditions that prevailed during the crucial ploughing and planting period, severely limited both the area under cultivation and the expected yields. However, such setbacks are not the fundamental cause of the malaise in the sector, which has been characterised by low growth in output and productivity for many years, a factor which has led the Government to initiate a review of the effectiveness of its policies to support the sector.

1.12 With the impact of the Orapa expansion project still feeding through, both the mining sector and the economy as a whole will experience further significant growth in 2000/01. In its *Annual Economic Report 2001*, the Government indicated that growth in mining in excess of ten percent should again be expected.[2] It is, however, not clear whether the non-mining activities will continue to expand at the modest growth rates seen in 1999/00 or there will be some improvement.

1.13 One factor that will influence growth is the rate of increase in Government spending. The most recent budget estimates (Table 1.1; more details are given in Section 2 of this chapter) provide a mixed picture. Recurrent spending by Government is budgeted to grow strongly by some 12 percent in real terms in the 2000/01 fiscal year, which will provide support to the many businesses that depend on Government's custom. In contrast, real growth in development spending may be negative. This pattern of budgetary allocation suggests that growth in both construction and related business services as well as the output of the government sector itself, where wages and salaries are the major component, could slow down.

(ii) Expenditure

1.14 The latest GDP estimates include significant revisions to the breakdown by expenditure category. Most significantly, the methodology for estimating household expenditure has been revised, resulting in a much smoother pattern of growth rates. One result of the new methodology is that the very rapid rate of increase in expenditure initially estimated for 1998/99, which had been associated with the large Government pay increase in 1998, is no longer evident.[3]

1.15 In 1999/00, the most significant development was the impact of the recovery in the international diamond markets. As expected, the share of stockbuilding in GDP fell sharply to 0.4 percent due to the selling of stockpiled diamonds compared to 7.7 percent in 1998/99 when diamond stocks were built up due to weak international demand.[4] Correspondingly, the balance of exports minus imports increased from a negligible 0.4 percent of GDP in 1998/99 to 12.5 percent in 1999/00.

Table 1.1: REAL GROWTH IN GOVERNMENT SPENDING,[1] 1999/00 AND 2000/01

	1999/00	2000/01
Total	5.5	5.3
Wages and salaries	3.0	0.5
Other recurrent[2]	6.4	11.9
Development	7.8	-2.9

1. Real growth rates calculated using the CPI inflation in the middle of the financial year (i.e. September). For 2000/01 the most recent published estimates of spending are used.
2. Excludes interest on public debt.

Source: *Financial Statements*, MFDP

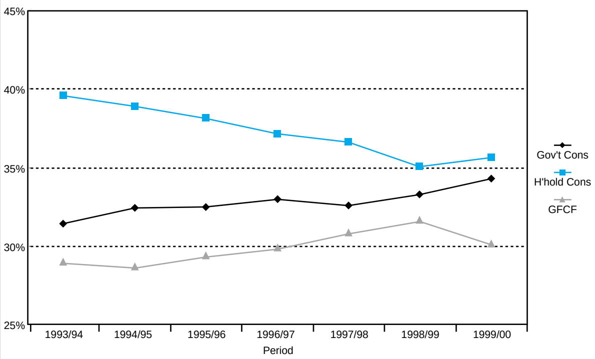
[2] *Annual Economic Report 2001*, page 22.

[3] See Bank of Botswana *Annual Report 1999* (p45). Originally, the expenditure growth rate was estimated at 23.4 percent. It has now been revised to 6.1 percent.

[4] While this movement is in line with expectations, the data on stock building should be treated with some caution because it is now calculated as a residual.

1.16 Chart 1.1 shows the composition of domestic expenditure, excluding stockbuilding, since 1993/94. The exclusion of stocks highlights the changing balance between consumption by households and government, on the one hand, and gross fixed capital formation on the other. Over the period 1993/94 - 1999/00 there has been a clear trend for household consumption to decline in importance relative to government consumption. During the mid-1990s, there was an increase in the share of gross fixed capital formation, reflecting the increased pace of the government's investment programme. However, the share fell back in 1999/00 due to the slower real growth rates of government development spending.

CHART 1.1: DOMESTIC EXPENDITURE EXCLUDING STOCKBUILDING (PERCENT OF GDP), 1993/94 – 1999/00



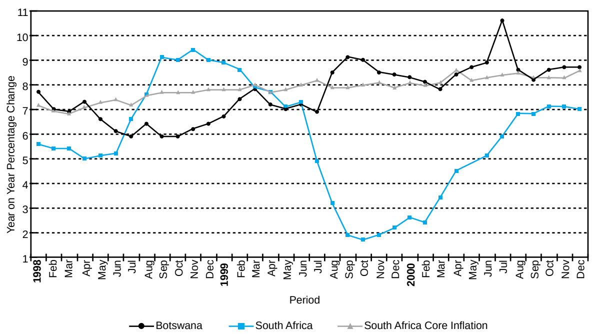
Inflation

1.17 During 2000[5], upward revisions were made to the Consumer Price Index (CPI), backdated to July 1999. Partly reflecting the revisions to the index, inflation rose in 2000. More importantly, however, the rise in inflation was a result of the supply shocks during the year associated with the adjustments of administered prices and the rise in the cost of oil imports, as well as the momentum of inflationary pressures that set in during 1999. Based on the revised index, inflation rose to an average of 8.6 percent in 2000 compared to 7.8 percent in 1999 and 6.5 percent in 1998. After a peak of 10.6 percent in July 2000, inflation eased to 8.7 percent by the end of the year.

1.18 The factors that drove inflation during 2000 included the rise in fuel prices, which in turn, raised production costs. There was also an increase in rentals charged by the Botswana Housing Corporation (BHC). Simultaneously, the growth of domestic demand was still high, although the trend was downward. Fuel prices were increased four times during the year: in January, March, July and September, as a result of which pump prices reached record high levels. Furthermore, floods early in the year had an adverse effect on prices of both domestic and imported consumables, while public sector house rentals, which were increased by up to 25 percent in July, also contributed to the rise in the cost of living.

1.19 As shown in Chart 1.2, Botswana's inflation was generally higher than South Africa's core inflation[6] throughout 2000.

CHART 1.2: BOTSWANA AND SOUTH AFRICA ANNUAL INFLATION

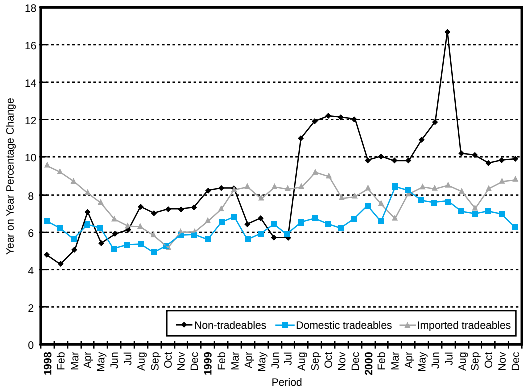


1.20 The cost of imported tradeables accelerated from an increase of 7.9 percent in 1999 to 8.8 percent in 2000, reflecting mainly the rise in oil prices. For domestic tradeables, the rate of price increases showed a declining trend, slowing down from 6.7 percent in the previous year to 6.3 percent in 2000. Apart from the technical factor which raised inflation to double digits, the cost of non-tradeables, which are mostly services, rose at a reduced rate of 9.9 percent compared to 12.0 percent in 1999.

5 The revisions were a result of the failure to include the July 1999 BHC rental increases in the CPI at the appropriate time. The revisions took place in August 2000.

6 Core inflation excludes mortgage interest rates and prices of various volatile food items.

CHART 1.3: CPI INFLATION BY TRADEABILITY



Employment

1.21 Significant revisions were made to the estimates of formal sector employment for September 1999.[7] While these changes affected all sectors, they had two principal effects. First, the overall growth rate in employment for the year to September 1999 was revised upwards to 6.4 percent compared to an original estimate of 5.8 percent. Second, the rate of increase in employment by Government was revised downwards to 2.1 percent against the earlier rate of 3.2 percent, while that of the non-government sectors was increased to 9.6 percent from 7.7 percent. The revisions reinforced the trend of the late 1990s when the non-government sectors took the lead in employment growth.

1.22 The relative employment growth pattern continued into 2000. Provisional estimates for September show that overall employment rose by a much slower rate than in 1999. Again, the main source of this growth was outside of Government, with non-government employment growing by 3.1 percent. Employment by Government rose by only 0.6 percent. The employment increases in manufacturing (1.3 percent) and construction (3.3 percent), were in line with the GDP estimates, indicating that activity in these sectors was fairly robust.

1.23. The mining sector reported a slight fall in employment. The employment performance was consistent with the rapid growth in the sector's output, as the Orapa expansion was achieved on the basis of high capital intensity and enhanced efficiency rather than additional employment. However, prospects are that there will be additional mining employment due to the planned expansion of the Phoenix copper-nickel mine near Francistown[8] as well as the small new diamond mine that is scheduled to be opened near Orapa, both of which are expected to become operational during 2002.

1.24 The real estate and business services sector also showed a very small fall in employment. Lack of job growth in this sector was also consistent with GDP estimates which, as already indicated, showed slow growth for this sector.

1.25 Since 1997, the cumulative growth in formal sector employment has been 20.3 percent. Although employment in the informal and traditional sectors are excluded, it would be expected that the rapid growth in employment would reduce the rate of unemployment. Evidence of such a reduction was indicated by the Central Statistical Office which estimated that in 2000 the unemployment rate was 15.8 percent compared to 19.6 percent in 1997, which was, in turn, an improvement on the rates in excess of 20 percent during the first half of the 1990s.

2 THE 2001 BUDGET SPEECH

Policy Issues

2.1 The 2001 Budget Speech was made in the context of the Mid-Term Review (MTR) of the NDP 8, which had been approved by Parliament during 2000 (Box 1.2). The theme for the Speech was 'accelerating economic diversification'. In addressing the theme, the Speech covered a wide range of issues. It presented various new initiatives ranging

[7] Such revisions were to be expected since the original estimates, released early in 2000, were provisional, being based only on partial response to the employment survey undertaken by the Central Statistics Office.

[8] The number of employees at Phoenix is expected to double to around 900. However, the number of net new jobs will be smaller, due to the phasing out of operations at Selkirk. Some of the workforce from this operation will be relocated to Phoenix.

Box 1.2: Mid-Term Review of NDP 8

The preparation of a Mid-Term Review (MTR) is a standard feature of the development planning process in Botswana. The purpose of the MTR is to monitor progress on the implementation of the policies outlined in the National Development Plan (NDP) and to assess whether these policies need any adjustment in the light of recent developments that have taken place since the preparation of the plan. Such developments may include changes in economic circumstances and/or a reordering of priorities. Therefore, MTR provides a necessary element of flexibility in the planning process; it also undertakes important groundwork prior to the preparation of the next NDP.

At the time of the preparation of NDP 8, the theme of which is 'Sustainable Economic Development', the main issues were determined to be: economic diversification, employment creation, poverty reduction, policy reform in the public sector, provision of infrastructure and cost recovery, human resource development, rural development, as well as environmental conservation and land use planning. In preparing the MTR, there were widespread consultations, both within the Government and more widely, about whether these issues were still relevant. The MTR confirmed their importance, with particular stress on unemployment, poverty reduction, public sector reform and conservation. In addition, other important issues have now come to the fore: HIV/AIDS, financial discipline, citizen economic empowerment, as well as recurrent and maintenance costs.

As a result of the identification of the additional issues, significant emphasis was given to several of these emerging issues in the 2001 Budget Speech, following the approval by Parliament of the MTR. Most obviously, the issue of tackling HIV/AIDS received prominence with the announcement of various initiatives and associated funding. This adjustment of priorities was clearly necessary: the estimated number of HIV positive people in Botswana increased by two-thirds since NDP 8 was prepared.

The issue of citizen economic empowerment has become prominent in public discussion since the beginning of NDP 8. While the economy generally continued to perform well (in the first half of the plan period, GDP growth was about two percent per annum higher than initially anticipated), the perception that Batswana were being sidelined in the process of development intensified. It was appropriate that this concern was reflected in the MTR and it was anticipated that certain special measures would be introduced. At the same time, however, it was clear that the main emphasis would continue to be on effective education and training to enable Batswana to compete in business, rather than protection from such competition.

During the period covered by the MTR, development spending was characterised by 'front-end loading', which attempted to reduce the backlog of delayed projects. This had put considerable strain on the limited resources, especially skilled manpower, available to the Government and private sector contractors. As a result, serious problems of cost escalation and poor work quality emerged. Costs also increased because, in many instances, the initial estimates of projects' outlays and scope were inadequate. Government has clearly recognised the problem, but the practical challenges of achieving the necessary financial discipline remain very great. That there is continued pent-up demand for further public spending, was clear when the MTR was discussed by Parliament and was not approved until some proposals to cut back on the level of development spending had been amended to include additional projects. For this reason, there may remain the risk that some of the problems associated with rapid spending will continue. While including these revisions in its budget for the rest of NDP 8, the Government was very careful to stress the importance of the related elements in the MTR, in particular, the need to give more priority to maintaining the current stock of public infrastructure and introducing meaningful measures of cost recovery.

from the establishment of new entities that would implement specific policy objectives, to reviews of some existing policies.

2.2 In putting together the Budget for 2001/02 the Government was faced with the challenge of reconciling competing objectives. On the one hand, there were strong demands for increased spending, while on the other, there were compelling reasons for slowing down expenditure. The need for a rise in expenditure emanated from two principal sources. First, the imperative of meeting the challenges posed by national emergencies, notably, the human and economic costs arising from the HIV/AIDS epidemic and the damage caused by the severe flooding in 2000. Second, as a result of revisions to the NDP8, the Government was committed to scheduling several public infrastructure programmes earlier than had originally been intended.

2.3 These demands were fuelled further by the buoyancy of Government revenues over the previous two years, which resulted in budget surpluses that were much healthier than originally anticipated. However, the extent to which the fiscal surpluses can support arguments for a rapidly accelerated programme of public spending is limited. The main source of higher revenues has been the Government's share of receipts from diamond exports, and the established policy is that such revenue should be used only for investment. Therefore, while the capital cost component of additional spending may be covered easily by development outlays, the related recurrent costs would, in most cases[9], need to be met from other revenue sources, which have not, as yet, been growing at a rapid rate.

2.4 At the same time, the reasons for Government's restraint in spending during 2000/01 remain valid. Rapid implementation of public spending programmes risks escalating costs and poor work quality; and when infrastructure projects are completed, the recurrent costs of their operation and maintenance require additional budgetary allocations. Moreover, in both the short- and long-term, the rise in Government's demands on national resources risks crowding out the private sector, thereby jeopardising the objective of economic diversification.

2.5 In the event, demands for increased spending prevailed and the development budget was increased significantly compared to 2000/01. For the remaining two years of the plan, an additional P5.5 billion has been budgeted, an increase of 31.0 percent over the previously agreed total of P17.9 billion. However, while proposing the rise in expenditure, it was also announced that such spending would be accompanied by other measures that, if carried out, will have important implications for future budgets.

2.6 Among the measures taken was the need to ensure that the maintenance costs are monitored and managed very carefully. Consequently, all ministries were directed to prepare, by June 2001, consolidated requirements for dealing with the backlog of maintenance costs. Thereafter, an accelerated maintenance programme would be prepared based on these needs. It was further indicated that the funding of the maintenance programme would take priority in future budgets, over further increases in development spending.

2.7 Several references were made to the need to introduce measures of cost recovery in health, education, sports facilities and road usage. More generally, the Speech emphasised that the MTR, while allowing additional spending, had also stressed the need for introducing cost recovery, and that this was an integral part of the policy package that had been approved by Parliament.

2.8 With regard to cost recovery, two observations are appropriate. First, even if cost recovery is introduced in a way that helps to ensure that the budget is sustainable in the long term and that public infrastructure is properly maintained, this does not deal

[9] This qualification is important. Under the policy, recurrent costs associated with education and health are regarded as investment. Therefore, to the extent that additional spending is concentrated in these areas, mineral revenues can be used to meet the entire cost.

with the problem that Government will be absorbing additional resources, possibly at the expense of the private sector. Second, while the principle of cost recovery may have been agreed upon, the details are still being finalised. Initially, it was decided to charge school fees for foreign children attending state schools in Botswana and some very limited measures were introduced in 2000 to raise funds for road maintenance[10]. Other proposals are still at the consultation stage.

2.9 In view of the seriousness of the HIV/AIDS epidemic in Botswana, the Speech accordingly stressed the importance of allocating appropriate resources to support well-thought-out programmes to mitigate the impact of the epidemic. Priority was given to enhancing the capacity of the health facilities to deal with patients with HIV/AIDS-related conditions.[11] For this reason, a programme of hospital upgrading is to be implemented together with complementary measures to ease the shortage of health personnel.

2.10 Moreover, the recently established National AIDS Coordinating Agency (NACA) is drawing up a National HIV/AIDS Care and Prevention Plan, which is to be completed by mid-2001. An integral part of the plan is coordination of the national effort to combat the pandemic with assistance from external parties including charitable foundations, academic institutions and pharmaceutical companies. Several such partnerships have already been established. With the national plan still under preparation, the extent of various programmes is being finalised. It was for this reason that the Budget Speech indicated that further allocations of funds might be needed later in the year to meet additional costs that may arise, including the possible provision of anti-retroviral drugs on a more widespread basis to HIV/AIDS sufferers, the feasibility of which is still being assessed.[12]

2.11 During 2000 the privatisation policy was extensively discussed and approved by Parliament. Since then, the Government has taken steps to begin implementing the policy with the initial step of establishing a Public Enterprise Evaluation and Privatisation Agency (PEEPA) and a chief executive officer is to be appointed early in 2001. The Government has also conducted programmes of consultation and public education on the privatisation process.

2.12 While a masterplan for privatisation is to be drawn up by PEEPA as one of its first tasks, it was announced that the Botswana Telecommunications Corporation (BTC) was likely to be an early candidate for privatisation, especially in view of the fact that the corporation has performed poorly, both technically and financially at a time when an efficient telecommunications system is increasingly an essential prerequisite in the global economy.

2.13 The already initiated privatisation of Air Botswana progressed further during 2000. With technical assistance from the International Finance Corporation (IFC) as lead advisor, necessary reviews and consultations took place, and in December 2000 a preliminary background memorandum was issued inviting expressions of interest from potential strategic investors. The whole privatisation process, which will include the selection of a strategic investor and an initial public offering of shares in the airline, is scheduled to take place during 2001.

2.14 During the past few years, the subject of economic empowerment of citizens has been debated widely. The need for citizen economic empowerment is in response to a widespread perception that Batswana are playing only a secondary role in the economic development of the country, and that

10 These measures, which included an increase in vehicle registration fees, are limited in the sense that funds raised will only cover a small portion of total maintenance costs. According to the Speech, the measures will raise an additional P30 million per annum, while in 1999 an independent report estimated that the cost of maintaining the country’s core road network, was at that time, in the region of P250 million.

11 A study conducted jointly by the Government and the United Nations Development Programme (UNDP) on the impact of AIDS had estimated that in 1998 more than half of the patients in hospital wards were suffering from such conditions.

12 Such drugs are currently available to victims of rape, those involved in hospital accidents and as part of the mother-to-child-transmission prevention programme.

economic power is concentrated in the hands of foreign nationals and businesses. A particular concern is that even when Batswana with necessary skills are available, they are often overlooked in favour of foreigners.

2.15 The Budget Speech addressed this issue by announcing a series of initiatives to promote citizen owned business ventures, including the establishment of:

- a system of reservation and preference for citizens in awarding consultancy contracts. The preferences will be an extension of the system already in place for construction projects;

- a refinancing of the micro-lending fund for Small, Medium and Micro Enterprises (SMMEs). An additional P70 million will be committed following the full utilisation of the initial P150 million during 2000. Funds will also be provided to improve the assistance given to borrowers and monitoring of projects that are funded. In addition, it was announced that tougher measures would be taken to recover repayment arrears;

- an autonomous Citizen Entrepreneur Development Agency (CEDA). The Agency will take over from Government both the responsibility of providing assistance to SMMEs and the activity of the Financial Assistance Policy (FAP). The financial support provided under FAP through grants will be discontinued and replaced by subsidised loans, with the interest rate and the repayment period depending on the size of the loan.[13] These loans will be available only to citizen-owned businesses. However, a venture capital fund will also be established under CEDA, which will be available to joint ventures between citizen and foreign investors. It is anticipated that CEDA will undertake mentoring and monitoring of the enterprises that it finances in order to increase the survival rate of these enterprises; and

- a Citizen Entrepreneur Mortgage Assistance Equity Fund (CEMAEF). The fund will take equity stakes in citizen owned properties which are threatened by loan foreclosure, in order to prevent ownership of the assets being transferred to foreigners.

2.16 The operational details of the schemes will subsequently be developed. However, two observations at this stage might be appropriate. First, these measures concentrate on citizen economic empowerment in terms of business *ownership*. This is important, but it is only one aspect of empowerment, which is likely to apply only to a minority of the population. For most Batswana, gaining access to worthwhile *employment* opportunities is the most important objective. An important test of these schemes will, therefore, be the extent to which they contribute to employment growth, as well as strengthening citizen ownership of business activities.

2.17 Second, pursuing the objective of empowerment should not distract from addressing the fundamental difficulties that can accompany the sort of assistance that is to be provided. For instance, there may be good reasons to exclude foreigners from receiving the assistance provided through FAP. But the other problems that FAP had been facing, such as poor performance, insufficient monitoring and abuse of funds should also be addressed.

2.18 With regard to CEMAEF, the criteria for administering the fund will determine the usefulness of the scheme. There may be a case for providing such assistance when the volatility of the property market undermines the prospects of a project that is basically viable. But there is a danger that property developers, if they perceive that support will

13 The SMME category will be broadened to include loans up to P150 000 at an interest rate of 5 percent (compared to the current ceiling of P20 000 and an interest rate of 15 percent). The interest rate on medium scale projects, with loans of up to P2 million, will attract an interest rate of 7.5 percent.

be easily forthcoming when they run into difficulties, will embark on projects without taking proper account of the risks involved.

2.19 While promoting citizen economic empowerment, the Speech also reiterated the Government's belief in attracting foreign investors and workers, who can provide the much needed financial and human capital. To this end, a programme to rationalise and improve the efficiency of the system under which work and residence permits are issued will be undertaken during 2001. It is recognised that Botswana needs external resources for development.

2.20 A number of policy reviews were announced in the Budget Speech. These are likely to form an important input into NDP 9, the preparation of which is scheduled to begin later in 2001. The announcements included:

- a strategic review of the Botswana Meat Commission (BMC). The Commission, which operates under the BMC Act of 1965, has been facing problems of securing sufficient purchases from farmers to make its operations viable. Generally, it has not been able to fulfil its quota for preferential market access to the EU, which is the principal source of revenue, and the capacity of the abattoirs has been significantly under-utilised. For its part, the BMC believes that it is disadvantaged by the way it is taxed while, on the other hand, the Commission's monopoly over beef exports is being questioned. The review will cover all these aspects of BMC's operations;

- a review of the 1973 *Rural Development Policy* has already been commissioned and a report is expected by mid-2001. The review will propose updates to the policy in order to take into account the perceived inadequacies of the existing policy, the significant changes to the economy since 1973 and the aspirations of *Vision 2016*. Among the objectives of the review will be to address issues such as rural unemployment, underemployment and poverty alleviation;

- an assessment of the effectiveness of Government's programmes to support the agricultural sector will be undertaken. There is great concern that the substantial financial allocations to these programmes have not produced the desired results in agricultural development; and

- an eco-tourism strategy is to be developed based on the Botswana Tourism Development Programme, which identified the potential for tourism based on cultural, archaeological and historical attractions.

2.21 In addition to the policy reviews underway or those to be commissioned, the Government is in the process of considering the recommendations of completed reports. Among the reports are the Science and Technology Policy and proposals to reorganise the Ministry of Commerce and Industry. Policy decisions regarding both issues are expected during the year, and the Budget Speech indicated that the implementation of the Science and Technology Policy might require extra funds over and above those already included in the Budget.

2.22 The next Population and Housing Census will take place in 2001. After the completion of the Census, it is expected that a third Household Income and Expenditure Survey (HIES) will be undertaken. Given the major economic and technological changes that have taken place in recent years, significant changes since the last HIES was conducted in 1993/94 are anticipated. The HIES will provide information on key issues including poverty and income distribution. It will also be a basis for an update of the basket of goods used to calculate the Consumer Price Index (CPI).

Public Finances

2.23 The Budget Speech presented details for the final outturn for the 1999/00 financial year, the revised estimates for 2000/01 and the proposed budget for 2001/02 as summarised in Table 1.2.

The 1999/00 Final Budget

2.24 The final results for 1999/00 fiscal year show a surplus of P1 536 million. This is considerably higher than the P510 million that was forecast early in 2000 and a turn around of nearly P2 billion compared to the original budget which had shown a deficit of P400 million. The principal cause of the move from a deficit to a surplus was an increase in mineral revenues, which were up by P1 851 million (38.2 percent) on the original budget. Moreover, the surplus was much larger than in the revised estimates due to lower spending than budgeted. The development budget was underspent by P418 million (10.8 percent), maintaining the trend of recent years, while the recurrent expenditure was P330 million (4.5 percent) below budget. The recurrent underspending may have resulted from under-utilisation of additional resources that had been made available for social programmes, including the cost of countering HIV/AIDS.[14]

The Revised 2000/01 Budget

2.25 The budget for 2000/01 is projected to show a surplus of P1 082 million compared to P47 million in the original budget. As was the case with the 1999/00 budget, the main reason for the improved outturn was increased mineral revenues, the estimate for which rose by P1 270 million. The revenues benefited from the depreciation of the Pula against the US dollar and the recovery of the international diamond markets during 2000. In addition, both non-mineral income tax and sales tax revenues were higher than the original budget, reflecting the continued buoyancy of the economy. However, revenue from the customs pool was lower due to the strengthening of the Pula against the rand during the year.

2.26 In the revised estimates for 2000/01, expenditure was slightly higher than in the original budget; however, the rate of increase

TABLE 1.2: THE GOVERNMENT BUDGET, 1999/00 – 2001/02 (P million)

	1999/00			2000/01		2001/02
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	10 475.4	11 921.7	11 963.1	11 777.1	12 962.5	13 557.5
o/w Minerals	4 836.1	6 546.2	6 687.3	6 287.6	7 557.3	7 953.0
Expenditure	10 875.5	11 411.9	10 427.5	11 730.3	11 880.9	14 084.3
Recurrent	6 954.3	7 378.2	7 047.9	8 187.9	8 234.5	9 368.2
Development	3 755.5	3 869.2	3 451.0	3 434.5	3 627.2	4 709.4
Balance	-400.1	509.8	1 535.6	46.7	1 081.6	-526.9

Source: *Financial Statements*, MFDP

[14] See Bank of Botswana *Annual Report 1999* (p49). One of the problems faced by Government is that, due to the stigma that is still attached to HIV/AIDS sufferers, the take up rate for these programmes of support is often low.

was slower than in previous years. The lower growth reflected the expenditure control policy introduced at the time of the 2000 Budget Speech, which reduced the extent of supplementary budget approvals during the year. Nevertheless, despite the smaller rate of expenditure increase, the revised final outturn may well, once again, show substantial underspending resulting in a higher budget surplus. In the first nine months of the fiscal year, only 68 percent of the revised budget had been spent, mainly due to the development outlays for which the proportion was 63 percent. While some acceleration of spending may be expected in the second half of the year, past experience suggests that the budgeted funds may not be fully utilised.[15]

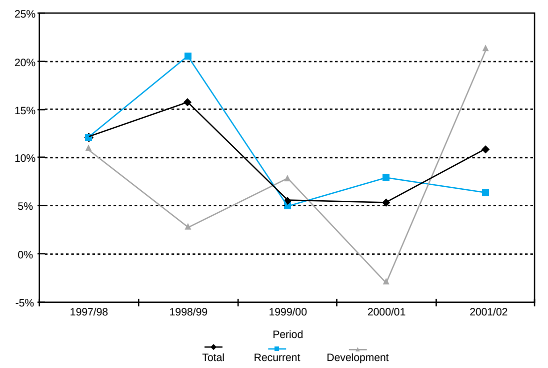
The 2001/02 Budget

2.27 A deficit of P527 million is budgeted for 2001/02. The deficit is expected to be a combined result of a P2 203 million (18.5 percent) increase in expenditure over the revised estimates for 2000/01 and a slower growth rate in revenue. Of the total expenditure, recurrent outlays are projected to rise by P1 134 million (13.8 percent), while the increase in development spending is P1 082 million (29.8 percent).[16] The allocations for recurrent spending, however, did not take into account the effect of any increase in the salaries of public employees, which, unlike past practice, was not announced in the Budget Speech (See below). The Speech also indicated areas where additional spending might need to be authorised during the year. In addition to areas already mentioned, this may include drought relief following shortfalls in rainfall during the last few months of 2000 and early 2001.

2.28 The very large increase in allocations for development spending is explained by the various demands described earlier. Chart 1.4 shows the real growth rates of spending since 1997/98, the first year of NDP 8. It is clear from the chart that the brakes applied on development spending in 2000/01 were only temporary. The rapid growth of spending projected for 2001/02, if achieved, will be a substantial fiscal stimulus to the economy, which may have implications in other areas, including the conduct of monetary policy.

2.29 In nominal terms, the total estimated cost (TEC) of the NDP 8 development budget has been revised from P11.8 billion to P23.4 billion, an increase of 98 percent. However, the development account has typically been characterised by underspending. In the first three years of the plan, only P9.0 billion was spent. Even if the budgeted P4 709 million is spent in 2001/02, spending in 2002/03 will need to be P5 958 million, a growth of 26.5 percent, if the TEC is to be met.

CHART 1.4: REAL GROWTH IN GOVERNMENT SPENDING DURING NDP 8



2.30 The additional outlays of P5.5 billion to the NDP 8 TEC reflect a variety of priorities. These are, to a certain extent, shown in Table 1.3 which gives the major allocations among ministries. The greater priority accorded to health is reflected in the budget for the Ministry of Health, which has been more than doubled in the face of HIV/AIDS. However, as is clear from the 'comments' column in the table, the allocations by ministry do not fully reflect the sectoral shares. For instance, the allocation outlays for the Ministry of Local

[15] As a very simple illustrative calculation, if spending in the last quarter of 2000/01 were to continue at the same rate as for the rest of the year, there would be an expenditure shortfall of P1 083 million (9.1 percent) compared to the revised budget. If revenues were on target, then the budget surplus would nearly double from P1 082 million to P2 135 million.

[16] The balance is made up of net lending and FAP grants, which together show a small decline.

Government also reflect its involvement in parts of programmes that involve other ministries, including the upgrading of water and sanitation systems, as well as projects for the construction of primary schools and rural roads. Similarly, the increase in funding for the Ministry of Lands and Housing is mostly due to the budget for Government offices, a project which has, once again, been increased in scope.[17]

2.31 As already pointed out, the Budget Speech did not include details of any adjustments to public service salaries. Instead, it was announced that a review was underway to compare the conditions of service for public officials against prevailing market rates. The review was prompted by the concern that, despite the implementation of the recommendations of the 1998 Salaries Review Commission and the introduction of various special schemes of service, Government continues to experience high rates of attrition among certain categories of its employees. Therefore, the exercise was scheduled to be undertaken urgently, presumably in order to minimise the delay in announcing any salary adjustment.

2.32 Conducting such a review may well have created an impression that a pay adjustment, that more than compensates for inflation, is in the offing. However, in determining any award it should be borne in mind that Government has difficulty retaining employees due to demand from a buoyant private sector for labour skills that are in short supply. Given the Government's role as the economy's largest employer, any significant adjustments that are made to its workers' pay structure will also lead to feedbacks into private sector wages, which may affect

TABLE 1.3: ALLOCATION OF ADDITIONAL FUNDS TO NDP 8 DEVELOPMENT BUDGET FOLLOWING THE MID-TERM REVIEW

Ministry	Budget as of 31/03/01 (Pmillion)	Increase (Pmillion)	Growth (%)	Comment
State President	2 237	390	17.4	Mainly Botswana Defence Force
Education	2 364	430	18.1	Senior secondary schools and vocational training
Local Gov't	3 154	1 418	44.9	Primary schools, sanitation and rural roads
Works, Transport and Communication	2 920	502	17.2	Roads and rural telecommunications
Minerals, Energy and Water Affairs	2 710	769	28.4	Water and sanitation
Health	807	1 054	130.6	Hospitals and health science institutes
Lands and Housing	824	505	61.3	Government offices
Other	2 841	450	15.8	
Total	17 857	5 519	30.9	

Source: 2000/2001, Estimates of Expenditure, MFDP

[17] This time it includes a new headquarters for the Ministry of Commerce and Industry, which has been brought forward from NDP 9.

prospects for employment growth and further diversification of the economy.

2.33 Also related to the conditions of service for public servants, plans to establish a contributory funded pension scheme for Government workers, reached an advanced stage. The Botswana Public Officers Pension Fund was registered and a Board of Trustees appointed. An actuarial evaluation of Government's outstanding pension liabilities was expected to be completed by March 2001, and during the year the necessary revisions to the relevant legislation will be made. During 2001/02, the Government budgeted two separate financial contributions to the fund. First, the recurrent budget provided for P150 million as the requirement for the year. Second, a transfer of P500 million will be made as an initial contribution towards covering outstanding liabilities. However, the latter payment is not part of the 2001/02 budget[18]. Nevertheless, it could constitute a fiscal stimulus to the economy as the balances will no longer be held at the Bank of Botswana but will instead, be invested by the pension fund in both domestic and offshore assets.

Fiscal Legislation

2.34 The current tax bands for levying personal income tax at rates between zero and 25 percent were established in 1997. Since then, inflation has eroded their real value. Therefore, in order to compensate for the loss in purchasing power, both the threshold for income tax payment and the brackets at which the higher rates of tax are introduced, are to be increased by 25 percent to P25 000 and P18 750, respectively. As a result, all incomes of less than P25 000 per annum will be tax exempt and a tax reduction of P3 125 per year will be applicable to salaries of P100 000 and above.

2.35 In addition to this inflation-related adjustment, a number of other changes were announced for the Income Tax Act aimed at a number of different objectives, including:

- *Correction of anomalies*: the Act will be revised to ensure that the legal basis on which diamond mining is subject to company income tax is clarified;

- *Encouraging savings*: currently, both employers and individuals are allowed tax free contributions to approved superannuation schemes. The tax free amounts are based on a maximum percentage of employee earnings, and are also subject to a ceiling of P9 000 per annum. The real value of this sum has been eroded by inflation, and for this reason, the ceiling will be removed;

- *Curbing tax evasion*: measures to prevent individuals and businesses leaving the country while not having settled their tax liabilities will be strengthened; and

- *Levelling the playing field*: the way that aircraft leases are taxed in Botswana puts local airline operations at a disadvantage compared to non-resident operators. Such leases will now be made exempt from tax. This initiative might enhance the attractiveness of Air Botswana's privatisation.

2.36 The necessary legislation for the introduction of Value Added Tax (VAT) was passed by Parliament in 2000. The current intention is that the tax will actually be introduced in July 2002, a revised schedule that is later than initially planned. The extra time needed prior to the introduction of the tax will allow for more extensive consultations with, and education of, businesses that will be affected by the tax, as well as allow for the administrative machinery to be properly put in place. The preparatory arrangements are essential, as experience elsewhere has shown that the potential advantages of VAT can quickly be eroded if the appropriate arrangements are not put in place.[19]

[18] Technically, the transaction shows up in the financing of the budget deficit with a decline in Government cash balances being matched by a positive entry in the 'other financing' item of the accounts.

[19] For instance, the VAT-like Goods and Services Tax that was introduced in Australia in 2000, has run into serious problems. In particular, the administrative requirements for small businesses in filing frequent and complex returns have proved burdensome.

3. MONEY AND CAPITAL MARKETS

3.1 There was a significant reduction in the growth rates of monetary aggregates in 2000, despite an acceleration in nominal income growth and the rise in net foreign assets, which grew by 17 percent in 2000 compared to 8 percent in 1999. The increase in net foreign assets was attributed mainly to the buoyancy of the trade account following a rise in diamond exports and the depreciation of the Pula against major trading currencies, which outweighed an increase in net outflows on the services and financial accounts of the balance of payments. However, the potential monetary expansion impact of the increase in net foreign assets was offset by a substantial increase in the level of Government balances at the Bank of Botswana, and a decline in credit expansion to the private sector. As a result, the increase in net foreign assets was almost entirely offset by the decline in net domestic credit and valuation adjustments. The reduction in supply factors was combined with the outflows in respect of payments with the result that growth in broad money, M4, fell to zero in 2000 compared to 26 percent in 1999.

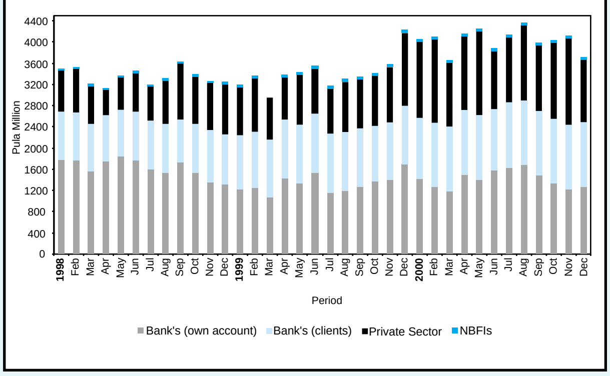
Monetary Policy

3.2 In response to the rise in inflation, monetary policy remained tight throughout the year. In an endeavour to curb growth in credit, and ultimately inflation, the Bank raised the Bank Rate twice during the year, from 13.25 percent to 13.75 percent in February and to 14.25 percent in October 2000. Correspondingly, commercial banks responded by adjusting their lending and deposit rates upwards, albeit by smaller margins for deposit rates.

3.3 To supplement the effectiveness of the increase in the Bank Rate in controlling credit expansion, open market operations (i.e. sales and purchases of Bank of Botswana Certificates (BoBCs)) were conducted to absorb the excess liquidity, and to assist in steering interest rates in the desired direction. There were 11 auctions of BoBCs, at which papers ranging in maturities from 119 to 364 days were issued.

3.4 However, total outstanding BoBCs declined as at the end of December 2000 to P3 712.4 million from P4 230.2 million in December 1999. The drop of 12.2 percent in BoBCs outstanding in 2000 contrasted with a rise of 30.3 percent in 1999. Commercial banks continued to dominate the overall holdings of BoBCs, though their portfolio declined by 25.4 percent to P1 272.8 million in December 2000. BoBCs held on behalf of clients increased by 9.7 percent, while the portfolio of other financial institutions decreased by 10.7 percent. The other private sector holdings of BoBCs fell by 13.7 percent to P1 180.9 million in December 2000 from P1 367.7 million in December 1999.

CHART 1.5: BoBCs OUTSTANDING



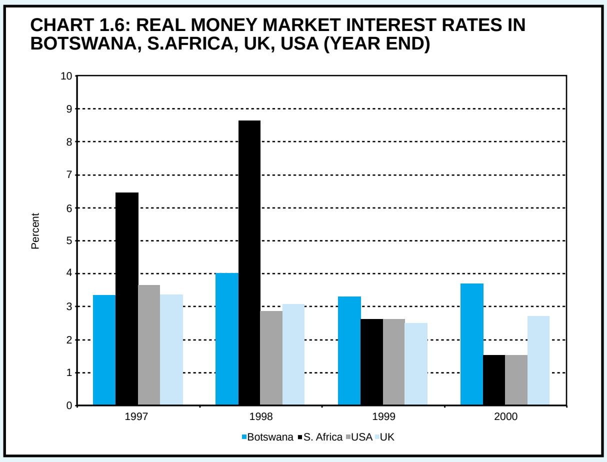
3.5 The open market operations were supplemented by repurchase agreements (Repos), reverse repurchase agreements (Reverse Repos) and the secured lending facility (SLF). The facilities were used to smoothen short-term liquidity fluctuations in the banking system between auctions.

Real Interest Rates

3.6 Real interest rates on 3-month BoBCs rose from 3.3 percent in December 1999 to 3.7 percent in December 2000. The rate was higher than the comparable real interest rates in South Africa[20] (1.3 percent), the USA (1.3 percent) and the UK (2.8 percent). The real interest rate on 88-day deposits was 1.4

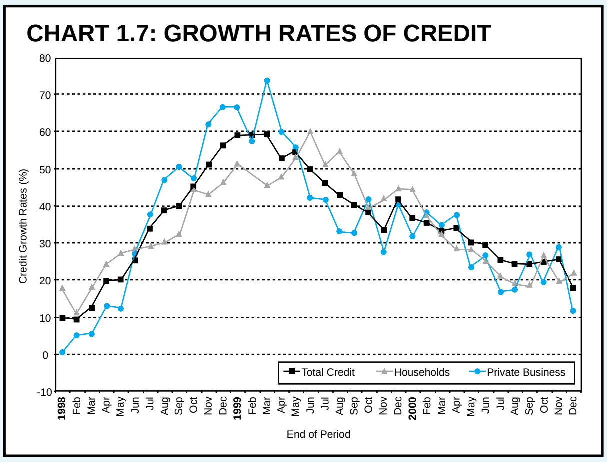
[20] Deflated using core inflation.

percent at the end of 2000 compared to 0.7 percent at the end of 1999.



Domestic Credit

3.7 Growth of total commercial bank credit maintained a downward trend throughout the year, expanding by 17.7 percent in the twelve months to December 2000 compared to 41.4 percent in 1999. The downward trend was in response to both a tight monetary policy and expectations of lower growth in the non-mining sector of the economy. Credit to the household sector rose at a reduced rate of 21.8 percent in December 2000 compared to 44.6 percent in 1999, while lending to private sector businesses increased by 11.6 percent against 40.7 percent in the previous year.



Within the total, parastatal lending declined substantially by 13.2 percent, a turnaround from an increase of 98.7 percent in the previous year, reflecting a levelling off of recourse to the banking system, following the initial response to Government policy of discouraging the sector from relying on funding from the Government Public Debt Service Fund (PDSF).

Money Supply

3.8 The growth rates of all categories of monetary aggregates declined during 2000 compared to 1999 (Charts 1.8a and 1.8b). The slowdown in the rate of expansion was a result of the increase in Government balances at the Bank of Botswana (22.5 percent) during this period, which resulted from a deceleration in the growth of Government expenditure as well as outflows in respect of private sector external payments. Narrow money (M1), which comprises currency outside banks plus demand deposits, decreased by 1.2 percent in 2000 against a rise of 16.1 percent in 1999. For M2, defined as M1 plus savings and term deposits, there was virtually no change over the year compared to an increase of 25.3 percent in 1999, while M3 (M2 plus BoBCs held by the non-bank private sector) fell by 1.0 percent, down from an increase of 27.1 percent in 1999. The broadest measure of money supply, M4, which consists of M3 and foreign currency accounts (FCAs), was stable over the twelve month period to December 2000, against an increase of 25.8 percent in 1999.

Bank of Botswana

3.9 Total assets/liabilities of the Bank of Botswana rose by 17.4 percent during 2000 to P34 033.9 million compared to an increase of 8.9 percent in 1999. International reserves, the dominant component (99.5 percent) of assets, grew by 17.4 percent during 2000 to reach P33 880.2 million against a rise of 8.9 percent in 1999. The increase in reserves was attributed mainly to the recovery in diamond exports as well as the depreciation of the Pula against major international currencies.

3.10 The reserves are held in two tranches, the Pula Fund and the Liquidity Portfolio, together with a small portion as assets at the IMF. The Pula Fund, which is the long-term investment portfolio, grew by 17.4 percent in December 2000 from P24 453.7 million in

1999 to P28 711.6 million, while the Liquidity Portfolio increased by 18.6 percent, from P4 074.9 million in 1999 to P4 833.4 million in December 2000. The assets at the IMF rose by 3.5 percent to P335.1 million in December 2000 from P323.7 million in 1999.

3.11 On the liabilities side, deposits (74.0 percent of total liabilities) increased by 22.4 percent from P20 752.3 million in December 1999 to P25 174.4 million in December 2000. Of the total deposits, Government balances increased by 22.5 percent to P24 740.2 million in December 2000 compared to a growth of 5.1 percent in 1999. The higher rate of accumulation of Government deposits was attributed to improved mineral revenues and a slowdown in the rate of increase in Government expenditure. Bank of Botswana Certificates (BoBCs), the second largest component of liabilities, declined by 12.2 percent during 2000 to P3 712.4 million from P4 230.2 million in December 1999. The reduction occurred mostly in BoBCs held by both banks and their customers, which fell by 11.6 percent during the period.

CHART 1.8a: 12-MONTH NOMINAL GROWTH RATES OF MONETARY AGGREGATES

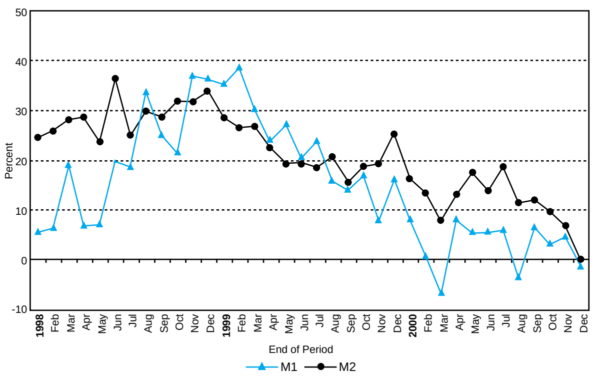
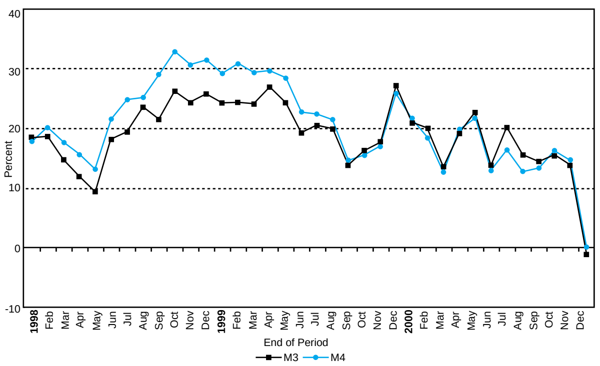


CHART 1.8b: 12-MONTH NOMINAL GROWTH RATES OF MONETARY AGGREGATES



Commercial Banks

Assets and Liabilities

3.12 Total assets/liabilities of commercial banks rose by 4.8 percent to P8 553.8 million as at end of December 2000 from P8 161.4 million in December 1999. Loans and advances amounted to P4 749.0 million and were 58.0 percent of total assets compared to 48.4 percent in 1999. Other major assets were balances due from foreign banks (P1 392.7 million) and BoBCs (P1 241.1 million) with respective shares of 16.3 percent and 14.5 percent.

3.13 Deposit liabilities of commercial banks expanded by 2.3 percent to P6 912.3 million as at the end of December 2000, a considerable slowdown from a growth rate of 24.6 percent in 1999. Of the total deposit liabilities, the largest portion (54.2 percent) was held by businesses followed by households (34.7 percent). The proportions of interest-earning deposits and demand deposits were 78.2 percent and 21.8 percent in December 2000 compared to 79.2 percent and 20.8 percent in December1999.

Foreign Currency Accounts (FCAs)

3.14 The most preferred currency in the FCA holdings was the US dollar, which was 77.0 percent of the total (68.7 percent in December 1999). This was followed by the pound sterling and South African rand, with shares of 11.4 percent and 8.0 percent, respectively, compared to 18.9 percent and 6.3 percent in 1999. South African rand deposits tend to fluctuate considerably, reflecting the utilisation of the balances mostly for transaction purposes. Pound sterling deposits have declined steadily over the years while US dollar balances have generally maintained an upward trend.

Credit Institutions and Merchant Banks

ulc (Pty) Ltd

3.15 ulc, formerly a credit institution, was during the year granted permission to convert into a merchant bank. Total assets/liabilities of ulc rose to P130.2 million in November 2000 from P118.1 million in December 1999. Advances were the largest component of assets, which totalled P125.8 million.

3.16 On the liabilities side, deposits were P103.1 million (79.2 percent of the total) comprising fixed deposits.

Investec Bank (Botswana) Limited

3.17 Investec Bank, a merchant bank which started operations in early 1999, has grown significantly. Its assets/liabilities amounted to P338.0 million in December 2000, a substantial rise from P76.9 million at the end of 1999. The largest component of its assets was inter-company debtors, amounting to P194.5 million in December 2000.

3.18 Deposits accounted for the largest share of liabilities (77.6 percent) and amounted to P262.4 million in December 2000, a considerable rise from P18.7 million in December 1999.

Non-Bank Financial Institutions (NBFIs)

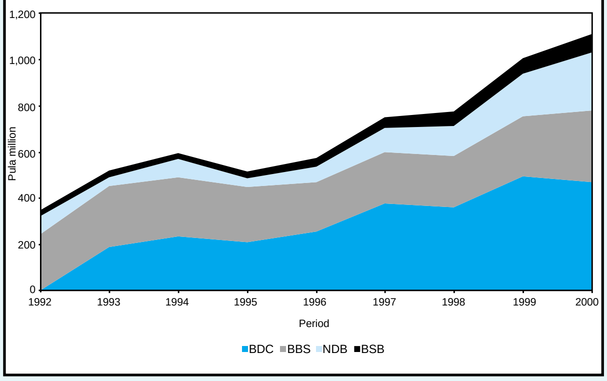
Total Lending by Non-Bank Financial Institutions

3.19 Total lending by Non-Bank Financial Institutions (NBFIs) increased by 10.5 percent from P1 001.4 million in 1999 to P1 106.1 million in 2000, compared to an increase of 29.7 percent in 1999. The Botswana Development Corporation (BDC) accounted for the largest share (43.2 percent) of NBFI lending. BDC's share was, however, below that of the previous year (49.3 percent). The fall in BDC's contribution was mostly attributed to large provisions for bad debts. The second largest share (28.1 percent) of NBFIs credit was accounted for by the Botswana Building Society (BBS), which increased its relative importance in 2000 from 25.9 percent in the previous year. Similarly, the shares of the National Development Bank (NDB) and the Botswana Savings Bank (BSB) rose to 22.9 percent and 6.8 percent in 2000 from 18.4 percent and 6.4 percent in the previous year, respectively.

Botswana Development Corporation (BDC)

3.20 Total assets/liabilities of BDC rose by 8.4 percent from December 1999 to P741.6 million at the end of 2000. The largest component of assets was loans and advances which, however, declined by 5.5 percent to P466.3 million in December 2000 from P493.5 million at the end of the previous year. BDC's portfolio was adversely affected by provisions for bad debts, which exceeded P100 million following, *inter alia*, the liquidation of the Hyundai motor vehicle assembly plant. Other major assets were deposits at commercial banks (P87.3 million), other investments (P83.9 million) and holdings of BoBCs (P76.5 million).

CHART 1.9: LENDING BY NON-BANK FINANCIAL INSTITUTIONS



3.21 Ordinary share capital increased by 69.8 percent to P485.2 million in 2000, and was the largest component of liabilities. Loans and advances from Government declined considerably, from P261.9 million in 1999 to P154.7 million in 2000. Both the large increase in share capital and substantial decline in loans from Government were explained by the conversion of a P100 million PDSF loan into equity.

Botswana Building Society (BBS)

3.22 Total assets/liabilities of BBS rose by 12.5 percent in 2000 compared to 3.8 percent in 1999, and were P424.2 million at the end of 2000. Among the assets, mortgages - the largest component - increased by 20.8 percent to P301.7 million, reflecting the continued buoyancy of the property market. Deposits at commercial banks rose by 17.9 percent to P80.4 million while holdings of BoBCs as well as loans and advances declined by 34.5 percent and 3.3 percent to P9.7 million and P9.2 million, respectively.

3.23 The main changes in liabilities included a rise of 4.1 percent in share capital to P179.9 million as at the end of December 2000. Borrowing, which amounted to P142.7 million, was the second largest component of liabilities and increased by 20.7 percent over the twelve months to December 2000. Of the amounts borrowed, P114.7 million (80.4 percent) was owed to PDSF. The liability to PDSF was, however, reduced by 3.0 percent during 2000 and the remaining major outstanding obligations were in respect of a bond issued in November 2000. Prospects for business expansion of BBS are expected to improve with the Parliamentary approval of the revised National Housing Policy (NHP) in February 2000. According to the revised NHP, Government is expected to facilitate the activities of the property market instead of being a financier and landlord.

National Development Bank (NDB)

3.24 As a result of its restructuring, NDB broadened the range of projects eligible for financing to include manufacturing, services and purchase of machinery, in addition to its traditional lending to the agricultural sector.

3.25 Total assets/liabilities expanded by 14.5 percent during the year to P310.4 million at the end of December 2000, from P271.0 million at the end of 1999. Loans and advances, which comprised 81.6 percent of total assets, rose by 37.2 percent during the year to reach P253.2 million. There was a very rapid (70.7 percent) increase in loans to the property sector from P55.2 million at the end of 1999 to P94.2 million in December 2000. Other sectors also increased their recourse to the NDB, with the trade and agriculture sub-sectors accounting for P95.7 million and P49.6 million, respectively, in 2000.

3.26 Accumulated profit (P168.1 million), which rose by 32.1 percent in 2000, was the largest component of liabilities at the end of the year. Loans from the PDSF fell slightly from P25.3 million in December 1999 to P24.9 million in December 2000.

Botswana Savings Bank (BSB)

3.27 The assets/liabilities of BSB expanded by 3.4 percent during 2000 to P156.9 million. Loans and advances, which grew by 17.9 percent during the year, reached P75.7 million at the end of December 2000 and comprised the bulk of the assets. Of the total loans and advances outstanding, lending for motor vehicle purchases (51.3 percent of the total) amounted to P38.8 million, followed by residential property loans (45.6 percent) totalling P34.5 million

3.28 Deposits, the main source of funds for BSB, amounted to P106.5 million, a growth rate of 4.9 percent during 2000, and accounted for 67.4 percent of total liabilities.

Other Financial Sector Developments

3.29 The Bank of Baroda was licensed during the year as a new commercial bank. It will begin operations in March 2001. In addition, ulc (Pty) Ltd had the mandate of its banking licence expanded from that of a credit institution to a merchant bank.

3.30 Subsequent to the launching of the International Financial Services Centre (IFSC) early in 2000, applications were received from three companies for licences to operate in the IFSC. The applicants were ABC Holdings Limited, a bank holding company; its subsidiary, the African Banking Corporation Limited; and Seed Co. International Limited. The application by

ABC Holdings Limited for a banking licence was conditionally approved for offshore banking operations through its subsidiary, the African Banking Corporation Limited. Furthermore, Seed Co. International Limited, a Botswana registered company, was granted permission to establish centralised corporate services activities to serve its subsidiaries in the region.

3.31 The Income Tax Act was amended to provide for a lower tax rate of 15 percent for approved IFSC projects. All IFSC projects are exempt from withholding taxes on interest and dividends in Botswana while Collective Investment Undertakings (CIUs) are exempt from corporate tax.

3.32 An insurance premium financing company, the Premium Credit Botswana (Pty) Ltd, started operations in February 2000. In association with the First National Bank Botswana (FNBB), the insurance premium company provides commercial clients with a facility to finance short-term insurance premiums, thereby reducing the burden of large annual payments to the insurer. In turn, the clients have up to ten months to repay Premium Credit Botswana.

3.33 The Government decided to seek a sovereign credit rating for the country, as part of its strategy to attract foreign investment. Benefits of a credit rating include the acquisition of internationally accepted economic and financial performance credentials which are considered by international investors. A favourable credit rating can also help to lower the cost of international borrowing and improve credit terms.

3.34 Accordingly, following an announcement of the decision by the Minister of Finance and Development Planning in the 2000 Budget Speech, the Government appointed JP Morgan Chase as an adviser on the rating exercise. Two rating agencies, Moody's and Standard and Poor's, visited the country in February 2001 to hold discussions with the Government, political and civic leaders, parastatals, private sector and other stakeholders in preparation for the credit rating exercise[21].

3.35 The interest rate charged on lending under the Small, Medium and Micro Enterprises (SMMEs) scheme was reduced from 18.0 percent to 15.0 percent with effect from April 1, 2000 with the objective of enhancing accessibility of Government programmes to Batswana. The Government-funded SMMEs financing programme was introduced in June 1999 and is administered by the National Development Bank (NDB).

3.36 Funds invested in Letlole National Savings Certificates (NSCs) continued to grow during the year. The certificates, launched in June 1999, were introduced with the objective of promoting a saving habit among Batswana. The NSCs are available in denominations of P50, P250 and P500 at an interest rate of 10 percent per annum. As at December 31, 2000 the total value of certificates issued was P1 648 850, with redemptions of P369 250, compared with P1 015 450 and P619 000, respectively, in 1999.

Botswana Stock Exchange

3.37 The Botswana Stock Exchange (BSE) domestic index rose by 3.9 percent during 2000, much reduced from its growth of 47.6 percent in 1999. The index, which was 1 399.3 in December 1999, rose to 1 453.5 during the year. Market capitalisation of the domestic companies' index rose by 7.6 percent year-on-year, to P5 244.7 million at the end of December 2000. The gain in the index was mainly attributed to the performance of the shares of Barclays Bank Botswana, First National Bank of Botswana and Standard Chartered Bank Botswana, while the values of the stocks of several other listed companies declined significantly during the year. The BSE was generally affected by foreign selling as investors tended to be

[21] In March 2001, Moody's awarded Botswana a sovereign credit rating of "A2-P1". This is by far Moody's highest sovereign rating in Africa, and is the same as ratings awarded to Israel, Greece and Slovenia. Similarly, in early April 2001 Standard and Poor's assigned credit ratings to Botswana for long-term currency debt (A), short-term foriegn currency debt (A-1) and long term local currency debt (A+). These ratings are also the highest in Africa and are the same as those awarded to Greece, Cyprus, Kuwait, Malta and Slovenia.

uncertain about the performance of emerging markets in general and the region in particular. An offshore bank, ABC Holdings Ltd, was listed on the exchange during 2000.

3.38 The foreign companies index (FCI) declined by 3.0 percent to 430.7 in December 2000 from 443.9 at the end of December 1999. No new foreign companies were listed during the year, while one company, McCarthy, was de-listed following the disposal of most of its investments in Botswana.

3.39 A P50 million 5-year bond, with a coupon rate of 14.25 percent, was issued on November 30, 2000 by Botswana Building Society (BBS). The issue was under-subscribed by 46.0 percent. The BBS bond issue follows floatations by the Botswana Development Corporation (BDC) and the Botswana Telecommunications Corporation (BTC) to raise funds from the market following Government's decision to wean parastatals off PDSF borrowing. The new issue brought the bond listings on the BSE to four, along with one commercial paper[22]. The bonds have not been actively traded on the BSE as investors have apparently preferred to hold them to maturity.

4. EXCHANGE RATES, TRADE AND BALANCE OF PAYMENTS

Exchange Rates

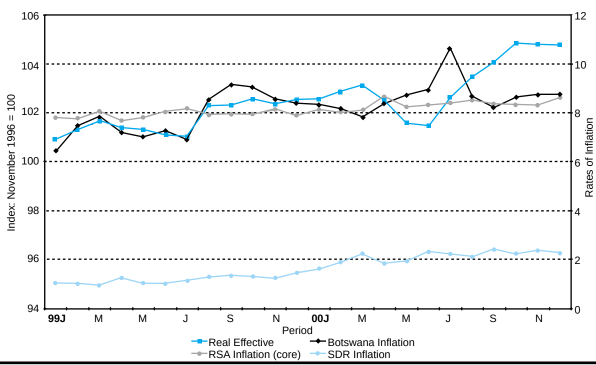
4.1 The broad policy framework for the determination of the Pula exchange rate was unchanged during 2000, and the thrust remained the maintenance of a stable and competitive real effective exchange rate for the Pula in order to support the export sector[23].

4.2 The policy objective of stabilising the real effective exchange rate was partially achieved during the year. The Pula appreciated in real effective terms by 3.0 percent during the year, following a 2.7 percent appreciation in 1999 (Chart 1.10). As a result the real effective exchange rate index rose to 104.4. Although the real effective exchange rate has appreciated during the past two years, it is still relatively close to the November 1996 base value of 100.0, indicating that policy to stabilise the rate has been reasonably successful over this period.

4.3 Movements in the overall real effective exchange rate, however, mask significantly different trends in bilateral real exchange rates against various trading partners (Chart 1.11). Against the South African rand, the Pula appreciated in real terms by 6.2 percent during the year, largely a reflection of the nominal appreciation of the Pula against the rand as the latter weakened against the US dollar. However, the Pula depreciated in real terms against most major international currencies, as the inflation differential between Botswana and industrialised economies was more than offset by nominal Pula depreciation. Real depreciation was particularly marked against the US dollar (9.2 percent), although overall real depreciation against the SDR currencies was only 3.3 percent.

4.4 The relative stability in international financial markets in the second half of 1999 and first quarter of 2000 was short-lived, and there

CHART 1.10: REAL EFFECTIVE EXCHANGE RATE OF PULA, INFLATION IN BOTSWANA AND TRADING PARTNERS, 1999 - 2000



[22] The bonds are the BBS-01 14.25% 2005, BDC-001 14% 2004, BTC 13.75% 2008, and INV1 FRN 2001. The commercial paper is the BTCP-01/02

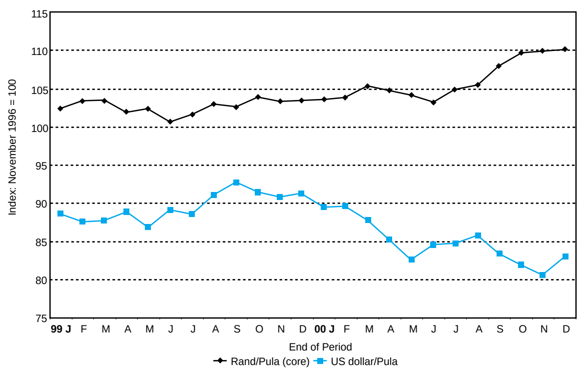
[23] The real effective exchange rate captures the totality of Pula movements against currencies of its major trading partners, after allowing for inflation differentials between Botswana and its trading partner countries, weighted by bilateral imports and exports. It is a measure of the relative competitiveness of domestic vis-à-vis foreign goods in international markets. An increase (decrease) in the real effective exchange rate denotes a loss of (gain in) competitiveness.

was recurring volatility during the rest of 2000[24]. The exchange rate variations were due to a combination of factors including an appreciation of the US dollar against most international currencies, rising world oil prices and unfavourable regional political and economic developments which adversely affected investor sentiment towards the rand. The weakness of the rand was compounded by a depreciation of the euro in relation to the US dollar. By the end of the year the South African currency had fallen, in nominal terms, by 18.9 percent against the US dollar and 14.3 percent against the SDR compared to 4.6 percent and 2.1 percent in the previous year.

4.5 In view of the high weight of the South African rand in the Pula basket, the depreciation of the rand contributed to a weakening of the Pula, which fell by 13.6 percent and 9.0 percent, in nominal terms, against the US dollar and the SDR. In the previous year the Pula lost ground against the US dollar and the SDR by 4.0 percent and 1.0 percent, respectively. The local currency also weakened against all other European currencies. It depreciated by about 6.0 percent each against the pound sterling and the euro, while falling by 3.3 percent against the yen as the latter also heavily depreciated against the US dollar.

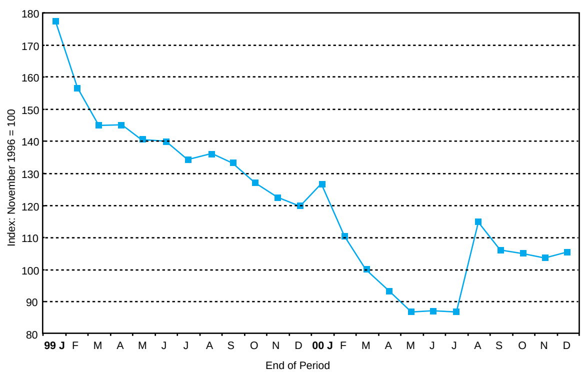
4.6 Against the Zimbabwe dollar, the Pula appreciated strongly by 25.4 percent in 2000, contrasting with a 2.3 percent depreciation during 1999. The appreciation mainly reflected the effect of three devaluations of the Zimbabwe dollar against the US dollar, effected between August and November 2000. As a result of the devaluations, the Zimbabwe dollar traded at about 55 Zimbabwe dollars to one US dollar (10.27 Zimbabwe dollars to the Pula) at the end of the year, from about 38 Zimbabwe dollars to the US dollar (7.39 Zimbabwe dollars to the Pula) prior to the devaluation. Despite the devaluations, the Zimbabwe dollar exchange rate continued to be strictly managed, leading to an overvaluation of the currency at official rates.

CHART 1.11: REAL PULA EXCHANGE RATES AGAINST THE RAND AND US DOLLAR



4.7 However, the real Pula exchange rate against the Zimbabwe dollar depreciated by 12.2 percent during the year (Chart 1.12), despite the strong nominal Pula appreciation against the Zimbabwe currency and a fall in Zimbabwe's inflation. This development was explained by the fact that Zimbabwe's inflation continued to be very high (55.2 percent in December) relative to that of Botswana (8.7 percent).

CHART 1.12: REAL PULA EXCHANGE RATE AGAINST THE ZIMBABWE DOLLAR



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[24] The fact that year-on-year changes show consistent patterns of depreciation of, say, the US dollar/rand and US dollar/Pula exchange rates or appreciation of the rand/Pula exchange rate during 2000, which would seem to indicate unidirectional movements, does not mean that these exchange rates did not fluctuate widely. On the contrary, these exchange rates fluctuated daily, in some cases quite sharply. For example, the rand, in particular, was periodically hit by speculative activity, forcing its value against the US dollar to drop each time that happened, followed by subsequent partial recovery. It is this inability of the rand to always recover fully which explains why year-on-year changes in US dollar/rand, US dollar/Pula and rand/Pula exchange rates show unidirectional movements.

TABLE 1.4: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES

Nominal Exchange Rates (foreign currency per Pula)			
As at end of	**1999**	**2000**	**Percent Change**
SA rand	1.3292	1.4106	6.1
US dollar	0.2159	0.1865	-13.6
Zimbabwe dollar	8.1919	10.2740	25.4
Pound sterling	0.1336	0.1250	-6.4
Japanese yen	22.11	21.39	-3.3
SDR	0.1573	0.1431	-9.0
Euro	0.2142	0.2008	-6.3
Real Pula Exchange Rate Indices (November 1996 = 100)[1]			
SA rand[2]	103.4	109.8	6.2
SA rand[3]	109.0	117.5	7.8
US dollar	91.3	82.9	-9.2
Zimbabwe dollar	120.0	105.4	-12.2
SDR	97.4	94.2	-3.3

Source: Bank of Botswana

1. Change of base year to November 1996 from January 1990 means that real rates quoted here are not comparable to those presented in this table in previous reports.
2. Calculated using core inflation. Core inflation is the all items consumer price inflation excluding mortgage interest rate costs and prices of various volatile food items.

Overview of the Balance of Payments

4.8 There was another large current account surplus of P2 882.4 million in 2000 which was a marginal improvement on the previous year's performance. The large surplus was mainly attributable to the high level of diamond exports. The overall surplus is forecast to increase from P1 828.9 million in 1999 to P1 940.9 million in 2000.

Trade Account

4.9 The trade account was mainly influenced by diamond exports. In 2000, overall exports increased by 10.8 percent from P12 292.4 million in 1999 to P13 622.6 million in 2000. Of the total, diamond exports rose by 16.2 percent from P9 812.8 million in 1999 to P11 397.7 million in 2000. The future expansion of diamond exports depends on the ability of the Diamond Trading Company (DTC)[25] to absorb all of Botswana's output, a factor which will, in turn, be influenced by world demand. Specifically, exports will be affected by economic recovery in Asia (principally Japan) and, to a lesser extent, the buoyancy of European economic expansion and the success in breaking into new markets (such as China). The United States, which is currently experiencing an economic slowdown, absorbs more than half of the world's diamond supply. In 2000, diamond exports benefited from the rise in sales of

[25] Formerly, Central Selling Organisation (CSO).

diamond jewellery, especially in the United States.

4.10 Copper/nickel exports also grew in 2000. Nickel prices increased from an average of USD3.66 per pound in 1999 to USD3.92 per pound in 2000. Similarly, copper prices rose, although at a slower rate than was the case for nickel. There were also increases in exports of soda ash (5.6 percent) and beef (2.9 percent). However, as a result of the closure of Hyundai motor vehicle assembling plant, exports of vehicles fell by 75.6 percent. Shipment of textiles was also adversely affected by a slump in production following closures of some textile factories.

4.11 Imports were provisionally estimated[26] to have risen by 8.0 percent to P9 360.2 million from P8 663.7 million in 1999. There were increases in imports of machinery and electrical equipment, which comprised the largest component of imports, as well as fuel. However, imports of vehicles and transport equipment are forecast to decline significantly due, in part, to the closure of the local motor vehicle assembling plant.

Current Account

4.12 As a result of the buoyant exports of diamonds, the current account surplus is estimated to have increased slightly to P2 882.4 million from P2 859.2 million in 1999. Of the total, the visible trade surplus increased by 17.5 percent from P3 629.0 million in 1999 to P4 262.4 million in 2000. There were, however, deficits in the transactions on services and income accounts.

4.13 The factor services account, which covers transportation, travel, insurance and other professional services, is projected to record a deficit of P1 024.2 million in 2000 compared to P721.0 million in 1999. The negative balance on services is expected to be mainly due to an increase in the cost of import freight.

4.14 The deficit on the income account, which includes compensation of employees and investment income, is expected to widen by 16.7 percent from P1.2 billion in 1999 to P1.4 billion in 2000. Among the factors affecting the performance is a 5.4 percent decline in foreign exchange investment income due to lower rates of return in the bond market, and significant increases in dividend payments.

4.15 There was a decline in the surplus on current transfers from P1.2 billion in 1999 to an estimated P1.1 billion in 2000. The outturn largely reflects intra-Southern African Customs Union (SACU) transactions.

TABLE 1.5: EXPORTS (f.o.b) BY COMMODITY BREAKDOWN (P million)

	1996	1997	1998	1999	2000	Percent Change
Diamonds	5 271.6	7 675.2	6 040.0	9 812.8	11 397.7	16.2
Copper/Nickel	411.5	343.4	32.0	405.2	551.6	36.1
Soda Ash	75.0	154.9	166.1	196.7	207.7	5.6
Beef	280.2	249.7	313.6	270.4	278.2	2.9
Textiles*	195.1	247.7	302.7	248.5	236.1	-5.0
Vehicles*	805.5	1 182.6	966.1	666.8	162.4	-75.6
Other Goods*	332.6	441.0	487.5	692.0	788.9	14.0
TOTAL	7 371.5	10 294.5	8 708.0	12 292.4	13 622.6	10.8

*Provisional estimates based on the first 3 months of 2000

Source: Bank of Botswana and Central Statistics Office

[26] Estimates for imports are based on actual data for only the first three months of 2000.

Capital and Financial Accounts

4.16 The combined deficit on the capital and financial accounts is expected to increase by 1.5 percent in 2000 as a result of the rise in the deficit on the financial account from P1.1 billion in 1999 to P1.2 billion. This will more than offset the impact of the surplus on capital account, which is projected to more than double to P194 million in 2000 compared to the previous year.

4.17 Capital account transactions include direct investment, capital transfers by migrant workers and technical assistance inflows from international organisations to the Government. The direct investment component of the financial account is forecast to record a reduced surplus of P131.2 million compared to P162.7 million in 1999.

Reserves

4.18 As a reflection of the buoyancy of diamond exports and the slowdown in imports, foreign exchange reserves were P33 882 million at the end of December 2000, an increase of P5 028 million (16.9 percent) over December 1999. The reserves were equivalent to 34 months of imports of goods and services, compared to 29 months at the end of 1999. In US dollar terms, the reserves increased by 1.4 percent from US$6 229 million at the end of 1999 to US$6 319 million in December 2000. Generally, the good performance in reserves in 2000 was a result of the buoyancy in diamond exports.

International Investment Position (IIP)

4.19 The IIP records the stock of foreign financial assets and liabilities. The balances at the end of a period reflect both transactions and valuation changes as well as other adjustments during the review period.

4.20 Detailed data on the IIP are available for 1999, while only aggregates are presented for 2000. During 1999, the stock of Botswana's foreign assets rose by P3.5 billion, a 9.4

TABLE 1.6: BALANCE OF PAYMENTS (P million), 1997 – 2000

	1997	1998	1999#	2000*
Current Account Balance	2 634	860	2 859	2 882
Visible Trade Balance	3 269	328	3 629	4 262
Services Balance	-841	-988	-721	-1 024
Income Balance	-529	505	-1 213	-1 440
Net Current Transfers	735	1 015	1 164	1 084
Financial Account Balance	20	-855	-1 127	-1 241
Capital Account Balance	62	135	95	194
Net Errors and Omissions	-398	118	2	-105
Overall Balance	2 318	256	1 829	1 941

Source: Central Statistics Office and Bank of Botswana

* Provisional

\# Revised

percent increase over 1998, a continuation of the rising trend observed since 1994. Of the P3.5 billion increase in assets, P2.4 billion was accounted for by foreign exchange reserves. There were also substantial increases in other investments abroad (P1.6 billion). The increase in foreign exchange reserves was, to some extent, offset by a decrease in other investment assets, which declined by 10.5 percent from P1.9 billion in 1998 to P1.7 billion in 1999 led by a fall in deposits and trade credits.

4.21 Foreign liabilities increased by P1.6 billion in 1999 following a rise of P1.8 billion in 1998. The bulk of the increase was accounted for by loans, which were mostly contracted by government. There was also an increase in direct investment from P5.8 billion in 1998 to P6.4 billion in 1999.

Industry and Country Classification of Foreign Investment

4.22 Tables 1.7 and 1.8 show Botswana's stock of foreign liabilities at the end of 1999 classified by industry and country of origin.[27]

4.23 As shown in Table 1.7, most (75 percent) of the foreign direct investment at the end of 1999 was in the mining industry. However, the stock was 5 percent lower than in 1998 but similar to that of 1997. The foreign direct investment liabilities continued to be dominated by BCL's indebtedness for loans and accrued interest. Wholesale and retail trade accounted for 9.1 percent of direct investment liabilities at the end of 1999, up by 2.7 percentage points on 1998 while the share of manufacturing declined from 5.4 percent in 1998 to 3.7 percent in 1999. Foreign investment liabilities of the financial sector increased their relative importance from 3.6 percent to 7.1 percent.

4.24 South Africa was the principal source of accumulated direct investment stocks at the end of 1999, accounting for 50.1 percent, which was 5 percentage points below that of 1998. The other important source of direct investment was the European Union, which accounted for 47.9 percent at the end of 1999.

4.25 Currently, the breakdown of investment by country of origin and industry classification does not distinguish between portfolio and other investment. Therefore, all the remaining stocks of foreign liabilities not classified as direct investment, have been shown in Table 1.7 as "Other Investment". Half of these liabilities in 1999, a proportion which was similar to those for 1997 and 1998, were in respect of general government debt, which is classified under public administration industry in Table 1.7, owed to international organisations.

4.26 The mining industry accounted for 24.1 percent of liabilities classified as "Other Investment". As was the case with direct investment, the bulk of the mining industry "Other Investment" liabilities are BCL's indebtedness. Manufacturing accounted for 5.8 percent of "Other Investment" liabilities, down from 12 percent in 1998, while the share of electricity, gas and water was 4.7 percent at the end of 1999, a reduction from the proportion in 1998. The decline in the share followed a substantial increase during 1998 associated with the funding for the North-South Water Carrier Project.

[27] There are descrepancies in the two tables between the totals for foreign directt investment and "Other Investment" due to information gaps

TABLE 1.7: STOCKS OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY, END DECEMBER 1999 (P'000)

	Foreign Direct Investment			Other Investment		
	Equity	Non Equity	Total	Equity	Non equity	Total
Mining	2 265 275	3 258 899	5 524 174	…	1 081 625	1 081 625
Manufacturing	211 865	61 475	273 340	581	261 679	262 260
Finance	465 619	57 486	523 105	550	125 606	126 156
Retail and Wholesale	632 028	38 205	670 233	…	78 385	78 385
Electricity, Gas and Water	…	…	…	…	210 070	210 070
Real Estate and Business Services	121 590	22 218	143 808	385	53 110	53 495
Transport, Storage and Communication	3 049	39 746	42 795	…	92 481	92 481
Construction	3 251	4 963	8 214	50	39 664	39 714
Hospitality	82 794	…	82 794	…	2 180	2 180
Public Administration	…	…	…	–	2 513 286	2 513 286
Other	79 609	…	79 609	90 600	28 144	118 744
Total	**3 865 080**	**3 482 992**	**7 348 072**	**92 166**	**4 395 630**	**4 487 796**

Source:Bank of Botswana

… Indicates that data were not available.

TABLE 1.8: STOCKS OF FOREIGN INVESTMENT IN BOTSWANA BY ORIGIN, END DECEMBER, 1999 (P'000)

	Foreign Direct Investment			Other Investment		
	Equity	Non Equity	Total	Equity	Non equity	Total
North and Central America	**4 627**	**33 414**	**38 041**	**…**	**188 535**	**188 535**
United States of America	4 428	32 472	37 170	…	188 535	188 535
Europe	**3 429 993**	**86 892**	**3 516 885**	**…**	**1 158 463**	**1 158 463**
United Kingdom	1 189 842	37 237	1 227 079	…	76 288	76 288
Germany	…	…	…	…	859 354	859 354
Luxembourg	2 174 653	3 653	2 178 306	…	83 914	83 914
Other Europe	45 011	43 424	88 435	…	82 883	82 883
Asia Pacific	**1 281**	**...**	**1 281**	**…**	**280 185**	**280 185**
Africa	**344 412**	**3 364 657**	**3 709 068**	**1 566**	**404 370**	**405 936**
South Africa	321 033	3 359 886	3 680 919	1 210	386 394	387 604
Middle East	**77 290**	**5 350**	**82 640**	**…**	**71 442**	**71 442**
Other	**…**	**116**	**116**	**90 600**	**2 292 675**	**2 383 275**
Total	**3 857 603**	**3 490 429**	**7 348 032**	**92 166**	**4 395 670**	**4 487 836**

Source: Bank of Botswana

… Indicates that data were not available.

PART B

THEME CHAPTERS

THEME: THE CHALLENGE OF ECONOMIC DIVERSIFICATION

BANK OF BOTSWANA

CHAPTER 2

INTRODUCTION:
THE CHALLENGE OF ECONOMIC DIVERSIFICATION

1. Introduction

1.1 The choice of the theme for this year's *Annual Report*, *"The Challenge of Economic Diversification"*, reflects the central role that the pursuit of diversification has been playing in Botswana's economic policy framework for the last decade or more. Diversification has been central to decisions made with regard to macroeconomic management, fiscal, monetary and exchange rate policies, as well as more focused sectoral policies, such as those relating to industrial development, and the thrust of institutional development. Again, reflecting its importance, the theme of Botswana's current National Development Plan, NDP 8, is *"Sustainable Economic Diversification"*.

1.2 Given that diversification has been pivotal to policy choices for several years, it is opportune to consider how successful the implementation and design of this policy focus has been. Chapter 3 of this *Report*, therefore, reviews *"Economic Diversification - The Track Record"*. However, the coverage goes beyond a simple review of progress made with diversification by reflecting on other related issues. One of these issues is that the economic environment within which diversification is being pursued, has undergone many changes over the past decade in Botswana, regionally and internationally. A major factor is that the process of the globalisation of the world economy has major implications for any country's development strategy. The *Report*, therefore, explores the relationship between diversification and Botswana's place in the global economy.

1.3 A further issue covered in the *Report* is an assessment of some of the policies that have been adopted in support of diversification. This arises for a number of reasons. First, as some policies have been in place for many years, there is merit in reviewing their impact, in conjunction with the progress made so far in achieving diversification objectives. Second, changes in the national and international economic environment can have a potentially major impact on appropriate policy choices. The external changes may stem from global economic trends, technological advances, institutional as well as legal developments related to regional and international trade agreements.

1.4 Traditionally, the focus of Botswana's diversification policy has been on the development of the manufacturing sector. Chapter 4, *"The Path to Diversification: Services or Manufacturing"* reviews whether this approach is still appropriate, and enquires whether, in the light of experience and relevant developments elsewhere, a broader approach should be taken that is not so sector-specific but encompasses various types of services as well.

1.5 Any assessment of diversification covers a wide range of economic policy issues. However, the Bank of Botswana, as a central bank, has a particular interest in financial sector development and monetary policy issues. These are discussed in Chapter 5, *"Financial Sector Policies for Diversified Growth"*. The chapter reviews the achievements in the financial sector since the preparation of a seminal report by the Government of Botswana and the World Bank on *"Financial Policies for Diversified Growth"* in 1989, following which a wide range of reforms were introduced relating to both the development of the financial sector and the conduct of monetary policy.

1.6 A further crucial issue in the context of diversification is the role of technology and human resource development. Most credible diversification strategies require the upgrading of both the technological resources and the skills base of the country, in order to take advantage of the enabling environment that the general policy framework attempts to create. Botswana has acknowledged this need by investing large amounts of resources in education. The issues raised in ensuring that labour market as well as science and technology policies are supportive of diversification are discussed in Chapter 6, *"Economic Diversification: The Role of Skills and Technology"*. Finally, Chapter 7 concludes with a brief discussion of *"The Role of Government"*.

1.7 This introductory chapter sets the scene for the rest of the *Report* by briefly considering two key issues. First, why diversify? What are the reasons behind this long-standing commitment to diversification in Botswana's economic policy choices? Second, what is Botswana's position in the global economy at the beginning of the third millennium, and how is this related to the policy objective of economic diversification?

2. Why Diversify?

2.1 Over the past three decades the Botswana economy has recorded impressive growth rates. However, much of this growth has been due to the prolonged and rapid expansion of one sector - the mining sector - and of Government, which has largely been financed by the proceeds of mineral revenues. Mining and Government together account for almost one half of Gross Domestic Product (GDP). As a result, the economy remains vulnerable to the vagaries of the mineral sector, especially diamond mining. It is this dependence upon a single sector that underlies the need to diversify.

2.2 While mining is by far the most important single sector of the economy, at present, it is worth recalling that this situation has not always been the case. At independence in 1966, the agricultural sector accounted for some 40 percent of GDP. This dependence on agriculture brought with it its own problems, and the growth of diamond mining in the 1970s marked, in many ways, a welcome diversification away from dependence on agriculture. But more broadly, the relative decline of agriculture and the growth of mining is a reminder that the Botswana economy has always been undiversified, although it has changed from one dominated by agriculture to reliance on mining.

2.3 The policy of diversification has emerged in response to the vulnerabilities embodied in the current economic structure with its dependence on mining. Despite the rapid economic growth that has been associated with the development of mining, there are a number of problems that diversification seeks to address.

2.4 *Risk*: an economy that is highly dependent upon any one economic commodity, sector or activity faces higher risks of fluctuations in performance than one with a more broadly based structure. An agricultural economy faces climatic and market risks. Similarly, a mineral based economy, particularly if it relies heavily on a single product, encounters risks associated with changes in prices and demand patterns. For instance, diamond producers have recently been exposed to the potential risk of consumer discontent over the so called "conflict diamonds". More generally, the prices of primary commodities, whether mineral or agricultural, tend to be volatile, adding to the uncertainties and risks faced by economies that are dependent upon these commodities. The risk problem is worsened if the dominant sector is itself undiversified. Diversification of an economy, by making it more broadly based, reduces its vulnerability to fluctuations in the dominant sector.

2.5 *Flexibility and Adjustment:* all economies are subject to external shocks, whether in the markets for particular commodities, or as part of broader economic trends and cycles. A diversified economy is likely to be in a better position to respond and adjust to such shocks, and is also more likely to give rise to a more equitable structure of income distribution and growth.

2.6 *Primary Commodity Dependence:* economies that are dependent upon the production and export of primary commodities have not just been vulnerable to volatility of prices and export earnings, but have generally experienced relatively slow rates of real income growth. Due to long-term relative price changes in the world economy, such economies have experienced a long-term deterioration in their commodity terms of trade, in that the prices of their primary commodity exports have risen more slowly than the prices of their imports of manufactured goods. This is partly due to technological changes, such as the replacement of copper wires with fibre optic cables, which has had an adverse impact on copper producers. Diversification away from primary commodities and towards manufactured goods and services would reduce vulnerability to the long-term deteriorating trend in the commodity terms of trade and the associated loss in real income.

2.7 *Employment:* although mining dominates GDP, it is highly capital intensive and has not made a significant contribution to employment in Botswana. Diversification into more "employment-intensive" sectors would assist in translating rapid economic growth into faster employment growth and, therefore, lower unemployment.

2.8 *Prospects for Diamonds:* Botswana has experienced rapid growth in diamond production and exports for most of the past three decades. But indications are that output from the diamond sector is unlikely to show significant growth over the next decade. If this happens, the sector that has provided the basis for growth in the past is unlikely to do so to the same extent in the future. Even if new diamond deposits are found and exploited, the proportionate impact of new mines on GDP will be less than it was in earlier years when the economy was smaller. Diversification - in the sense of finding new "engines of growth" for the economy - is, therefore, a prerequisite for continued growth in real incomes and employment, which would provide a basis for poverty reduction.

2.9 *Linkages:* a more diversified, broadly based economy is likely to have greater domestic linkages, i.e., a 1 percent increase in output of any one sector will have a greater impact on GDP, the more diversified is the rest of the economy. Thus, a more diversified economy is more likely to be able to generate self-sustaining growth.

2.10 There is no generally accepted norm for sectoral contributions of GDP or employment, which can be considered an ideal level of diversification; however, the general point is that a diversified economy is one that does not disproportionately rely on very few sectors, a single sector, or commodity. While certain dominant sectors or activities may be adaptable in response to changing market conditions, it is generally the case that the less diversified an economy, the more vulnerable it is to the problems indicated above.

3. Botswana in the Global Economy

3.1 Diversification has a particular relevance for small economies. First, small economies tend to be less diversified than larger economies. Second, they tend to be more open and, therefore, more dependent on imports, than larger economies. The two points are related. Due to the constraints imposed by economies of scale effects, small economies cannot produce as wide a range of goods for the domestic market as is the case with large economies. Therefore, in order to have available a broad range of consumption and investment goods, there is need to import. Ability to import implies availability of foreign exchange, which in turn depends on exports. Therefore, the "engines of growth" in such an economy must predominantly be export goods and/or services. Any growth that does not have a high export component would soon encounter a balance of payments constraint. Available opportunities for import substitution would soon be exhausted and thereafter grow in line with the economy as a whole. Domestic demand, therefore, has very limited potential to maintain sustainable growth.

3.2 This is one reason why Botswana's policy of diversification has always focused on exports. Indeed, it is clear that Botswana's rapid growth has been export-led, and although non-export sectors have also expanded rapidly, their performance has largely been "following" export sector growth. Future growth must also be export-led and, therefore, economic diversification implies export diversification. This point is discussed further in Chapter 4.

3.3 The emphasis on export-led growth does not just apply to Botswana. Recent years have seen the global economy become more integrated, with reduced barriers to international trade and capital flows. As a result, global trade has grown faster than global output, indicating that economies in general, are becoming more open and trade oriented. Simultaneously, flows of international investment have become increasingly important in stimulating and facilitating trade.

3.4 The growth of world trade has two important consequences. First, efficiency is important. As trade barriers come down and the global economy becomes more competitive, inefficient industries will find it more and more difficult to survive. This consideration underlines the importance of improving productivity and more generally, ensuring that economic distortions that may reduce competitiveness are minimised. Second, countries should increasingly specialise in producing goods and services in which they have a comparative advantage; this may, of course, change over time.

3.5 In this regard, the framework of international trade agreements, within which Botswana operates, is undergoing significant change. Historically, the most important trade agreement has been the Southern African Customs Union (SACU) Agreement, which provided for duty-free trade with South Africa and other small economies in the region (Lesotho, Namibia and Swaziland) and a relatively high degree of protection against imports from the rest of the world. In recent years, SACU tariffs have been progressively reduced, partly in response to membership of the World Trade Organisation (WTO), and this has increased competition from global imports in the SACU countries. The SACU Agreement is currently being renegotiated; while it is anticipated that the basic provisions ensuring free trade within the SACU area will be preserved, other aspects (such as governance and revenue distribution) may be altered.

3.6 The process of tariff reduction in the SACU area has been accentuated by the Free Trade Agreement between South Africa and the European Union (EU), under which barriers to imports into the SACU area from the EU are being progressively reduced. The SADC Free Trade Agreement will also reduce barriers to imports into the SACU area, as well as providing improved access for exports to the SADC market. The Lomé Convention, under which many African, Caribbean and Pacific (ACP) states enjoy privileged access to the EU market, is also coming to an end and is likely to be replaced by a new agreement under which access to the EU for ACP countries will be tied to reciprocal access to ACP markets for EU exporters. Finally, changes taking place under the auspices of the WTO and various rounds of international trade negotiations will also have a major impact in the areas of trade in agricultural products and textiles, which have hitherto been subject to various protection agreements. These changes will also impact on trade in services, as well as in trade-related areas such as the protection of intellectual property rights and investment incentives.

3.7 All these developments will have to be taken account of as Botswana considers how to promote diversification. Not only will the changes brought about by these developments be extensive, they are also likely to be rapid. One of the inevitable consequences of globalisation is that events taking place in various parts of the world economy have effects that spread widely and quickly throughout the world. Therefore, in order for firms and industries to survive, they have to be not just efficient but also adaptable. Decisions have to be taken and changes implemented quickly - a requirement that faces both firms and governments that set the policy environment within which firms operate.

CHAPTER 3

ECONOMIC DIVERSIFICATION: THE TRACK RECORD

1. Introduction: Measures of Diversification

1.1 The previous chapter identified reasons for the relevance of the objective of diversification to the needs of the Botswana economy. This chapter looks at the extent to which such diversification has already been achieved and reviews the various policies that the Government has introduced with the specific aim of supporting diversification.

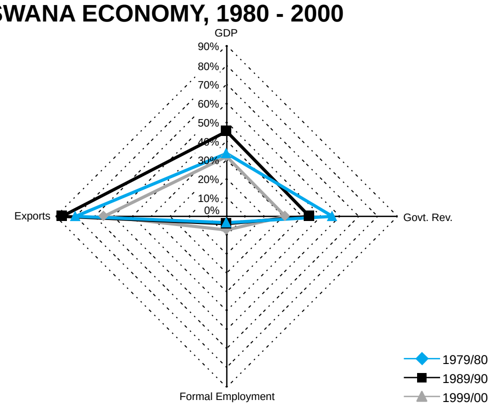
1.2 Fundamental to the analysis of the extent of diversification is the choice of measures, or indicators, of diversification. This might seem self-evident, but it is a point that is easily overlooked. In Botswana, diversification is often equated with reducing dependence on diamond mining. The many gains that diamonds have brought to the economy notwithstanding, the heavy reliance on this sector as a source of wealth creation and economic growth, has raised legitimate concerns about *over*-dependence. In this context, the first place to look for signs of diversification is the share of mining, and the diamond sub-sector in particular, in major economic aggregates including GDP, Government revenue, employment and trade. This is the subject of the next section.

1.3 This focus on the economic impact of the mining sector, however, does not tell the whole story. Diamond mining is currently the dominant economic activity in Botswana, but this was not always the case. As late as 1977/78, agriculture was still the largest sector in the economy, and rapid growth of diamond mining was the means of diversifying away from a sector characterised by slow growth, volatile output and low incomes. But the very success of this trend resulted in concentration in diamonds, the reduction of which is now the primary objective of diversification. Therefore, to regard diversification purely in terms of the need to reduce the *current* dependence on diamonds risks being too one-dimensional. For instance, there is a substantive difference between whether dependence on diamonds is replaced by dependence on another dominant sector or by growth across a wide range of economic activities. For this reason, the chapter also includes broader measures of diversification.

2. Dominance of the Minerals Sector

2.1 Chart 3.1 shows the changing importance of the mining sector between 1980 and 2000. It includes the sector's share in four different key macroeconomic indicators: GDP, formal employment, merchandise exports and government revenue.

CHART 3.1: THE MINING SECTOR IN THE BOTSWANA ECONOMY, 1980 - 2000



2.2 *Gross Domestic Product:* From contributing virtually nothing to the economy at the start of the 1970s, by 1979/80, mining accounted for just over 30 percent of GDP, due largely to the rapid growth in diamond mining. This trend continued through the 1980s as the mine at Jwaneng came on stream, and a high point in terms of the sector's contribution to GDP (at over 50 percent in 1988/89) was seen towards the end of the decade. There was then some decline in the 1990s as sectoral growth, while still generally healthy, was slower than in previous years. This is addressed further in the next section.

2.3 *Formal Sector Employment:* The direct contribution of the mineral sector to employment has never been very large. For the years shown in Chart 3.1, the largest share is only seven percent.[1] Moreover, the share has been in general decline. This reflects the fact that sectoral growth has been achieved mainly through capital investment and increasing the productivity of the labour force. Between 1981 and 2000, sectoral employment grew by only 14 percent, while output rose by over two *hundred* percent in real terms. This declining trend in employment share is technically an indicator of reduced dependence on the sector. But this is only trivially so. The fact that the sector has not been a major source of employment creation partly explains why increased diversification is seen as desirable.

2.4 *Merchandise Exports:* The dominance of mineral exports is readily apparent. By the end of the 1980s, they accounted for 65 percent of the total, and during the next decade the share increased to nearly 90 percent. It fell back somewhat during the 1990s to around 80 percent. However, this figure does not include the impact of the Orapa expansion project, which only came substantially on stream during 2000. It should also be pointed out that these data refer only to merchandise exports. To the extent that there has been some increase in the importance of exports of services during the past decade, the share of minerals in total exports has fallen further than indicated in the figure.[2]

2.5. *Government Revenues:* Although the sectoral share of GDP suggests some reduction of dependence on mining, its importance to Government revenues has increased. While striking, in fact, this is not surprising. The upward surge in diamond sales during 1999 led to an anticipated budget deficit turning into a record surplus; at the same time, during the 1990s growth in other revenue sources was muted as both external tariffs and rates of domestic income tax fell.

2.6 The continuing, and even increased dependence of Government revenue on receipts from minerals, has important policy implications. On the one hand, it emphasises the need for diversification of the Government's revenue base. Just as the sales boom in 1999 was the direct cause of the record budget surplus in 1999/2000, the slump seen in the previous year was the major factor contributing to the large budget deficit in 1998/99; avoiding such volatility is one of the main objectives of diversification. In addition, because of the Government's current policy of reserving all minerals' revenues for investment, alternative revenue sources are needed to support the recurrent budget.

2.7 At the same time, however, increased reliance on activity in other sectors of the economy to generate revenues for Government will necessitate strict control in the growth of public spending. This is because the tax rates prevailing in other sectors are much lower than those levied on diamond mining and, as a result, more diversified growth will have the consequence of lowering the effective tax rate. This suggests that a policy of keeping growth in public spending below the rate of economic growth will be required, if the revenue base is not to be put under undue pressure.[3]

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1 Note, however, that this figure may be an underestimate. This is to the extent that this figure includes only those directly engaged in mining activities. In addition, the major mines also employ people in various ancillary services, which are classified in other sectors. Nor does the figure include those engaged in prospecting, which is counted as a business service activity.

2 In 1990, services accounted for 10.4 percent of total exports; in 1999 the share was 12.1 percent.

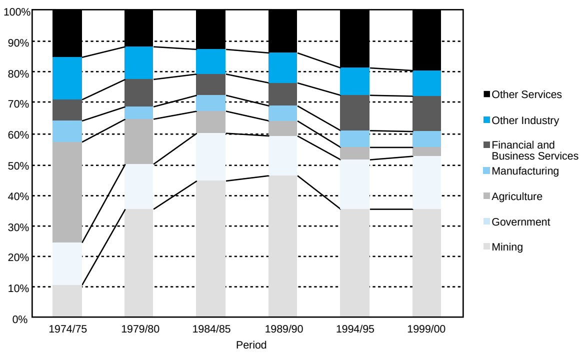
3 See the Bank of Botswana *Annual Report 1999* for further elaboration on this point (4.32, p89).

3. Structure of the Economy

Gross Domestic Product

3.1 Chart 3.1 looked only at the mining sector's contribution to GDP. Chart 3.2 shows the structure of GDP more broadly, giving the breakdown of GDP by major economic sector at intervals of five years between 1974/75 and 1999/00.[4]

CHART 3.2: STRUCTURE OF GDP BY SECTOR, 1974/75 - 1999/00

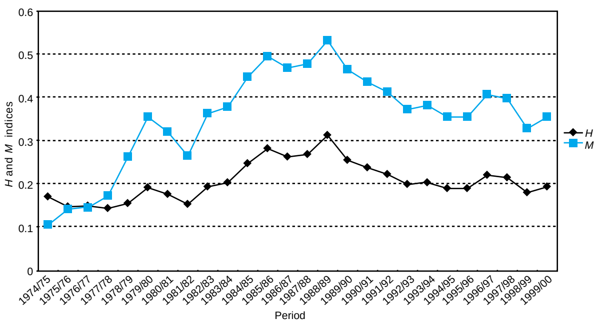


3.2 At the start of the period, the largest economic sector was agriculture. The mining sector had a share of less than ten percent. However, it was expanding rapidly and five years later, it had reached the dominant position described above. At the same time, the early dominance of agriculture was quickly reversed. This has been more than a case of slow agricultural growth not keeping pace with the rest of the economy. Over the period as a whole, the sector has been in absolute decline. According to the most recent estimates, real output in agriculture was about four percent lower in 1999/00 compared to 1974/75.

3.3 From 1974/75 to 1999/00, growth in the economy averaged 9.1 percent in real terms. That of the non-mining economy was 7.9 percent and if the negative impact of the decline in agriculture is excluded, the growth rate rises to 9.1 percent. Moreover, within the non-mining economy, it is apparent from Chart 3.2 that, with the exception of agriculture, growth was spread fairly evenly across the major sectors since, over the period, their GDP shares have remained more or less constant. Therefore, while the wealth of the mining sector may have provided the impetus that allowed the economy to develop so rapidly, the resulting growth has been broad based and, in that sense, significantly diversified. This point is often overlooked when focussing on changes in GDP shares as a measure of diversification. Such a focus does not directly take account of dynamic circumstances, especially the growth patterns in which those sectors were developing.

3.4 One consequence of this growth pattern, characterised by the expansion of mining and the decline of agriculture with other sectors remaining roughly constant in output shares, is that overall, the concentration of production in the Botswana economy has changed considerably less than is commonly imagined. This is indicated in Chart 3.3, which shows two alternative measures of concentration. First, there is development of the mineral sector alone (*M* in the Chart). The development is then compared with a 'Herfindahl' index (*H*), which is a broader measure that takes into account the changes in shares across all sectors.[5] In both cases, the maximum value is 1, which occurs if the whole economy is concentrated in one sector.

CHART 3.3: MEASURES OF CONCENTRATION OF PRODUCTION IN BOTSWANA, 1974/75 - 1999/00, HERFINDAHL INDEX *(H)* AND MINERAL SECTOR SHARE *(M)*



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4 The starting point of 1974/75 is chosen in large part because this is the date from which a consistent time series for GDP that provides this breakdown is available.

5 This was developed primarily as a measure of industrial concentration (i.e. the extent to which output within a particular sector is dominated by a few large firms). See, for instance, the Bank of Botswana *Annual Report 1993*, which used the Herfindahl index to analyse the extent of concentration within the banking sector in Botswana (p31).

3.5 It is apparent that the pattern of *H* is largely determined by that of *M* as, through much of the period, the movements in percentage terms match almost exactly. However, because of the effect in the early years when the movement from agriculture to mining was the source of increased diversification, the overall movement in *H* is much less than with *M*. Thus, while between 1974/75 and 1979/80 *M* increased from 0.10 to 0.35, *H* moved from 0.17 to 0.19, and was in fact, lower for the intervening years.

3.6 Overall, the broad picture that emerges is as follows. Following the initial increase in diversification as the importance of agriculture was reduced, in the decade 1978/79 to 1988/89, there was a rising trend in the overall concentration of production as the dominance of mining became increasingly pronounced. There was then some decline over the next four years as the period of slow growth in mining led to the share of other sectors increasing. Since then, there has been no consistent trend either towards greater concentration or increased diversification.

3.7 The performance of the *manufacturing* sector has received a lot of attention as an indicator of the extent of economic diversification. The rationale for this is reviewed critically in the next chapter. From Chart 3.2 it may seem that the performance of this sector has been disappointing since, between 1974/75 and 1999/00, its share of GDP *fell* from 6.5 percent to 4.9 percent. However, while this sector has certainly not matched the hopes and expectations of those who saw it as the key to a successful diversification of the economy, the focus on the GDP share can be highly misleading.

3.8 First, again there is the point that the GDP share does not indicate anything about growth rates. Over the period reviewed, the manufacturing sector grew by an average of 6.9 percent per annum, and such a growth rate can only be classified as 'low' in relation to the 9.5 percent rate at which the economy overall was growing. Similarly with employment, the overall picture is of healthy growth rates. Between the early 1980s and 2000, the annual average growth in formal employment in manufacturing was around 8.0 percent. However, it should be pointed out that much of this rapid growth occurred in the first part of the period. This is particularly the case regarding employment for which, during the 1990s, the growth rate averaged only 2.0 percent.

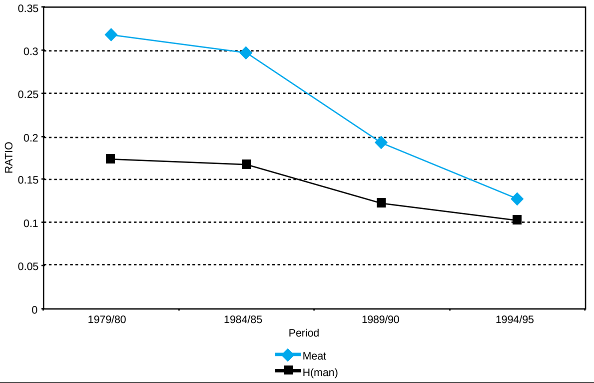
3.9 The other important point to appreciate concerning the development of manufacturing in Botswana is the extent to which there has been diversification *within* the sector. At the time of independence in 1966, the only significant manufacturing activity in Botswana was of meat and meat by-products, mainly undertaken by the Botswana Meat Commission (BMC). The next major addition to manufacturing was the establishment of the brewery in the 1970s. Chart 3.4 shows the extent to which the sector diversified between the end of the 1970s and the mid-1990s.[6] This chart is a repeat of the concentration measures used in Chart 3.3, but in this case applied to the manufacturing sector alone. The decline in the importance of the meat sector is readily apparent.[7] So is the reduction in overall concentration. However, the latter is less pronounced due to the increased importance of sub-sectors such as dairy and agro-products, bakeries, metal products, paper products and transport equipment.

3.10 In addition to manufacturing, the performance of the *financial and business services* sector should also be highlighted. From Chart 3.2 it appears that this has been the only major sector that has consistently seen a rising trend in its GDP share over time, a reflection of the widening and deepening of this sector in response to the needs of the business sector and increasing household real

[6] The choice of time period is again dictated largely by the availability of sufficiently detailed published data from the Central Statistics Office.

[7] Even this does not tell the full story. The meat products industry is no longer focussed solely on BMC. During the 1990s there was rapid growth in the domestic production of other meat products, such as poultry. The construction of the new abattoir for ostriches, which commenced in 2000, will help in a further diversification of this sub-sector.

CHART 3.4: CONCENTRATION IN THE MANUFACTURING SECTOR, 1979/80 - 1994/95



incomes that stimulated demand for such services. Besides achieving average growth higher than that of the economy as a whole, the sector also contributed to employment creation. Between 1981 and 2000 average annual growth in employment was 6.8 percent. The role of the financial and business services sector in economic diversification is addressed in more detail in Chapter 5.

Central Role of Government

3.11 Acting as a channel through which the wealth created by diamond mining has been reinvested, the Government has been the main link between the mining sector and the economy as a whole. While this helped support the rapid rate of overall development, one consequence is that the government sector has gradually increased in importance. This is clear from Chart 3.2. In particular, during the 1990s, the GDP share of the *general government* sector increased steadily. This was to the extent that this increase largely matched the fall in the share of mining. In part, this reflects the continuing rapid expansion of the government sector at a time when the rest of the economy was experiencing slower rates of growth than had previously been the case. During the 1990s, the government contributed 19.7 percent to overall growth, compared with 14.2 percent in the 1980s.

3.12 But this dominant role stretches beyond the direct contribution to GDP. Much of private sector business is heavily geared to meeting the needs of the Government through a variety of channels, which include:[8]

- implementing the public investment programme. Notable here is the construction sector, where the Government is the largest source of demand with its programmes of expanding public infrastructure. It should be noted, however, that the view that the construction sector is entirely dependent on Government, is an exaggeration. According to the detailed national accounts for 1994/95, Government accounted for ‘only’ 60 percent of construction investment;

- meeting current supply requirements. A good example is the domestic publishing industry, which is generally thriving, with local branches of several major international publishing houses. While involved in various activities, their core business is meeting the book requirements of the education budget, which has been expanding rapidly. This type of example is replicated widely across other economic sectors. In the mid-1990s, the supply requirements by government were equivalent to nearly 70 percent of non-mineral exports; and

- the spending power of Government workers. Between 1990 and 2000, direct employment by Government (including local government) contributed 73.8 percent of total formal sector employment growth and, as a result, its total share of formal jobs rose from 31.1 percent to 40.4 percent. According to the 1993/94 Social Accounting Matrix (SAM), Government was at that time, the source of 42 percent of total wage payments, a share that is likely to have increased subsequently. Thus, both the number employed by the Government and the wages paid have a significant impact on domestic demand.

[8] The dominant position of the Government is discussed in some detail in the Bank of Botswana *Annual Report 1999* (pp82-85).

3.13 The overall result is that Government-induced demand has been very significant for the development of the domestic economy. While this has been a stimulus for development to a wide range of businesses, it should be clear that this situation cannot continue indefinitely into the future. Development based on the central role of Government goes directly against the necessary outward-looking orientation for development.

Export development

3.14 Since the development of export markets is the cornerstone for the long-term prospects of a small economy such as Botswana, the extent to which reliance on traditional exports is reduced is a key indicator of diversification. As was made clear from Chart 3.1, exports are dominated by sales of diamonds. This dependence on traditional exports increases further once other mineral commodities are included. However, within traditional exports, the extent of reliance on diamond sales has been growing as the contributions of beef and copper-nickel have decreased over time. In 1981 the share of meat and meat products in total exports was 18.2 percent; by 1999 it had fallen to 1.8 percent. Similarly, exports of copper-nickel fell from 24 percent of the total in 1981 to 4.6 percent in 1999.

3.15 Over time, the share of non-traditional exports has increased gradually. Again, given the continuing buoyancy in diamond exports, this may be regarded as more of an achievement than some may suppose. However, while the aggregate figures may suggest some trend improvement in terms of a more diversified export base, a closer look quickly suggests that the firm establishment of such export markets has proved to be very difficult. The most recent example of this was the severe blow to the motor vehicle industry in 2000 with the closure of the Hyundai assembly plant. To this point, exports of vehicles had been the main source of growth in non-traditional exports through much of the 1990s. In 1995 they accounted for 66 percent of non-traditional exports, and during the period 1996 to 1999 vehicle exports accounted for 47.8 percent of manufacturing exports and 9.4 percent of total merchandise exports.

3.16 Another hoped-for source of export growth has been the textile sub-sector. However, this has also demonstrated considerable fragility. Diversification of exports is a function of markets as well as products, and the textile industry in Botswana was badly affected when the initial target market, Zimbabwe, started experiencing economic difficulties. Since then, attention has turned to supplying both South Africa and other global markets; the latter through exploiting the combination of available supply of labour and Botswana's relatively favourable access to these markets. Success has been only limited, however. Between 1991 and 1999 the nominal value of textile exports grew by 9.1 percent per year, but there has been considerable volatility around this average and real growth rates were much lower.[9] Throughout this period, the difficulties of the sub-sector were highlighted by a series of high-profile closures of textile businesses, often having received considerable amounts of financial support from the Government.

4. Government Support for Diversification

4.1 In the face of the rapidly expanding mining sector, the Government recognised, at an early stage, the potential problems associated with over-dependence. Experience from other countries showed clearly the difficulties of development based on a narrow base of primary commodities. The limitations caused by the small size of the domestic market were apparent and it was clear from the outset that diamond mining, whatever other benefits it promised, would not be a major source of employment for the rapidly growing population. In this context, even as the mineral-led boom gained momentum, the need for diversification of the economy away from minerals was introduced as an explicit policy objective. Fortunately, the boom itself

[9] As an indication of this, the US dollar value of textiles declined by 1.6 percent per year over the same period.

generated resources that, if used wisely, could help support the goal of wider socio-economic development.

4.2 This objective was pursued at several distinct levels. First, great stress was placed on encouraging development in the context of prudent economic management. In part, this entailed the effective control and use of available resources, in particular, using wealth from the diamond mines to develop the public infrastructure as a necessary platform for long-term development. But it also meant ensuring that macroeconomic conditions did not work against the objective of diversified development. Notable in this regard, has been the attention given to managing the exchange rate so that the competitiveness of domestic producers outside the mining sector, is not disadvantaged. The Government has also adopted a policy of low rates of direct taxation as a means of encouraging business development.

4.3. Second, a variety of parastatals were established to encourage the development of commercial activity. In terms of promoting economic diversification, the most prominent of these are the Botswana Development Corporation (BDC, established in 1970) and the National Development Bank (NDB, established in 1974). Third, over time, 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. The remainder of this section provides a brief discussion of some of these initiatives.

Financial Assistance Policy

4.4 The Financial Assistance Policy (FAP), which began in 1982, has been the main Government incentive scheme aimed at encouraging investment and employment opportunities in a range of economic activities in Botswana. Its main objective has, however, been to encourage development in manufacturing. But it also covers other areas, including agriculture outside cattle ranching and dry land farming, small-scale mining and, at a later stage, some service-related activities, notably tourism. The specific objective of creating employment is supported by basing the grants available under the scheme primarily on the number of jobs that a qualifying business venture is expected to generate.

4.5 Over the years since its introduction, the scheme has grown tremendously. In 1982/83, the first year of operation, the Government budget shows that only P1 million was spent, or 0.2 percent of total expenditure. In 1999/2000 the amount was P110 million, or 1.1 percent of the total. The mid-1990s was a period of rapid growth; in 1995/96, for example, the total doubled from the previous year to P72 million.

4.6 These figures, however, tell only part of the story of the development of FAP. It has also grown considerably in complexity. At its inception it was dealing with generally small and straightforward business ventures; by the end of the 1990s it was increasingly interacting with intricate, large-scale projects, often with a significant international dimension. This inevitably put increasing strain on the administration of the programme in terms of both appraising applications for funds for their suitability and, crucially, in the follow up monitoring of businesses.

4.7 FAP has been evaluated on a regular basis. Generally, the results of these reviews have given broad support for the scheme, concluding that it was providing value for money in terms of supporting the creation of viable employment opportunities. However, the most recent evaluation (the fourth, completed in March 2000) was far more critical. This reflected the fact that rapidly increasing expenditures in the 1990s had not had a commensurate impact on job creation or sustainable business activity. This, it argued, was due to problems of fraud and abuse, inadequate administrative and monitoring capacity, and an outdated structure of incentives. The report pointed out further that most of the problems were occurring at the level of the small-scale component of the scheme, principally because both appraisal and monitoring at this level, was extremely weak. This conclusion goes against the common perception that the main cause of FAP abuse is at the level of larger scale businesses.[10]

4.8 Given the changing economic circumstances, FAP has clearly become outmoded. The economic case for its immediate abolition appears to be strong. To the extent that it has created employment, this has been at significant financial costs and has increased the extent of dependence on Government. At the same time, there remains considerable support for the view that the underlying objectives of FAP continue to be legitimate. In the 2001 Budget Speech it was announced that these objectives would be pursued through a newly established body, the Citizen Entrepreneur Development Agency (CEDA) with the emphasis moving away from cash grants to other forms of support (see Chapter 1 for further details).

Industrial Development Policy

4.9 The Industrial Development Policy (IDP) was originally introduced in 1984. The objectives were the diversification of the economy away from heavy dependence on mining, promotion of the private sector and creation of employment opportunities for the growing population. In the mid-1990s a review was undertaken, necessitated by both the changing economic circumstances and the need to review the effectiveness of the original policy framework. Following this, a revised policy was published in 1997. While the objectives remained unaltered, there was considerable change in the strategies identified for their achievement.

4.10 The 1984 IDP mainly focused on an import substitution strategy of industrialisation. Whether such a strategy would be successful, given the constraints of the small domestic market, was always open to question. In any case, the change in the international and regional environment, especially the establishment of the World Trade Organisation (WTO) and the accession to the Southern African Development Community (SADC) Protocol on Trade Cooperation, necessitated a review. The strategy of the new IDP addresses the following issues:

- the limited scope for development based on the small domestic market;
- reorientation of the existing SADC and SACU trade and industrial development arrangement which provide increased competing investment and trade opportunities within the region;
- the impact of the decline in the degree of industrial protection against outside competition following the establishment of the WTO and the opening of South Africa under the new political dispensation; and
- the need to promote rapid growth in productivity and efficiency as critical elements of competitiveness in global trade in goods and services.

4.11 In order to meet the challenges of the changing regional and global environment, the objective of the new IDP is to develop an efficient and competitive export-oriented industrial and service sector. To this end, the Government strategy is to provide an environment conducive to the development of the private sector through the following:

- bilateral and multilateral negotiations with the aim of maximising access to export markets;
- encouraging investors and entrepreneurs to improve labour productivity and promotion of competitive unit labour costs; and
- efforts to reduce the cost of utilities.

4.12 As part of the process of implementation, the

[10] As announced in the 2001 Budget Speech, the evaluation report estimated that 75 percent of small-scale FAP projects have not survived beyond the period of assistance. The comparative rates for medium- and large-scale projects were 45 percent and 35 percent, respectively.

Government established a high-level National Committee for the Implementation of the Industrial Development Policy. This is supported by specialised working groups in the key areas of land, infrastructure and utilities; human resource development and training; as well as technology development. Also in line with the objectives of the new IDP, the Government implimented additional measures of special sectoral support. These included the establishment of the Botswana Export Development and Investment Agency (BEDIA) and the programme to support Small, Medium and Micro Enterprises (SMMEs).

BEDIA

4.13 As a direct consequence of the 1997 IDP, the Government established BEDIA to take over the role of export development and investment promotion previously undertaken by the Trade Investment and Promotion Agency (TIPA) of the Ministry of Commerce and Industry. BEDIA is a parastatal body and, as such, has enhanced autonomy; the agency aims to promote investment in Botswana, particularly in manufacturing. It seeks to achieve this through both advertising the attractions of the country as an investment location and support through a ‘one-stop’ service centre that assists investors with matters such as work and residence permits, securing of land and buildings, business licensing and identifying potential citizen joint venture partners. To help deal with the specific problem of the shortage of factory space, BEDIA is directly involved in the establishment of new factory shell complexes.

4.14 While BEDIA has been in effective operation only since 1998, it has adopted a high profile, conducting promotion missions to a variety of countries worldwide. BEDIA also invites groups of potential investors to Botswana and an increasing number of foreign applications for support from FAP have been channelled through the agency.

Support for SMMEs

4.15 Over time, the Government has set up a variety of schemes to support SMMEs, in recognition of the potential role of small enterprises in the socio-economic development of the country. These include the reservation policy (under which certain categories of businesses are reserved for citizens), the Botswana Enterprise Development Unit (BEDU), the Business Advisory Service and the Rural Industrialisation Programme. However, it was recognised that there remained problems faced by SMMEs that needed to be addressed in a coordinated fashion. For this reason, in 1997 the Government established a task force, led by the private sector, in order to design a comprehensive policy framework for SMMEs. The resulting policy framework for SMMEs was published in 1999, the main features of which are as follows:

- the creation of an enabling environment within which SMMEs will flourish;
- an integrated approach to SMME development which ensures cohesion and linkages between the various programmes;
- effective implementation of the SMME policy and assessment of the policy against measurable objectives; and
- discouragement of SMME dependence on Government.

In line with these principles, the SMME policy provides for the establishment of a Small Business Council as an advisory body to both Government and SMMEs. This council will monitor Government policies and regulations affecting SMMEs, develop proposals for new projects and programmes to strengthen SMMEs and monitor the impact of SMMEs’ support programmes.

4.16 Following the development of the policy framework, various specific measures were announced in the 1999 Budget Speech.[11] Of these, most attention has been given to the micro-credit scheme. With an initial injection of P150 million, the intention was to establish a self-financing revolving fund providing people with low incomes access to resources to develop viable businesses. Administration of the scheme by the National Development Bank was meant to ensure independence from Government. Demand for the funds was overwhelming, while arrears accumulated rapidly as many beneficiaries experienced problems in servicing their loans. As a result, by mid-2000 the funds had been completely drawn down. In response, as announced in the 2001 Budget Speech, the Government decided to recapitalise the fund while at the same time, placing its operation under CEDA with, it is anticipated, an enhanced capacity to administer the scheme effectively (see Chapter 1 for details).

Trade Policy

4.17 Given the key role played by the development of export markets in successfully diversifying the economy, trade policy is a matter of key importance. Recognising this, the Government has played an active role in regional and international fora that review trade policy.

4.18 Membership of the Southern African Customs Union (SACU) provides Botswana producers with access to the largest market in Africa. Exports also benefit under the Cotonou (formerly Lomé) agreement, which provides duty free access for most goods to EU markets. The major beneficiary of this in Botswana is the beef industry. Opportunities for exports may also be enhanced through the passing in 2000 by the US Congress of the African Growth and Opportunities Act.[12]

4.19 However, recent developments also mean that in coming years, the Botswana market will itself become increasingly open to imports from producers outside the SACU region. Membership of SACU effectively binds Botswana into accepting the terms of the EU-South Africa Trade and Development Cooperation Agreement, which provides for the extension of reciprocal access to imports from the EU. Moreover, implementation of SADC Free Trade Agreement began in September 2000. The Agreement charts a programme for the liberalisation of inter-SADC trade for the period to 2012 and, again as a SACU member, Botswana is committed to a faster programme than non-SACU SADC countries.

4.20 It might be feared that such opening of domestic markets to competition from, on the one hand, the productive efficiency of European producers and, on the other, regional producers with lower costs, may harm the prospects for diversification. In the short run, some transitional problems might be expected. However, looking to the longer term, in the context of an overall economic environment that remains business-friendly, dynamic gains in terms of improved productivity and increased investment are anticipated. With the opening up of the Southern African region, Botswana, given its central location, reputation for political and economic stability and an advanced infrastructure, is well placed as a gateway to attract investor interest.

Other Support

4.21 From time to time, the Government has taken the initiative in support of the development of particular economic sectors. Most notable, perhaps, have been the various programmes to stimulate growth and development of agriculture. However, there is general recognition that these have not achieved very much and Government has announced the intention to undertake a general review of the

[11] For more details see Bank of Botswana *Annual Report 1998* (p48).

[12] There is some expectation that this will provide positive benefits as reputable producers seek suitable locations to take advantage of the new export opportunities to the United States. However, full requirements to access the benefits have yet to be completed and the Government will consider very carefully the implications of the Act's various conditions, including the extent to which its rights in the WTO might be limited, before proceeding further.

efficacy of such support schemes. At the same time, demonstration projects relating to the National Masterplan for Agricultural Development (NAMPAD) are due to get underway in 2001. The emphasis of the plan is the introduction of efficient management techniques and production technologies in selected areas, such as wastewater irrigation and dairy farming, where it is felt that agricultural production in Botswana can be competitive.

4.22. Tourism is another sector where plans for specific support are being developed. Since the mid-1990s tourism related investment has had access to assistance under FAP. However, with the main focus of FAP being on generating employment for unskilled labour, the particular needs of tourism, which tends to be more capital- and skilled-labour-intensive, were not fully met. The Botswana Tourism Development Programme has been undertaken with the aim of devising initiatives to suit these needs more closely and the establishment of a Tourism Development Fund is also under consideration.

5. Conclusion

5.1 The chapter has examined the diversification of the economy in the context of buoyant growth since 1974. Some progress has been made and, to a greater extent than is commonly realised. The expansion of the diamond sector has continued throughout the period and for this reason, the rapid growth of other sectors is sometimes overlooked. Indeed, with the exception of the declining agricultural base, all sectors have contributed significantly to the growth of the economy over the past twenty-five years.

5.2 Nevertheless, the challenge of effective diversification largely remains to be met. The export base is still heavily concentrated, and therefore vulnerable to market changes. The leading role of the mining sector has supported a broad range of developments but has not provided much direct support for the specific objective of employment creation. The dependence of the rest of the economy on Government has been steadily increasing, a trend that cannot be sustained in the long run.

5.3 The chapter has further reviewed key elements of the Government's support for diversification. These have showed some positive results but have also demonstrated the serious difficulties that can arise with incentive schemes based on the use of public funds. Inevitably, there is a risk that such schemes will lead to further dependence on Government

5.4 In the context of this assessment of the track record of diversification, this review now moves on to examine in more detail, the past and future role played by key economic sectors in the diversification process.

CHAPTER 4

THE PATH TO DIVERSIFICATION: SERVICES OR MANUFACTURING?

1. Introduction

1.1 The title of this chapter may appear to suggest that economic development is best achieved by focussing on a particular sector or sectors in the economy. Such an approach is apparent in Botswana where the identification of 'engines of growth' is commonly seen as summarising the challenge for diversification away from the mining sector.

1.2 Rather, the aim here is to argue *against* such a viewpoint, or at least to point to its associated dangers. These dangers include the judging of development against narrow criteria and policies of support that commit financial and other resources unquestioningly to the preferred sectors. In contrast, the argument is that the proper basis for development is an emphasis on policies that create *conditions* for growth, with less attention to the form - i.e., the engines - that growth might take. Economics may provide insights into what is good for economic growth, stressing the importance of factors such as education, technological development, economic and political stability. But how growth will manifest itself in particular circumstances is far less easy to anticipate, with commentators usually being, at best, wise only after the event.

2. Preference for Manufacturing

2.1 The major example of promoting a particular sector as a precondition for wider development is the common belief that such development is founded on the establishment and maintenance of a strong manufacturing sector. Such a belief has certainly received significant support in Botswana, where diversification and development of manufacturing are frequently regarded as being synonymous. Preferential support for manufacturing has also been seen at the policy level. The orientation of the Financial Assistance Policy (FAP) towards manufacturing and the concessionary rate of company income tax for some manufacturing businesses, are examples of this approach.

2.2 It would, of course, be a great exaggeration to suggest that the Botswana Government has ignored the potential for developing other sectors. The 1993 World Bank report on opportunities for industrial development in Botswana gave service development equal billing; and from this came the 1998 *Industrial Development Policy* (IDP), which is not restricted to manufacturing.[1] The International Financial Services Centre (IFSC) initiative, which also includes a preferential tax regime, and the preparation of a master plan for the development of tourism are recent examples of specific Government support for non-manufacturing activities. But the general orientation of discussion is typically based on the premise that the establishment of a successful manufacturing sector is the key to sustainable development.

2.3 Despite the support it has received, the manufacturing sector in Botswana has failed to take off to the extent that has been hoped for. The closures of major manufacturing ventures, which have typically received financial support from Government, have received prominent coverage. The close succession of several such closures in the second half of 2000 caused particular anguish. This was exacerbated by their coinciding with the selling off of the assets

[1] See *Industrial Development Policy for Botswana*, Section 3.

of the Hyundai manufacturing plant that was closed earlier in the year, which finally brought to an end attempts to re-launch the motor vehicle industry in Botswana.

2.4 This is, of course, far from the whole story. The variety of manufacturing businesses that perform very well is not so newsworthy, but just as important. As Chapter 3 of this report points out, overall growth in the sector has been generally impressive. But this has not matched expectations: in particular, perhaps, growth in output has not been accompanied by similar increases in sectoral employment.

2.5 What conclusion should be drawn from this? Some commentators have suggested that this 'failure' means that support for manufacturing has not been sufficiently extensive and/or well targeted. According to this view, support should be *intensified* and that the even-handed sectoral approach of the IDP is misguided. Such intensification would imply special government support for chosen industries including, possibly, an extension of state ownership in the targeted areas.

2.6 The alternative view, which is the thrust of this chapter, is that, given the conditions in Botswana, the focus on manufacturing risks being taken too far. Historically, this emphasis may have been appropriate. In the past, the best hope for promoting export-led growth and mass employment outside the primary sector, did lie in manufacturing. But it is argued here that this was due primarily to the lack of alternatives rather than because conditions for establishing large-scale manufacturing in Botswana have ever been particularly promising. This constraint has now been eased as current trends in technological development have greatly reduced the economic advantages supposedly associated with manufacturing. While this is a relatively new phenomenon, Botswana should be aiming to take full advantage of these enhanced opportunities.

2.7 This is not to suggest that support for the conditions that would encourage viable manufacturing to thrive in Botswana should not be forthcoming. For instance, the current emphasis on manufacturing in the promotional activities of BEDIA is appropriate. Rather, the point being made is that it is not the prospects in this sector alone that will determine success or failure in the wider development effort.

3. The Fallacy of the View that 'Manufacturing is Different'

3.1 The superiority of manufacturing compared to other forms of production, remains a commonly held belief. Rich countries worry about 'deindustrialisation'. Similarly, developing countries fret if they do not possess rapidly growing manufacturing sectors. Attracting (and retaining) investment in manufacturing is a major preoccupation of governments in both sets of countries. This preoccupation can go to such an extent that successes or failures in other sectors can pass relatively unnoticed. What then is the basis for this belief in the primacy of manufacturing?

3.2 At the most general level, the belief is the result of a simple historical association of manufacturing with success in economic development. The economies that are the constituents of the 'developed' world and the various 'clubs' of rich countries, such as the Organisation for Economic Cooperation and Development (OECD) and the G-8, mostly achieved this status originally through growth in manufacturing. Moreover, this is not just the success of a bygone age. Just as it was the industrial revolution in the eighteenth century that launched Britain, followed by other European economies and the United States, to economic pre-eminence, the 'miracle' growth of Japan and, subsequently, the Asian 'tiger' economies in the second half of the twentieth century, was also based on manufacturing. Clearly, it would seem, the formula has been successful over a sustained period of time.

3.3 Moreover, not only is manufacturing seen as delivering the goods as measured by aggregate economic wealth. It is also regarded as a foundation for development that is accompanied by various desirable features;

these include the following:

- **Employment:** mass production - the feature of much of the manufacturing industry - is commonly associated with mass employment. Conversely, decline in manufacturing is seen as a major cause of mass *un*employment: hence the concerns regarding deindustrialisation in the advanced economies. In the developing economies, where unemployment rates are frequently very high, development that is accompanied by rapid employment creation would seem to be particularly desirable;

- **Exports:** 'export led growth', which occurred in a number of countries including Germany, Japan and other east Asian economies, was based on the successful development of manufacturing. This would seem particularly relevant to Botswana due to the smallness of the domestic market;

- **Technological progress:** many inventions may be of more assistance to manufacturers. It has also been argued that manufacturing is inherently more dynamic - characterised by 'learning-by-doing' - than other sectors. For this reason, economies with strong manufacturing bases would tend to remain advanced technologically, which in turn, will support increasing production and, therefore, real incomes; and

- **Economic linkages:** manufacturing encourages linkages, both forward and backward, within the domestic economy.

It must be acknowledged immediately that there is considerable truth in all these points. For example, in its *World Development Report*, the World Bank highlights the manufacturing share of GDP on the grounds that it 'is generally the most dynamic part of the industrial sector'.[2] But in each respect the issues involved are more complex and the supposed advantages of manufacturing far less clear-cut than is often supposed.

'Engine' of Growth

3.4 For the developed countries at least, growth centred on manufacturing is a thing of the past. In the OECD economies services account for more than two thirds of output and up to 80 percent of employment. Apart from a residual belief that manufacturing is indeed something special, the practical concern is that those workers whose jobs are lost due to *de*industrialisation do not have the skills to find alternative employment. But this does not deal with the point that since the world economy still needs manufactured goods, emerging economies should aspire to take over. According to this argument, it is their 'turn' for industrialisation: the more so, because the driving force for *de*industrialisation is the cheaper labour available elsewhere.

3.5 In broad terms, this view is correct. One of the hindrances to successful development is the reluctance of the high-income economies to open fully their markets for free trade in manufactured goods. But acknowledging this does not mean that all emerging economies are equally well placed to take advantage of such opportunities.

3.6 At the same time, the suggestion that countries that do not industrialise will miss out on development does not bear up to careful scrutiny. In Europe, for example, small land-locked countries such as Switzerland and Luxembourg have some of the world's highest per capita incomes but only modest manufacturing bases. Instead, they have built a reputation on providing quality services for their larger industrialised neighbours. Among the developing economies, one of the original Asian tigers, Singapore, largely sidestepped industrialisation, using its advantages of strategic location, stability and efficient administration to develop services and become the preferred headquarters location

[2] See, for example *World Development Report 1997*, p237 footnote a.

for multinational companies. At first sight, these experiences would seem to have relevant lessons for Botswana. As an example of this potential, in November 2000 the world's largest medical assistance company, International SOS, acquired an interest in MRI Botswana based on the view that Botswana was a suitable hub for expansion in the region for such services.

Mass Employment

3.7 Mass production no longer means mass employment. Labour has become increasingly unnecessary as part of manufacturing production processes. The physical capabilities of machines increasingly replace rather than supplement labour. A good example of this in Botswana is the recent investment at the Orapa and Jwaneng diamond mines in the 'Aquarium' processing plants. The aim of this is to increase automation and reduce reliance on labour and, as such, further weaken the already narrow direct linkages between the diamond sub-sector and the rest of the economy.

3.8 The extent to which this occurs or not depends on the cost of labour. If wage rates are sufficiently low, then mass employment may still be possible, as manufacturing will be biased towards labour intensive production techniques. However, technological developments mean that such production will tend to be in simple products where the key element of competitiveness is price. As such, this type of manufacturing will be concentrated where the costs of labour are low, and, in the worldwide context, Botswana does not fare well in this respect.

3.9 A further reason for caution regarding the potential for employment arising from manufacturing, is that such an association can lead to an unintentional, but potentially dangerous, bias in policy. Specifically, proposed ventures that promise large-scale employment creation may tend to be viewed too uncritically when consideration is being given to provide public resources in support of the projects. With hindsight, it might be argued that this has affected policy in Botswana, which has provided substantial amounts in support of manufacturing investments through programmes such as FAP, the Botswana Development Corporation and others. Certainly, in the wake of the spate of closures of large scale manufacturing that occurred during 2000, serious questions were raised from a variety of quarters, including from within Government, about whether the credentials of the various investors had been scrutinised properly before agreeing to commit public resources to them.

3.10 Nor is mass employment necessarily confined to manufacturing. The potential for large-scale employment resulting from service industries should not be discounted. Indeed, mass production of services may be on a rising trend. A dynamic telecommunications industry can result in the creation of many jobs. For example, in Senegal it is estimated that private telecentres have led to 3000 additional jobs. Moreover, on the basis of efficient telecommunications, telephone help lines (for financial services, booking systems, etc) can also employ many people.[3] Such employment does not usually require highly skilled labour, and technological progress, which has reduced the costs of telecommunications, means that provision of these services can be traded internationally (see below).

Tradeability

3.11 In the past, trade has been based on natural commodities and manufacturing. In their models, economists have frequently categorised services as non-tradeable. This is in large part, because the provision of a service has typically demanded the physical presence of both the service provider and the consumer. Clearly, this gives the edge to domestic suppliers, since transport costs of people are inevitably greater than that of goods.

3.12 Technological progress has worked against

[3] It has been estimated that in the United Kingdom, call centres employ more than 400 000 people. This is more than two percent of the labour force and exceeds the total employment in the coal, steel and motor industries combined.

this. Physical presence is no longer so important, given better communications; and when transport is required, the costs are lower. Also of great importance and again due to technology, it is now far easier than before to unbundle services to take advantage of the potential benefits of the division of labour. This is to the extent that the various components of a service no longer need to be physically close, enabling low cost elements to be located in countries where the supply of labour is cheap. For this reason, in the United States some aspects of service provision, such as computer programming, airline revenues accounting, insurance claims and call centres, have been moved to lower-cost locations in the same time zones.[4]

3.13 Thus, the technical barriers to trade in services are much reduced. This leaves regulatory and institutional barriers. A start has been made in dismantling these with the General Agreement on Trade in Services (GATS), which was one of the major results of the Uruguay Round of international trade negotiations. Signatories to the GATS are the members of the World Trade Organisation. However, the agreement is only the start of a long process. Although signatories accepted the principle of service trade liberalisation[5], the initial commitments in this regard vary widely, and for many categories, countries have opted to remain ‘unbound’.[6]

3.14 Trade in services presents complex challenges. This is because it involves more than the movement of goods across frontiers. To export services may require entry by the consumer into the supplier country. Tourism is a good example of this. Similarly, service imports can entail allowing foreign businesses into the consuming country. For this reason, such trade inevitably interacts with frequently sensitive areas of national jurisdiction such as immigration, residence and employment laws.[7] At the same time, because of the previous difficulties in trading in services, regulatory environments have tended to evolve largely independently. Therefore, adapting them to facilitate cross border trade can be very difficult.[8]

3.15 Despite these caveats, it is to be hoped that GATS offers significant potential for encouraging trade in services. The interests of developing countries are explicitly built into the structure of the Agreement, which requires members to enter into agreements that improve the access of developing countries to distribution networks and information as well as gain better access for their service suppliers. But what this means in practice remains to be seen. The Agreement is at an early stage, more in line with the initial tariff cutting when the General Agreement on Tariffs and Trade (GATT) was launched in 1947, than the current position regarding trade in goods. It has already been stalled by the failure in 1999 to agree on the framework for the next round of international trade negotiations.

Cradle of Technology

3.16 On technology, it should be readily apparent that some developments have been especially helpful to manufacturing. Examples here include improvements to power generation and to transport. The former reduces the costs of operating machines that are utilised in manufacturing, while the latter lowers the costs of moving them. As such, both encourage mass production. Such earlier generations of technical revolutions, while increasing the capital intensity of production, can be seen as expanding the physical capabilities of labour. Not surprisingly, this was particularly helpful to manufacturing.

3.17 But other factors are equally apparent. Some forms of technical progress are more neutral across sectors. The current revolution in

4 In particular, to the islands of the West Indies.

5 The main category of services that are excluded from the GATS is ‘services supplied in the exercise of governmental authority’.

6 This is a technical term which means that a country has not made any commitment to trade liberalisation in that category.

7 These are explicitly excluded from the GATS.

8 Although again the contrast here with manufacturing, where required production standards can differ widely between countries, should not be taken too far. Indeed such standards have been used as a form of hidden barrier to trade.

communications and information technology (CIT) is a case in point. This generation of technical improvements extends the knowledge capabilities of labour; information can be stored in greater volumes and processed more quickly. This continues to benefit manufacturing, but is relevant for other sectors as well.

3.18 Moreover, to the extent that advances in technology do continue to help manufacturing, they may counteract other factors that have been seen to favour emphasis on the sector. That manufacturing is no longer to be equated with the mass employment of relatively unskilled labour, while opportunities for this are increasingly available in the services sector, has already been mentioned.

3.19 On the question of the supposed inherent technological dynamism of the manufacturing sector, it should be pointed out that this point is typically made in contrast to natural resource based development. The suggestion is that when development is based on natural resources the benefits of technology may not be realised. However, this is an argument against over-concentration on the primary sector. The relevant question is whether diversification *away* from natural-resource-based activity should necessarily imply concentration on manufacturing.

3.20 Some research work has argued that economies that have relied heavily on service sectors have tended to exhibit lower growth compared to those where development is more concentrated on manufacturing, thus lending support for the view that manufacturing is inherently more dynamic. However, support is far from conclusive. A particular problem is that measuring the output of service sectors is very difficult, one result of which is that improvements in service quality are often not taken into account. This can depress estimates of growth in the services sector.[9]

Domestic Multipliers

3.21 Table 4.1 provides some information on economic linkages, using data drawn from the 1993/94 social accounting matrix (SAM). Manufacturing is compared to the service sector and the private sector excluding diamond production.

TABLE 4.1: DOMESTIC LINKAGES – MANUFACTURING COMPARED TO SERVICES (PERCENT)

	Manuf.	Manuf. excl. food processing[1]	Services defn#1[2]	Services defn#2[2]	Private sector excl. diamonds
DIC/GO	42.4	32.4	27.1	31.8	32.8
M/GO	28.9	39.4	7.3	7.2	13.6
DIC/VA	148.1	115.3	41.3	54.1	61.1
VA/GO	28.7	28.1	65.6	61.0	53.6
CL/GO	9.5	8.7	18.1	15.0	13.9

Notation:
GO: Gross Output; **DIC:** Domestic Intermediate Consumption; **M:** Imports; **VA:** Value Added;
CL: Citizen Labour

1 Food processing covers meat and dairy/agro products. Beverage production and bakery products, which rely heavily on imports have not been included.

2 The first definition of services, 'defn#1', includes all the non-government services sectors while 'defn#2' excludes wholesale and retail trade, traditional and non-profit services.

Source: Central Statistics Office, Social Accounting Matrix 1993/94

9 As an example, in 1999 new estimates of GDP for the USA were produced covering the period since 1959. The estimates incorporated improved methods for measuring the output in financial services to take into account quality improvements. As a result, growth estimates for several years were revised upwards.

3.22 As shown in the table, manufacturing does not have a distinct advantage in domestic linkages compared to services and non-diamond-mining private sector in general. It is true that the ratio of domestic intermediate consumption to gross output was considerably higher for manufacturing at 42.4 percent. However, this is entirely explained by the food-processing sub-sector where, drawing on the domestic agricultural base (mainly beef but increasingly in other areas including poultry and dairy products) the backward linkages are naturally strong. Without this, the ratio falls to 32.4 percent, which is very much in line with both the service sector and the private sector more widely. If it is accepted that the potential for future growth in agriculture is very limited, this latter figure may be a better indicator of the marginal rate of linkage that might be expected from diversified development of manufacturing.

3.23 This argument is itself far from conclusive. If the assessment of the potential for agricultural development is too pessimistic, then the domestic linkages created by future growth would be stronger. However, what is clear is that the question of linkages is empirical: there is nothing inherently special about manufacturing in this regard. In Botswana the manufacturing sector has grown rapidly in comparison with many other countries. However, it has not been accompanied by the extent of domestic linkages, which might have been anticipated. As Table 4.1 shows, manufacturing has remained much *more* dependent on imports for supplies than the rest of the economy.

3.24 Another sign of such linkages not having occurred naturally, is the extent to which the need to strengthen such linkages has become a policy issue. This is the logic behind policies that attempt to distinguish 'real' manufacturing industries. The lower company income tax rate is not available to manufacturing businesses where the production process is a low-value activity such as assembling components or packaging, which are presumed to be particularly import intensive. Similarly, there has been calls to increase the extent of domestic processing of the country's natural resources such as diamond polishing and leather working. That this has not so far occurred is a frequent source of lament, even if the reasons for the lack of development of such industries are not hard to discern.[10]

3.25 The aim here is not to make a judgement on whether encouraging forward and backward linkages is desirable or not. There may well be good reasons to argue for a judicious policy in support of this. For instance, the efforts by the Ministry of Commerce and Industry in Botswana to establish a database of potential local suppliers should be a worthwhile initiative. Rather, the point is that such linkages are not an automatic consequence of development. Moreover, the extent of 'natural' domestic linkages may be decreasing. The increasing tradeability of services discussed above is a case in point, since the very logic of establishing an IFSC in Botswana rests on it. The proposed policy of target industries and active support for creating linkages recognises this also, but it goes a step further by making a judgment on what the pattern of development *ought* to look like.

4. The Case for Services: Assessing Botswana's Comparative Advantage

4.1 The range of economic activities covered by the 'services' sector is very diverse. Therefore, making statements that are applicable for the service sector as a whole is very difficult. At least manufacturers have the common feature that the end result is a physical product.

4.2 For the purposes of this analysis the services sector is taken to include the national accounts sub-sectors of hotels and restaurants, transport, communications, financial and business services. The major exclusions from this are wholesale and retail trade, traditional services such as domestic

[10] Take the diamond polishing industry for example. Given the high value/weight ratio of rough diamonds, the relative transport costs are low, which reduces the advantages of processing them where they are mined (see Bank of Botswana *Annual Report 1999*, p79).

servants and traditional doctors and non-profit organisations.[11] The aim of using this definition is to focus on the areas which would form the basis of a modern service-based economy. The intention is not in any way, to devalue the contribution made to national output by the excluded sub-sectors.[12] In fact, it should be noted that their exclusion should reduce further the case that the service sector is inherently less dynamic.

4.3 Economics teaches that countries' strategies to develop are most effective when based on areas where they possess *comparative advantages* in production. This is a technical economic term that in practice, is much overused and misunderstood (see paragraph 4.10 and footnote 14). Without going into the various details surrounding it, the basic idea is that everyone stands to benefit if each country specialises in what it does best - regardless of whether other countries produce that same good more efficiently in absolute terms - and relies on others to supply goods where it is relatively less efficient. (Such an assessment should be careful to take proper account of the extent of indirect costs of production, such as the effects of establishing a particular type of production on the local environment.)

4.4 In what areas a country has comparative advantage depends on many factors. But a good starting point is to consider goods in terms of the inputs that they require in their production, and then to compare these with the extent to which a country is well endowed with those inputs.

4.5 The most obvious characteristic for services is that they are 'weightless', i.e., there is little or no physical product. Now that they are also increasingly tradeable, this feature has profound implications for patterns of trade. In particular, the appropriate location for production will be less determined by physical transport costs and should enhance the opportunities for economies previously disadvantaged by such considerations.

4.6 Given its geographical characteristics (land-locked and with a limited natural resource base) the 'weightless' economy would seem an area where Botswana would expect to have a comparative advantage. Attributes where the country has already demonstrated such an advantage are themselves 'weightless'. Examples here include a reputation for stability and prudent management. This is an area where further positive progress is anticipated, such as in the acquisition of a sovereign credit rating.

4.7 The Government's policy towards education would also seem to strengthen this argument. In recent years, the proportion of GDP spent on education in Botswana has been among the highest in the world (see Chapter 7). If this investment is well targeted then, compared to other developing countries, the comparative advantage should lie in the knowledge-based areas of development.

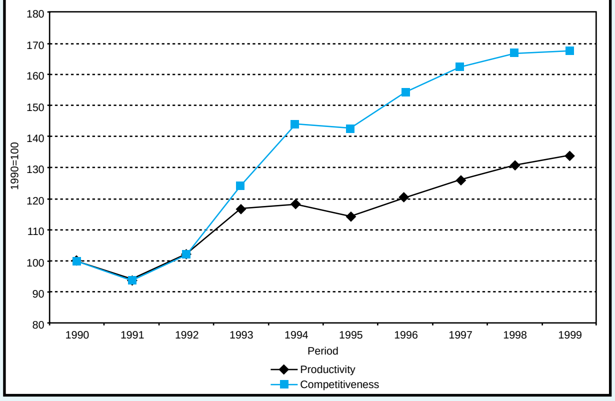
4.8 At the same time, it may seem difficult to envisage Botswana competing seriously in areas which are based on the large-scale employment of low-cost labour. Various factors work against this. In particular perhaps, the high cost of living in Botswana, arising in part from the extensive need to import, may put upward pressure on wages compared to countries where basic necessities can be obtained at lower cost.

4.9 This point should not be taken too far given that evidence does not immediately confirm that wage costs in Botswana are significantly out of line when compared with other countries. But it does not seem that a ready availability of cheap labour has been the major spur to investment in manufacturing in recent years. During the 1990s, real wage rates in manufacturing have been declining. Assuming that there has been no matching decline in productivity, such a trend might be taken to indicate increased competitiveness. But growth in output has not been matched by equivalent growth in employment. As a result competitiveness has been increasing

[11] This is 'defn#2' used in Table 4.1.

[12] It should also be noted that a thriving trade sector is also a necessary component of a modern economy. Its exclusion here is to avoid the suggestion that development based on consumption activities rather than investment and production is being encouraged.

CHART 4.1: PRODUCTIVITY AND COMPETITIVENESS IN MANUFACTURING, 1990 - 1999



faster than suggested by the trend in the real wage (see Chart 4.1).[13]

4.10. It is important to note the precise implications for the idea of comparative advantage. It points to where a country should be best positioned to compete; to possess a comparative advantage does not automatically also imply a *competitive* advantage.[14] The extent to which it does compete effectively in certain areas still depends on basic factors, notably whether the cost of the various factors of production is realistic compared to their contribution to output. (In particular, perhaps, this applies to labour, where wage levels can be influenced significantly by factors other than productivity.) Thus, to say that Botswana may have a comparative advantage in service production should not raise expectations that it can immediately compete effectively in these areas.

4.11 As one example of this last point, which does *not* relate to labour productivity, it should be clear that to take advantage of the opportunities of the 'weightless' economy an efficient system of telecommunications is essential. There is economic research that indicates the boost to growth that arises from concentrating investment in this sector. This is a lesson that Botswana could do well to bear in mind, a point that is taken up again in Chapter 6. Botswana has for some time, managed to avoid being classified as a case, seen as being all-too-common in Africa, where the inefficiency of a state-owned telecommunications is holding back development more widely. In Botswana, the Botswana Telecommunications Corporation (BTC) has operated on a sound financial footing while achieving connection rates that are respectable, if not outstanding, by world standards.[15] But the clear deficiencies in the current operation - of which the burgeoning cellular phone sector may be seen as in part a consequence - cannot continue if such potential opportunities are to be realised. Already in Botswana there has been considerable disquiet about the quality of services provided by BTC from those promoting the introduction of Internet services into the country. Despite this, however, according to some independent estimates the number of Internet users in Botswana as a proportion of the population is one of the highest in Africa.[16] This might be taken as an indication of some potential for developing business in these areas.

4.12 The range of international services that might be expected to locate in Botswana is wide. The initiative to establish the IFSC is based on a presumed comparative advantage centred on financial and business stability. This has entered the implementation stage, with considerable regional and international interest. Various regional organisations are headquartered in Botswana with more to follow. A natural extension from this would be for private sector businesses with a regional focus, to locate in the country. The safe and stable environment, efficient service

13 The measure of competitiveness shown in Chart 4.1 is based on measures of the real minimum wage. A broadly similar (although more volatile) picture emerges if real average wages are used. Productivity is defined as sectoral GDP per worker.

14 This is something that is not always well understood, a situation not helped by the common usage where the terms comparative and competitive advantage are often used interchangeably.

15 In 1997 the number of access lines provided by BTC per 100 people was 4.7. This is below the average of 6 for the group of low and middle-income countries taken as a whole, but far higher than the 1 for sub-Saharan Africa (excluding South Africa). Moreover development has been very rapid: in the four years from 1995 annual growth in this measure in Botswana was 17.1 percent, reaching a figure of 6.4 in 1999. This said, such macro-level figures can be misleading. For instance, they do not take into account the extent to which public phones are frequently out of service and, more critically for overall development prospects, the speed with which lines are provided to applicants for new connections.

16 According to the *Business Africa* (January 1st to 15th 2001) Botswana had 12 000 Internet users, or 0.76 percent of the population. This is well ahead of most countries reported in the survey. But it is also well behind South Africa and Mauritius for which the estimates were 4.19 percent and 4.66 percent, respectively.

provision and associated tourist attractions, is conducive for holding international meetings and conferences. For example, in 2000 the country hosted major international conferences for statisticians, telecommunications regulators, science and technology experts and for the construction industry.

4.13 A further point is that as real incomes rise, the balance of demand tends to switch in favour of services. This has been seen in the pattern of domestic consumption in Botswana, where the growth in recent years in such low-skill and sometimes labour-intensive services as valet car wash facilities, convenience stores, fast food outlets (including door-to-door delivery) and radio-controlled taxis has been evident.[17] As a result, significant numbers of jobs have been created. This point may also be applicable to the potential for developing export markets in services, the demand for which is buoyant as incomes rise. A good example is the potential for developing the tourist industry in Botswana. But, in saying this, it must be stressed that to be successful in competing in such markets, the emphasis will very much need to be on the quality of the product.

5. The Case for Manufacturing Restated

5.1 The potential for service development should be recognised. But the danger of swinging the balance too far in that direction must also be acknowledged. The myth that manufacturing is something special should not be replaced by a similar myth for services. Further development of financial and business services as well as tourism can contribute meaningfully to growth in national output and employment creation. But by themselves they cannot be expected to achieve development goals.

5.2 Geographical factors may not reduce the potential for Botswana to develop as a centre for manufacturing by as much as is sometimes made out. It is true that land-locked countries are generally disadvantaged. This is especially so when, as is the case with Botswana, they are not served by navigable waterways that facilitate transport.[18] But the view of Botswana as an isolated, land-locked country developed at a time when such disadvantages were magnified by regional instabilities. Now there is the prospect of the Southern African region as a whole developing into a dynamic integrated market. In such circumstances, Botswana, with its *central* position in this region, could be an ideal business location, not just for business headquarters, as suggested above, but for manufacturing operations also. This would in some ways be a repeat of an earlier period: in the nineteenth century, the land that is now Botswana was very important not just as a transport route but also as a trading centre.

5.3 The planned relocation from South Africa to Botswana by a leading manufacturer of blankets announced in November 2000 explicitly identified the locational advantages as the prime attraction. Similarly, a potential Namibian investor in the Botswana milling industry anticipated increasing domestic production capacity on the basis of regional export potential.

5.4 Some manufacturing may also be relatively ‘weightless’. This observation may seem to point towards ‘light’ manufacturing. But it is more than this: what really matters is a high value to weight/transport cost ratio. Again the example of the diamond industry demonstrates this in Botswana. The example of Switzerland, where manufacturing has been centred on ‘light’ high-value products such as precision engineering, pharmaceuticals and luxury confectioneries, is again relevant.[19] If Botswana businesses can start to compete in markets for goods that

[17] Another example is the mushrooming in 2000 of manned public cellular phone facilities. While also a reflection of the dynamism of the market economy, this is a less encouraging example, however, since it is largely a reflection of continued difficulties experienced by Botswana Telecommunications Corporation in providing satisfactory service levels with its public phone network.

[18] In the land-locked areas of large countries such as the United States, the existence of such waterways - the Great Lakes and the Mississippi River for example - has facilitated the developments of wealthy industrialised urban centres.

[19] The relevance of the Swiss experience in Botswana can be taken further. The Pula was once famously described as the Swiss Franc of Africa owing to its strength and the country’s reputation for financial stability.

are less driven by price alone, but which emphasise attributes including quality, diversity and timeliness of delivery, then manufacturing may again be a viable option.

5.5 To the extent that the IT revolution no longer encourages mass production in manufacturing, it also increases the viability of small-scale production as the advantages of physical proximity of all the stages of production are reduced. Moreover, developments such as the Internet mean that it is more feasible for small firms in developing countries to market their goods in developed markets.

5.6 In the wake of the passage of the *Africa Growth and Opportunity Act* through the United States Congress during 2000, there has been some optimism expressed that this will lead to significant international interest in investing in Africa. This will arise as suppliers to the vast US consumer market look to take advantage of the opportunities of reducing the costs of duties and quotas that the Act provides for a wide range of goods produced in qualifying African countries. These countries include Botswana and it might be expected that under such a focus, the country would come out well. Moreover, it is anticipated that such investors will be reputable international producers, rather than those that have been attracted mainly by grants from FAP. But while this provides some hope that there is a window of opportunity to establish effective manufacturing industry in Botswana, this supports the argument that this chapter has set out to make. The attraction for investors will be Botswana as a business location in general.

6. Conclusion

6.1 There is *nothing* in this chapter that suggests that Botswana should ignore the potential for manufacturing as a basis for future development. As already noted, the past 'failure' of the sector to develop is easily exaggerated. Rather, the point being made is that the balance between manufacturing and other sectors should be explicitly and consistently neutral. To emphasise manufacturing may place unrealistic expectations on that sector as well as risk ignoring other viable avenues for sustainable development.

6.2 The chapter has focussed on services as an alternative to manufacturing. This is because there are good reasons to believe that this is an area where the country might hope to have an effective comparative advantage. The problems of high transport costs associated with manufacturing would be minimised and maximum use could be made of the potential from a labour force that is increasingly well educated.

6.3 But the real lesson of the chapter is not that it is a choice between manufacturing *or* services. Rather, it is manufacturing *and* services, *and* many more. The whole logic of argument is in favour of diversification, promoting conditions that encourage the effective exploitation of economic opportunities across a broad range of sectors. In contrast, the search for 'engines of growth' emphasises basing development on identifying and promoting particular sectors that will drive the economy through the next stage of development.

6.4 Encouraging such broad-based development in turn, implies policies that *are* neutral across sectors. Many policies currently being followed are neutral. Promoting Botswana as stable, both politically and economically, characterised by business-friendly conditions such as low taxes, lack of corruption, good labour relations, a work force with extensive exposure to formal education and a sound financial system, are attractive conditions across all sectors. Nor are dedicated programmes to deal with the special needs of various sectors inconsistent with this approach. But the design and assessment of such programmes should not be influenced by some presumption that development in particular sectors is inherently more beneficial. This is especially since such reasoning can increase the extent to which well-intentioned development policies may fall victim to the activities of investors whose main intention is to benefit from the award of public resources.

6.5 The evidence, such as it is, suggests that the advantages which underpin successful development of manufacturing are not easily established in Botswana. Now that opportunities to develop without reliance on manufacturing are increasingly apparent, the country should pay due attention to establishing conditions where it is best placed to do so. In this context, a lopsided focus on manufacturing can be a damaging distraction.

CHAPTER 5

FINANCIAL SECTOR POLICIES FOR DIVERSIFIED GROWTH

1. Introduction

1.1 A decade has passed since the Government began to implement the *Financial Sector Development Strategy*[1]. Progress made in implementing the strategy up to 1996 was reviewed in the Bank's *Annual Report* for that year. As indicated in the *Annual Report*, the focus was in four principal areas for developing the financial sector, viz, curtailing the role of Government as the major source of finance for parastatals, improving the efficiency and soundness of commercial banks, promoting the development of domestic money and capital markets, and improving the effectiveness of development financial institutions.

1.2 Among the important developments in the 1990s were an increase in the number of banks, diversification of their services as well as growth in capital market infrastructure and instruments. In fact, over the past ten years (1989/90 - 1998/99), the share of "banks, insurance and business services" in the national accounts nearly doubled, a development which was accompanied by growth in the number and types of financial institutions during the period, a process which is itself an aspect of economic diversification.

1.3 This chapter briefly reviews the financial sector reforms that have since been implemented, examines the degree to which the financial sector has developed and suggests possible new policy measures that will need to be considered as the economy diversifies and integrates into the international global economy.

2. Financial Sector Reforms: A Progress Report

The Pre-1989/91 Period

2.1 Prior to the reforms that took place in the period 1989-91, the financial sector was characterised by a lack of competition and a limited range of financial institutions and instruments. While Botswana never experienced the degree of direct controls on the financial sector that characterised many developing economies in the 1970s and 1980s, there was significant intervention by the Bank of Botswana and the Government in the operations of the financial sector. Until 1986, interest rates were controlled by the central bank through a system of maximum lending rates and minimum deposit rates, while the level of interest rates was heavily influenced by the Bank of Botswana's call deposit rate. Although the Bank had statutory power to control the growth rate of bank credit, this power was only used once, in 1981, when the country experienced balance of payment problems. At no time did the authorities attempt to exercise any direct controls over the sectoral allocation of credit, nor did Government borrow from the banking system. A fairly strict system of exchange controls on capital movements (although not on current account transactions) restricted savers from accessing offshore financial assets, which may well have offered higher yields than domestic assets.

2.2 During this period, the instruments of monetary policy were quite limited. Monetary policy was largely implemented through

[1] Botswana: Financial Policies for Diversified Growth. World Bank/Government of Botswana, August 1989

direct controls that the Bank of Botswana exercised over commercial banks' interest rates (until 1986), and subsequently through the Bank's call deposit rate. The latter facility had been introduced to absorb excess liquidity from the banking system, and therefore the call deposit rate had the important function of representing the marginal return on deposits accepted by the banks. The interest rate at which the Bank of Botswana lends to the commercial banks, the Bank Rate, was also varied in accordance with monetary policy objectives. However, given the environment of excess liquidity in the banking system, there was virtually no lending to the banks, and for ths reason, changes in the Bank Rate had little direct impact, although it remained important as a benchmark rate. Similarly, excess liquidity meant that changes in reserve requirements were largely ineffective from a monetary policy perspective, as they would have had to be raised to very high levels in order to have a significant impact on the commercial banks' ability to lend. Also during this period, the Bank of Botswana had no scope to conduct open market operations, as the usual instruments for this purpose (Treasury Bills or central bank paper) did not exist.

2.3 For much of the 1980s, interest rate policy was more concerned with the cost of borrowing than with remunerating deposits. Given excess liquidity, policy attempted to encourage borrowing through keeping interest rates low and, as a result, interest rates were negative in real terms for most of the period up to 1993. The combination of low interest rates and exchange controls meant that financial assets yielding positive real returns to savers were virtually non-existent.

Financial Sector Reforms: The Post 1989-91 Period

2.4 The current monetary policy framework specifies the objectives, the intermediate target and the instruments for achieving the objectives. In order to improve transparency in the conduct of monetary policy, the Bank began to issue yearly *Monetary Policy Statements* in 1998. The *Statements* provide a background to the issues addressed by monetary policy and indicate the direction of policy.

Monetary Policy: Objectives, Instruments and Operations

2.5 As is the case in most countries, monetary policy is a major component of macroeconomic policy aimed at achieving macroeconomic balance. In line with international trends, the objectives of monetary policy are low and stable inflation and maintenance of positive real interest rates that are comparable to those prevailing in international capital markets. The reference interest rate for international comparison is the real yield on three-month Bank of Botswana Certificates (BoBCs), while the intermediate target is the growth in banking system credit in order to restrain credit-financed expenditure. In the course of implementing monetary policy, the Bank monitors the rate of growth in Government spending, given its impact on total national expenditure.

2.6 The Bank Rate and auctions of BoBCs are the two key tools of monetary policy. The use of Open Market Operations (OMO), through the sale and purchase of BoBCs by the central bank to and from commercial banks and other counterparties, was initiated in 1991. The second instrument, the Bank Rate, is the interest rate charged by the Bank for short-term borrowing by commercial banks. The rate is also a signal for the desired level and direction of banking system interest rates. A reduction in the rate indicates a need to expand bank lending and vice versa for an increase in the rate, although banks in Botswana borrow infrequently from the central bank due to high levels of liquidity in the banking system.

2.7 Reserve requirements, which could be an alternative or complementary to OMO, are not actively used since they tend to act as a tax on banks' loanable funds vis-à-vis other institutions that provide similar services. Moreover, in view of the excess liquidity in the banking system, changes in reserve requirements are unlikely to have a significant impact on bank lending unless they are raised very sharply.

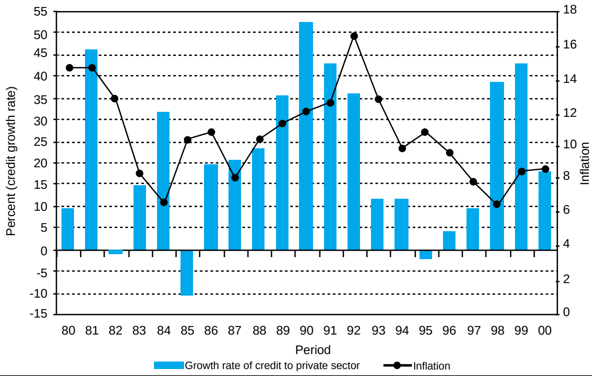
2.8 The framework for the implementation of monetary policy has undergone steady improvement during the decade. Nevertheless, much remains to be done to further enhance its effectiveness. Key areas of attention remain the exact nature of the relationship between interest rates and credit growth, between different types of expenditure growth (household, investment, government) and inflation, the impact of other sources of price pressures, such as import prices, on domestic inflation, and the dynamics of these and other relationships.

Monetary Policy Performance

2.9 A review of policy operation and performance examines movements in credit growth rates, interest rates and inflation. Among the factors affecting the operation of monetary policy are excess liquidity, the degree to which the money market is developed and the competitiveness of participants in primary and secondary money markets. Therefore, apart from the specified targets and objectives of the new monetary framework, success also requires progress in eliminating those factors which have hitherto been constraints to effective monetary policy implementation.

2.10 Trends in the annual rates of growth of credit to the private sector are shown in Chart 5.1. As shown in the Chart, from 1988 there was substantial increase in the growth rate of credit to the private sector, peaking at 52 percent in 1990. In turn, inflation subsequently increased markedly, and reached 17.7 percent in June 1992. This rise in inflation was a combined result of excess demand and the increase in prices of imported goods[2]. In the event, despite the stated monetary policy objective of achieving positive real rates of interest, most deposit rates remained negative in real terms as inflation rose to unprecedented levels.

CHART 5.1: BOTSWANA-GROWTH IN CREDIT TO THE PRIVATE SECTOR AND INFLATION, 1980 - 2000



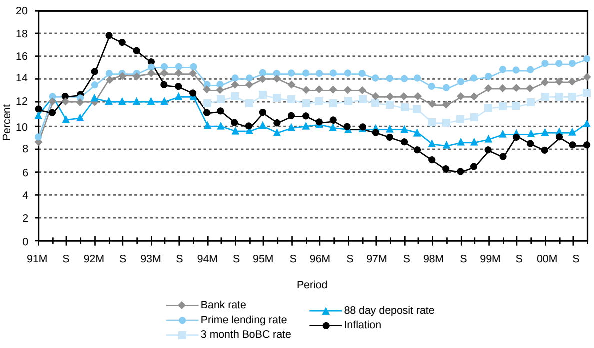
2.11 From the second half of 1992, inflation decreased and fell to 5.9 percent in the second half of 1998, its lowest level since 1985. The slowdown in inflation followed the decline in the rate of growth of credit to the private sector to moderate levels up to 1997. These developments were the result of adjustments to the Bank Rate and sterilisation of excess liquidity through the sale of BoBCs as well as slower growth in the non-mining sector of the economy and government spending. The extent of the absorption of excess liquidity is represented by the volume of BoBCs outstanding.

2.12 However, inflation subsequently rose in 1999 and 2000. Among the factors responsible for the rise in inflation were the substantial growth rate in credit to the private sector, the significant addition to liquidity in the economy following the July 1998 adjustment in public sector salaries, the rapid growth of government expenditure and, more recently, the sustained increase in oil prices. In an effort to contain inflation, the Bank Rate was raised in February 1999, March 1999, February 2000 and October 2000. The liquidity mopping up as indicated by BoBCs outstanding was, however, less aggressive, although yields on BoBCs rose steadily during the period.

2.13 Overall, despite the rise in inflation in 1999 and 2000, there is evidence that over time, the operation of the policy variables has resulted in a restrained rate of credit growth, lower

2 *See, for example, Wright and Kahuti, 1997, "The Real Costs of Inflation in Botswana", in Aspects of the Botswana Economy.*

CHART 5.2: BOTSWANA-INTEREST RATES AND INFLATION (1991 - 2000)



inflation and positive real rates of interest. Most notable was the substantial reduction in the growth rate of credit to the private sector in 2000 compared to 1999, a factor which eased domestic pressures on inflation.

2.14 There were also policy achievements with respect to real interest rates in Botswana. The rate for three month BoBCs has compared favourably to similar instruments in major international markets since 1993. The real effective yield on BoBCs averaged 3.53 percent in 2000 compared to an average of 2.65 percent in the USA and 2.87 percent in the UK.

Banking Supervision

2.15 Another aspect of the financial sector development strategy was the promotion of efficient operations of commercial banks and other private sector financial institutions by encouraging greater competition within the industry. In line with this aspect of the strategy, additional commercial banks were licensed. Correspondingly, the Bank of Botswana ceased to regulate bank tariffs and to be directly involved in the commercial banks' business location decisions.

2.16 In order to ensure the soundness of commercial banks and the financial sector in general, the supervisory powers of the Bank were enhanced under the new Banking Act, 1995. The Act also widened the Bank's regulatory powers beyond commercial banks and leasing companies to include merchant banks, discount houses and other specialized institutions, as well as delegating to the Bank the authority to process and issue banking licences. Furthermore, the Act strengthened the provisions contained in the previous Act, for direct involvement of the Bank in dealing with distressed financial institutions. Under this provision the Bank can directly intervene to rehabilitate distressed institutions, restore public confidence in the affected institution(s) and forestall a systemic financial crisis. There is also a provision for collaboration with other external supervisory authorities on matters of banking supervision including money-laundering issues. The Bank was further granted the responsibility 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.

Exchange Control Liberalisation and Abolition

2.17 In February 1999, Botswana abolished all exchange controls, a logical step following the significant and progressive liberalisation that had taken place over a period of many years. The increased integration into international financial markets will enable the country to tap global financial resources as firms and households will take the opportunities available to diversify both their investment portfolios and sources of funds. However, there are downside risks that accompany increased integration into global financial markets. Increased financial flows across national boundaries can render open economies susceptible to adverse shifts in market sentiment. From this perspective, the new situation presents challenges to policymakers in dealing with the prevention and resolution of financial crises of either domestic or external origin. It also poses new challenges in the implementation of monetary policy.

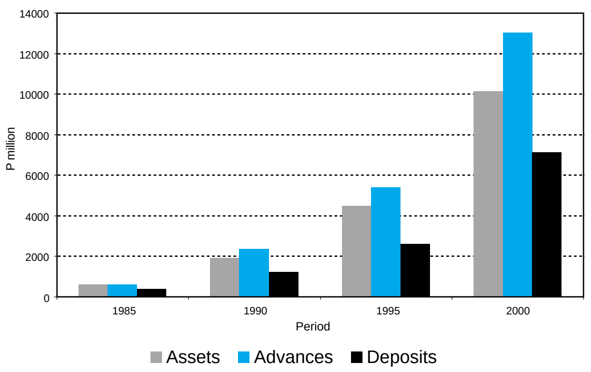
3. Financial Sector Growth: A Review of Recent Trends

Institutional Developments

3.1 Charts 5.3 and 5.4 highlight the funding provided by the various types of institutions.

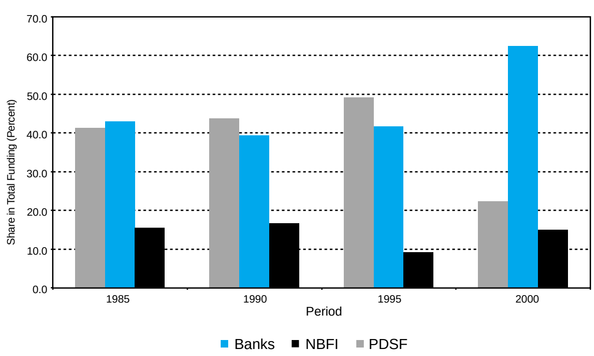
As can be seen from the charts, the financial system is dominated by commercial banks, followed by the Government's Public Debt Service Fund (PDSF) and non-bank financial institutions (NBFIs). Lending by commercial banks has increased sharply since the beginning of the 1990s, rising from P754 million in 1990 to P4.2 billion in 1999, while PDSF loans increased more slowly: from P914 million in 1990 to a peak of around P2.5 billion in 1997, then falling to just over P2.1 billion in 1999. The decrease in PDSF lending reflects Government policy of progressively weaning parastatals off dependence on public funds as part of the financial sector development strategy. As a result, the share of commercial banks in the total advances of financial institutions has increased sharply, while that of the PDSF has declined since the mid-1990s. The share of NBFIs has remained steady, except for a decline in the mid-1990s when the restructuring of some NBFIs necessitated substantial write-offs of loans.

CHART 5.3: SELECTED ASSETS AND LIABILITIES OF THE BANKING SYSTEM



Note: Advances include government loans to parastatals from the Public Debt Service Fund (PDSF)

CHART 5.4: ADVANCES BY SELECTED FINANCIAL INSTITUTIONS (RELATIVE SHARES)



3.2 There is also a growing money market, which involves trading in BoBCs. The outstanding market value of the certificates grew from P200 million in May 1991 to P4.2 billion in 1999, but fell slightly to P3.7 billion in 2000. However, secondary market transactions (i.e., trading outside the Bank by counterparties) have remained low, totalling P498.3 million between January and December 2000, or 13 percent of the outstanding market value of BoBCs.

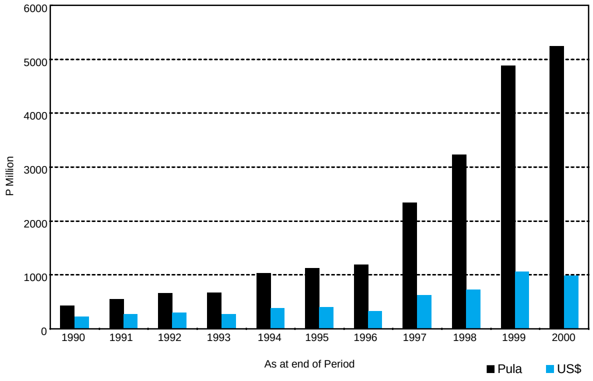
3.3 Chart 5.5 shows the growth rates and market capitalisation of the Botswana Stock Exchange (BSE). The stock market, which was established in 1989, performed remarkably well during the first few years after its establishment, in terms of the level of capitalisation, the value of shares and returns to shares. However, the growth in the value of shares and returns has recently tapered off. During the first eleven years of its existence, sixteen companies have been listed, while market capitalisation grew at an average rate of 30.5 percent per annum. As at the end of 2000, market capitalisation was nearly P5.2 billion. Another significant development on the stock market has been the existence of dual listing[3] of stocks as part of exchange control liberalisation.

3.4 The main investors on the BSE are domestic insurance companies and pension funds, which are obliged to hold a certain proportion of their portfolio in the form of domestic assets. For these institutional investors and other savers, the establishment of the stock exchange provided a welcome addition to the range of available financial assets, especially at a time when exchange controls restricted the purchase of offshore assets. Taken over the period as a whole, real returns on BSE-listed equities have been good. Nevertheless,

3 As at the end of 2000, there were seven dual listed stocks. These are mostly companies with some business interests in Botswana, with their primary listings on the Johannesburg Stock Exchange.

there has generally been a problem of liquidity in the market, with a shortage of marketable stock. Over the last two years, however, this problem has diminished, due partly to the selling of shares by foreign investors as emerging markets generally fell out of favour. One recent development has been the development of an embryonic bond market, as two parastatals (Botswana Telecommunications Corporation and the

CHART 5.5: MARKET CAPITALISATION OF THE BOTSWANA STOCK EXCHANGE



Botswana Development Corporation) floated bonds with a total nominal value of P100 million. In addition, a South African bank, Investec, issued short term paper with a value of P182 million, and just before the end of 2000, the Botswana Building Society floated a P50 million bond.

3.5 A further significant development in the financial sector during the 1990s has been the growth of pension and life insurance funds. Most large and medium sized companies in the private and parastatal sectors now have their own pension funds, the management of which is generally contracted out to professional fund managers. Correspondingly, pension and life fund assets have risen rapidly and were over P2 billion in 2000. At least 30 percent of these assets must be invested domestically, while the remainder can be invested offshore. The main domestic assets held by these institutions are shares and bonds quoted on the Botswana Stock Exchange, commercial property and BoBCs. Contributions to pension and life funds are generally made through salary deductions on a contractual basis, and have played an important role in sustaining the savings rate of the household sector. The funds represent an important pool of long term savings, and one of the key tasks in developing the financial sector is to ensure that these savings can be applied to productive investments, which are generally in need of long term funds, without exposing savers to excessively high risks.

3.6 As the development of the capital market and financial sector liberalisation progresses, it is expected that the relative share of commercial banks in the intermediation process will be reduced. However, for firms that are unlikely to raise funds from the capital markets, commercial banks will continue to be a major source of funds.

3.7 The lending decisions of financial institutions are normally based on considerations of market and credit risks, which may not always coincide with some socio-economic goals. In the event that purely business considerations in lending are inconsistent with other socio-economic objectives, the Government may need to address the special borrowing needs of certain segments of society in a transparent and efficient manner. In meeting such special needs the related challenges are, first, to ensure that the financial sector should remain a major conduit for channelling the funds to targeted sections of the society and, second, to maintain the viability of the institutions involved as well as the overall competitiveness of the financial sector.

3.8 It is in this context that the Government has established certain schemes that are aimed at providing finance for viable investments that may not be able to satisfactorily meet their entire financial requirements through private and parastatal financial institutions. These include the Financial Assistance Policy (FAP), which provides grants for approved investments in manufacturing, tourism and non-traditional agriculture, and the Small, Medium and Micro Enterprise (SMME) scheme. Both of these are discussed in more detail in chapter 3.

Financial Intermediation and Economic Growth

3.9 The financial sector contributes to the development process through the administration of the payments mechanism and intermediation between savers and borrowers. One objective of financial sector policies is the promotion of improvements in the ability of the financial sector to discharge these functions. Provided that intermediaries finance viable projects, the overall effect is an increase in the average productivity of investment.

Indicators of Financial Development

3.10 A study[4] of the relationship between four financial development indicators and four growth indicators for 77 countries averaged over the period 1960 - 89 (Table 5.1), reported a wide range of values for the financial development and growth indicators across all the countries. Nevertheless, the study reveals two major conclusions. First, that each financial indicator is positively and significantly correlated with each growth indicator and, second, that the financial indicators are highly correlated with each other. The study then concludes that, overall, financial development is strongly linked to economic growth.

3.11 Table 5.1 shows comparable data for Botswana for the 1980 - 2000 period. The results do not wholly conform to the average outcome reported in the 77-country study. While Botswana's financial development indicators appear to be highly correlated with each other, the correlation between the financial development and growth indicators is neither consistently high nor consistently positive. The reduced robustness of the

TABLE 5.1: CONTEMPORANEOUS CORRELATIONS OF GROWTH AND FINANCIAL INDICATORS, 1969 – 1989 (BOTSWANA, 1980 - 2000)*

	GK	INV	PROD	DEPTH	BANK	PRIVATE	PRIV/Y
GYP	0.77	0.58	0.98	0.56	0.44	0.37	0.50
	0.29	0.10	0.87	0.33	-0.54	-0.33	0.63
GK		0.65	0.64	0.69	0.56	0.49	0.65
		0.30	0.72	0.29	0.24	0.24	0.21
INV			0.50	0.54	0.59	0.49	0.48
			0.72	0.96	-0.80	0.64	0.54
PROD				0.47	0.36	0.30	0.41
				0.24	0.15	0.11	0.49
DEPTH					0.59	0.45	0.82
					0.82	0.66	0.88
BANK						0.79	0.63
						0.53	0.66
PRIVATE							0.68
							0.64

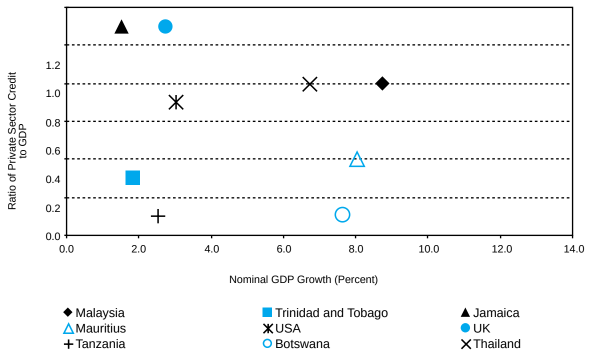
**The relevant correlation coefficients for Botswana (1980-2000) are in the shaded rows.*

GYP	=	*Real per capita GDP growth rate,*
GK	=	*Real per capita capital stock growth rate,*
INV	=	*Ratio of investment to GDP,*
PROD	=	*GYP – (0.3)*GK,*
DEPTH	=	*Ratio of liquid liabilities to GDP,*
BANK	=	*Deposit bank domestic credit divided by deposit bank domestic credit plus central bank domestic credit,*
PRIVATE	=	*Ratio of claims on non-financial private sector to domestic credit,*
PRIV/Y	=	*Gross claims on the private sector to GDP.*

[4] See King and Levine, 1993, "Finance, Entrepreneurship and Growth: Theory and Evidence", *Journal of Monetary Economics.*

results is probably due to the role of mining in the country's economic performance. The Government has played a key role in promoting growth by channelling the mining revenue into various developmental needs. This factor explains why financial depth is less correlated with real per capita growth rate and the capital stock growth rate compared to the average reported in the cross section study. However, financial depth is highly correlated with the ratio of investment to gross domestic product while private sector credit is correlated with some of the growth indicators.

CHART 5.6: FINANCIAL AND GROWTH INDICATORS (AVERAGE OVER 1985 - 1999)



3.12 Chart 5.6 further highlights the link between financial development and economic growth, and Botswana is compared with selected countries at different stages of development. It is evident that more developed countries and rapidly growing developing countries have higher rates of financial depth. While Botswana has a lower rate of financial depth than the other rapidly developing economies and the more developed economies, its growth rate compares favourably.

(i) Financial Deepening

3.13 Most measures of financial depth utilise the ratio of liquid assets to gross domestic product as an indicator, on the assumption that the size of the financial sector is positively correlated with the provision of financial services. There is evidence to the effect that the ratios of liquid assets to GDP are higher in the more developed economies than in developing countries, indicating that in these countries, more savings are channelled through the financial system and are, therefore, intermediated. Similarly, financial systems are deeper in the rapidly growing countries, such as East Asian countries, compared to the low-income countries in Africa.

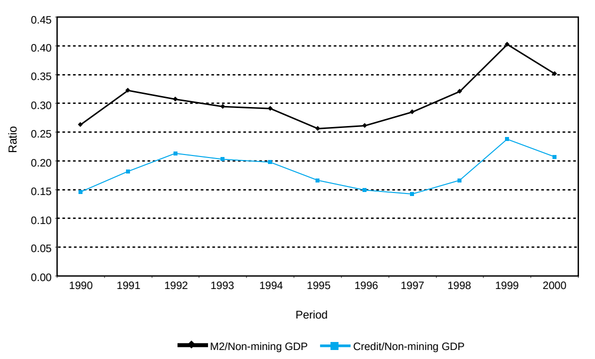
TABLE 5.2: INDICATORS OF FINANCIAL DEPTH-RATIO OF FINANCIAL AGGREGATES TO GDP (1985 AND 1998)

	1985			1998		
	M1/GDP	M2/GDP	PvCredit/ GDP	M1/GDP	M2/GDP	PvCredit/ GDP
USA	0.15	0.47	0.67	0.13	0.50	0.69
UK	0.04	0.64	0.47	0.03	0.92	1.19
Malaysia	0.18	0.44	0.61	0.21	0.75	1.06
Thailand	0.08	0.50	0.47	0.10	0.93	1.14
Jamaica	0.14	0.33	0.23	0.15	0.32	0.32
Mauritius	0.12	0.37	0.28	0.12	0.65	0.58
Trinidad & Tobago	0.13	0.34	0.33	0.12	0.40	0.35
Tanzania	0.21	0.12	0.02	0.36	0.32	0.16
Zambia*	0.17	0.12	0.19	0.06	0.10	0.08
Botswana**	0.10(0.22)	0.20(0.22)	0.10(0.11)	0.07 (0.15)	0.21(0.32)	0.12(0.16)

* GDP data for Zambia is unavailable for 1998, so the figures reported are for 1997.
** Figures in parenthesis are ratios calculated using non-mining GDP.

3.14 Table 5.2 shows the relevant ratios to nominal GDP for selected industrialised, emerging market economies (middle income) and low-income countries. The selected measures of financial deepening are the ratios of currency and demand deposits (M1), M1 plus savings and time deposits (M2), and credit to the private sector to GDP. There is no clear correlation between M1 and the level of development. The ratio of M2 to GDP is, however, markedly higher in countries at a higher level of development than in the less developed countries. The ratios reflect the existence of a range of financial institutions and financial claims that exist in the more developed and the rapidly growing countries. Similarly, the ratio of private sector credit to GDP is higher in the more developed and rapidly growing economies, indicating the greater use of the formal financial institutions to finance economic activity undertaken by the private sector.

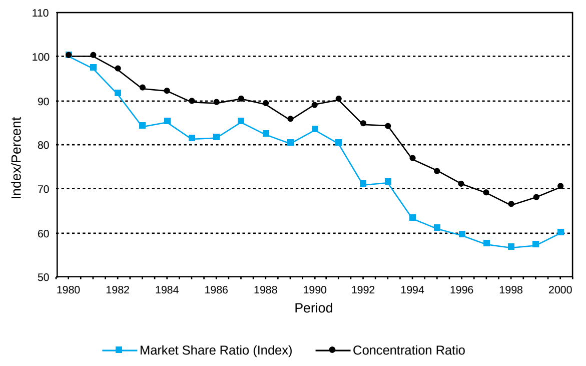
CHART 5.7: MEASURES OF FINANCIAL DEPTHS



3.15 Comparison of the various indicators in Table 5.2 shows that Botswana's level of financial depth was comparable with low income African countries in 1998, but markedly lower than that of countries with similar income levels. Although the ratios of credit and M2 to GDP have increased during the 1990s, the trend has not been consistent and there was a significant decline in these indicators in the middle of the decade. This coincided with an increase in BoBC holdings by the banks, as an alternative risk-free asset compared to advances.

3.16 Financial development can also be analysed using measures of concentration in the banking system. It is assumed that a less concentrated (and presumably more competitive) banking system reflects a greater level of financial development which is better suited to serve the diverse and emergent needs of a growing economy. The degree of concentration in the banking sector is measured using two alternative ratios: a two-bank concentration ratio[5], which measures the market share of the largest two banks in the economy, and a market share ratio, which takes into account the total number of banks and their respective market shares.

CHART 5.8: COMMERCIAL BANKS MARKET SHARE AND CONCENTRATION RATIOS



3.17 Chart 5.8 shows the trends in the two concentration ratios for Botswana. For a while there were only two banks, and there was a decrease in concentration when a third bank entered the market in 1981. However, from 1983 to 1991 there was virtually no change in the degree of concentration, and the market share of the two largest banks remained above 90 percent. However, from 1991 there was a marked decline in concentration in the banking system as shown

[5] The ratio is determined by calculating the proportion of the deposit liabilities of the two largest banks to the total deposit liabilities of all the banks. To reflect the trend in this ratio a series from the available data for Botswana is calculated. In this regard, a Herfindahl index (see Smirlock, 1985,"Evidence on the (Non) Relationship Between Concentration and Profitability", Journal of Money, Credit and Banking), based on the relative sizes of deposits held by individual banks is calculated. The index is calculated, for each year, by taking the share of each bank in total deposits of commercial banks and squaring. It is expressed by the formula: Index= $\sum_{i=1..n}\left(\frac{Di}{TD}\right)^2$, where TD is total deposits in all the commercial banks, and Di deposits with bank i.

by the decrease in both concentration ratios up to 1998. This trend reflects the changes in the banking system, deriving from policy changes implemented since the early 1990s, which facilitated the entry of new institutions into the financial sector and the introduction of competitive new services. By the end of 2000 the market share of the largest two banks had decreased to less than 60 percent.

(ii) *Banking System Efficiency*

3.18 The degree of bank profitability can alternatively be measured by the return on assets or equity, the cost-income ratio, or the interest margin[6]. Chart 5.9 shows the range of return on average assets for banks in Botswana over eleven years, while Table 5.3 shows a comparison with selected countries. By these measures commercial banks in Botswana have remained largely profitable, and compare favourably with banks internationally. The interest margin represents the banks' return on intermediation and is likely to be higher where banks can attract a greater amount of relatively low cost current account deposits and where high lending rates are unchallenged due to lack of competition. Chart 5.10 shows the trends in the prime lending rate and the 88-day deposit rate. The

CHART 5.9: COMMERCIAL BANKS-RATES OF RETURN ON ASSETS,1990 - 2000

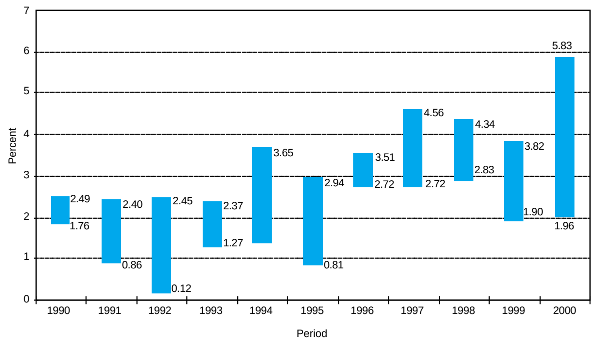


CHART 5.10: INTEREST RATES AND INTEREST RATE SPREAD, 1991 - 2000

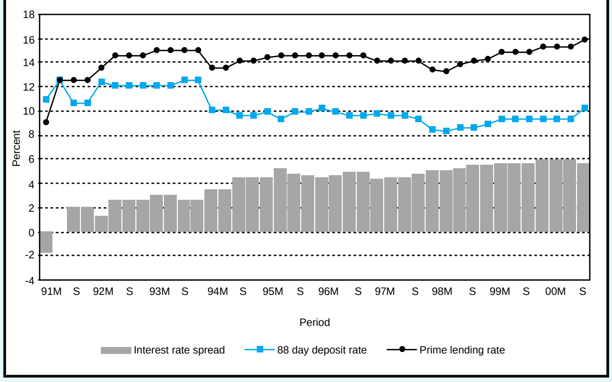


TABLE 5.3: BANK PROFITABILITY IN SELECTED COUNTRIES, 1999 (Return on Average Assets and Return on Equity in Selected Countries)		
Country	**Return on Average Assets**	**Return on Equity**
Botswana	3.20	45.00
Jamaica	1.30	13.07
South Africa	1.00	13.10
Zambia	2.85	29.49
Mauritius	2.20	17.60
Trinidad and Tobago	2.30	17.60
Malaysia	2.22	20.06
Tanzania	0.13	2.87
Thailand	0.59	10.74
United Kingdom	0.85	13.52
United States of America	1.11	15.56

Source: Central Banks

[6] The difference between the lending rate and the deposit rate.

spread between these two rates shows the intermediation margin; it is evident that the gap between the two rates has widened during the 1990s. This is contrary to what might have been expected given the increasing competition that should have been accompanied by a reduced intermediation margin.

3.19 The high levels of commercial bank profitability could indicate the absence of competition and the possibility of oligopolistic behaviour, which may result in inefficient intermediation. Notwithstanding this, profitability is, generally, indicative of soundness of banks and establishes the public's confidence in the banking system. Furthermore, to an extent that profits are derived from lending business, it reflects viability/productivity of the activities being financed[7]. Profits, to the extent that they are retained, sustain the growth of individual banks and their ability to finance higher thresholds and increase the range of activities that may be financed.

3.20 Other relevant areas for analysis of efficiency of intermediation include the quality of payments and other services. Recent improvements in this regard include the reduction in the lags in cheque clearing and the abolition of exchange controls. The efficiency of services has been enhanced by increased adoption of new technology including automated teller machines (ATMs), debit and credit cards and on-line access to accounts for corporate and personal customers. At the same time, there has been a progressive introduction of special products for personal accounts, particularly targeted at regular salaried employees. Other facilities include foreign currency accounts (FCAs), which can help in reducing the transactions costs for some categories of account holders; they also attract interest rates that are comparable to those in the overseas respective currency markets and can be used as a hedge against exchange rate risks.

3.21 The innovations made by the banking system are consistent with international trends especially with respect to infrastructure. The trend is also buttressed by the fact that banks in Botswana have reputable international parent banks. Notwithstanding the notable infrastructural improvements and the range of products, there remains anecdotal evidence of inefficiencies in customer services at counters and delays in the cheque clearing process.

Services of the Financial Sector

Deposit Mobilisation

3.22 The relative performances in deposit mobilisation by the different types of financial institutions is shown in Table 5.4. Deposit mobilisation by the commercial

TABLE 5.4: BOTSWANA: RELATIVE SIZE OF FINANCIAL INSTITUTIONS (Percentage Distribution)

		1985	1990	1995	2000
Advances	**PDSF**	41.4	43.8	49.1	22.4
	Commercial banks	43.1	39.4	41.8	62.5
	NBFI	15.5	16.8	9.1	15.1
Deposits	**Commercial banks**	87.6	88.8	95.1	96.0
	NBFI	12.4	11.2	4.9	4.0

Source: Banks; Non-bank Financial Institutions; Ministry of Finance and Development Planning

[7] It is noted, however, that a significant amount of lending is for personal consumption backed by employment income (rather than business income). Profits also comprise interest earned on BoBCs.

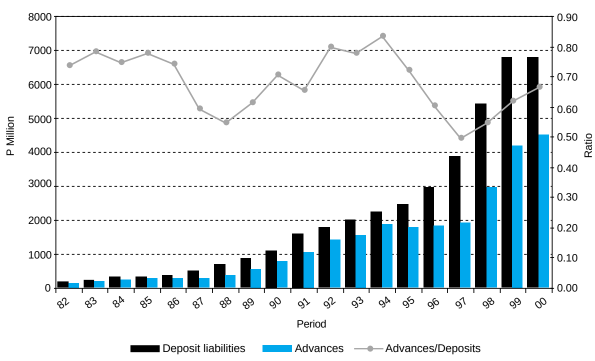
banks has previously been influenced by excess liquidity in the system and lack of opportunities for profitable financial investments in the domestic market. The incidence of excess liquidity was a reflection of limited domestic absorptive capacity in the context of exchange controls. Since the adoption of a new monetary policy framework, however, the banks can hold excess funds in Bank of Botswana Certificates. Furthermore, given the liberalisation of exchange controls, residents are free to invest and utilise any of their funds abroad. Therefore, the existence of excess funds in the domestic market reflects preference for domestic liquid funds taking account of a combination of factors that include market and portfolio risks as well as transaction costs.

3.23 For development finance institutions, the limitations imposed by the relevant statutes, their narrow range of services overall and, until recently, the ready availability of government funds, were apparently the more significant factors limiting the ability and incentive for deposit mobilisation. Furthermore, the absence of certain payments facilities at the Botswana Building Society and the Botswana Savings Bank, for example, limit the services they offer, and therefore their attractiveness to potential customers. The other development finance institutions are statutorily inhibited from taking deposits, although they can raise funds in the market. In the past, the government could readily finance them at relatively low cost; for this reason, there was no incentive to even raise wholesale deposits from the market.

Credit Allocation

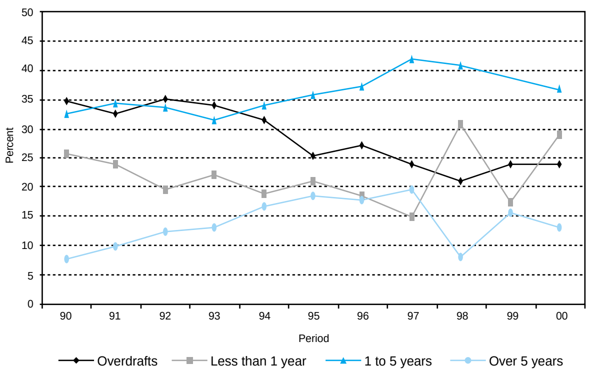
3.24 The higher level of deposit mobilisation by the commercial banks suggests an enhanced intermediary role vis-à-vis the private sector. To examine the extent of allocation of mobilised funds, reference is made to the ratio of advances to deposits, the trend of which is shown in Chart 5.11. The ratio fell significantly in the mid-1990s, and by 1997 the banks were lending only 50 percent of deposits, which may be considered a relatively low level of intermediation. The decline in the proportion of deposits lent out followed a period of rapid credit growth in the early 1990s, and a subsequent period of rising arrears and bad debts. This experience caused the banks to reassess their lending policies and appraise credit risks, and led to an increased preference for the risk-free returns and liquidity offered by Bank of Botswana Certificates. The improved performance of the private sector since 1997 and enhanced investment opportunities has, however, led to a rise in the proportion of deposits lent out to nearly 70 percent by 2000. Nevertheless, there is considerable scope for banks to increase their lending relative to deposits. Whether or not they can do so will depend on the availability of effective credit demand from borrowers with acceptable risk profiles, and the banks' ability to reduce the costs of assessing and monitoring risk. It should be noted, however, that the structural characteristics of the economy, including an excess of savings over investment, are likely to depress the level of bank lending relative to deposits, and private sector credit relative to GDP, in comparison with some other countries.

CHART 5.11: COMMERCIAL BANKS-DEPOSIT LIABILITIES AND ADVANCES



3.25 Another important aspect of intermediation relates to the maturity structure of credit and its allocation (Chart 5.12). A varying maturity spectrum of credit reflects diverse funding options for important elements of real sector productive activity such as payments, operations, innovation and investment. Payments and operations funding as well as services would normally be fulfilled through cheque account, overdraft and short-term lending to provide liquidity and the financing of stocks and day-to-day costs. Effective intermediation should additionally facilitate the flow of funds to private productive investments, which normally require longer term funding. Thus, whether lending was for productive purposes or not could, at least to some extent, be seen from the sectoral distribution of loans and the term structure of the loans. A combination showing preferences for short-term lending to households, for example, would indicate consumption lending. In contrast, long-term lending to private businesses is more likely to suggest productive lending. A review of the maturity breakdown shows that the banks mostly lend for one to five years and this lending has been increasing. This range of

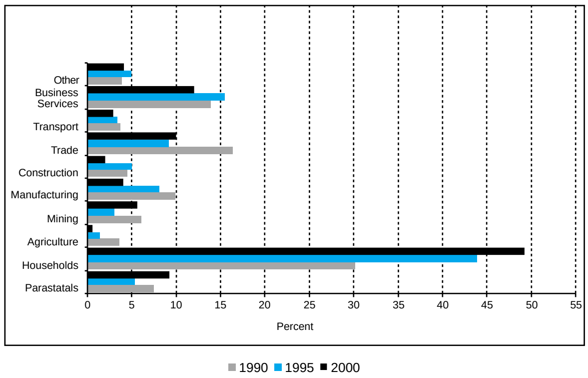
CHART 5.12: SHARES OF ADVANCES BY MATURITY



maturity covers short-term personal loans and lending for household durables and motor vehicles. Notably, overdrafts which are mostly used by businesses for payments and funding of operations have been declining as a proportion of total lending. However, although the maturity structure continues to be dominated by loans of up to five years and overdrafts, the proportion of loans over five years has been steadily increasing.

3.26 Data on sectoral flow of credit show that a large and increasing share flows to the household sector (see Chart 5.13). It is notable that considerably less credit flows to areas normally associated with growth-inducing activities such as agriculture, mining and manufacturing; on the other hand, the trade and service sectors attract comparatively higher levels of credit. This suggests that, while banks may be effective in providing funds for routine operations and consumption purposes, there is relatively less lending for investment. This may reflect the bias by the banks towards short-term lending.

CHART 5.13: SECTORAL DISTRIBUTION OF CREDIT



It is possible, though, that the funding requirements of the relatively large businesses could not be met by the domestic banks individually, given their level of capitalisation and restrictions with respect to loan concentration. This may also apply to funding of utility parastatals, although in their case recourse to PDSF borrowing and government-assisted foreign borrowing was, until recently, the overriding reason.

3.27 Although commercial banks reported an increasing proportion of lending to households, this could include a significant amount used for (household) business operations, especially in agriculture, small retail, taxis and property development. The classification under households reflects the circumvention of the more formal and detailed requirements for loan applications classified as business compared to the easily structured application process for personal loans. There are a number of implications of this for the quality of returns on the investment being financed. First, those who qualify for personal loans are normally people in professional employment and, therefore, do not necessarily devote focused attention to their business ventures. Second, the applications do not benefit from professional project evaluation and, therefore, their financing is not necessarily on the basis of projected positive return from the investment. It is, therefore, possible that there is a significant amount of investment capital with low returns. This has implications for future rates of economic growth.

4. Conclusions

Bank of Botswana: Monetary Policy

4.1 Openness and increased integration into global financial markets imposes an obligation of unfailing discipline on the conduct of economic policy so as to maintain policy credibility and consistency as well as minimise the impact of possible financial market crises. In globalised international financial markets, increased inter-linkages between markets and the degree of sensitivity of capital flows, not only make monetary policy more complex, but also underline its critical role in creating a stable domestic economic and financial environment. In this context, it is important to sustain a transparent and consistent monetary policy framework, which is clear in terms of objectives and implementation.

4.2 There is increasing consensus and emphasis in many countries that central banks should pursue price stability as the single and overriding objective of monetary policy. Price stability is important for at least two reasons. First, it is a necessary condition for attaining sustainable growth, as low and stable inflation contributes to economic expansion by stimulating investment and improving productivity. Second, a single objective helps to insulate the central bank from political pressures. Otherwise, monetary policy can be subjected to electoral cycles, thereby adversely affecting its credibility and consistency in controlling inflation. The need for consistency and credibility is important since fiscal policy is expected to be supportive of a monetary policy stance.

4.3 A major challenge for monetary policy in Botswana, which emerges as the economy increasingly integrates into the global financial markets, is the potential for large capital inflows or outflows, which can undermine the maintenance of macroeconomic stability. Under a flexible exchange rate regime, economies are to a certain extent, insulated from such shocks by the ability of the exchange rate to adjust. With a pegged exchange rate, such as Botswana has, significant interest rate differentials in relation to other countries, could cause large and potentially disruptive capital flows. In practice this has not been a problem since the abolition of exchange controls in 1999, but it could be in future as domestic financial markets evolve. It will, therefore, be necessary to monitor carefully the relationship between exchange rate and monetary policies in future and to ensure that appropriate choices are made in the face of evolving policy constraints.

Prudential Supervision

4.4 Liberalisation of the financial sector in Botswana was supported by the establishment of an adequate framework for the prudential regulation and supervision of licensed financial institutions. The Banking Act, 1995 addresses the need for maintenance of a sound banking system that can support economic diversification. However, one of the lessons drawn from the East Asian crisis is the importance of removing inherent weaknesses in the supervisory legislation for dealing with troubled institutions. The Banking Act, 1995 deals with this problem by granting the Bank unambiguous powers to move swiftly to either rehabilitate or promptly close a troubled financial institution, thereby limiting the prospects for systemic risk. Another important lesson which emerged from the South East Asian crisis, which the supervisory authorities in Botswana need to be cognisant of in the context of the globalised financial markets, is vigilance in monitoring and strictly enforcing the levels of lending to related parties as well as the degree of foreign currency risks assumed by large corporations and financial institutions.

4.5 Currently, the supervision of development finance institutions (which are established under various statutes other than the Banking Act) is limited both in scope and in the supervisory action that could be enforced. This situation needs to be reviewed particularly with respect to the regulation and supervision of deposit-taking financial institutions such as the BBS and the BSB, as well as lending institutions, especially the NDB. Unsound financial institutions are also unlikely to attract deposits efficiently and would not easily raise funds in the private market. Conversely, the inefficient financing of unviable projects would not support sustainable economic growth in general and diversification in particular. Furthermore, fully supervised development finance institutions would improve their ability to raise funds from the private market, promote the development of the capital market and increase the efficiency of the financial system.

4.6 Besides the existing firm prudential and supervisory legislation, which has underpinned and supported the process of financial sector liberalisation in Botswana, there are challenges that need to be met on an on-going basis, as the economy grows in complexity. The challenges include diversification of the nature and number of financial institutions, their manner of operation, the increased complexity of financial services and greater incidence of cross-border operations. These developments have implications, on the one hand, for the allocation of regulatory and supervisory responsibilities for banks and related institutions and for the capital market. On the other hand, there are implications for the programme of supervision, cross-border cooperation, and the overall efficiency and integrity of the process. Therefore, the development of new innovative financial products and the emergence of financial conglomerates, as the economy gets integrated into a globalised world economy, will require the continuous modernisation and adaptation of the regulatory framework so as to ensure a resilient financial system.

Financial System and Economic Development

4.7 The financial reforms that have taken place since the late 1980s were intended to ensure that the financial sector would play a positive supportive role in economic diversification. To a certain extent, this has been achieved: the range of financial products, markets and institutions has been significantly extended, with more specialisation and, hopefully, greater efficiency. Nevertheless, more remains to be done, especially in developing the bond and stock markets. Although these markets now exist, the provision of finance by the private sector still remains dominated by the commercial banks. It is also evident that there has been little significant financial deepening, contrary to expectations; again indicating that more remains to be done in expanding the role of the financial sector. The lack of financial deepening may reflect a failure of the financial sector to penetrate significantly throughout the economy, and the development of financial markets and institutions that can serve a broader range of economic activities remains a challenge, whether through the provision of savings products or the finance for investment.

CHAPTER 6

BUILDING THE NECESSARY BASE OF SKILLS AND TECHNOLOGY?

1. Introduction

1.1 Earlier chapters have discussed the areas in which Botswana might expect to develop in order to achieve the objective of a diversified economy. This chapter examines the fundamental question of how the country should equip itself with the necessary base of productive capital and skilled labour so that these goals can be realised. In particular, the chapter looks at what needs to be done in order to take advantage of the economic opportunities resulting from technological development.

1.2 According to *Vision 2016*, 'Botswana will have entered the information age on an equal footing with other nations'.[1] What such an 'equal footing' will mean in practice is not clear since by 2016 the country will clearly not be a technological leader like the USA and other industrialised countries. But it is clear that the country intends to pursue seriously economic development objectives based on skills development, technology and knowledge. This is an ambitious goal since, by some measures at least, Botswana is counted as one of the countries that are still considered 'technologically excluded'.[2]

1.3 The answer to this question may seem easy, summed up in a single word - 'investment'. This has been emphasised by the Botswana Government. In the 2000 Budget Speech it was stated that 'one of the major policy challenges is to raise investment as a proportion of GDP from the current level of about 25 percent to around 40 percent' if the goals of *Vision 2016* are to be achieved.[3] If the emphasis is on skills and technology development, then investment should also be concentrated in these areas. In this regard, the Government has shown a repeated commitment to continue to invest in education and has recognised the importance of supporting the advancement of science and technology.

1.4 Up to a point, the emphasis on increasing the rate of investment may be appropriate. But economic research increasingly emphasises that investment by itself may not be sufficient to stimulate rapid development. Other supportive conditions must be in place so that the capital created by the investment can be utilised effectively. This may seem obvious, but it is a point that is easily forgotten, with too much attention being paid to asset accumulation as an end in itself, rather than in support of other objectives, such as means to increase productive capacity and efficiency. This is something that may risk being encouraged by focussing on an overall rate of investment since this emphasises the aggregate total rather than the quality of the components. Put simply, unproductive investment does not support economic growth. Such an emphasis may also lead to a bias in favour of investment in physical assets, as this is the form of capital that is most easily quantified.

1.5 This chapter takes the need to encourage higher rates of investment as given, and concentrates attention on the supporting

[1] *Vision 2016*, p5.

[2] Although it must be noted that such measures, insofar as they are based on the extent of primary commodities in countries' exports, can be misleading. In Botswana, the importance of diamond mining dominates many aggregate economic statistics, to the extent that the impact of other potentially important developments can be obscured. Moreover, to classify primary commodity exports as 'low tech' ignores the technology that may be required for their production. Diamond mining in Botswana has many "high tech" aspects.

[3] *Vision 2016* targets real income growth of nearly 8 percent per year.

conditions that will help yield its maximum potential. The emphasis is on encouraging an economy that is outward looking and flexible in orientation.

1.6 It is appropriate that the issues of technology and skilled labour are discussed together, since the similarities between the two are greater than is often realised. Both contribute to the enhancement of the capital stock. Both face some of the same problems; notably, achieving the appropriate balance between public and private sector involvement such that investment levels are optimised. For this reason, policy conclusions that are reached regarding technology development may also be relevant for skills development, and vice versa. Moreover, they are clearly complementary since technology, however close it is to the 'cutting edge', may be of little value if people do not have appropriate skills to use it effectively.

2. Some General Observations

The need to be outward looking - in all respects

2.1 Whether based on manufacturing or services, a diversified Botswana economy will need to be comprehensively outward looking. Already necessitated by the small size of the domestic market, this imperative is reinforced by the need for the country to both face up to the challenges and take advantage of the opportunities due to globalisation.

2.2 This is generally recognised in the case of technology. It is uncontroversial that relevant technologies should be utilised, regardless of where they have been developed. In Botswana, there has been little hesitation in either the public or private sector in utilising foreign technology. Institutions involved in promoting domestic technology, such as the Botswana Technology Centre (BOTEC), the Rural Industries Innovation Centre (RIIC) and the Department of Agricultural Research, are active participants in this approach.

2.3 What is sometimes less clearly understood is that this point is equally applicable to the issue of skilled labour. 'Best practice' elsewhere, including in the developed economies, increasingly recognises that not all skills and technology can be home grown, with consequent moves to free up movement of labour between countries. As this is the case in developed countries with large populations and well-established high quality education systems, it would seem to be even more applicable for countries such as Botswana where the opposite conditions prevail.

2.4 Botswana has a good record of a pragmatic and generally welcoming attitude towards utilising foreign labour. This is one of the factors contributing to the country's economic success. There are, however, considerable pressures to move more rapidly in the direction of 'localisation' of the work force, especially in the face of an increasingly educated population and persistent high rates of unemployment.

2.5 Investment in the education of Batswana is indeed crucial. The slogan 'Education, Education, Education' as the key to economic development has a lot of merit. However, the common belief that the use of foreign expertise is a stopgap measure while local skills are being developed, is only valid to a certain extent. Having an environment that attracts talented and enterprising people from elsewhere in the world is a requirement with no time limit. The realisation of this imperative was underscored at the *Asia Pacific Economic Summit 2000*, organised by the World Economic Forum, where it was agreed that 'the key priority for countries...aiming to build new knowledge based economies is to invest in education *and attract talented individuals*' [emphasis added]. While reached in the context of the Asia Pacific region, this conclusion is equally applicable to all countries with similar aspirations.

2.6 Moreover, if the objectives of *Vision 2016* are to be realised, this necessitates a long period of sustained and dynamic economic expansion. Despite widespread unemployment, it is unlikely that the local labour force will be able to meet all the demands for the necessary skills. Already, the aggressive pursuit of localisation objectives by institutions in the public sector - which has a dominant impact on the labour market as a whole - has resulted in intensive competition for certain categories of labour. In the circumstances, the pursuit of the legitimate goal of localisation may require a significant degree of flexibility in its application, in a dynamic and fast growing economy, which will continuously require new skills.

2.7 The impact of the HIV/AIDS epidemic in Botswana has made an emphasis on being outward looking even more necessary. The risk that labour with relevant skills may not be available, is much increased and employers should have the flexibility to use the available labour efficiently and supplement it where necessary. Otherwise, the country, which is already disadvantaged by a small population and skills base, will be handicapped further. This need was emphasised in a report produced for Government in 1999, which argued that a significant factor influencing the extent to which the macroeconomic prospects of the country would be affected in the face of HIV/AIDS, would be the extent of flexibility that the private sector is allowed in recruiting necessary foreign labour.

2.8 However, while the economic case for continued, and even increased, flexibility in the utilisation of labour from other countries is strong, this should not be seen as advocating uncritically the complete freedom of movement of labour between countries. This could lead to the legitimate economic requirements of a country such as Botswana being overwhelmed by the consequences of social and economic imbalances that exist elsewhere. Moreover, the movement of labour involves issues which are wider than purely economic, and proper account must also be taken of these factors.

More than just investment

2.9 The emphasis in much development thinking, is on the accumulation of capital (both physical and human) as the key for successful development. In this respect, the example of the 2000 Budget Speech in Botswana has already been noted. However, influential recent economic research reaches the conclusion that factor accumulation is <u>not</u> the major determinant of economic growth.[4] According to this view a much more important role should be accorded to various contributing factors that ensure that capital is used productively rather than creating incentives that encourage asset accumulation *per se*.

2.10 This general conclusion must itself be interpreted carefully. It does not deny the importance of investment in promoting economic growth. For the early stages of development in particular, the accumulation of basic public infrastructure is essential. But it does suggest an emphasis that is often overlooked by economists and policy makers. In particular, it points to the need to assess critically, the role played by governments in encouraging development. This is both as investors in their own right and through the incentives they offer to the private sector to invest. Regarding the former, it is increasingly recognised that simply categorising all investment by governments as contributing to capital accumulation can be very misleading. Governments' spending priorities are frequently determined by factors other than economic return.[5] Given the very large contribution made by the Botswana Government to national investment, this is a matter to be taken seriously. As to the latter, private sector investment is driven by the expectation of making adequate returns. If this does not result in subsequent economic growth it is likely to be because there exist

4 See, for instance, 'It's Not Factor Accumulation: Stylised Facts and Growth Models' by W. Easterly and R. Levine (World Bank Working Paper, 2000).

5 Such factors range from the legitimate pursuit of other social objective to the problem that Government bureaucracies are not well suited to making sound, commercial investment decisions.

incentives, such as investment grants or artificially low interest rates that encouraged unproductive investment. In Botswana, as an example, the overall impact of the Financial Assistance Policy (FAP) should be viewed critically in this light.

2.11 The factors that encourage productive investment are many and complex, and it remains a priority for economic research to gain a fuller understanding of them. But of central importance is likely to be the proper functioning of labour markets. In particular, it is widely recognised that inflexibility in labour markets can hamper investment in modern technology. For example, it has been suggested that this is one reason why economic growth in Europe in the 1990s has not matched that seen in the USA. Again, if this is the case for the advanced economies, it is likely to apply in at least equal measure to countries where the track record for profitable investments is less well established.

There are no short cuts

2.12 The potential for growth based on technology is not a panacea for development. The success of such a strategy still depends on other essentials being firmly in place including, in particular, a stable macroeconomic environment with a conducive business climate. Botswana is well placed in this regard, but it will need to sustain the basic thrust of the underlying policies.

2.13 Moreover, the fact that technologies exist does not necessarily mean that they will be put to good use. This is apparent in the advanced economies where the effective utilisation of 'new-generation' technologies is proving more of a challenge than optimists had initially anticipated. The huge amounts being invested in broadband telecommunications represent major gambles for the companies concerned, while the struggle to survive by many e-commerce operators has signalled the need for caution in these areas. Developing countries face similar problems, not just of acquiring technologies but also in their effective application. There is a general danger of *over*-investment in technologies, where advanced equipment is acquired without there being available the necessary resources to use it productively.

3. Key Questions for Botswana

3.1 The issues discussed so far raise many more detailed questions; many more than can be dealt with here. Four are focussed on below, which are considered particularly relevant to Botswana:

- The extent of reliance on domestic or imported technology;
- Striking the right balance between public and private sectors in the funding of investment;
- Potential conflict with promoting diversified growth and other policy objectives;
- The consequences of HIV/AIDS.

Reliance on domestic or imported technology

3.2 While Botswana has readily accepted the need to utilise foreign technology, the extent to which development of a domestic technology capability should actively be encouraged, is still a relevant question. There are at least two good reasons why not having a domestic technology base does seem to leave countries at a disadvantage.

3.3 First, many technologies are not universally adaptable, a problem that particularly affects countries in tropical regions. This is for the simple reason that certain sorts of technology, such as biotechnology and medicines, are specifically developed for temperate climates. To compound matters, there may not be sufficient commercial incentive for the technology developers to undertake the necessary research in areas of interest to tropical countries. The low incomes in these countries can create a vicious circle where lack of demand can fatally inhibit the commercial viability of developing technologies that could help raise productivity and, therefore, incomes. These considerations would seem to support a case for policy intervention by governments in support of the development technology that is appropriate for their countries.

3.4 Second, the absorption of imported technology may be made more effective if the importing economy itself has an active and effective technological base. This is not just because domestic research and development helps make necessary adaptations to local conditions. In addition, a significant local technological base can facilitate technology transfer through 'learning by experimenting'.

3.5 It is important not to take these arguments too far. Basic considerations suggest that the comparative advantage of developing countries lies with *using*, with lower costs of other inputs, technologies created elsewhere, rather than *creating* such technologies. The point is that there are other important routes for technology transfer apart from those, such as trade and foreign direct investment, that typically receive most attention. An emphasis on this may be appropriate for Botswana, with its ambitious goals regarding education which, if achieved, should support a domestic base in technology. Moreover, the country's advantages as a regional hub may also point to the potential for policies that support 'headquarters' functions such as research and development.

3.6 Where technology is imported, the important objective is to make the economy 'technologically congruent.' In other words, the economy should be able to incorporate technological advances developed elsewhere efficiently. This may not be straightforward. Experience elsewhere has shown that the transfer of technologies is not always easy, even between advanced economies.[6] Such considerations suggest that a policy of openness to trade and investment may not be sufficient by itself to achieve the desired congruence. It may also be important to establish effective links with well-established technological leaders if developing countries are to converge effectively with higher income economies. As an example of such an approach in Botswana, BOTEC has a 'Partnership with Giants' strategy, which is based on cooperation agreements with leading science and technology establishments around the world.

The balance between public and private sector

3.7 It is generally accepted that there is a role for government involvement in encouraging investment. If left to the private sector alone there could be under-investment in the face of various positive 'externalities' that would accompany the investment.[7] This applies to all sorts of capital, but in particular to human capital and technology where such externalities are likely to be greater as compared to physical capital.[8]

3.8 In Botswana, the small size of the domestic market may suggest that there is a particularly active role for the Government to play. Technological progress is likely to be subject to economies of scale. Innovators seem to work best together rather than in isolation and, for this reason, they concentrate in technology 'hubs', of which 'Silicon Valley' in California is perhaps the best-known example. For countries with small populations such as Botswana, this creates a problem since the best local innovators are likely to be attracted elsewhere. In turn, this suggests a possible need for action by Government, such as incentives for innovators to come to Botswana. Whether such an intervention would be worthwhile or not, depends on the extent to which a domestic technology base is seen as a priority.

6 For instance, industrial technologies developed in the United States have often been based on large-scale production and the intensive use of natural resources and physical capital. Frequently this was not the optimal form of production when transferred to European conditions.

7 'Externality' is a technical economic term referring to cases where the price paid for a good (or service) does not fully reflect its costs or benefits. Thus, if some of the benefits from an investment do not accrue to the investor only but to others more generally, then the level of private investment is likely to be less than desirable. Education is usually considered to be such a case.

8 Conversely, physical capital may be more prone to *over* investment due to negative externalities. This is where the investor does not have to pay all the associated costs. The risk of environmental degradation due to pollution and depletion of natural resources is a major concern in this respect.

3.9 In some instances the dividing line between public and private sector responsibilities is reasonably clear-cut. For example, there is general acceptance that it is governments' responsibility to provide general education both as a social objective and as the foundation on which the 'knowledge capital' created by private sector businesses is built. But, beyond this, the edges can blur quickly. An example here is the extent to which public funds should be used to support more specialised, tertiary education.

3.10 Even in cases where government support for private investment might seem to be desirable in principle, practical difficulties may intervene to the extent that the costs outweigh the benefits. Using public funds to support training is a case in point. Employers frequently claim that on-the-job instruction is the most effective form of training. But there is a concern that funds provided to support this may just be used as a general subsidy for labour. In Botswana, this sort of problem has plagued the administration of both company income tax, which allows for approved training costs to be offset against tax liabilities, and training grants under FAP. Similarly, subsidies targeted for research and development, could turn into general subsidies for capital costs.

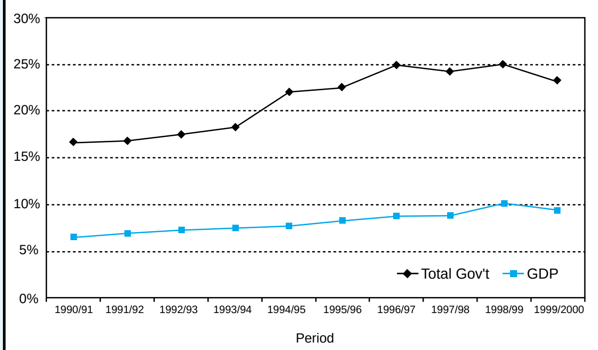
3.11 The risk of such misapplication of public funds may bias government support towards 'off the job' programmes which could at least result in better control. However, different problems then emerge. Worldwide, designing effective training programmes that increase the earning potential of workers in a cost effective manner, has proved very difficult. Where there have been successes, these have frequently proved difficult to replicate elsewhere where conditions may be crucially different.

3.12 Again, parallel problems exist with support for technology. In both instances, the problem is the extent to which the publicly funded education/research institutions are integrated into the relevant markets, which they are intended to support. In Botswana there exist several such Government-supported institutions: Botswana Technology Centre (BOTEC), the Botswana National Productivity Centre (BNPC) and, most recently, the Botswana Training Authority. Designing strategies that achieve the requisite integration may be their principal challenge.

3.13 There also remains a danger of bias towards physical capital development. For one thing, since it is visible, it is easy to monitor. Moreover, the large numbers of jobs that are created through the construction industry may be appealing, especially when considering the allocation of public spending. The last is obviously an important consideration in Botswana, given the predominant role that Government currently plays in investment in physical capital.

3.14 In Botswana, the Government can, with considerable justification, claim that it has not ignored the need to develop human capital. Throughout the 1990s great priority was given to public spending on education. This is shown in Chart 6.1, which shows spending on education as a proportion of total government expenditure and of GDP. By both measures, the allocation has been increasing and, as a share of GDP, Botswana ranks among the highest in the world. Comparative research has reported that, depending on the geographical region, countries typically allocate between three and six percent of national income on education.[9] At the start of the 1990s Botswana was already at the top end of this range; by the end of the decade it was far higher.

CHART 6.1: EDUCATION SPENDING AS A PROPORTION OF TOTAL GOVERNMENT EXPENDITURE AND GDP, 1990/91 - 1999/2000



[9] See, for example, 'Achieving Schooling for All' by C. Colclough and S. Al-Samarrai, in *World Development*, November 2000.

3.15 This spending is aimed at meeting ambitious practical commitments, currently centred on maintaining a guarantee of the opportunity for nine years basic education to all children and increasing the proportion proceeding to senior secondary school. At the start of NDP 8 the transition rate from junior to senior secondary school was 32 percent. By the time of the Mid-Term Review this had increased to 46 percent, which was on track for achieving the objective of 50 percent by the end of the plan period. There is also expansion in other areas, such as vocational training, where the objective is to increase the transition rate from junior secondary school from five percent in the late 1990s to 15 percent by the end of NDP 8. Yet more is envisaged: *Vision 2016* foresees '...universal and compulsory education up to the secondary level...' and a flexible system so that '...people can enter and leave the education system at different times in their lives.'[10]

3.16 Moreover, this commitment to education is clearly linked to supplying the economy with labour that is not only 'educated' in the general sense but also equipped with relevant skills. The *Revised National Policy on Education* (RNPE) emphasises focussing the curriculum on what people need to know, in particular in the area of science and technology. Business studies are also given a central focus. The RNPE was followed by the *Science and Technology Policy for Botswana (1998)*. Subsequent to this a consultancy report was prepared on '*Focussing Investment in Innovation*', which was submitted to the Government in 2000. Proposals for the implementation of the science and technology policy are expected to be announced during 2001.

3.17 However, despite the impressive commitments in terms of aggregate spending, overall objectives and agreed policies, there remain some concerns about implementation. In particular, whether enough money in the education budget is actually getting through to the schools and whether the available teaching staff are able to cope fully with the demands of such a multifaceted policy. At the same time, while education has been provided largely free at the point of delivery, thus increasing its 'inclusiveness' across social classes, there is also concern that continuing poor social conditions of some households continue to undermine the objective of schooling for all. This is because not all children are able to take full advantage of the opportunities in education that would do much to improve their future prospects.[11] As an indicator of this, according to data for 1997, only 76.5 percent of the eligible group were still at school in the final (ninth) year of the basic education programme.[12]

3.18 While there is a clear case for extensive Government involvement in promoting development of skills and technology it is important that the private sector does not become over reliant on public funds. Government policies should not encourage this, and it is important in this respect, that policies should be clearly demarcated and adhered to. Too much flexibility, where 'special cases' are given further support, could encourage the private sector to overstate its requirements and problems as a means of attracting additional public resources that, in fact, may not be really needed.

Potential conflicts in policy

3.19 Not all policy objectives are necessarily supportive of diversified economic growth. This is not necessarily wrong. There is no reason why economic goals should in every instance be given primacy. Other objectives (social, environmental, cultural, etc) may in some instances take precedence. However, there is a danger of confusion if various objectives are subscribed to without realising the extent to which they may not be mutually supportive, therefore, it is important to appreciate where these conflicts can arise.

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10 *Vision 2016*, p30.

11 This concern was highlighted in the 1996 report on poverty in Botswana.

12 See *Education Statistics Report 1997*, Table 12 (b).

3.20 In Botswana, unless handled carefully, the objective of promoting citizen economic empowerment could prove to be a case in point. Some of the proposals regarding empowerment do not fit the prescription that a vibrant and diversified Botswana economy must, *by necessity*, be outward looking. This is particularly the case with policies that protect the domestic economy and even groups within it, against competition from outside. Such policies are inherently inward looking.

3.21 This is not to argue against empowerment. Policies that equip local businesses to compete effectively, and which may include explicit patronage and support from Government, can also be outward looking. However, there is a powerful argument that the least empowered of all are those who are unemployed. If this viewpoint is accepted, then it would seem to follow that empowerment programmes should not work against the priority objectives of reducing unemployment and poverty. In turn, this will be best promoted by policies that encourage outward looking and diversified growth in the economy.

3.22 The programme of privatisation on which the Government is preparing to embark, should be seen in this context. There are legitimate expectations that this should lead to significant participation, in terms of both ownership and management, by Batswana in the operations of the privatised enterprises. However, in seeking to meet these aspirations, the principle objective of privatisation, which is to promote improved productivity and the efficient allocation of resources, should not be lost sight of. An important example here is that of

Box 6.1: The Macroeconomic Impact of HIV/AIDS

HIV/AIDS poses a threat to continued economic growth in Botswana. This is mostly because of its impact on the labour force, but also because of possible impacts on savings and investment.

The major impact of HIV/AIDS is likely to be on the overall rate of economic growth, as the supply of labour will be reduced.

Per capita incomes will not be so much affected since the major cause of lower economic growth is a slowdown in the rate of population growth. However, during the period when many people are seriously ill, living standards *will* be affected as incomes of households fall while necessary expenditures increase to meet the costs of caring for sick people.

AIDS orphans represent a particular challenge. They must be provided for effectively, not only for their sake but also to help avoid serious social problems, such as a rising crime rate, that could impact negatively on the economy, emerging in the future.

HIV/AIDS affects all subgroups of the population and existing shortages of skilled labour will be exacerbated. To some extent, this can be met by substitution of capital for labour. But private sector investment is heavily dependent on confidence that labour requirements will be adequately met. HIV/AIDS increases uncertainty in this respect. Increased flexibility regarding the use of expatriate labour may be required to retain investor confidence.

The savings rate has been high in Botswana, and resources continue to be available for investment. However, their allocation may be affected as they are increasingly diverted into meeting the social costs associated with HIV/AIDS. Moreover, the resources are mainly in the public sector, and the extent to which government investment can sustain economic growth is limited. Again the emphasis must be on establishing conditions that maintain private sector confidence in the future of the economy despite the human tragedy of HIV/AIDS.

telecommunications, a service that plays a central role in promoting development, as has been stressed elsewhere in this report. Having the most efficient telecommunications system possible would do much to help empower Batswana as a whole, rather than just the inevitably smaller sub-groups which would receive the direct benefits of ownership. For this potential benefit to be maximised, the privatisation of BTC should not proceed in any way that compromises access to capital, technology and expertise, from wherever it needs to be obtained.[13]

Consequence of HIV/AIDS

3.23 The human tragedy of the HIV/AIDS epidemic in Botswana is ever more apparent. While the full extent to which this will be reflected in deteriorating economic performance is still to be seen, clearly there will be some cost. Valuable resources in the form of human capital will be lost while others, including human, technical and physical capital, are being diverted to the tasks of controlling the disease and mitigating its social costs. Undoubtedly, this will have an adverse impact on the diversification effort.

3.25 Several studies have been commissioned by the Government to determine the impact of HIV/AIDS in Botswana. These include a detailed assessment of the potential economic impact, together with suggestions as to how this may be mitigated. Box 6.1 highlights the most important of these conclusions. Once again, the issue of flexibility is of central importance. In Botswana, the human resource must be the basis for diversified development and HIV/AIDS will severely reduce this resource. If in such circumstances the momentum of economic development is to be continued, alternatives *must* be found. These include the more extensive use of foreign labour to fill the human resource gap. Otherwise, potential investors will be deterred from locating in the country if there is increased uncertainty as to whether their requirements regarding labour can be met.

4. Conclusion

4.1 Skills and technology development must underpin the objective of achieving diversified growth. The country has passed the stage where continued accumulation of physical capital will alone continue to yield high returns. For this reason, the emphasis on investment needs to be supplemented by stressing the requirement to create an environment where capital in all its forms, can be used productively. The key features of such an environment are that it should be outward looking, stable and adaptable.

4.2 Botswana has a strong institutional base that supports skills and technology development, together with policies that recognise the various linkages and complementarities which mean that support for development, in these various areas, cannot take place independently of what is being undertaken elsewhere. However, while the country has a multitude of policy objectives as well as coordinating and implementation structures that would seem to add up to an impressive commitment to promoting economic development, the key challenge is the effective implementation of these policies. This is recognised by Government, which for several years, has stressed the need to improve implementation. But the extent of structures which aim to improve programme delivery, may itself risk creating too much bureaucracy and regulation. This potential problem was identified in the *Africa Competitiveness Report 2000/01*, which noted in its country profile of Botswana that 'The country is overburdened with institutional structures to the point where delivery of services has become lethargic'.[14] Rectifying this situation is just as important, if not more so, for achieving the underlying objective of economic diversification than developing further detailed policies of specific sectoral support.

[13] While the focus here is on BTC and telecommunications the same basic point is applicable more widely, especially to key utility services such as power and water.

[14] *Africa Competitiveness Report 2000/01*, World Economic Forum, p94.

CHAPTER 7

CONCLUSION: THE ROLE OF GOVERNMENT

1. Introduction

1.1 Previous chapters have reviewed the various efforts to encourage diversification away from reliance on the mineral sector and the accompanying prominent role of the Government in the Botswana economy. The extent of success in achieving this goal has been reported. In this regard, the degree of diversification is greater than commonly realised, since diamond mining continued to expand through the 1990s and into the new millenium. However, the foundations of this diversification are lacking in depth, remain fragile and results in terms of providing employment opportunities have been less than hoped for. The various obstacles and constraints that hinder further progress in diversification have been identified and analysed. This concluding chapter draws these various threads together and makes a general assessment of the role of the Government in supporting the continuation and strengthening of the process of diversification.

1.2 Faced with the constraints to diversification, there has been a strong temptation for the Government to intervene in order to steer the economy in the desired direction. There are many and repeated calls for it to do so, the argument being that the economy remains too small and the private sector too under-developed for the market-based development paradigm to work successfully in Botswana.

1.3 These views have some validity. In particular, the extent of the domestic economy, combined with the country's physical size and location, conspire against development in several ways. Even so, there are various compelling reasons that suggest the need for extreme caution in following an approach based on intensified Government intervention. Government has a clear role in the provision of an effective physical, legal and institutional public infrastructure, and this is a fundamental prerequisite for sustainable diversification. Beyond this, the areas where more specific intervention can be justified are limited and very careful consideration needs to be given to the content and mode of Government activism.

2. A Culture of Dependency

2.1 A clear danger of active Government intervention is that any diversification that results risks being too dependent on continued Government patronage. Outwardly, the economic structure could appear more diversified. But this is hardly in line with the reduced dependence on Government that it has been argued, needs to be achieved. Continuing to support growth through an expansion of public sector demand, whether it is for the construction of buildings and roads, procurement of supplies or consumption demand of Government employees, cannot be sustainable in the long-term.[1]

2.2 The pessimistic view that the private sector is too weak to develop without intensified public sector assistance, is certainly not supported simply by reference to high-profile corporate failures. The free entry and exit of businesses, including their failure, is a necessary feature of the market economy. Ironically, the various failures in Botswana

[1] As a simple, but telling, example of the type of problems that can arise, fieldwork for the recent evaluation of FAP found that a major use of FAP grants was to support companies during times when contracts to supply government were not available. In other words the FAP grants, rather than supporting the process of improving productivity of labour, were simply perpetuating unproductive dependence on Government.

may in fact point to the *risks* of utilising Government resources to establish sustainable businesses rather than the need for more such support.

2.3 While the lack of depth in the private sector at present is acknowledged, there is no good reason to suppose that this is a chronic condition. On the contrary, encouraging development that is dependent on Government patronage will tend to delay progress, or even risk worsening the problem. Weaknesses in the private sector remain in some areas, but such problems will only be encouraged and become further embedded in the economic structure if Government support is intensified. There is a clear parallel here with the 'infant industry' argument for protecting domestic industry from outside competition. The danger is that the infant could fail to grow up.

3. Market Failure not Sufficient Justification

3.1 Examples of other countries where governments have been central to the development effort, is of limited relevance. For a start, the apparent permanence of these achievements has been eroded in many instances. Second, appropriate attention should be given to the concern that the success of such support is contingent on social and economic conditions in those countries which cannot be assumed to prevail in Botswana.

3.2 More generally, it should be appreciated that identifying instances where the operation of the market has failed to produce the hoped-for results, does not mean that government intervention will improve the situation. Experience suggests that government involvement in business is problematic and frequently not successful. This applies to the most well resourced public administrations. Despite its size relative to the overall economy, the Government of Botswana has limited resources to administer its various policy initiatives, and the rule of thumb that government should stick to the job of governing is generally appropriate.

3.3 A good case in point is that of the implementation of FAP. Part of the problem with the scheme was that it overwhelmed the resources that Government was able to devote to its administration. The lack of both effective pre-project appraisal and post-project monitoring contributed greatly to the waste of resources that the scheme had clearly become by the end of the 1990s. More fundamentally, the Government was inherently ill equipped to manage the intermediation of resources to private businesses.

4. Sending the Wrong Signals

4.1 It is recognised that there are clear cases where, left to itself, the private sector is unlikely to produce sufficient levels of investment. This is due to the positive externalities associated with the investment such that the total return is greater than that accruing to the investor. A case in point is non-specialised education and, for the same reasons, it can be argued that basic research in science and technology is unlikely to be adequately supported by the private sector. Moreover, in Botswana, the small population limits the potential for realising economies of scale, which may further inhibit investment in knowledge-based capital. Therefore, in principle at least, there is a good case for public intervention in these areas.

4.2 But designing appropriate programmes based on this principle, faces practical problems. It is all too easy for a government to send the wrong signals and, by indicating a willingness to meet some of the costs of investment, it may cause the private sector deliberately to understate its willingness to invest. This is particularly likely to occur if the support is seen to be discretionary rather than rule based. A discretionary approach increases the perception that arguments in favour of being treated as a special case may be worth pursuing. Such a tactic is more likely in cases where Government is dealing with 'large' investors who may have a stronger bargaining power to extract more resources.[2]

[2] Seen from this perspective, it is unfortunate that governments frequently show clear willingness to apply the greatest discretion when dealing with such 'large' investors.

4.3 In Botswana, these dangers are compounded by the Government's seemingly strong financial position. Financial support may be called for in the name of 'diversification' or 'empowerment' when, in fact, such demands could be little more than rent seeking. Moreover, in addition to the risk of the unproductive use of public funds, it should be recognised that the Government's capacity to enter into programmes of financial support, is more limited than is often supposed. One consequence of diversification of the economy away from the mining sector, is that the effective tax rate will fall, thus putting pressure on the revenue base.

4.4 Government must also be wary of the risk of encouraging *over* investment. In particular, the tendency to concentrate on the accumulation of physical capital should be guarded against. In this respect, improved collection of data on the extent of non-physical investment in Botswana would be welcome. This would cover information on areas such as spending on research and development and the extent to which the stock of natural (or environmental) capital is being preserved, enhanced or degraded.

5. Choosing Priorities

5.1 A very important priority for Government is to ensure that its heavy investment programme in education yields positive results. This goal is not guaranteed by meeting intermediate targets relating to development of school facilities and increasing student enrolment ratios; and the capacity of the teaching staff to deliver the ambitious objectives of the new curriculum must be a concern. Moreover, ensuring that an educated labour force is also a productive one is a challenge that is yet to be met convincingly. The objective of enhancing labour productivity is, in part, thwarted by the attitude that it is the responsibility of Government to deal with all problems.

5.2 A related priority is the need to integrate human capital development with well-targeted support for science and technology. In this connection, Government support is required, not only for providing resources to the publicly-funded research institutions, but also in ensuring that these institutions serve effectively the demands of their partners in private sector businesses, manufacturing or otherwise.

5.3 The Botswana Government has now embarked upon a programme of privatisation of public enterprises. The programme supports diversification in a number of ways, including reducing the extent of dependence on Government and promoting efficiency. The latter consideration is essential since, as the recent example of operational deficiencies at BTC has demonstrated clearly, bottlenecks in the provision of basic utility services runs the risk of holding back development more widely. For this simple reason, it is to be hoped that Government moves forward expeditiously with this programme, building on the momentum of the privatisation of Air Botswana that is due in 2001.

5.4 The case has been made that policies should be essentially neutral as to which sectors should be targeted for development. This is primarily on the basis that the special advantages of developing manufacturing are no longer so apparent. But it might be argued that the argument for neutrality is being taken too far since, while there may no longer be any good reason to favour manufacturing, there may be a case for considering policies that are particularly favourable to exports as opposed to production for the domestic market. Such a bias might appear to be consistent with the view that outward-looking development remains a priority for Botswana.

5.5 However, the case for policy neutrality stands up well in the context of the objective of export promotion. This is not to say that explicit support for export promotion is not desirable. But this should be at the general level, based on the positive externality of Botswana as a location for investment and production of tradeable goods and services. It is also important to avoid circumstances that would effectively discriminate against production of such tradeables. In this regard, it is essential that, as a non-sector-specific policy instrument, the real exchange rate of the Pula against trading partner currencies remains competitive. But beyond this, policies of more direct support for exports, such as subsidies, should be avoided. There is little empirical evidence from elsewhere that they are of benefit, and they raise the same practical problems as other policies based on subsidies and protection.

6. Impact of Globalisation

6.1 Special consideration was given to the challenge of diversification in the context of globalisation. Globalisation, the driving force of which is falling real costs of transport and communication, is not a new phenomenon. The current phase is characterised by the coincidence of an increasingly liberal and stable environment, together with rapid technological progress in the areas of communications and information processing.

6.2 There is no need for Botswana to fear these trends. Indeed, they should provide tremendous opportunities for growth. However, in order to take advantage of these opportunities as they unfold, a number of key fundamental preconditions should be met. In particular, the requirement of a world class telecommunications system is very important, and this is an area where in Botswana, significant improvements need to be made.

6.3 It is also important that policy making should be focussed and decisive, together with timely implementation. It is not being argued that policy decisions should be taken in haste on the basis of inadequate information. Rather, the point is that any tendency to adopt a leisurely pace in the process of policy formulation and which is top heavy on consultation, may lead to paralysis in implementation and lost opportunities in an increasingly complex and challenging global environment.