

**BANK
OF
BOTSWANA**

ANNUAL REPORT

2006



BOARD MEMBERS
as at December 31, 2006



L K Mohohlo
Governor and Chairman



G K Cunliffe



S S G Tumelo



D K U Corea



B Moeletsi



C S Botlhole-Mmopi



H Siphambe



B B Bolele



B K Molosiwa

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DEPUTY GOVERNORS
as at December 31, 2006

O A Motshidisi

M D Pelaelo

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ABBREVIATIONS USED IN THE REPORT

AACB	Association of African Central Banks
ABC	‘Abstain, Be Faithful and Condomise’
ACP	Africa, Caribbean and Pacific
ADB	African Development Bank
AGOA	Africa Growth and Opportunity Act
AIDS	Acquired Immunodeficiency Syndrome
ARV	Anti-Retroviral
BAIS	Botswana AIDS Impact Survey
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BEAC	Business and Economic Advisory Council
BEDIA	Botswana Export Development and Investment Authority
BEE	Black Economic Empowerment
BES	Business Expectations Survey
BFS	Botswana Financial Statistics
BIDPA	Botswana Institute for Development Policy Analysis
BIS	Bank for International Settlements
BISS	Botswana Inter-bank Settlement System
BIUST	Botswana International University of Science and Technology
BMC	Botswana Meat Commission
BoB	Bank of Botswana
BoBC	Bank of Botswana Certificates
BOBS	Botswana Bureau of Standards
BPOPF	Botswana Public Officers Pension Fund
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
BTC	Botswana Telecommunication Corporation
BURS	Botswana Unified Revenue Service
BVI	Botswana Vaccine Institute
CEDA	Citizen Entrepreneurial Development Agency
CIU	Collective Investment Undertakings
CLC	Code Line Clearing
CPI	Consumer Price Index
CPIX	A CPI used in South Africa that excludes mortgage interest payments
CSO	Central Statistics Office
DCI	Domestic Company Index
DS	Demographic Survey
ECH	Electronic Clearing House

EIA	Environmental Impact Assessment
EPA	Economic Partnership Agreement
EU	European Union
FAP	Financial Assistance Policy
FCA	Foreign Currency Account
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FSDS	Financial Sector Development Strategy
GATT	General Agreement on Tariffs and Trade
GCSE	General Certificate of Secondary Education
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GNP	Gross National product
HDR	Human Development Report
HIES	Household Income and Expenditure Survey
HIV	Human Immunodeficiency Virus
HLCC	High Level Consultative Council
ICT	Information and Communications Technology
IFS	Integrated Field Services
IFSC	International Financial Services Centre
IIP	International Investment Position
ILO	International Labour Organisation
IMF	International Monetary Fund
IPO	Initial Public Offering
KYC	Know Your Customer
LDC	Least Developed Country
LEA	Local Enterprise Authority
LFS	Labour Force Survey
MCST	Ministry of Communications, Science and Technology
MFDP	Ministry of Finance and Development Planning
MoH	Ministry of Health
MPC	Monetary Policy Committee
MPS	Monetary Policy Statement
MTI	Ministry of Trade and Industry
MTR	Mid-Term Review
NACA	National AIDS Coordinating Agency
NAV	Net Asset Value
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NCSS	National Clearance and Settlement System

NCTPN	National Committee on Trade Policy and Negotiations
NDB	National Development Bank
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NEMIC	National Employment, Manpower and Incomes Council
NGO	Non-Governmental Organisation
NMGDP	Non-Mining Gross Domestic Product
NPS	National Payments System
OSSC	One-Stop Service Centre
PDL	Poverty Datum Line
PDSF	Public Debt Service Fund
PEEPA	Public Enterprises Evaluation and Privatisation Agency
PMP	Privatisation Master Plan
PMTCT	Prevention of Mother-to-Child Transmission
PPADB	Public Procurement and Asset Disposal Board
PPP	Public Private Partnership
REER	Real Effective Exchange Rate
REPO	Repurchase Agreement
RIDS	Rural Income Distribution Survey
RTGS	Real Time Gross Settlement System
SACU	Southern African Customs Union
SADC	Southern African Development Community
SBPA	Small Business Promotion Agency
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Right
SMME	Small, Medium and Micro Enterprise
SSA	Sub-Saharan Africa
SWIFT	Society for Worldwide Inter-bank Financial Telecommunications
TEC	Tertiary Education Council
TIPA	Trade and Investment Promotion Agency
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNSO	United Nations Statistical Office
USA	United States of America
VAT	Value Added Tax
VCB	Venture Capital Board
VCF	Venture Capital Fund
WITFOR	World Information Technology Forum
WTO	World Trade Organisation

PART A

STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK, 2006

BANK OF BOTSWANA

DEPUTY GOVERNORS
as at December 31, 2006



O A Motshidisi



M D Pelaelo

HEADS OF DEPARTMENT
as at December 31, 2006



N A Mabe
Accounting & Planning



A M Motsomi
Research



R H Nlebesi
Banking & Currency



O Mabusa
Banking Supervision



J Ghanie
Technical Services



P Gundersen
*Financial Markets
(Acting)*



E T Rakhudu
Human Resources



O Modisa
Payments & Settlement

STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK IN 2006

THE GOVERNOR'S FOREWORD

In accordance with Section 68(1) of the Bank of Botswana Act (CAP 55:01), I present the Bank's 2006 Annual Report. The Report describes the policies pursued and activities undertaken by the Bank during the year in fulfilment of the main objective, other supportive policies and operational goals.

The Bank's main objective is to promote and maintain monetary stability, which is reflected in a low, stable and predictable level of inflation. This objective is vital in supporting the broad national development goals of sustainable economic diversification and increased employment opportunities which, in turn, contribute to poverty reduction. In an effort to realise this key objective, the Bank has maintained strong and collaborative relationships with its stakeholders, which include the Government, national and international institutions, as well as the general public. These various contacts and communication channels helped inform the Bank's policies and operations towards the attainment of the wider national economic and social goals.

In this regard, therefore, the rise in inflation during 2006 was a major policy challenge to the Bank's monetary policy stance. Inflation accelerated at the beginning of the year, from 11.4 percent in December 2005 to a peak of 14.2 percent in April 2006 due to domestic supply shocks and the effects of the 2005 Pula devaluation, while domestic demand conditions were moderate. As a result of the negative inflationary outlook in early 2006, and in a bid to signal the Bank's commitment to achieving low inflation, restrain possible second-round price increase effects and influence inflationary expectations, the Bank Rate was increased by 50 basis points in February 2006.

Although global economic growth was robust, increasing from 4.9 percent in 2005 to 5.1 percent in 2006 with strong expansion in China, India, UK and Japan, and energy prices rose, global inflation was benign as it increased from 3.7 percent in 2005 to 3.8 percent in 2006. Inflation in advanced economies also rose modestly from 2.2 percent in 2005 to 3.1 percent in 2006. South Africa's target measure of inflation (CPIX) rose from 3.9 percent in December 2005 to 4.6 percent in December 2006, which was within their target range of 3–6 percent. Therefore, external influences on domestic inflation were negligible mainly due to increased competition and restrictive monetary policy in major economies, which contained the inflationary impact of oil price increases, as well as the appreciation of the Pula against the rand.

As a result of the effects of moderate demand, the dissipation of the impact of the devaluation, tight monetary policy and favourable external influences, inflation declined to 8.5 percent by year-end, a level which was on the path to the medium-term inflation objective of 3–6 percent. Together with the downward crawl of the nominal effective exchange rate, reduced level of domestic inflation and external inflationary trends, the real effective exchange rate stabilised during the year, and this contributed to the ongoing efforts to improve export competitiveness and, therefore, economic diversification.

The activities relating to the banking system gathered momentum during the year. Commercial banks and the International Financial Services Centre (IFSC) institutions continued to be solvent, profitable and prudently managed, despite the ongoing challenges of, *inter alia*, the quality and cost-effectiveness of banking services.

The foreign exchange reserves, which increased to P48 billion at the end of 2006, continued to be managed prudently in line with best international practice. Overall, the Bank's financial performance was impressive, with assets rising by 38 percent to P48.3 billion and shareholders' funds increasing by 59 percent to P30.8



billion. The Bank's total income in 2006 was P6.3 billion, while the net income was P4.4 billion.

The Bank has also developed a forward looking strategic plan. This includes improvements in the analytical framework of a more proactive monetary policy intervention, and a review of the management systems so that the Bank can continue to uphold good corporate governance. Furthermore, the Bank continued to benefit from interaction with various national and international stakeholders as this fosters a proactive development and implementation of policies. As a consequence, the Bank was able to function efficiently and effectively during the year and, in the process, identified the emerging challenges and formulated strategies to address them. Generally, the Bank has lived up to expectations in 2006 and all operations were conducted in accordance with up to date risk management procedures and standards of good governance.

In light of the progress made in 2006, I take pride in the support extended by the Board and all staff in achieving the Bank's mandate.

A handwritten signature in black ink, appearing to read 'Linah K. Mohohlo', with a stylized flourish at the end.

Linah K Mohohlo
GOVERNOR

STATUTORY REPORT ON THE OPERATIONS OF THE BANK IN 2006

The Bank's Organisation and Management

The Bank of Botswana falls under the purview of the Minister of Finance and Development Planning (Minister), who appoints members of the Board, except the Governor, who is the ex-officio Chairman of the Board; the Governor is appointed by His Excellency the President. The Permanent Secretary of the Ministry of Finance and Development Planning (MFDP) is also the ex-officio Board member. The Minister presents the annual report to Parliament and this contains the Bank's operations and financial performance.

The Board

Under the Bank of Botswana Act (Cap 55:01) and the Bank's Bye-Laws, overall responsibility for the operations of the Bank is vested in the Board of the Bank. In line with this mandate, the Board is responsible for ensuring that the principal objectives of the Bank, as set out in the Act, are achieved. Furthermore, the Board ensures that appropriate policies, management and administrative systems, as well as financial controls, are in place at all times in order for the Bank to achieve its objectives in an efficient and effective manner. Accordingly, the Board has a direct role in the strategic planning of the Bank, and in determining the broad policy framework. In this regard, the Board approves the annual budget, monitors the financial and operational performance, reviews reports of the external auditors and may call for special policy reviews.

The Board comprises nine members; other than the Governor and the Permanent Secretaries of MFDP and the Ministry of Trade and Industry (MTI), the other members are drawn from the private sector and academia and are appointed in their individual capacity; the latter status extends to the Permanent Secretary of MTI. The Board is required to meet at least once each quarter, although in practice there have been six or more annual meetings for many years. The Audit Committee of the Board is chaired by a non-executive Board member, and its main responsibility is to ensure that accounting policies, internal controls and financial practices are based on established rules and regulations. The Governor submits a report, after Board approval, 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

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 is supported by the Executive Committee in managing the Bank on a day-to-day basis, and represents the Bank in its relations with the Government, other domestic stakeholders and the relevant international institutions. For instance, the Governor represents the country in the Board of the International Monetary Fund.

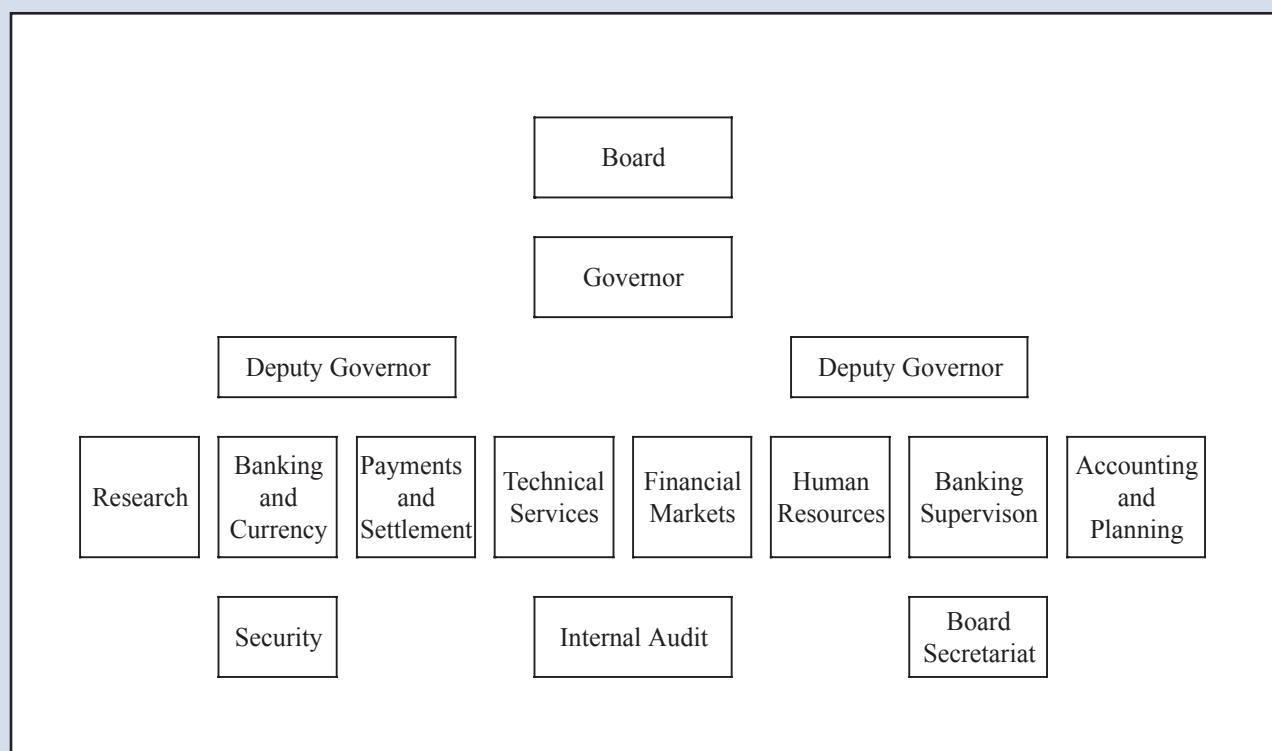
The Executive Committee

The Executive Committee comprises the Governor, Deputy Governors and Heads of Department; there are other co-opted members such as Senior Advisors. The Committee meets weekly to deliberate on the day-to-day management issues of the Bank and review progress in the implementation of policies as enshrined in annual work programmes and the Bank's medium- and long-term strategic plans.

Departments and Divisions

In order to carry out its functions and supporting activities, and as outlined in the organisation chart below, the Bank is organised into Departments and Divisions. At the end of 2006, the Bank's eight Departments comprised Accounting and Planning, Banking and Currency, Banking Supervision, Financial Markets, Human Resources, Payments and Settlement, Research and Technical Services; the Divisions comprised the Board Secretariat, Internal Audit and Security.

Chart 1: Organisation Chart as at May 1, 2006



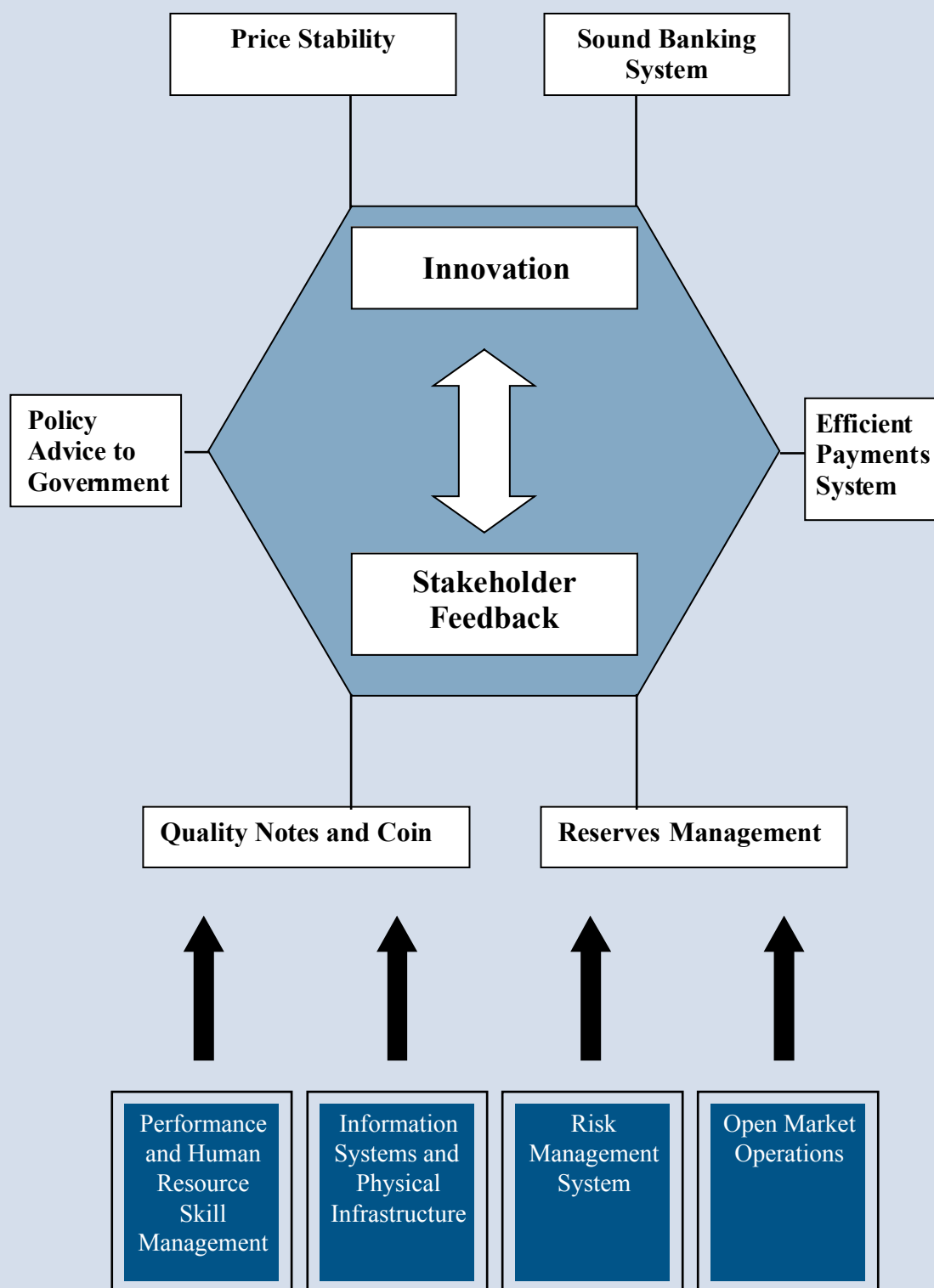
The Bank's Mission and Objectives

The Mission of the Bank of Botswana is to contribute to the sound economic and financial management of the country. This is achieved by promoting and maintaining:

- monetary stability through the attainment of a sustainable, low and predictable level of inflation;
- a safe, sound and stable banking system through supervision and regulation;
- an efficient, secure and reliable payments system;
- public confidence in the external and internal value of the national currency;
- the provision of efficient banking services to customers;
- beneficial international financial relations; and
- the provision of sound economic and financial advice to the Government.

In pursuit of these objectives, the Bank is guided by governance codes of conduct and practices that uphold the principles of accountability and transparency in all its operations and activities.

Chart 2: Mission and Objectives



The Bank's Functions and Activities

As prescribed by the Bank of Botswana Act (CAP 55:01), the major responsibilities of the Bank include:

- the conduct of monetary policy;
- implementation of the exchange rate policy;
- issuance of currency;
- regulation and supervision of banks and other financial institutions;
- management of foreign exchange reserves;
- provision of banking services to the Government, banks and selected public sector organisations; and
- provision of monetary and financial policy advice to the Government.

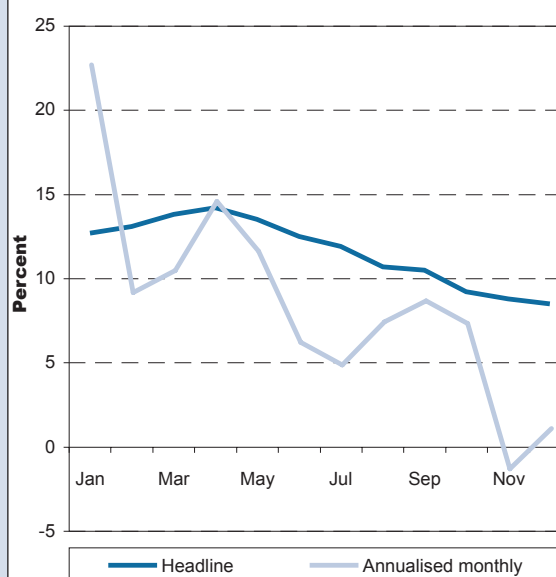
Monetary Policy

The objective of monetary stability is reflected in achieving and maintaining a low, stable and predictable level of inflation. In this regard, the Bank introduced a medium-term inflation objective in 2006 of 3–6 percent to be achieved over the period 2006–2008. Since inflation is fundamentally influenced by monetary and credit factors, the Bank's anti-inflation strategy focuses on the control of the banking system's credit growth as an intermediate target. In implementing monetary policy, the Bank uses indirect policy instruments, particularly open market operations and the Bank Rate. The Bank may also use banking regulations and moral suasion to achieve monetary policy objectives. However, in maintaining monetary stability, the Bank uses, in the main, Bank of Botswana Certificates (BoBCs) to control the liquidity in the financial system and influence short-term interest rates. In addition to the Secured Lending Facility, the Bank also uses Repurchase Agreements (Repos) to manage short-term and overnight liquidity fluctuations in the banking system. The Bank incorporates data on fiscal and other policies of the Government in the design of the monetary policy framework and in implementing the strategies 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 could undermine monetary stability and, therefore, the nation's prospects for sustainable economic development. The broad framework of monetary policy is presented to the public in the annual Monetary Policy Statement (MPS) and its medium-term review.

The Bank pursued a relatively tight monetary policy during 2006 as inflation accelerated early in the year due to the residual effects of the May 2005 devaluation and other price and cost adjustments, especially the re-introduction of fees in public secondary schools and the rise in fuel and beef producer prices. In order to restore price stability, as well as forestall a rise in inflationary expectations and second-round price effects, the Bank Rate was increased by 50 basis points to 15 percent in February 2006. In the circumstances, inflation slowed in the latter half of the year to a level much closer to the Bank's inflation objective of 4–7 percent (Chart 3).

Other policy and operational measures included restricting the purchase of BoBCs to the banks, with

Chart 3: Inflation Indicators 2006



effect from March 2006, and raising the commercial banks' reserve requirements from 3.25 percent to 5 percent from February 2006. Moreover, a 364-day BoBC was re-introduced in order to diversify the maturities of the Bank's liquidity control tools; the 14-day BoBC was issued weekly, while the 91-day and 364-day BoBCs were issued on the first and third week of each month, respectively. In addition, the volume of excess liquidity in the banking system was moderated by the direct payment of Debswana's dividends to the Government to the Bank's off-shore account with effect from November 2006.

Exchange Rate Policy

The Bank is responsible for implementing the exchange rate policy. In line with the Bank of Botswana Act, the President sets the framework for the determination of the external value of the Pula on the recommendation of the Minister of Finance and Development Planning, after consultation with the Bank. The Pula is pegged to a basket of currencies comprising the South African rand and the Special Drawing Right (SDR - the unit of account of the International Monetary Fund, which comprises the US dollar, British pound, euro and Japanese yen). From the end of May 2005, a crawling band exchange rate mechanism was introduced with the rate of crawl based on the differential between the Bank's inflation objective and forecast inflation of trading partner countries. The Bank calculates the exchange rate for each business day, and quotes the buying and selling rates for major international currencies to the banks. The Bank also monitors the Pula exchange rate developments regularly with a view to advising the Government on ways of maintaining a stable real effective exchange rate (REER) and price competitiveness of domestically produced goods.

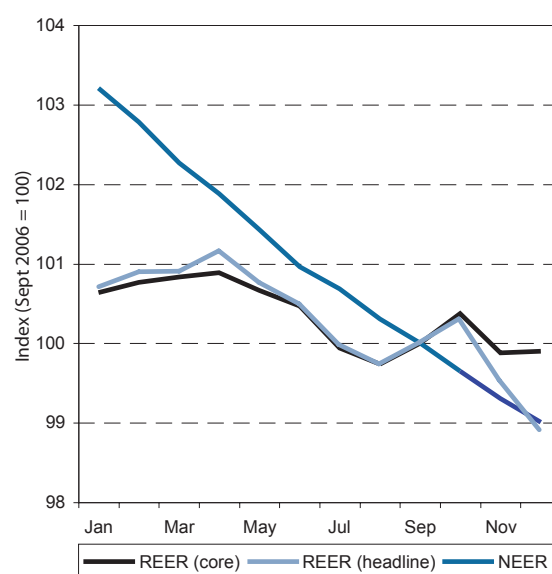
The exchange rate policy aims at supporting the international competitiveness of the country's products, which requires that the REER remains relatively stable at all times. Stability of the REER is attained through the crawling band exchange rate mechanism as reflected in price stability in Botswana in line with that of trading partner countries. During the latter half of 2006, the REER stabilised as a result of the reduction in inflation and the downward crawl of the nominal effective exchange rate (NEER), an outcome which enhanced the competitiveness of producers of exports and other tradeable goods and services in support of the country's economic diversification efforts (Chart 4).

Currency Management

The availability of a safe and convenient currency is essential for an efficient payments system. This fosters confidence which, in turn, facilitates payment transactions and economic activity in general. For this reason, the Bank routinely ensures that there is an adequate supply of high quality notes and coin in circulation by withdrawing and replacing soiled and damaged currency. The Bank maintains stringent standards in the design and production of both notes and coin to ensure their acceptance as a medium of exchange and to deter counterfeiting and other forms of mutilation.

As at the end of December 2006, currency in circulation amounted to P1.1 billion, an increase of 15 percent over the previous year's P935 million. In addition, in July 2006, the Bank decided to rationalise the currency

Chart 4: Nominal and Real Effective Exchange Rate Indices



Source: Bank of Botswana

denominations by phasing out the P1, P2, and P5 banknotes, with a view to their eventual demonetisation in 2011.

Payments and Settlement System

The Bank collaborates with private sector institutions, international organisations and the Government in introducing improvements to the safety and efficiency of the payments system. In 2006, the Bank put in place a number of operational rules and regulations for payments and settlement, adopted new technology, provided additional personnel and restructured its procedures in order to enhance the efficiency and security of the payments and settlement system.

A major development during the year was the introduction and launching of the Real Time Gross Settlement (RTGS) System, also referred to as the Botswana Inter-bank Settlement System (BISS). The system enhances the efficiency and security of banking and settlement transactions by enabling secure high value on-line and real-time payments; it also reduces systemic transactions risk, in addition to improving treasury management. The RTGS was linked to the Society for Worldwide Inter-bank Financial Telecommunications (SWIFT) in order to enable the automation of transactions from the point of transmitting the instruction to final settlement. In addition, the RTGS was interfaced with the Globus banking system in order to facilitate integrated processing of transactions. This arrangement, together with the existing link between Globus and the Code Line Clearing system (CLC), permits the continuous automation of transactions for banking, electronic transfers, clearing and settlement, for the benefit of the Electronic Clearing House (ECH), the Government, commercial banks and the Bank.

The introduction of the RTGS has necessitated the introduction of the Intra-day Lending Facility to complement the Secured Lending Facility, in a bid to accommodate the liquidity needs of banks during the day.

A further development during 2006 was the review of the National Payments System (NPS) Act, 2003. This was part of the process of implementing the National Clearance and Settlement Systems (NCSS) Act, 2003 and its Regulations. The revised Rules and Regulations of the ECH have since been adopted by the commercial banks and the Bank and the ECH's licence renewed. In accordance with the Act, the clearing function is vested with the banks, while the Bank supervises its operations.

Supervision of Banks and Other Financial Institutions

Through ongoing banking supervision and regulatory activities, the Bank seeks to achieve a sound and stable financial system. Accordingly, the Bank ensures that the mechanisms for sustaining the safety and soundness of licensed financial institutions are appropriate and that the institutions are managed in a prudent and safe manner. To this end, the Bank enforces prudential standards with respect to capital adequacy, liquidity, asset quality and corporate governance of the banks. In addition to its focus on the safety and soundness of licensed financial institutions, the Bank is responsible for ensuring that banks maintain high professional standards in their operations in order to provide efficient customer service in a transparent manner. The Bank also has a surveillance responsibility with regard to breaches of the Banking Act (CAP 46:04) by the public, especially in the form of activities that involve unauthorised deposit taking and use of banking names. Under the provisions of the Banking Act, the Bank also has specific responsibilities relating to combating money laundering. Accordingly, banks are required to adhere to 'know your customer' (KYC) provisions when opening accounts, retain appropriate records, report suspicious activities and cooperate fully with law enforcement agencies in an effort to combat financial crimes and, in particular, money laundering. The Bank is also responsible for the regulation and supervision of the International Financial Services Centre (IFSC) institutions, as well as the administration of the Collective Investment Undertakings Act (CAP 56:09).

Licensing of New Banks

Two banking licence applications were processed during the year. The first was for an investment banking licence and the second for commercial banking. The investment banking application was unsuccessful as it did not meet some of the licensing requirements under the Banking Act; while the application for a commercial banking licence was being assessed as at year-end. Bank Gaborone Limited, which was licensed in February 2006, commenced commercial banking operations in September, thus bringing the total number of privately owned banks to seven by year-end.

Financial Condition of Licensed Financial Institutions

Through regular bilateral and trilateral meetings, on-site examinations, risk profiling, and 'early warning' reports, the financial condition of all banks was assessed to be generally satisfactory during 2006 (Table 1). The significant growth in balance sheets was mainly a result of increased customer deposits following the discontinuation of holdings of BoBCs by non-banks. The quality of assets remained generally strong and this is an indication of prudent and sound credit management policies. In addition, the two statutory banks (Botswana Savings Bank (BSB) and the National Development Bank (NDB)) and the Botswana Building Society (BBS) continued to perform satisfactorily in 2006.

Table 1: Measures of Financial Institutions Soundness and Range of Prudential Standards for Licensed Banks – 2006 (percent)

	Prudential Standard	Range of Prudential Standard for Local Banks
Capital Adequacy	≥ 15	15.6 – 35.5
Liquid Asset Ratio	≥ 10	53.5 – 67.8
Profitability (Return on Assets)	Positive	1.2 – 4.8
Profitability (Return on Equity)	Positive	17.5 – 78.7
Asset Quality (Non-Performing Loans/Total Loans)	≤ 2.5	2.8 – 22.2
Intermediation (Advances/Deposits)	≥ 50	32.9 – 51.3

Banking System Performance and Efficiency

The combined effect of the dominant ownership of banks by major reputable international banks and the effective supervisory regime meant that commercial banks continued to be well capitalised, very solvent and highly liquid. However, despite increased competition through new entries into the banking system, operational inefficiencies, as reflected in the widening interest rate margins and the high cost of banking services, remained a source of concern. Equally important, the low intermediation ratios point to the need for banks to introduce new products, both on the liability and asset side, in order to further deepen the country's financial system.

International Financial Services Centre (IFSC)

Four new IFSC institutions, with regulatory approval from the Bank, were licensed during the year, compared to one in 2005. This brought the total number of IFSC enterprises offering corporate, financial and management services to 17. Despite persistent losses by one of the licensed IFSC financial institutions during the year, it still met both the statutory minimum capital requirements and prudential ratios for banks in Botswana.

Collective Investment Undertakings (CIUs)

Total net asset value (NAV) of the funds managed by CIUs, excluding inward marketed ones, rose by 75

percent to P7.7 billion as at the end of December 2006. However, the number of domestic fund management companies was unchanged at three.

Externally Registered Funds Marketed in the Domestic Market

With the entry of Imara Asset Management Ltd, there were three funds approved for domestic marketing in 2006 compared to two the previous year. As at the end of the year, the number of foreign registered funds marketed in Botswana rose to nine.

Bureaux de Change

Six new bureaux de change were licensed, thus bringing the total to 42 as at the end of 2006. Mogoditshane, Francistown, Ghanzi and Lobatse each had one of the newly licensed bureaux, while two were located in Gaborone. The eight bureaux de change examined during the year generally complied with the Bureaux de Change Regulations, except that they delayed submission of audited financial statements to the Bank on the grounds of high audit fees. Bancon Bureau de Change had its licence withdrawn on account of non-compliance with the Regulations.

Micro-Finance Institutions

The balance sheet of the only deposit-taking micro-finance institution in the country, Women's Finance House, expanded by 94 percent during 2004/2005. This was mainly due to increased deposits and capital grants.

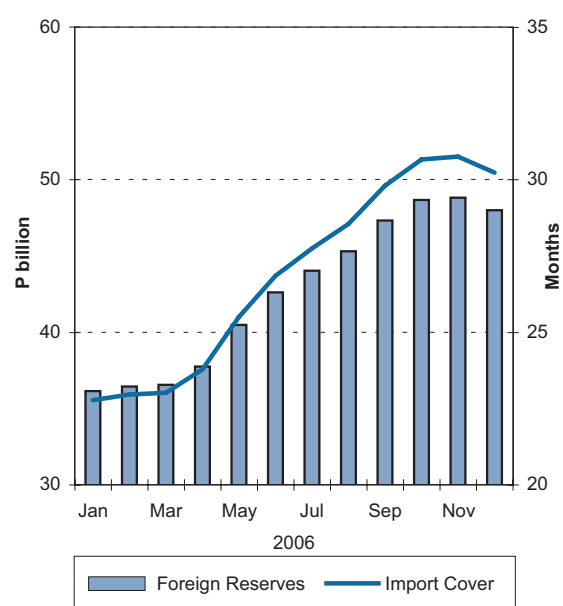
The Bank neither regulates nor supervises non-deposit-taking micro-lending operations. It is expected that the newly promulgated Non-Bank Financial Institutions Regulatory Authority will provide supervisory and regulatory oversight for the operations of micro-lending businesses.

Reserves Management

Botswana's official foreign exchange reserves are managed by the Bank on behalf of the Government. The Bank ensures their safety and return by diversifying the investments within a framework of acceptable risks. As Botswana's foreign exchange reserves have continued to grow, the Bank has sub-divided the reserves into two tranches to meet different objectives. A portion of the reserves is invested in long-term assets (Pula Fund) such as long-term bonds and equities, with a view to maximising expected return within acceptable risk parameters; there is also the Liquidity Portfolio, which is invested in money market and short-term instruments with a view to meeting the nation's ongoing foreign exchange requirements for international transactions.

As at December 31, 2006, the official foreign exchange reserves amounted to approximately P48 billion; this is an increase of 38.6 percent in the twelve months to December 2006. The reserves were equivalent to 30 months of imports of goods and services. In foreign currency terms, the level of official foreign exchange reserves at the end of 2006 was SDR 5.3 billion and USD 8 billion.

Chart 5: Foreign Exchange Reserves and Import Cover



Source: Bank of Botswana

The Bank conducted the two annual consultations with the fund managers, global custodian and portfolio consultant to review the policies, management and performance of the externally managed portion of the reserves.

Policy Analysis and Advice

In addition to its responsibilities of formulating and implementing monetary policy, the Bank serves as economic and financial advisor to the Government on a wide range of issues. These include, *inter alia*, exchange rate policy, financial sector development, taxation, industrial development and trade. To help inform public policy discussion and debate, the Bank conducts annual briefings on economic trends based on the Annual Report, and publishes macroeconomic statistics, the bi-annual business expectations survey and the Research Bulletin, which are distributed to stakeholder institutions and the public. Moreover, the Bank was also represented on a number of national committees and task forces, including, *inter alia*: the High Level Consultative Council (HLCC), National Employment, Manpower and Incomes Council (NEMIC), MFDP/BoB Working Group, Competition Policy Legislation Reference Group, Statistics Producers Committee, Taxation Review Committee, CPI Rebasing Reference Group, National Committee on Trade Policy and Negotiations (NCTPN) and the Business and Economic Advisory Council (BEAC).

Financial Relations with Government

The shareholder's funds (including the Government Investment Account) rose by 59 percent to P30.8 billion in December 2006. The increase was due to the buoyant overall balance of payments during the year, as well as the 79 percent increase in the currency revaluation reserves and the 12 percent rise in the market revaluation reserve. The IMF Reserve Tranche (a liability to Government) declined to P56.4 million from P58.2 million at the end of the previous year. On the asset side, the Bank's holding of Government bonds decreased slightly from P88.5 million at the end of 2005 to P88.4 million at the end of 2006. In addition, the Bank was able to pay a dividend to the Government of P550 million.

International Relations

The Bank maintained good relations with regional and international organisations during 2006 (Table 2). The Governor and staff of relevant Departments took part in meetings of the SADC Committee of Central Bank Governors, Association of African Central Banks (AACB) and Bank for International Settlements (BIS), as well as the Annual Joint Meetings of the International Monetary Fund (IMF) and World Bank.

The Bank also benefited from long-term and short-term IMF technical assistance, and staff placements at IMF Headquarters in Washington, DC. (USA). The annual Article IV Consultation Mission visited the country in June 2006 to review and discuss economic and financial developments with the country's authorities while the review of ratings by Moody's Investors Service and Standard and Poor's was conducted in May and October 2006, respectively.

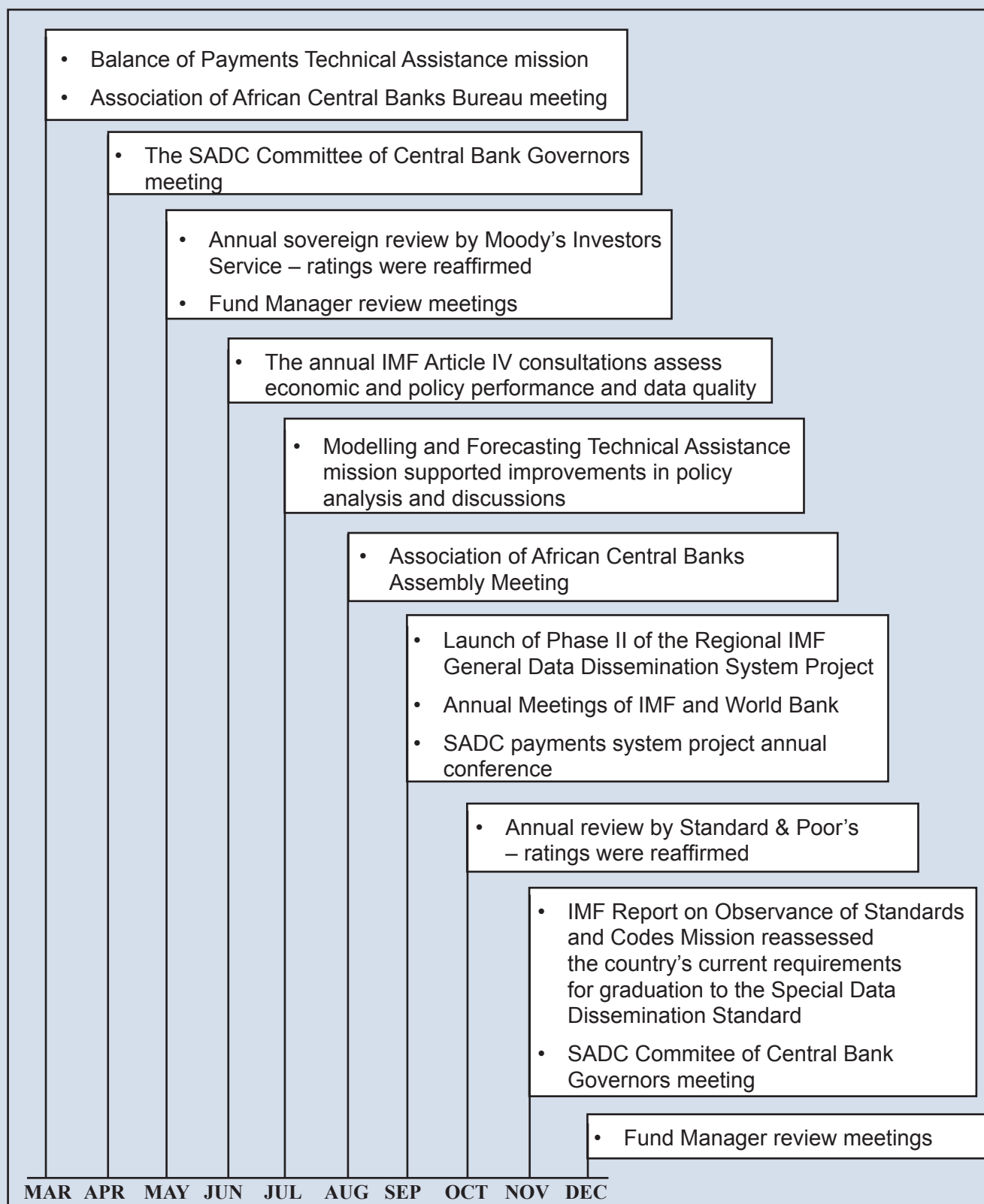
Medium Term Strategic Plan

Based on the environmental scans and operational goals formulated during the first half of 2006, the Bank adopted a Medium Term Strategic Plan for the period 2007-2009. The plan covers strategies and priorities that will be pursued over the three-year period in pursuit of the Bank's goals. The objective of the plan is to enhance the Bank's performance in contributing to the country's stable macroeconomic and financial environment.

Internal Audit

Twenty-four scheduled audits and one special audit were conducted by the Internal Audit Division during

Table 2: Interaction with the International Community in 2006



Source: Bank of Botswana

2006, with reports rated according to the significance of the findings. The audits assessed internal controls and communicated the findings, while assisting the Bank in achieving its objectives in the most efficient, safe and cost-effective manner. Summaries of the findings and recommendations were submitted to the Audit Committee. As part of risk management, the Control Risk Self-Assessment programme continued to play a

major role in ensuring that Departments and Divisions were proactive in identifying potential risk areas and in ensuring the appropriateness of risk mitigation strategies.

Information Technology

Several new information technology systems were implemented during the year with a view to improving efficiency in a number of operational areas of the Bank, including payments and settlement, banking, human resource management, accounting and financial markets. The new human resources system should facilitate easy access, updating and downloading of personal data. Following the completion of the Bank's Off-site Disaster Recovery Planning Facility, back-up systems are to be relocated to the new site while there are continuing improvements to the security of the Bank's information technology system.

Protective Services

Currency Counterfeits

The Bank's security infrastructure, procedures and training improved further during the year. As the sole issuer of currency, the Bank maintained vigilance against counterfeits of banknotes in collaboration with law enforcement agencies. During the year, counterfeit banknotes with a face value of P209 000, of which 99 percent were in the P100 denomination, were confiscated by the law enforcement agencies. To alleviate this problem, the Bank contributed to a deepening of knowledge of law enforcement authorities on the effects of counterfeits, importance of prioritising prosecution of suspects and encouraging the application of the criminal charges related to counterfeits under the appropriate legislation, which would provide for deterrent sentences upon conviction.

Security Audit and Threats Analysis

In line with international best practice, the Bank engaged specialist consultants to conduct an independent Security Audit and Threat Analysis for all its facilities and related information technology infrastructure. As a result of the continuous improvements in the security infrastructure and procedures over the years, the consultants' finding was that, overall, the Bank's security system compared favourably with those of other central banks in the world. Some of the consultants' recommendations will be implemented as part of the ongoing Technical Security Upgrade Project.

Information Dissemination and Public Education

The Bank of Botswana is committed to expanding public knowledge about the Bank, the financial system and other aspects of the economy. In that regard, the Bank publishes and disseminates a number of materials, including the Annual Reports, Monetary Policy Statement (MPS), Botswana Financial Statistics (BFS), and some educational booklets. In addition, economic briefings were held for Cabinet members, parliamentarians, senior government officials, representatives of the private and parastatal sectors, the media and members of the diplomatic corps in 2006.

Moreover, the Bank continues to implement a public education programme on banking and financial matters. This includes efforts aimed at educating the public on the security features of currency and possible illegal banking activities. In that regard, the Bank has published booklets, such as 'Know Your Currency', 'Money and Banking in Botswana' and 'Money Matters'. The latter is an animated booklet, which offers basic definitions and explanations of the functions of money; the booklet is made available to schools. In addition, as part of its public education and outreach programme, the Bank participated in the Botswana Consumer Fair, school career fairs, radio and television programmes and hosted familiarisation tours of its premises for students.

Industrial Relations and Staff Development

The Bank continued to face the challenge of a rising vacancy rate during 2006 due to competition for skilled manpower in the labour market. Vacancies increased from 21 at end-2005 to 27 by end-2006. Consistent with the Bank's policy to pursue its strategic objective of attracting and retaining high calibre staff, the Bank took part in two remuneration surveys during 2006 conducted by tsa Badiri Consultants (in conjunction with Hay Group South Africa) and P3 Management Consultants. The results of the survey confirmed the uncompetitiveness of the Bank's remuneration package in general.

The Bank's efforts to mitigate the negative impact of the HIV/AIDS pandemic on productivity and staff health continued throughout the year. In this regard, it is notable that the number of staff enrolled on the Bank's Special Programme for HIV/AIDS increased as a result of increasing awareness. The Bank also continued to offer free counselling services to its staff.

Relations between the management and the Central Bank Union were cordial during 2006. Meetings of the Joint Negotiating Committee were held during the year to deliberate on matters of mutual interest. Following the promulgation of the amended Trade Disputes Act, a review of the General Conditions of Service was initiated to ensure compliance with the new labour laws.



ANNUAL FINANCIAL STATEMENTS

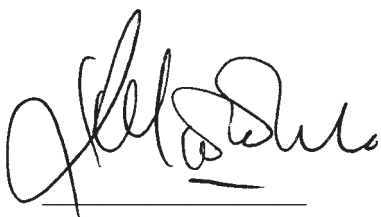
2006

BANK OF BOTSWANA

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The Annual Financial Statements set out on pages 32 to 51 were approved by the Board on March 30, 2007 and signed by:



Linah K Mohohlo
Governor



Nozipho A Mabe
Director, Accounting and Planning Department



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INDEPENDENT AUDITORS' REPORT

TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the annual financial statements of Bank of Botswana, set out on pages 33 to 51, which comprise the balance sheet as at December 31, 2006, the income statement, cash flow statement and statement of changes in shareholder's funds for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

The members of the Board are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects the financial position of Bank of Botswana as of December 31, 2006, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

Deloitte + Touche

Deloitte & Touche
Certified Public Accountants

March 30, 2007
GABORONE

Audit.Tax.Consulting.Financial Advisory.

Member of
Deloitte Touche Tohmatsu

National Executive: GG Gelink Chief Executive AE Swiegers Chief Operating Officer GM Pinnock Audit DL Kennedy Tax
L Geeringh Consulting MG Crisp Financial Advisory L Bam Strategy CR Beukman Finance TJ Brown Clients & Markets
SJC Sibisi Public Sector and Corporate Social Responsibility NT Mtoba Chairman of the Board J Rhynes Deputy Chairman of the Board
Resident Partners: JY Stevens Senior Partner FC Els M Marinelli P Naik DL O'Connor

A full list of partners and directors is available on request.

BALANCE SHEET

December 31, 2006

	Notes	2006 P'000	2005 P'000
ASSETS			
Property and Equipment	1	144 734	127 668
Foreign Exchange Reserves			
Liquidity Portfolio	2.1	10 592 440	9 285 046
Pula Fund	2.2	36 854 514	24 867 274
International Monetary Fund (IMF)			
Reserve Tranche	3.1	56 370	58 201
Holdings of Special Drawing Rights	3.2	335 396	281 133
Administered Funds	3.4	136 919	118 747
Total Foreign Exchange Reserves		47 975 639	34 610 401
Government of Botswana Bonds	4	88 355	88 464
Other Assets	5	73 753	52 460
TOTAL ASSETS		48 282 481	34 878 993
LIABILITIES			
Notes and Coin in Circulation	6	1 069 719	935 263
Bank of Botswana Certificates	7	14 002 691	12 416 133
Deposits	8	2 135 112	1 596 622
Allocation of Special Drawing Rights (IMF)	3.3	39 736	34 595
Liabilities to Government (IMF Reserve Tranche)	9	56 370	58 201
Dividend to Government	10	137 500	426 169
Other Liabilities	11	56 656	34 553
Total Liabilities		17 497 784	15 501 536
SHAREHOLDER'S FUNDS			
Paid-up Capital	12	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		20 467 583	12 209 061
Currency Revaluation Reserve		6 610 393	3 688 770
Market Revaluation Reserve		2 081 721	1 854 626
General Reserve	13	1 600 000	1 600 000
Total Shareholder's Funds		30 784 697	19 377 457
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		48 282 481	34 878 993
FOREIGN EXCHANGE RESERVES IN US DOLLARS ¹		7 992 741	6 309 476
FOREIGN EXCHANGE RESERVES IN SDR ²		5 315 701	4 405 904
1 Pula/United States dollar		0.1666	0.1823
2 Pula/SDR		0.1108	0.1273

INCOME STATEMENT

Year ended December 31, 2006

	Notes	2006 P'000	2005 P'000 (Restated)
INCOME			
Interest – Foreign exchange reserves		1 468 041	862 628
Dividends – Foreign exchange reserves		195 867	216 423
Interest – Government of Botswana Bonds	22	8 846	9 774
Net market gains on disposal of securities		374 539	1 219 054
Net realised currency gains	14	2 172 447	1 878 717
Net unrealised currency gains	14	1 803 125	1 651 235
Net unrealised market gains		–	7 570
Net profit on domestic foreign exchange deals		246 269	175 197
Other income		16 241	11 472
		<u>6 285 375</u>	<u>6 032 070</u>
EXPENSES			
Interest	15	1 680 767	1 364 150
Administration costs		208 454	191 874
Depreciation (net write back)/expense	1	(2 088)	18 258
Net unrealised market losses		13 373	–
		<u>1 900 506</u>	<u>1 574 282</u>
NET INCOME FOR THE YEAR		4 384 869	4 457 788
TRANSFER TO CURRENCY REVALUATION RESERVE	14	(3 973 017)	(3 511 611)
NET INCOME BEFORE TRANSFER FROM/(TO) GOVERNMENT INVESTMENT ACCOUNT		411 852	946 177
TRANSFERS FROM/(TO) GOVERNMENT INVESTMENT ACCOUNT		138 148	(205 008)
NET INCOME AVAILABLE FOR DISTRIBUTION		550 000	741 169
APPROPRIATIONS			
DISTRIBUTION TO GOVERNMENT		(550 000)	(741 169)
Dividend to Government from Pula Fund		(550 000)	(420 000)
Residual net income		<u>–</u>	<u>(321 169)</u>

CASH FLOW STATEMENT

Year ended December 31, 2006

	Notes	2006 P'000	2005 P'000 (Restated)
OPERATING ACTIVITIES			
Cash generated by operations	17	2 516 271	3 541 713
INVESTING ACTIVITIES			
Net Investments		(8 072 616)	(5 182 854)
Proceeds from redemption of Government of Botswana Bonds		–	19 189
Interest received from Government of Botswana Bonds		8 846	9 921
Proceeds from disposal of property and equipment		84	587
Purchase of property and equipment	1	(15 024)	(15 699)
NET CASH USED IN INVESTING ACTIVITIES		(8 078 710)	(5 168 856)
FINANCING ACTIVITIES			
Dividend to Government	10	(838 669)	(412 025)
Government Investments		6 266 652	2 014 763
NET CASH GENERATED FROM FINANCING ACTIVITIES		5 427 983	1 602 738
NET INCREASE IN CURRENCY IN CIRCULATION		(134 456)	(24 405)
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(935 263)	(910 858)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(1 069 719)	(935 263)

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS

Year ended December 31, 2006

	Share Capital P'000	Currency Revaluation Reserve P'000	Market Revalua- tion Reserve P'000	General Reserve P'000
Balance at January 1, 2005	25 000	129 893	1 270 700	1 600 000
Transfer from Income Statement as previously stated	—	4 517 644	—	—
Prior year adjustment resulting from change in accounting policy	—	(1 006 033)	—	—
Transfer from Income Statement as restated	—	3 511 611	—	—
Unrealised currency gains for the year on non-monetary 'available-for-sale' financial instruments	—	1 006 033	—	—
Net unrealised market gains for the year on 'available-for-sale' financial instruments	—	—	677 709	—
Transfers to Government Investment Account:				
Unrealised market gains for the year	—	—	(93 783)	—
Unrealised currency gains for the year	—	(958 767)	—	—
Government investments	—	—	—	—
Net gains not recognised in the Income Statement for the year	—	3 558 877	583 926	—
Net income for the year as previously stated	—	—	—	—
Prior year adjustment for change in accounting policy	—	—	—	—
Net income for the year as restated	—	—	—	—
Transfer to Currency Revaluation Reserve as restated	—	—	—	—
Dividend to Government from Pula Fund	—	—	—	—
Residual net income transferred to Government	—	—	—	—
Transfers to/(from) the Income Statement for the year:				
Excess of Government Pula Fund Income over Pula Fund Dividend	—	—	—	—
Balance at December 31, 2005	25 000	3 688 770	1 854 626	1 600 000
Transfer from Income Statement	—	3 973 017	—	—
Unrealised currency gains on 'available-for-sale' non-monetary financial instruments	—	741 078	—	—
Net unrealised market gains for the year on 'available-for-sale'	—	—	564 641	—
Transfers to Government Investment Account:				
Unrealised market gains for the year	—	—	(337 546)	—
Unrealised currency gains for the year	—	(1 792 472)	—	—
Government investments	—	—	—	—
Net gains not recognised in the Income Statement for the year	—	2 921 623	227 095	—
Net income for the year	—	—	—	—
Transfer to Currency Revaluation Reserve	—	—	—	—
Dividend to Government from Pula Fund	—	—	—	—
Transfers to/(from) the Income Statement for the year:				
Excess of Government Pula Fund Income over Pula Fund Dividend	—	—	—	—
To cover residual deficit	—	—	—	—
Balance at December 31, 2006	25 000	6 610 393	2 081 721	1 600 000

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

Government Investment Account P'000	Accumulated Profit P'000	Total P'000	
8 936 740	–	11 962 333	Balance at January 1, 2005
–	–	4 517 644	Transfer from Income Statement as previously stated
–	–	(1 006 033)	Prior year adjustment resulting from change in accounting policy
–	–	3 511 611	Transfer from Income Statement as restated
–	–	1 006 033	Unrealised currency gains for the year on non-monetary 'available-for-sale' financial instruments
–	–	677 709	Net unrealised market gains for the year on 'available-for-sale' financial instruments
93 783	–	–	Transfers to Government Investment Account:
958 767	–	–	Unrealised market gains for the year
2 014 763	–	2 014 763	Unrealised currency gains for the year
			Government investments
3 067 313	–	7 210 116	Net gains not recognised in the Income Statement for the year
–	5 463 821	5 463 821	Net income for the year as previously stated
–	(1 006 033)	(1 006 033)	Prior year adjustment for change in accounting policy
–	4 457 788	4 457 788	Net income for the year as restated
–	(3 511 611)	(3 511 611)	Transfer to Currency Revaluation Reserve as restated
–	(420 000)	(420 000)	Dividend to Government from Pula Fund
–	(321 169)	(321 169)	Residual net income transferred to Government
205 008	(205 008)	–	Transfers to/(from) the Income Statement for the year:
12 209 061	–	19 377 457	Excess of Government Pula Fund Income over Pula Fund Dividend
			Balance at December 31, 2005
–	–	3 973 017	Transfer from Income Statement
–	–	741 078	Unrealised currency gains on 'available-for-sale' non-monetary financial instruments
–	–	564 641	Net unrealised market gains for the year on 'available-for-sale'
337 546	–	–	Transfers to Government Investment Account:
1 792 472	–	–	Unrealised market gains for the year
6 266 652	–	6 266 652	Unrealised currency gains for the year
			Government investments
8 396 670	–	11 545 388	Net gains not recognised in the Income Statement for the year
–	4 384 869	4 384 869	Net income for the year
–	(3 973 017)	(3 973 017)	Transfer to Currency Revaluation Reserve
–	(550 000)	(550 000)	Dividend to Government from Pula Fund
128 970	(128 970)	–	Transfers to/(from) the Income Statement for the year:
(267 118)	267 118	–	Excess of Government Pula Fund Income over Pula Fund Dividend
20 467 583	–	30 784 697	To cover residual deficit
			Balance at December 31, 2006

ACCOUNTING POLICIES

December 31, 2006

BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

The financial statements are prepared on the historical cost basis as modified to include the revaluation of investments in domestic and foreign assets, liabilities, and the result of the activities of the Pula Fund. The principal accounting policies stated below have been consistently applied except where noted, and comply with International Financial Reporting Standards in all material respects.

ADOPTION OF NEW AND REVISED STANDARDS

The Bank has adopted all the new and revised Standards issued by the International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRIC) that are relevant to its operations and effective for annual reporting periods beginning on January 1, 2006.

At the date of authorisation of these financial statements, the following Standards were in issue, but were not effective:

IFRS 7 Financial Instruments: Disclosures.	Effective for annual periods beginning on or after January 1, 2007.
IAS 1 (Paragraphs 124 a and b): Presentation of financial statements, requiring the disclosure of information regarding the Bank's objectives, policies and processes for managing capital	Effective for annual periods beginning on or after January 1, 2007

The Board anticipates that the adoption of these Standards in future periods will have no material impact on the financial statements of the Bank.

CHANGE IN ACCOUNTING POLICY

International Accounting Standard 21 – 'The Effects of Changes in Foreign Exchange Rates' requires that unrealised exchange gains/losses relating to non-monetary items be recognised directly in the Statement of Changes in Shareholder's Funds. From 2005, these gains/losses have been recognised in the Income Statement. The policy for accounting for the unrealised exchange gains/losses on non-monetary financial instruments has been amended and these are now reported directly in the Statement of Changes in Shareholder's Funds in line with the Standard. Comparative figures for the year ended December 31, 2005 have been restated to effect this change. The effect of this change on the Income Statement and Currency Revaluation Reserve as at December 31, 2005 is as follows:

P'000

Income Statement:

Decrease in unrealised currency gains	(1 006 033)
Decrease in Transfer to Currency Revaluation Reserve	1 006 033
Net effect on Net Income Available for Distribution	—

Currency Revaluation Reserve:

Decrease in Transfers from Income Statement	(1 006 033)
Increase in unrealised currency gains for the year on non-monetary 'available-for-sale' financial instruments	(1 006 033)
Net effect on Currency Revaluation Reserve	—

ACCOUNTING POLICIES (CONTINUED)

December 31, 2006

FINANCIAL INSTRUMENTS**General**

Financial instruments carried on the Balance Sheet include all assets and liabilities, including derivative instruments, but exclude property and equipment.

Short-term Investments (Liquidity Portfolio)

The Bank has designated the Liquidity Portfolio as a fund in which money market instruments and bonds are invested to facilitate payments for regular transactions.

Securities invested in this portfolio are initially recognised at cost and are subsequently remeasured at market value based on bid prices. All related realised and unrealised gains and losses are taken to the Income Statement.

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

Long-term Investments (Pula Fund)

This is a long-term fund intended to maximise returns and is invested in foreign financial instruments with a long-term duration. These investments, which may be sold in response to needs for liquidity, changes in interest rates, exchange rates, etc. are classified as 'available-for-sale'. These securities are initially recognised at cost (which includes transaction costs) and are subsequently remeasured at market value, based on bid prices.

All realised currency gains/losses are taken to the Income Statement. Unrealised currency gains/losses on monetary items are recognised in the Income Statement and those on non-monetary items are reported in the Statement of Changes in Shareholder's Funds. In line with the Bank's policy, exchange gains/losses for this fund are not distributable and are, therefore, appropriated to the Currency Revaluation Reserve.

Unrealised revaluation gains and losses arising from changes in the market value of the instruments classified as 'available-for-sale' are recognised in the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated market value or impairment adjustments are included in the Income Statement as gains or losses from investment securities.

All purchases and sales of investment securities in the fund are recognised at trade date, which is the date that the Bank commits to purchase or sell the investments.

Derivative Instruments

Derivative financial instruments are recognised in the Balance Sheet at cost (including transaction costs) and are subsequently remeasured at market value, based on bid prices for assets held or liabilities to be issued, and ask/offer prices for assets to be acquired or liabilities held. The treatment of market value movements in derivative instruments depends on whether they are designated as part of the Pula Fund or the Liquidity Portfolio.

FOREIGN CURRENCY ACTIVITIES

All transactions denominated in foreign currencies are translated to Pula at the bid rates of exchange for all sales, and offer rates of exchange for all purchases, at the transaction date.

ACCOUNTING POLICIES (CONTINUED)**December 31, 2006**

Where amounts denominated in one foreign currency are sold in order to buy other foreign denominated currency such that neither profit nor loss is realised on the transaction, mid exchange rates are used to offset exchange rate risk.

All monetary assets and liabilities denominated in foreign currencies are translated to Pula using the bid and offer rates of exchange, respectively, at the close of the financial year. All exchange gains/losses realised on disposal of financial instruments and unrealised exchange gains/losses arising on translation of monetary items are included in the Income Statement. However, all gains and losses relating to disposals whose proceeds are reinvested in foreign assets, and unrealised gains/losses arising on monetary financial instruments are not considered distributable in terms of Bank policy; they are appropriated to the Currency Revaluation Reserve. All unrealised exchange gains/losses on translation of non-monetary 'available-for-sale' assets are reported in the Statement of Changes in Shareholder's Funds, until the financial assets are derecognised, at which time the cumulative gains/losses previously recognised in Shareholder's Funds are recognised in the Income Statement.

BANK OF BOTSWANA CERTIFICATES

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

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

GOVERNMENT OF BOTSWANA BONDS

The Bank acquired Government of Botswana Bonds for purposes of facilitating orderly trading in the local bond market. The bonds, which may be sold in response to needs to intervene in the market, are classified as available-for-sale securities.

The bonds are initially recognised at cost and are subsequently remeasured at market value, based on bid prices. All unrealised gains and losses arising from changes in the market value are recognised in the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated market value adjustments are included in the Income Statement as gains or losses from Government of Botswana Bonds.

All regular purchases and sales of bonds are recognised at trade date, which is the date that the Bank commits itself to purchase or sell the bonds.

SECURED LENDING FACILITY

Under the Secured Lending Facility, the Bank provides emergency and intermittent funding to solvent financial institutions, intended to bridge overnight liquidity shortages. The advances are secured by Government of Botswana Bonds and Bank of Botswana Certificates (BoBCs), valued at market prices on the date of the transaction. The Bank has the right to call for additional collateral, should the value of the security decline during the tenure of the facility. Interest earned on the advances is credited to the Income Statement, while advances outstanding as at the Balance Sheet date are recorded under the heading 'Advances to Banks'.

ACCOUNTING POLICIES (CONTINUED)

December 31, 2006

REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

This facility is one of the mechanisms designed to deal with short-term liquidity fluctuations in the domestic money market. It is available to solvent institutions licensed and supervised by the Bank.

Securities purchased under agreement to resell (Repurchase Agreement) are recorded as funds receivable under the heading 'Advances to Banks'.

Only high quality, marketable and freely transferable paper with a minimum amount of risk is acceptable as security at the discretion of the Bank. Government and Government guaranteed securities of any maturity and other eligible paper with a remaining life of 184 days or less are also acceptable as security.

Securities sold under agreement to repurchase (Reverse Repurchase Agreement) are disclosed as Deposits.

The term of the repurchase agreement and reverse repurchase agreement varies from overnight to one month, depending on the liquidity conditions in the domestic market.

Interest earned by the Bank on repurchase agreements is credited to the Income Statement, while interest paid by the Bank on reverse repurchase agreements is charged to the Income Statement.

ASSETS, LIABILITIES AND PROVISIONS RECOGNITION**Assets**

Assets are recognised when the Bank obtains control of a resource as a result of past events, and from which future economic benefits are expected to flow to the Bank.

Contingent Assets

The Bank discloses a contingent asset arising from past events where it is probable that economic benefits will flow from it, but this will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events outside the control of the Bank.

Liabilities and Provisions

The Bank recognises liabilities (including provisions) when:

- (a) it has a present legal obligation resulting from past events;
- (b) it is probable that an outflow of resources embodying economic benefits will be required to settle this obligation; and
- (c) a reliable estimate of the amount of the obligation can be made.

Derecognition of Assets and Liabilities

The Bank derecognises a financial asset when it loses control over the contractual rights that comprise the asset and transfers substantially all the risks and benefits associated with the asset. This arises when the rights are realised, expire or are surrendered. A financial liability is derecognised when it is legally discharged.

ACCOUNTING POLICIES (CONTINUED)

December 31, 2006

INCOME AND EXPENSE RECOGNITION

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

OFFSETTING FINANCIAL INSTRUMENTS

The Bank offsets financial assets and liabilities and reports the net balance in the Balance Sheet where:

- (a) there is a legally enforceable right to set off;
- (b) there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously;
- (c) the maturity date for the financial assets and liability is the same; and
- (d) the financial asset and liability is denominated in the same currency.

In view of the fact that the Bank values its foreign exchange investments on a portfolio basis, assets and liabilities within each portfolio have been set off.

GENERAL RESERVE

Under Section 7(1) of the Bank of Botswana Act (CAP 55:01), the Bank of Botswana is required to establish and maintain a General Reserve sufficient to ensure the sustainability of future operations of the Bank. The Bank may transfer to the General Reserve funds from other reserves, which it maintains, for the purposes of maintaining the required level of the General Reserve.

CURRENCY REVALUATION RESERVE

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

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

MARKET REVALUATION RESERVE

Any changes in the value of the Bank's long-term investments 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.

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost less related accumulated depreciation and any accumulated impairment losses.

Land and buildings are revalued on a fair value basis every two years, and the recoverable (revalued) amounts disclosed by way of a note to the financial statements, providing that revalued amounts are in excess of the carrying amounts. Where the carrying amounts are more than the revalued amounts, an impairment loss is recognised in the Income Statement.

ACCOUNTING POLICIES (CONTINUED)**December 31, 2006**

At each balance sheet date, the Bank reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any).

Any impairment loss is recognised immediately in the Income Statement.

Where an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years.

Depreciation is charged so as to write-off the cost or valuation of assets, other than land and buildings under construction, over their estimated useful lives, using the straight-line method. The estimated useful lives, residual values and depreciation methods are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

A gain or loss arising on disposal or retirement of an item of property and equipment is determined as the difference between the net sales proceeds and the carrying amount of the asset and is recognised in the Income Statement.

RETIREMENT BENEFITS

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

FINANCE LEASES

The Bank classifies leases of land, property and equipment where it assumes substantially all the benefits and risks of ownership as finance leases. Finance leases are capitalised at the estimated net present value of the underlying lease payments. The Bank allocates each lease payment between the liability and finance charges to achieve a constant periodic rate of interest on the finance balances outstanding for each period. The interest element of the finance charges is charged to the income statement over the lease period. The land, property and equipment acquired under finance leases are depreciated over the useful lives of the assets, on the basis consistent with similar property and equipment.

RELATED PARTY TRANSACTIONS

The Bank enters into various transactions with other wholly owned or partly owned Government institutions and its key management personnel (related parties). All related party transactions are entered into at arm's length in the ordinary course of business.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

December 31, 2006

1. PROPERTY AND EQUIPMENT

	Free- hold Land P'000	Lease- hold Land P'000	Buildings P'000	Capital Works in Progress P'000	Other Assets P'000	Total P'000
Cost or Valuation						
Balance at the beginning of the year	607	3 486	128 934	10 872	77 269	221 168
Additions	—	—	—	3 374	11 650	15 024
Disposals	—	—	—	—	(1 723)	(1 723)
Transfers	—	—	8 768	(10 595)	1 827	—
Adjustments	—	—	—	—	9	9
Balance at the end of the year	607	3 486	137 702	3 651	89 032	234 478
Accumulated Depreciation						
Balance at the beginning of the year	—	—	33 920	—	59 580	93 500
Charge for the year	—	—	3 284	—	7 125	10 409
Revision of economic lives and residual values	—	—	—	—	(12 497)	(12 497)
Disposals	—	—	—	—	(1 677)	(1 677)
Adjustments	—	—	—	—	9	9
Balance at the end of the year	—	—	37 204	—	52 540	89 744
Net book value at December 31, 2006	607	3 486	100 498	3 651	36 492	144 734
Net book value at December 31, 2005	607	3 486	95 014	10 872	17 689	127 668

Revaluation of Properties

Freehold and leasehold land and buildings were valued by an independent professional property valuer in December 2006 at an open market value of P152 000 000 (2004 – P152 305 480).

Depreciation

During the year, a review of the asset lives and residual values of equipment resulted in a net write back of depreciation of P12 497 005 relating to both 2005 and prior years, which has been accounted for prospectively in line with the provisions of IAS No. 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'. This resulted in the net credit depreciation of P2 088 109 in the Income Statement for the year.

The revised annual depreciation rates used in the calculation of depreciation are as follows:

	Percent		Percent
Buildings	2.5	Computer software	20
Furniture, fixtures and equipment	5-50	Motor vehicles – Commercial	20-25
Computer hardware	25	– Bullion Truck	5

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2006

2. FOREIGN EXCHANGE RESERVES

	2006 P'000	2005 P'000 (Restated)
2.1 Liquidity Portfolio		
Bonds	3 111 888	2 968 293
Amounts due from Pula Fund	585 460	457 956
Net Payables	(54 901)	(18 071)
Cash and Cash Equivalents	6 949 993	5 876 868
	<u>10 592 440</u>	<u>9 285 046</u>
2.2 Pula Fund		
Equities	10 528 490	8 012 907
Bonds	22 622 064	15 830 080
Amounts due to Liquidity Portfolio	(585 460)	(457 956)
Net Payables	(550 640)	(311 431)
Cash and Cash Equivalents	4 840 060	1 793 674
	<u>36 854 514</u>	<u>24 867 274</u>
Pula Fund Balance Sheet		
<i>Capital Employed</i>		
Government	19 967 583	11 637 399
Bank of Botswana	16 886 931	13 229 875
	<u>36 854 514</u>	<u>24 867 274</u>
<i>Employment of Capital</i>		
Investments	36 854 514	24 867 274
Investments expressed in US dollars ('000)	6 139 962	4 533 304
Investments expressed in SDR ('000)	4 083 480	3 165 604
Pula Fund Income Statement		
<i>Income</i>		
Interest and dividends	1 052 882	820 970
Realised market gains	377 759	1 196 195
Realised currency revaluation gains	979 851	1 285 809
Unrealised currency revaluation gains	1 516 763	1 491 004
Sundry income	113	17
	<u>3 927 368</u>	<u>4 793 995</u>
<i>Expenses</i>		
Administration charges	(70 592)	(75 030)
<i>Net income for the year</i>	<u>3 856 776</u>	<u>4 718 965</u>
Transfer to Currency Revaluation Reserve	<u>(2 496 614)</u>	<u>(2 776 813)</u>
<i>Net income before transfer from/(to) Government Investment Account</i>	<u>1 360 162</u>	<u>1 942 152</u>
Transfer from/(to) Government Investment Account	138 148	(205 008)
<i>Net income available for distribution</i>	<u>1 498 310</u>	<u>1 737 144</u>
Appropriations		
Dividend to Government	(550 000)	(420 000)
Bank of Botswana's share of net income	<u>948 310</u>	<u>1 317 144</u>

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2006

	2006 P'000	2005 P'000
3. INTERNATIONAL MONETARY FUND (IMF)		
3.1 Reserve Tranche		
This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is its membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holdings of Pula by the IMF, which initially were equal to 75 percent of the quota, have changed from time to time as a result of the use of Pula by the IMF in its lendings to member countries.		
Quota (SDR 63 000 000)	568 592	494 894
Less IMF Holdings of Pula	(512 222)	(436 693)
Reserve Position in IMF	56 370	58 201
The IMF Holdings of Pula are represented by a Non-Interest Bearing Note of P165 324 035 (2005 – P165 324 035) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in current account held at the Bank (included in other deposits in Note 8).		
3.2 Holdings of Special Drawing Rights	335 396	281 133
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 (IMF)	39 736	34 595
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.		
3.4 Administered Funds		
This relates to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust. The amount represents SDR 15 065 760 (and interest accrued thereon) lent on August 31, 2002, to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries Trust Fund, a fund administered in trust by the IMF.	136 919	118 747
4. GOVERNMENT OF BOTSWANA BONDS		
Government Bond BW002 purchased on 31 March 2003, maturing on March 1, 2008, bearing interest at the rate of 10.25 percent, receivable semi-annually in arrears:		
Market value	85 374	85 483
Interest accrued	2 981	2 981
	88 355	88 464
5. OTHER ASSETS		
Staff Loans and Advances	56 972	44 850
Prepayments	1 510	3 312
Other	15 271	4 298
	73 753	52 460

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2006

	2006 P'000	2005 P'000
6. NOTES AND COIN IN CIRCULATION		
Notes	1 005 157	875 526
Coin	64 562	59 737
	<u>1 069 719</u>	<u>935 263</u>
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.		
7. BANK OF BOTSWANA CERTIFICATES		
Face Value	14 302 570	12 496 680
Unmatured Discount	(299 879)	(80 547)
Market Value	<u>14 002 691</u>	<u>12 416 133</u>
Bank of Botswana Certificates are issued at various short-term maturity dates and discount rates.		
8. DEPOSITS		
Government	663 068	618 244
Bankers	1 039 144	452 541
Other	432 900	525 837
	<u>2 135 112</u>	<u>1 596 622</u>
These represent current accounts lodged by Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free.		
9. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)	<u>56 370</u>	<u>58 201</u>
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		
Balance due at the beginning of the year	426 169	97 025
Dividend to Government from Pula Fund	550 000	420 000
Government share of residual net income	–	321 169
Paid during the year	(838 669)	(412 025)
Balance due at the end of the year	<u>137 500</u>	<u>426 169</u>
The final instalment of the pre-set dividend of P137 500 000 unpaid at December 31, 2006 was provided for in accordance with Section 6 of the Bank of Botswana Act (CAP 55:01), which requires that all profits of the Bank be distributed to the shareholder, the Government.		
11. OTHER LIABILITIES		
Accounts payable	12 304	4 713
Other creditors and accruals	44 352	29 840
	<u>56 656</u>	<u>34 553</u>
12. PAID-UP CAPITAL		
Authorised and paid-up capital	<u>25 000</u>	<u>25 000</u>
The capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act (CAP 55:01).		

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2006

	2006 P'000	2005 P'000 (Restated)
13. GENERAL RESERVE	1 600 000	1 600 000
In the opinion of the Board, the General Reserve, taken together with other reserves which the Bank maintains, is sufficient to ensure the sustainability of future operations of the Bank.		
14. NET CURRENCY REVALUATION GAINS RECOGNISED IN THE INCOME STATEMENT		
Total net realised gains	2 172 447	1 878 717
Total net unrealised gains	1 803 125	1 651 235
Total net currency revaluation gains taken to the Income Statement	3 975 572	3 529 952
Appropriated to Currency Revaluation Reserve:		
Net realised and reinvested in foreign assets	(2 169 892)	(1 860 376)
Net unrealised currency gains	(1 803 125)	(1 651 235)
Transferred to Currency Revaluation Reserve	(3 973 017)	(3 511 611)
Net currency revaluation gains retained in the Income Statement	2 555	18 341
15. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	1 589 259	1 295 537
Debswana Tax Holding Account (Note 22)	53 267	42 804
Reverse Repurchase Agreements	38 241	25 759
National Savings Certificates	–	50
	1 680 767	1 364 150
16. CASH FLOW STATEMENT		
This has been prepared under International Accounting Standard No. 7 – Cash Flow Statements (Revised 1992). The definition of cash in the Standard is not wholly appropriate to the Bank. Due to its role in the creation and withdrawal of currency in circulation, the Bank has no cash balances on its balance sheet (also see Note 6). However, it has the ability to create cash when needed.		
17. CASH GENERATED BY OPERATIONS		
Net income for the year	4 384 869	4 457 788
adjustments for:		
Net realised and unrealised exchange gains	(3 973 017)	(3 511 611)
Depreciation (net write back)/expense	(2 088)	18 258
Profit on disposal of property and equipment	(38)	(570)
Interest – Government of Botswana Bonds	(8 846)	(9 774)
Operating cash flows before movements in working capital	400 880	954 091
Increase/(Decrease) in Deposits – banks and other	493 666	(224 947)
Increase in Deposits - Government	44 824	137 014
Increase in Bank of Botswana Certificates	1 586 558	2 766 861
(Increase)/Decrease in other assets	(21 293)	1 953
Increase/(Decrease) in other liabilities	11 636	(93 259)
Cash generated by operations	2 516 271	3 541 713

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2006

	2006 P'000	2005 P'000
18. CAPITAL COMMITMENTS		
Approved and contracted for	2 638	12 348
Approved but not contracted for	39 021	27 670
	<u>41 659</u>	<u>40 018</u>

These capital commitments will be funded from internal resources.

19. GOVERNMENT OF BOTSWANA BOND AGENCY

In accordance with Sections 56 and 57 of the Bank of Botswana Act (CAP 55:01), the Bank acts as agent of the Government for the issuance and management of the Government Bonds. An analysis of the bonds issued is provided below:

Government of Botswana Bonds issued as at December 31, 2006

Bond Detail	BW 002	BW 003	Total Since Inception P'000
Date of Issue	March 31 and December 1, 2003	May 6 and November 3, 2003	
Date of Maturity	March 1, 2008	October 31, 2015	
Interest Rate (per annum)	10.25 percent	10.25 percent	
Nominal Value (P'000)	850 000	900 000	1 750 000
Net Discount (P'000)	(21 029)	(32 571)	(53 600)
Net Proceeds) (P'000)	828 971	867 429	1 696 400
Interest Paid (P'000)	287 000	302 375	589 375
Interest Accrued) (P'000)	29 363	15 800	45 163

- (i) Net proceeds realised from the issue of the bonds were invested in the Government Investment Account.
- (ii) Interest is payable on all bonds on a semi-annual basis in arrears. Total cumulative interest payments of P750 625 000 (including that relating to redeemed bond BW001 of P161 250 000) made to December 31, 2006 (2005 – P571 250 000) were funded from the Government's current account maintained with the Bank.

20. RISK MANAGEMENT POLICIES IN RESPECT OF FINANCIAL INSTRUMENTS

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

21. COMPARATIVES

Where necessary, comparative figures have been restated to conform with changes in presentation in the current year. The adjustments required as a result of the change in accounting policy are reflected in the Income Statement, Accounting Policies and the Statement of Changes in Shareholder's Funds.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2006

22. RELATED PARTY BALANCES AND TRANSACTIONS

Balances and Transactions with the Government

The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2006 were:

- (i) provision of banking services, including holding of the principal accounts of the Government;
- (ii) management of the Notes and Coin in issue, including printing and minting of notes and coin; and
- (iii) being the Government agent in issuing of bonds.

The aggregate balances in Government accounts are disclosed in Notes 8 to 10.

No charge is made to the Government for provision of these services, except for commissions charged in domestic foreign exchange transactions, which are included in 'Profit on domestic foreign exchange deals' in the Income Statement. This amounted to P96 831 689 (2005 – P38 893 560).

The Bank earned interest on its holding of the Government of Botswana Bonds (as described in Note 4) of P8 846 000 (2005 – P9 774 000).

Other Related Party Balances and Transactions

Included in the Income Statement as interest expense are:

- (i) Amounts paid to the following Government wholly owned or partly owned public sector organisations in respect of their investments in Bank of Botswana Certificates as follows:

	2006 P'000	2005 P'000
Botswana Savings Bank	1 846	8 218
Debswana Diamond Company (Pty) Ltd	461	18 903
Motor Vehicle Accident Fund	669	19 540
Total	2 976	46 661

These are included in the Bank of Botswana Certificates interest expense of P1 589 259 000 (2005 – P1 295 537 000) in Note 7.

- (ii) Debswana Diamond Company (Pty) Ltd, a company partly owned by the Government, holds a special 'Debswana Tax Holding Account' at the Bank to facilitate payment of the company's tax obligations to the Government. Interest is payable on the daily account balance, at the rate of 60 basis points below the prevailing BoBCs three month rate. The interest expense paid in this regard is reflected in Note 15.
- (iii) Purchases of P300 480 (2005 – P160 611) were made from Air Botswana, an institution wholly owned by the Government. These were charged to Administration costs in the Income Statement.
- (iv) Amounts due to related parties.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

December 31, 2006

There were no balances with Government owned or partly owned institutions as at December 31, 2006. The balances as at December 31, 2005 provided below and included in Note 7, related to outstanding Bank of Botswana Certificates, which non-commercial banks (with the exception of merchant banks) are no longer allowed to trade in, effective March 1, 2006.

	2006 P'000	2005 P'000
Botswana Savings Bank	—	69 557
Debswana Diamond Company (Pty) Ltd	—	59 919
Motor Vehicle Accident Fund	—	184 141
Total	—	313 617

Included in the balance of outstanding 'Deposits – Other' in Note 8 are the following balances with Government-owned or partly owned institutions.

	2006 P'000	2005 P'000
Botswana Development Corporation	6	—
Botswana Postal Services	168	—
Botswana Savings Bank	2 593	7 296
Debswana Diamond Company (Pty) Ltd	12 874	159 831
Motor Vehicle Accident Fund	—	36
Total	15 641	167 163

The amounts outstanding are unsecured and have no fixed repayment terms.

Remuneration of Key Management Personnel

Key management personnel comprise the Governor, Board Members, Deputy Governors and Heads of Department.

The gross emoluments of the key management personnel for the comparative years are detailed below:

	2006 P'000	2005 P'000
Non-Executive Board members	51	45
Executive Management	5 554	4 932
	5 605	4 977

PART B

THE BOTSWANA ECONOMY IN 2006 AND THEME CHAPTER

BANK OF BOTSWANA

CHAPTER 1

THE BOTSWANA ECONOMY IN 2006

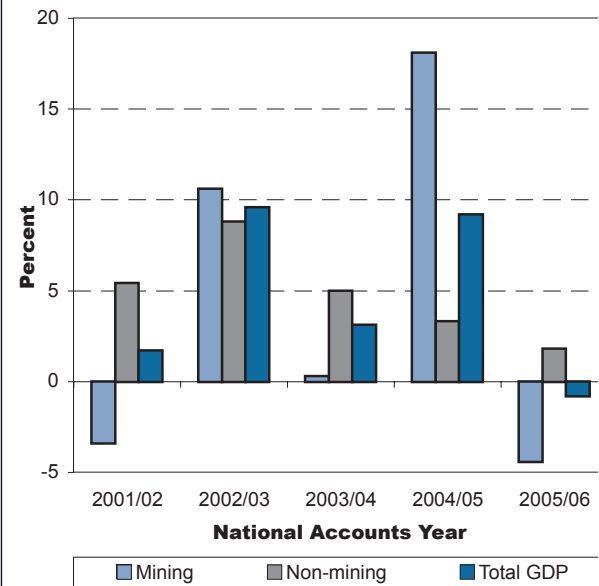
1. OUTPUT, EMPLOYMENT AND PRICES

(a) National Income Accounts

1.1 Preliminary estimates indicate that gross domestic product (GDP) contracted by 0.8 percent in 2005/06,¹ a sharp fall from the 9.2 percent growth rate (revised from an initial estimate of 8.4 percent) in 2004/05 and was below the forecast 4.2 percent expansion for 2005/06 in the Mid-Term Review (MTR) of National Development Plan 9 (NDP 9). As a result, the average annual GDP growth rate for the first half of NDP 9 (2003/04 – 2005/06) was reduced to 3.8 percent from 4.7 percent projected in the MTR.

1.2 The major source of contraction of the economy in 2005/06 was the *mining* sector which declined by 4.4 percent. In particular, output of diamonds fell by 4.3 percent having grown by 18.1 percent in 2004/05. Notwithstanding the volatility of diamond output in the national accounts, evident in Chart 1.1, the mining

CHART 1.1: GROWTH IN REAL GROSS DOMESTIC PRODUCT



Source: Central Statistics Office.

sector had been performing strongly. On a calendar year basis, diamond output continued to grow between 2005 and 2006.² In addition, while mining was the principal source of eco-

TABLE 1.1: GDP GROWTH BY MAJOR ECONOMIC SECTOR, 2003/04 – 2005/06

	2005/06 (prelim)	2004/05 (revised)	2004/05 (prelim)	2003/04 – 05/06 (average)
Agriculture	-3.6	-11.0	3.3	-3.9
Mining	-4.4	18.1	18.2	4.7
Manufacturing	-3.3	8.6	-3.3	1.7
Water & electricity	3.6	3.5	3.3	4.5
Construction	-3.3	0.9	0.7	-0.1
Trade, etc.	5.9	-7.0	-6.6	3.2
Transport & communication	18.2	-0.7	5.6	4.7
Banks, insurance & business services	1.7	4.9	4.1	2.9
General government	4.0	4.6	3.6	4.6
Social & personal services	7.8	10.4	-0.5	7.8
Total GDP	-0.8	9.2	8.4	3.8
Excluding mining	2.0	3.3	1.9	3.4
Excluding mining & government	1.2	2.9	1.3	2.9

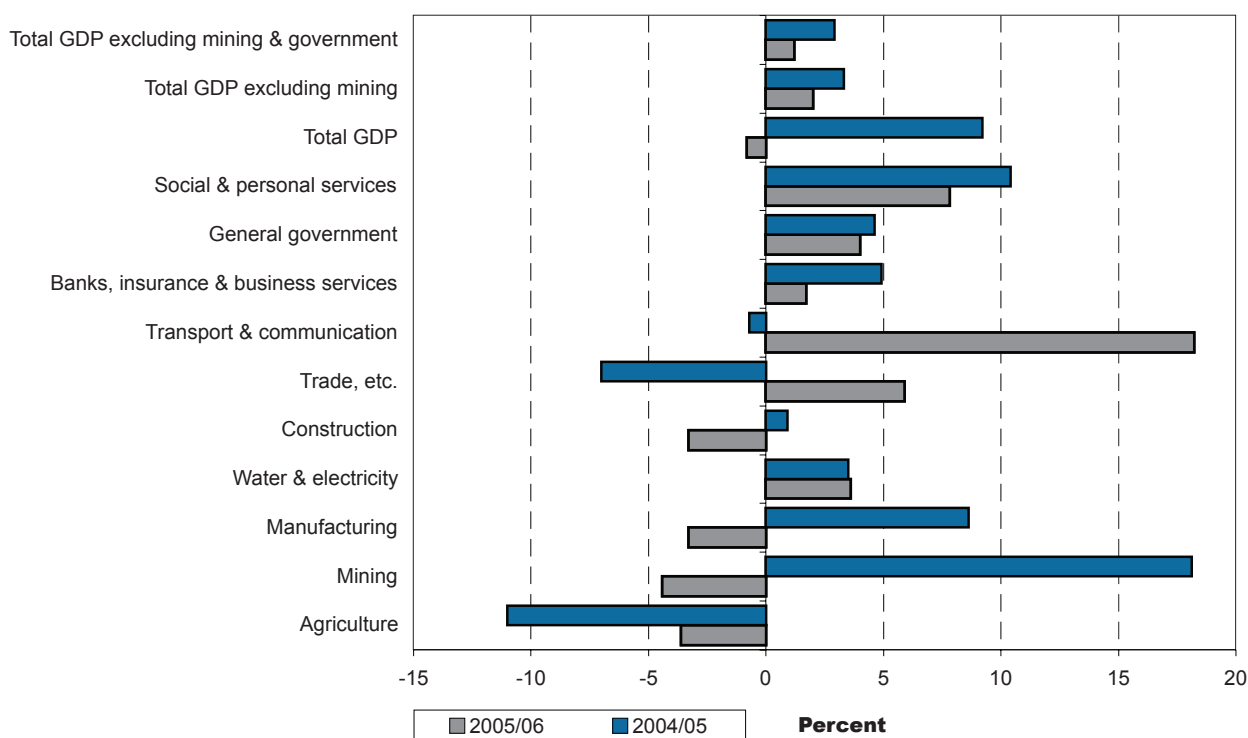
Source: Central Statistics Office.

1. The national accounts years run from July to June.
2. Production was 34.3 million carats in 2006, up by 7.5 percent compared to 31.9 million carats in 2005. It should also be noted that the output of the mining sector is currently underestimated since the provisional figures for 2005/06 do not include an estimate for gold production.

conomic contraction in 2005/06, average growth in mining GDP in the first half of NDP 9 was 4.7 percent per annum, higher than the forecast of 3.5 percent. In addition to the negative growth of mining, several other sectors recorded sluggish performance rates compared to the forecasts.

both revised and initial estimates for 2004/05. The significant revisions for 2004/05 include *manufacturing*, where the revised estimate is 8.6 percent compared to a preliminary figure of –3.3 percent, projecting the performance of the sector in a much more positive light. There was similarly a large upward revision (from –0.5 to

CHART 1.2: ECONOMIC GROWTH BY SECTOR



Source: CSO.

1.3 Non-mining GDP grew by 2 percent in 2005/06 compared to 3.3 percent in 2004/05. If *general government* (which grew at 4 percent) is excluded, growth was even lower at only 1.2 percent. However, one contributory factor was the slow growth in the various adjustment items.³ Excluding these, growth in the non-mining economy (including government) was 3.7 percent, up from 1.8 percent in 2004/05.

1.4 The sectoral composition of GDP growth in 2005/06 is shown in Table 1.1, together with

10.4 percent) for *social and personal services*. Conversely, growth in *agriculture* was revised down from 3.3 percent to –11 percent. Table 1.1 also includes average sectoral growth rates for the first half of NDP 9, which may give a better picture of underlying performance. In this regard, it is notable that only the small *social and personal services* sector, which accounts for about four percent of GDP, has averaged growth of more than five percent per annum.

1.5 Apart from the impact of the decrease in mining output, negative growth in 2005/06 was also due to contraction in several key sectors, including *agriculture* (–3.6 percent), *manufacturing* and *construction* (both –3.3 percent) as shown in Chart 1.2. In *agriculture*,

3. These consist of taxes (both internal and on imports) and subsidies on production as well as an estimate of the costs of financial intermediation services to other productive sectors. In 2005/06, the net contribution of these items to total GDP was 4.2 percent.

growth in the arable sub-sector, boosted by the good rains in early 2006, was offset by continued decline in livestock production.

- 1.6 The problems facing livestock farmers, which included the temporary closure of the Botswana Meat Commission (BMC) abattoirs due to an outbreak of foot and mouth disease in the northern parts of Botswana, were mirrored by the poor performance of meat and meat products, which accounts for only 6 percent of *manufacturing* output. Following a very strong performance in 2004/05, there was also contraction in the beverages sub-sector with the major operator reporting difficult trading conditions as consumer demand weakened.⁴ Textile output, which is mainly for export, grew by 5.4 percent, although this appears low relative to the faster growth indicated by trade statistics.⁵ The poor performance of *construction* is, in the main, attributable to the slow pace of government development spending. In turn, this may also have had a negative impact on manufacturers serving the construction industry, although this is not directly discernible from the published national accounts data.⁶
- 1.7 To a varying extent, other sectors experienced positive growth. At 3.6 percent, growth in *water and electricity* was virtually unchanged from 3.5 percent in 2004/05. However, all the expansion was due to greater electricity output, as output of the water sub-sector declined due to the water usage restrictions in the Gaborone area for the whole of 2005/06.
- 1.8 The estimate for growth in the *trade, hotels and restaurants* sector is 5.9 percent, suggesting a strong recovery from -7 percent in 2004/05. However, this growth was due mainly to the hotels and restaurants sub-sector which

expanded by a substantial 33.6 percent following contraction the previous year. This may reflect major events held in Botswana during 2005/06, including the SADC Heads of State Meeting and the World Information Technology Forum (WITFOR). Also indicative of depressed consumer demand, the wholesale and retail sector grew by only 0.9 percent. At 18.2 percent, *transport and communication* showed the highest growth of any major sector.

- 1.9 Within the overall growth of 1.7 percent for the *banks, insurance and business services* sector, the banking sub-sector (which accounts for about 40 percent of sectoral output) grew strongly by 11.7 percent, consistent with the rapid growth in deposits in early 2006, resulting from the decision to phase out non-bank holdings of Bank of Botswana Certificates (BoBCs). This was, to a large extent, offset by negative growth for insurance, real estate and business services.
- 1.10 Gross domestic expenditure (in real terms) is estimated to have fallen by 11.7 percent in 2005/06, indicating the depressed state of the domestic economy. Only government consumption showed positive growth, and this was marginal at 0.6 percent. Household consumption and gross fixed capital formation (GFCF) fell by 3.1 percent and 6.4 percent, respectively, and this is reflected in a 12.6 percent decrease in imports. However, exports grew strongly by 18 percent, due principally to rapid growth in mineral exports (Section 3 below on balance of payments). This supports the view that the reported contraction in mining output reflects the timing of the review period rather than any underlying weakness in the mining sector.

(b) Economic Outlook

- 1.11 The economy has been growing less rapidly in the first half of NDP 9 than anticipated by the MTR. The decline in domestic expenditure in 2005/06 is unprecedented, and comes after the 12 percent devaluation of the Pula in May 2005, which contributed to

4. Sechaba Brewery Holdings Ltd. *Annual Report 2006*.

5. Nominal gross output of the textiles sub-sector grew by 19.3 percent in 2005/06; however, over the same period trade statistics show growth in textiles exports of 46 percent.

6. With 'other manufacturing' now accounting for fully three-quarters of sectoral output, a more detailed breakdown of this category would enhance analysis of trends in manufacturing.

an erosion of consumer purchasing power, as well as possible adverse impact on business confidence. Measures that served to help restore demand, including the 8 percent across-the-board increase in Government salaries and additional concessions on both direct and indirect taxes that became effective in mid-2006, were not expected to have a significant effect during the 2005/06 national accounts year, but should start to have an impact in 2006/07. However, government spending, which was budgeted to increase rapidly during 2006/07, rose only modestly due to continued slow implementation and did not have the large positive impact on growth that was anticipated.

- 1.12 Despite sluggish government spending, major private sector projects have continued to make progress. This is especially the case in the mining sector where a number of new developments are expected to come on stream in the short-to-medium term,⁷ which can be expected to boost output and job creation in mining and other sectors, particularly construction. Positive developments in manufacturing, arising from expanded diamond processing operations and associated service industries, are also anticipated from 2008 onwards.
- 1.13 More broadly, the twice-yearly Business Expectations Survey (BES) conducted by the Bank of Botswana, the results of which have been published since early 2006, indicates that local businesses are increasingly positive about economic prospects, despite difficult trading conditions in some sectors. Confidence has been highest among export-oriented companies, and this points to improved competitiveness following the 2005 devaluation. It is notable that sentiment has also been improving among domestic businesses, in the context

7. These developments include the opening of the Lerale diamond mine and the Dukwi copper mine in 2007 and 2008, respectively. A further new diamond mine is also expected to be developed by 2009, while coal mine development associated with expanded electricity generation for both domestic consumption and export is anticipated.

of budgeted substantial growth in government expenditure. Implementation of the budget has, however, been constrained by limited implementation capacity. There is also some risk of emerging supply-side bottlenecks as demand for skilled labour and other productive inputs increases. This is particularly the case in the construction industry as infrastructure spending in the region accelerates, especially in South Africa in advance of the 2010 soccer World Cup.

(c) Employment

- 1.14 During the year ending March 2006, formal sector employment is estimated to have declined by 3 800 jobs (1.3 percent),⁸ following a rise of 8 000 jobs (2.8 percent) the previous year. This is in stark contrast to the growth of 3 percent per annum in formal employment between 2001 and 2005.
- 1.15 The reported fall in employment is more than fully accounted for by a loss of 10 100 jobs (10.5 percent) in central government. This movement, which reversed a sharp upward trend in government employment over the previous two years, does not appear to be consistent with the continued growth in the contribution of general government to GDP.
- 1.16 Outside of government, growth in formal sector jobs accelerated, with employment in the private and parastatal sectors increasing by 3.3 percent, compared to only 0.2 percent in the year ending March 2005. This was led by a 13.3 percent (1 200) increase in mining and quarrying jobs. Other sectors with employment growth rates exceeding 5 percent were transport and communication, finance and business services, as well as community and personal services. All other sectors also showed positive growth in employment except for agriculture and water and electricity, where there were small declines. The sectors showing positive employment growth included manufacturing (3.7 percent) and construction (2.2 percent), although in both cases

8. The March 2006 employment figures are provisional.

the corresponding sectoral growth rates for 2005/06 were negative.⁹ After several years of little change, employment by parastatals grew rapidly by 16.1 percent. This reflects the establishment of autonomous bodies to carry out functions previously undertaken by government such as the Botswana Unified Revenue Service (BURS) and the Local Enterprise Authority (LEA).

- 1.17 Preliminary results of the 2005/06 Labour Force Survey (LFS) estimate the national unemployment rate at 17.6 percent, an improvement from 19.5 percent in the 2001 census and 21.5 percent in the previous LFS in 1995/96. In the 10 years between the two surveys, the labour force grew by 48.1 percent, while total employment within the relevant age group increased by 55.5 percent.¹⁰ As expected, unemployment is concentrated among the youth with the highest rate (35.2 percent) in the group aged 20–24.
- 1.18 The LFS results indicate that job opportunities in both the formal and informal sectors have been growing more rapidly than the labour force over the longer term. It is, however, important to note that, while it could be expected that a survey focusing on the labour force directly might provide more accurate information, this conclusion should be qualified in several important respects. The preliminary results, for example, do not indicate the extent of either underemployment or trends in labour force participation. Moreover, the large numbers shown as being employed in agriculture contrasts significantly with other data sources, notably the 2001 population census which records a much lower number.¹¹

9. Comparisons between trends in output and employment, while instructive, must be interpreted with caution. The two data sets are not fully consistent in terms of coverage and timing, and allowance must also be made for possible changes in labour productivity.
10. Total employment shown in the 2005/06 LFS was somewhat higher due to the inclusion of young children (aged 7 and over) in the survey in order to measure the extent of child labour in Botswana. However, by convention, for statistical purposes the labour force excludes those under 12.

(d) Inflation

- 1.19 Global economic growth accelerated from 4.9 percent in 2005 to 5.1 percent in 2006.¹² The faster growth occurred despite higher energy prices and the tightening of monetary policy in some of the major economies. Mainly on the back of rising international oil prices, which peaked at US\$76 per barrel in August, but subsequently fell back to end the year at US\$61 per barrel, inflation in advanced economies rose from 2.2 percent in 2005 to 3.1 percent in 2006. In South Africa, the target measure of inflation, CPIX¹³, rose from 3.9 percent in December 2005 to 4.6 percent in December 2006, although remaining within that country's target range of 3–6 percent. Rising inflation in South Africa reflected in part the depreciation of the rand since mid-2006 due to the current account deficit together with less positive sentiment towards emerging markets in the face of monetary policy tightening in the major economies, as well as higher global commodity prices.
- 1.20 Domestic demand conditions in Botswana were generally moderate in 2006. Despite a general upward trend, in the first nine months of the year, the annual growth of commercial bank credit to the private sector remained within the upper limit of the range considered to be consistent with the Bank's annual inflation objective of 4–7 percent. The impact on demand of rising credit growth, which surpassed the Bank's target in the final quarter of 2006, was moderated by growth in government expenditure being

11. According to the LFS, a total of 169 300 persons were engaged in agricultural employment, of which 137 100 worked on their own family farms/cattle posts. The equivalent figures for the 2001 census were only 44 500 and 17 600, respectively. While migration from neighbouring countries in recent years, together with good rains in 2006, may have boosted agricultural employment, the large difference remains hard to reconcile. Meanwhile the 2002/03 HIES included an estimate of 57 100 working on family farms and cattle posts.
12. Global figures and projections are based on the *World Economic Outlook for September 2006* and the *International Financial Statistics* published by the IMF.
13. CPIX refers to the consumer price index excluding mortgage interest rates.

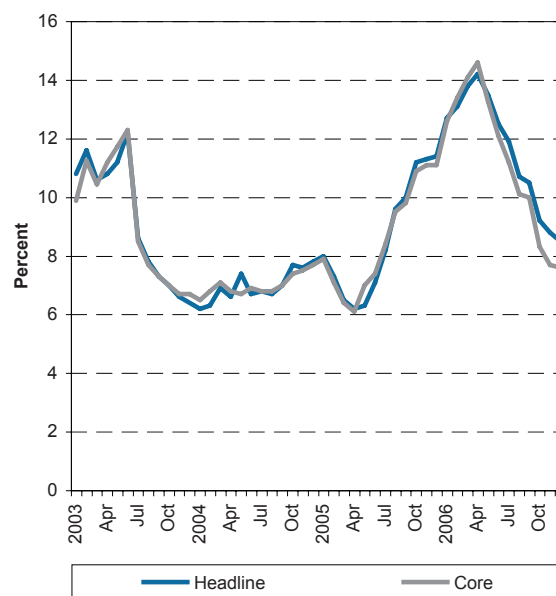
significantly below budgeted levels.

1.21 Upward pressures on inflation came mainly from an increase in administered prices and the re-introduction of tuition fees in public secondary schools in January 2006. During the course of the year, there were also increases in public transport fares as well as tariffs charged by the Botswana Telecommunications Corporation and Botswana Power Corporation. Although there were downward adjustments in fuel prices towards the end of the year, they were also generally higher during 2006 compared to 2005. As with an increase in administered prices, rising meat prices resulting from a large upward adjustment in January 2006 of cattle prices by the Botswana Meat Commission was a significant domestic factor affecting inflation in 2006.

1.22 Although inflation accelerated at the beginning of 2006, peaking at 14.2 percent in April, it had been on a downward trend since May 2006 as the impact of the May 2005 devaluation started to drop out of the inflation calculation. Inflation fell for eight successive months to reach 8.5 percent in December. The generalised decrease in inflation was reflected in the decline in the 16 percent trimmed mean measure of inflation from 11.1 percent in December 2005 to 7.6 percent in December 2006.¹⁴

1.23 A new consumer price index (CPI) basket was introduced in September 2006 and was used to calculate national inflation from October onwards. By extending the range of goods and services in the basket from 256 to 384 items, and revising the weights based on consumption patterns identified in the 2002/03 Household Income and Expenditure Survey (HIES), the new basket will more accurately track current inflation trends. In addition, changes

CHART 1.3: BOTSWANA HEADLINE AND CORE (16 PERCENT TRIMMED MEAN) INFLATION



Source: CSO and Bank of Botswana.

to methodology and to the classification of goods and services were introduced to bring the calculation of the CPI in line with best international practice.¹⁵

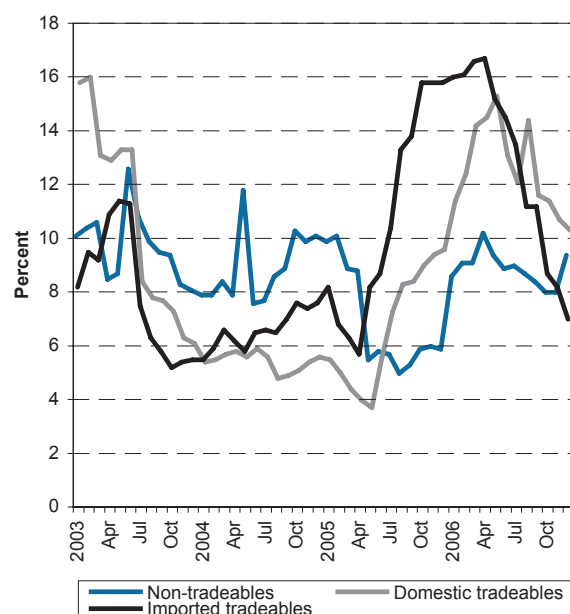
1.24 The annual rate of change in the cost of all-tradeables fell significantly from 13.6 percent in December 2005 to 8 percent in December 2006, again reflecting the dissipating impact of the May 2005 devaluation. The fall in imported tradeables inflation, from 15.8 percent in 2005 to 7 percent in 2006 was particularly pronounced. In contrast, although falling from a peak of 15.3 percent in May 2006, domestic tradeables inflation rose from 9.6 percent to 10.3 percent in the same period. This is largely explained by more rapid price increases for a range of food products, including cereals and meat, which are classified as domestic

14. The Bank of Botswana's preferred measure of core inflation uses the 16 percent trimmed mean. This approach removes 8 percent (by item weight) from each end of the range of price changes, regardless of their source. This contrasts with other exclusion measures where the items to be removed are predetermined. It is planned that the CSO will publish both the trimmed mean and an index that excludes administered prices in 2007.

15. The methodological changes include a revised formula (the 'chained Laspeyres' method) which takes into consideration continually changing consumption patterns by allowing for the introduction of new items and substitution for discontinued products. The use of the geometric rather than the arithmetic mean in aggregating the index makes some allowance for substitution between goods in response to relative price changes. For full details of the changes, the reader is referred to the October 2006 CPI Brief published by the CSO, and the more detailed technical guide which is expected to be published shortly.

tradeables. Inflation for non-tradeables rose from 6 percent to 9.5 percent during 2006, thus indicative of the effects of an increase in administered prices.

CHART 1.4: INFLATION FOR TRADEABLES AND NON-TRADEABLES



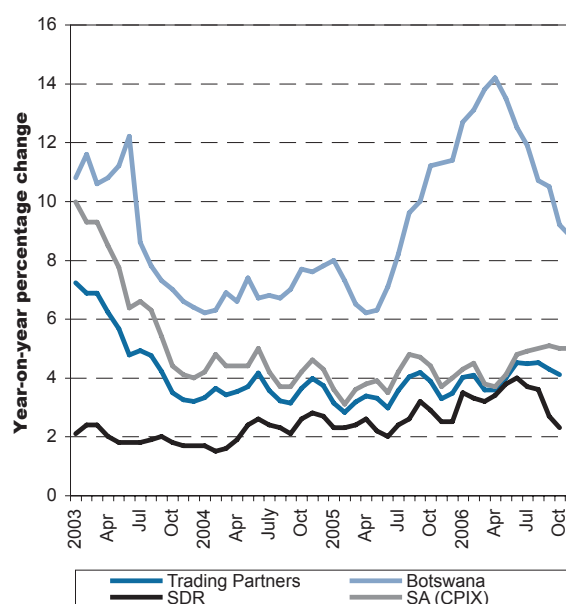
Source: Central Statistics Office

(e) Inflation Outlook

- 1.25 Global economic output is expected to remain strong in 2007, with forecast GDP growth of 4.9 percent, down slightly from an estimated 5.1 percent in 2006, due to sustained growth across the advanced economies, as well as in China and India. The forecast robust global economic performance is largely due to the positive impact on domestic demand in the USA of lower energy prices, increased business investment in some major economies, and the continuing strong expansion in supply capacity of the emerging Asian economies, particularly China and India. Despite the forecast buoyant output expansion, it is expected that global inflationary pressures will continue to be restrained as a result of competitiveness in the goods market and productivity gains, as well as monetary policy vigilance and continued successful management of inflation expectations. Although world inflation rose to 3.8 percent in 2006 from 3.7 percent in 2005, mainly as a result of the increase in oil prices,

global inflation is forecast to fall to 3.7 percent in 2007. For the countries that make up the SDR (euro zone, Japan, United Kingdom and USA), average inflation is forecast to fall to 2.2 percent in 2007 from 2.8 percent in the previous year. South African inflation is projected to peak marginally above the upper end of the target range of 3–6 percent in the first half of 2007 and to average 5.4 percent in 2007, compared to the 4.7 percent in 2006. Upside risks to inflation in South Africa include strong household consumption expenditure, underpinned by an increase in house prices and rapid extension of credit to the household sector.

CHART 1.5: INFLATION IN BOTSWANA AND TRADING PARTNERS



Source: CSO and Bank of Botswana

- 1.26 In Botswana, credit growth maintained an upward trend during 2006, moving above the upper end of the Bank of Botswana's 11–14 percent target range during the final quarter and rising to 18.6 percent in December. High credit growth may intensify domestic demand pressures and, while growth in government spending was slow during 2006, project implementation may pick up towards the end of the 2006/07 fiscal year and into 2007/08. Nevertheless, as indicated by the 2005/06

national accounts, expenditure in the domestic economy has been subdued across all sectors, leaving some slack for recovery without adding to inflationary pressures.

2. PUBLIC FINANCE AND THE 2007 BUDGET SPEECH

- 2.1 Under the theme 'Improved Productivity – the Key to Sustainable Economic Diversification and Global Competitiveness', the 2007 Budget Speech emphasised the need for all stakeholders in the Botswana economy to improve on past performance, including the effective use of both local and global talent, if the goal of economic diversification beyond diamond mining is to be realised. In 2006, the Business and Economic Advisory Council (BEAC) submitted a report to Cabinet highlighting the need for more openness and increased competitiveness in the economy. The Budget Speech noted that the Government is working on a plan to facilitate implementing the report's proposals, including the fast tracking of identified projects to create a more investor friendly environment and accelerate development of the private sector.
- 2.2 The Budget Speech recognised that weak project implementation within Government leads to chronic under-spending, especially of the development budget, which undermines the nation's development programme. In this context, it was acknowledged that if all projects envisaged in the MTR of NDP 9 are to be completed within the current plan period (i.e., by the end of 2008/09), local capacity will need to be augmented by international contractors and skilled labour in order to both alleviate local skills shortages and benchmark against global standards of quality and productivity.

16. The Government financial year runs from April 1 – March 31. As well as reporting the proposed budget for the coming financial year, the Budget Speech includes revised estimates and final figures for the current and previous financial years, respectively.

(a) Budgetary Performance – 2005/06 and 2006/07

(i) 2005/06 Final Budget Outturn

- 2.3 The final budget outturn for 2005/06 was a surplus of P4.6 billion, substantially in excess of P1.6 billion forecast in the revised budget published in February 2006.¹⁶ The larger surplus arose from substantially lower expenditure and a slight increase in revenue compared to the revised estimates.
- 2.4 Total receipts were P22.3 billion, 2.6 percent above the revised estimates. This resulted from the increase in customs receipts arising primarily from a payment that was due to Botswana under the old Southern African Customs Union (SACU) agreement and mineral revenue, which benefited from a bigger depreciation of the Pula against the US dollar than had been forecast.
- 2.5 Total expenditure and net lending of P17.6 billion was 12.4 percent lower than anticipated in the previous estimates. The development budget was underspent by almost 15 percent, and the ministries had attributed the failure to spend P667 million of allocated funds to, among others, slow land allocation and tendering procedures, poor performance by contractors and the requirement, since 2005, for projects to be accompanied by an environmental impact assessment (EIA). The recurrent budget was also underspent, by 10.4 percent or P1 642 million. As well as some payments relating to students studying abroad being made by the Ministry of Education after the end of the financial year, this underspending was attributed to delays in procurement and in recruiting specialised personnel. It is also suggested that the low rate of spending for both the development and recurrent budget reflects the positive impact of measures to improve cost control and productivity.

(ii) 2006/07 Revised Budget

- 2.6 The surplus of P1.7 billion that was originally budgeted for 2006/07 was revised substantially upwards to P4.4 billion. These

revised estimates were based on two principal assumptions. First, that revenue will be higher due to an additional payment of P2.1 billion from SACU, arising from a large surplus in the SACU revenue pool.¹⁷ In addition, non-mineral tax revenues exceeded the forecast by P395.2 million or 13.6 percent, which was attributed to an improvement in tax collection since the establishment of the BURS in 2004.

ing was only 45 percent, meaning that the rate of spending must increase very rapidly in the final quarter if the estimate is to be realised. Given the recent track record, this appears unlikely, and this leads to the conclusion that the final surplus for 2006/07 will be substantially higher than currently envisaged in the official forecasts.

TABLE 1.2: GOVERNMENT BUDGET 2005/06 – 2007/08 (P MILLION)

	2005/06			2006/07		2007/08
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	20 566	21 697	22 267	24 144	26 797	27 179
Mineral revenue	9 926	10 889	11 045	11 389	11 374	10 890
Non-mineral	10 640	10 808	11 222	12 755	15 423	16 289
Expenditure	20 454	20 122	17 632	23 222	22 409	26 441¹
Recurrent	15 720	15 796	14 155	17 234	16 861	19 245
Of which personal						
emoluments	5 436	5 436	5 216	5 998	5 556	7 086
Development	4 858	4 450	3 783	6 035	5 595	7 257
Net lending	-124	-124	-306	-47	-47	-61
Balance	112	1 575	4 635	922	4 388	738

1. The expenditure budget shown for 2007/08 includes a provision for the 6 percent increase in government salaries. This was not shown in the Government's *Financial Statements*, but was included with the Budget Speech on the Government website (www.gov.bw).

Source: Government of Botswana.

- 2.7 The second major assumption is that, at P22.4 billion, the revised estimates for expenditure for 2006/07 show almost no change from the original budget. In particular, the original development budget of P5 800 million has been revised down by only 3.5 percent to P5 595 million, despite the low levels of spending that prevailed during much of the year. In the first three quarters of 2006/07 (i.e., April to December 2006), 68 percent of the revised recurrent budget had been spent, indicating that the forecast was reasonable. However, the equivalent figure for development spend-

(b) 2007/08 Budget Proposals

(i) Budget Framework

- 2.8 The 2007/08 budget is the second budget prepared within the framework of the 'fiscal rule' introduced as part of the MTR of NDP 9. This limits government spending to a maximum of 40 percent of GDP, and aims to ensure a sustainable budget across the years. With nominal GDP for 2007/08 forecast at P66.7 billion and P26.4 billion budgeted for expenditure and net lending, the ratio of spending to GDP is 39.7 percent. While the actual margin may well be somewhat wider due to continued underspending, the 40 percent ceiling may be effective in constraining requests for supplementary funding. However, the application of the rule could be enhanced

17. The surplus arose due to the original forecasts for customs and excise collections that are paid into the revenue pool being substantially exceeded. It was subsequently determined that the additional payments owed to SACU members would be paid during 2006/07 rather than spread over more than one year.

if the basis for the government's GDP forecast is made public and some indications of actual movements in GDP are made available within the period to which the rule is being applied.

- 2.9 The MTR also targeted increasing the share of development spending in the budget from 25 percent in 2006/07 to 30 percent by the end of NDP 9. For the 2007/08 budget the proportion is 27 percent. While this is seen as critical for underpinning sustainable economic diversification, such a rebalancing of the budget in favour of capital spending poses certain risks. Without continuing productivity improvements in the public sector, the recurrent budget could be squeezed, and this could undermine the capacity to maintain and operate expanded public infrastructure. In addition, if the current trend of underspending continues, the actual trend in the development budget may persistently fall short of the objective.

(ii) *Budget Balance*

- 2.10 The initial forecast of the 2007/08 budget outturn is a surplus of P1 267 million, or P738 million once allowance has been made for the adjustment to public service salaries. This is based on total revenue and grants of P27.2 billion against total expenditure and net lending of P25.9 billion (P26.4 billion including the salary adjustment). The narrowing surplus compared to the revised estimates for 2006/07 is due to marginal revenue growth combined with continued rapid expansion of budgeted expenditure.

(iii) *Revenue*

- 2.11 Revenue growth in 2007/08 is expected to be 1.4 percent, with mineral revenues, which make up 40 percent of the total, expected to decline by 4.2 percent to P10.9 billion. Payments from SACU are projected to be P7.4 billion, or 27 percent of total revenue, a small increase on the previous year which reflects continuing rapid expenditure on imports into the SACU region and excisable goods. However, it was noted in the Budget Speech that such high levels of

SACU revenues could not be expected to last, especially given that average tariff rates are likely to be reduced substantially as part of regional trade agreements with major trading partner countries. In addition, significant unanticipated currency movements could affect the Pula value of both minerals and SACU revenue.¹⁸ The main domestic taxes, that is non-mineral income tax and VAT, show solid growth of 7.2 percent and 15 percent, respectively.

(iv) *Expenditure*

- 2.12 Total expenditure and net lending for 2007/08 is expected to grow by P4 billion, or 17.8 percent to P26.4 billion. The P18.7 billion recurrent budget will increase to P19.2 billion once a 6 percent across-the-board adjustment to government salaries and related payments is included.¹⁹ This increase is in line with the formula introduced following the MTR of NDP 9 under which government salaries increase at half the rate of inflation (inflation in 2006 averaged 11.6 percent) with any additional increases funded by productivity improvements. In this context, the Budget Speech noted that most government workers also receive performance based increments which are in addition to the cost of living adjustment.
- 2.13 Recurrent expenditure is budgeted to grow by 14.1 percent (11 percent excluding the salary increase).²⁰ Contributory factors to this increase include the extra costs to central government resulting from the takeover of the administration of junior secondary schools, the establishment of additional local authorities for Chobe, Moshupa and Tonota, as well the

18. The budget is based on the assumption that there will be little movement between the currencies that comprise the Pula basket.

19. Related payments include salaries at parastatals funded by government subventions and various allowances (e.g., old age pensions, destitutes' allowances and community based organisations such as village development committees) paid by central and local government.

20. This is not the same growth rate for recurrent expenditure that was reported in the Budget Speech which also included statutory loan repayments that are recorded as financing items in the standard budget presentation.

Local Enterprise Authority (LEA)²¹ and the Non-Bank Financial Institutions Regulatory Authority (NBFIRA).

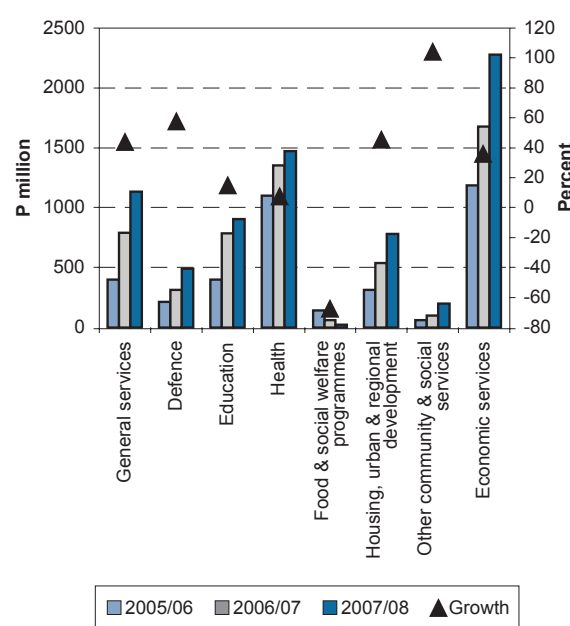
- 2.14 Development expenditure is budgeted to grow by 29.7 percent to P7.2 billion. However, this growth rate is in comparison with the revised estimates for development spending for 2006/07 which, as already noted, are likely to overstate actual spending. In turn, this may cast some doubt on whether the 2007/08 development budget can be achieved. Even if the projected growth rate is realised, this will be from a lower base (i.e., lower spending than budgeted in the previous year) and is dependent on the success of various measures to improve project implementation.

- 2.15 Chart 1.6 provides a detailed sectoral breakdown of the development budget, showing both total allocations since 2005/06 and the budgeted growth between the 2006/07 revised estimates and 2007/08. The largest allocation in 2007/08 is for economic services, which includes a provision of P193 million for converting a loan to the Botswana Telecommunication Corporation (BTC) from the Public Debt Service Fund (PDSF) into equity. Health has been allocated 20 percent of total development spending, although most of this is not channelled through the Health Ministry but rather through the Ministry of State President to fund the HIV/AIDS alleviation programmes. A sharp growth in defence spending is mainly due to the purchase of a new presidential jet, while the falling allocation for food and social welfare is largely determined by lower provision for drought relief programmes, which could be reinstated if prevailing drought conditions persist.

- 2.16 A notable feature of the 2007/08 development budget is the explicit inclusion of maintenance spending. This applies to several allocations, including the BDF, local government and education. Given the need to address

maintenance backlogs, treating remedial programmes as development projects may be appropriate. Nevertheless, it should be understood that such spending is not additional investment, and categorising it as such can distort the objective of rebalancing the budget in favour of investment spending.

CHART 1.6: DEVELOPMENT SPENDING BY ECONOMIC SECTOR (2005/06 – 2007/08)



Source: Bank of Botswana.

(c) Fiscal Legislation

- 2.17 No new taxes or revision of tax rates were proposed for 2007, and this allows a period of consolidation following the changes made to both income tax and VAT legislation in 2006. These have mainly been implemented with the exception of the drafting of the Tax Administration Bill, which will be presented to parliament in 2007. The Bill will ensure that procedures under various tax laws are harmonised and simplified, with a view to further improving the efficiency of BURS. In addition, the Budget Speech highlighted recent amendments to the Income Tax (Training) Regulations, which will both simplify and broaden the conditions for employers to offset training costs against tax.²² The intention of these amendments is to encourage the

21. LEA was actually established in 2003, but delayed commencing operations due to delays in recruiting appropriately qualified personnel.

employment of inexperienced workers, particularly the youth.

(d) Measures to Improve Project Implementation

2.18 Given its theme of improved productivity, the Budget Speech appropriately focused extensively on the need to improve project implementation within government. While acknowledging reasons put forward for slow implementation, it was reported that the majority of ministries had not taken advantage of earlier steps to decentralise decision making, including commencement of pre-contract activities, such as identifying suitable land, once the draft expenditure estimates had been approved. It was announced that the Ministries which effectively undertake such activities for the projects included in the 2007/08 development budget would also be allowed to commence pre-contract work for the projects to be undertaken during the remainder of NDP 9. The Ministries are to be given authority to approve project memoranda up to a threshold of P10 million and will be encouraged to request movements of funds from slow- to fast-spending projects rather than request supplementary funding. The Ministries were, however, urged to remain committed to high priority areas rather than concentrate on easy-to-implement projects in order to use allocated funds.

2.19 Technical support departments, both in government and the local authorities, are to be strengthened and tendering procedures at the Public Procurement and Asset Disposal Board (PPADB) have been simplified and are subject to further review. However, effectively supporting the planned further rapid growth of capital will remain a challenge. This is especially the case with the objective of implementing all projects included in the MTR of NDP 9 during the plan period, of which only

two years remain. Even if implementation can be accelerated, ensuring that spending remains cost effective presents a further challenge.²³

2.20 It was also announced that, in order to speed up implementation, the requirement to conduct an EIA would be waived on a case-by-case basis. It is important that this measure is implemented in a manner that could not be perceived as undermining the original objective of taking proper account of environmental considerations. It may also lead to demands for similar treatment for projects initiated by the private sector, for which the requirement for an EIA may be equally burdensome.

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

3.1 Botswana's exchange rate policy objective is to maintain the country's competitiveness as measured by the real effective exchange rate (REER) of the Pula. In the context of the crawling band exchange rate regime introduced in May 2005, it is intended that this will be achieved through a continuous adjustment of the trade-weighted nominal effective exchange rate (NEER) of the Pula at a rate equal to the differential between the Bank's inflation objective and forecast inflation for trading partner countries. As a result of the crawling band mechanism, the NEER of the Pula depreciated by 4.5 percent year-on-year to December 2006.

3.2 Bilaterally, the Pula depreciated in nominal terms against all major international currencies during 2006. The largest depreciation of 19.6 percent was against the British pound, while the smallest (7.3 percent) was against the Japanese yen; the overall depreciation against the SDR was 13 percent. Against the South African rand, there was a small appreciation

22. The 200 percent deduction from tax will now be extended to on-the-job training and part time employees, while the requirement that training should not at the same time add value to the employer's output has been removed.

23. Any 'back-end loading' of the NDP 9 development programme could run into similar problems (such as cost escalation and poor implementation standards) as the front loading during the early years of NDP 8 in the 1990s. To counter this risk, the extensive use of non-local resources may be crucial, although this could be hampered by regional bottlenecks.

TABLE 1.3: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES**Nominal Exchange Rates (foreign currency per Pula)**

As at end of	2005	2006	Percentage Change
SA rand	1.1511	1.1565	0.5
US dollar	0.1814	0.1658	-8.6
Pound sterling	0.1050	0.0844	-19.6
Japanese yen	21.27	19.71	-7.3
SDR	0.1267	0.1102	-13.0
Euro	0.1527	0.1259	-17.6
NEER (index, September 2006=100)	103.6	99.0	-4.5

Real Pula Exchange Rate Indices (September 2006=100)¹

SA rand ²	92.8	97.4	5.0
SA rand ³	93.4	96.2	3.0
US dollar	110.7	107.1	-3.3
SDR	114.2	104.8	-8.2
REER (core)	99.8	99.9	0.1

1. The Botswana CPI has been rebased to September 2006 from the previous base period of November 1996. Therefore, there is a change in both the nominal and real exchange rate indices.
2. Calculated using core inflation. Core inflation is the rate of change of the all items consumer price index excluding mortgage interest costs and prices of various volatile food items.
3. Calculated using headline inflation.

Note: The REER (core) means that the real effective exchange rate was calculated using the South African core inflation.

Source: Bank of Botswana.

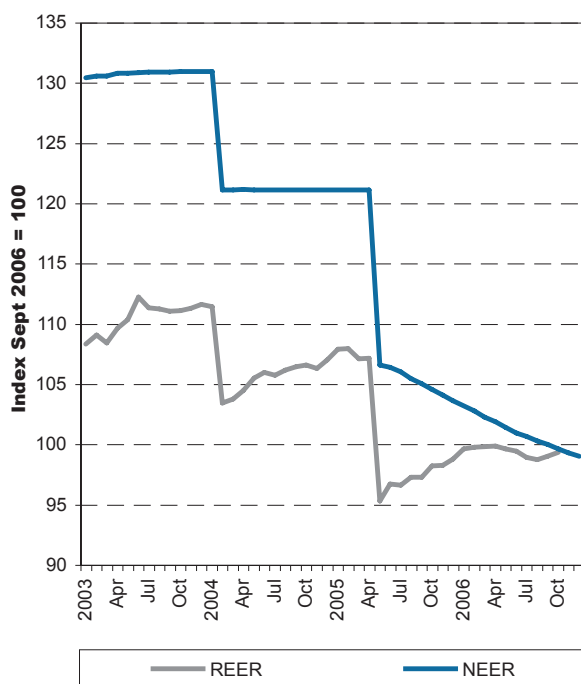
of 0.5 percent. The rand depreciated by 9 percent against the US dollar during the course of the year due to a combination of factors, including heightened global risk aversion towards emerging markets and concern over South Africa's large current account deficit.

- 3.3 During the 12 months to December 2006, the REER of the Pula was virtually unchanged.²⁴ The fall in domestic inflation towards the upper end of the 4–7 percent objective coincided with an increase in inflation in trading partner countries, thus resulting in a narrowing of the inflation differential to a level almost equal to the rate of crawl. However, while this indicates the success of the new exchange rate mechanism in supporting international competitiveness, it is important to emphasise

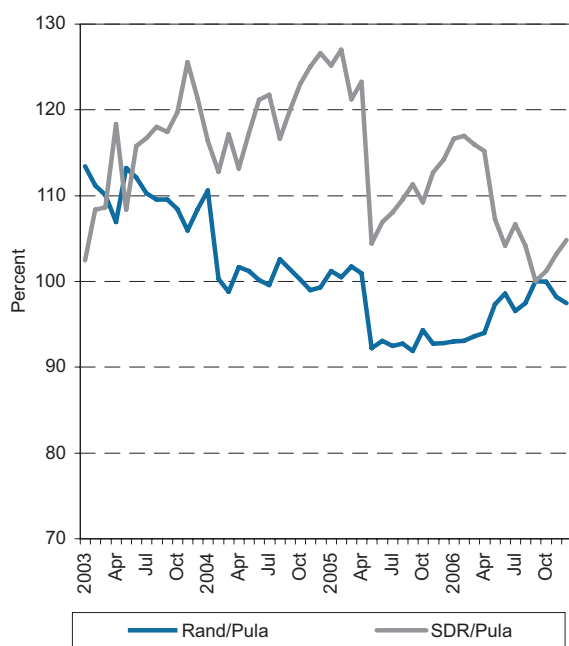
that the key to sustained competitiveness lies with improved factor productivity. A disproportionate reliance on monetary policy and the exchange rate can be costly, both in reducing the incentive for businesses to raise productivity and through the short-term disruptions to economic performance caused by policy adjustments necessary to maintain macroeconomic balance.

- 3.4 While overall, the REER was stable during 2006, bilateral movements were more varied. In line with the significant nominal depreciation against the major international currencies, the Pula depreciated by 8.4 percent and 3.3 percent in real terms against the SDR and US dollar, but appreciated by 5.8 percent against the South African rand (with South African inflation measured on a core inflation basis).

24. Depending on which measure of inflation in South Africa is used, there is either a small real depreciation (headline) or a marginal real appreciation (core; Table 1.3)

CHART 1.7: NOMINAL AND REAL EFFECTIVE EXCHANGE RATES INDICES

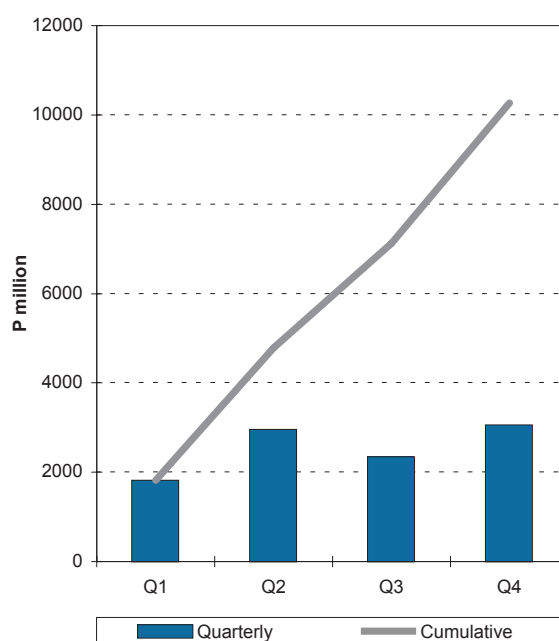
Source: Bank of Botswana.

CHART 1.8: REAL EXCHANGE RATE INDICES

Source: Bank of Botswana.

(b) Overview of the Balance of Payments

3.5 The overall external balance for 2006, derived from changes in the foreign exchange reserve was P10 256 million,²⁵ which is an increase of P3 220 million (45.8 percent) compared to P7 036 million in 2005. Chart 1.9 shows the overall surplus broken down on a quarterly basis; the largest net inflow was in the final quarter.²⁶

CHART 1.9: BALANCE OF PAYMENTS 2006 – QUARTERLY SURPLUS/DEFICIT

Source: Bank of Botswana.

(i) Current Account

3.6 The current account, which consists of merchandise trade, trade in services, income account and current transfers, shows an estimated surplus of P11 926 million in 2006, compared to P7 679 million in the revised estimates for 2005. This 55.3 percent increase is driven mainly by the rapidly growing merchandise trade surplus together

25. The overall balance is equal to the change in total official reserves adjusted for unrealised market and currency revaluation gains/losses.

26. The Bank of Botswana intends to publish detailed estimates of quarterly balance of payments on a regular basis in 2007.

TABLE 1.4: BALANCE OF PAYMENTS: 2001–2006 (P MILLION)

	2001	2002	2003	2004	2005*	2006#
Current Account	3 491	1 244	2 288	1 352	7 679	11 926
of which:						
Merchandise trade	4 149	4 447	4 441	3 904	8 196	11 423
Services	–1 010	182	–46	–204	165	612
Income	–801	–4 418	–3 543	–4 817	–4 148	–3 870
Net current transfers	1 153	1 368	1 436	2 469	3 466	3 761
Financial account	–2 976	–1 375	–1 875	–1 556	–296	–1 693
Capital account	34	4	111	149	161	126
Net errors and omissions	474	462	272	–217	508	–102.7
Overall balance	1 024	336	797	–272	7 036	10 256
* Revised						
# Provisional						
Source: Bank of Botswana						

with increased surpluses in both services and current transfers. The deficit on the income account was also lower than in 2005.

Merchandise trade

- 3.7 As a result of the continued good performance of the mining sector during the year, a surplus of P11 423 million is estimated on the merchandise trade account in 2006. Overall, exports are estimated at P26 558 million, which is a 17.3 percent increase from P22 635 million in 2005. The main contributor to the improved export performance was diamond exports, which increased by 16.1 percent, as they benefited from both increased production volumes and favourable foreign exchange movements, as the depreciation of the Pula against the dollar during 2006 was sufficient to offset a fall in the international prices for rough diamonds of approximately 4 percent. International prices of both copper and nickel continued to increase in 2006, averaging 304 US cents per pound (up from 167 cents/pound in 2005) and 1 100 cents/pound (up from 668 cents/pound), respectively. As a result, although production volumes remained similar to 2005, the value of copper and nickel exports increased by 66.1 percent, thus contributing approximately one third to the overall increase in exports. While production of both soda ash and gold increased in 2006

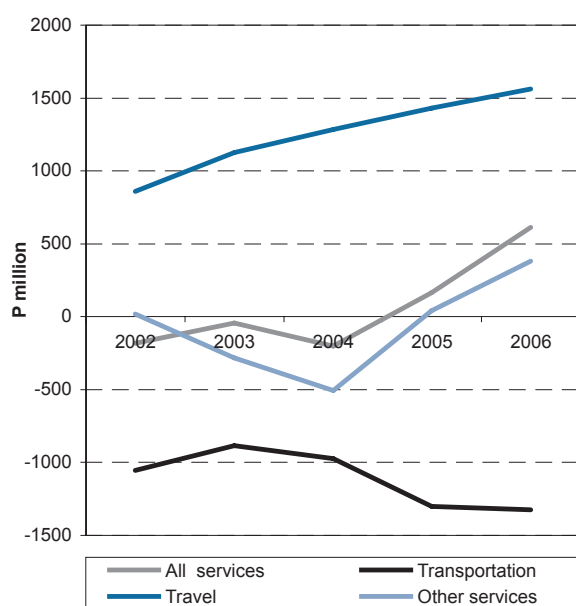
compared to 2005, the impact on export data is yet to be determined.²⁷

- 3.8 Textile exports declined by 18.1 percent to P915 million, after a period of rapid expansion, such as the 99.2 percent growth in 2005. Overall, however, non-mineral export categories continued to show strong growth. For example, the ‘other goods’ category, which includes such diverse products as pasta, chewing gum, biscuits and veterinary vaccines grew by an estimated 87 percent to P898 million.
- 3.9 Imports during 2006 are estimated at P15 138 million, a 4.8 percent increase from P14 440 million in 2005. Notably fuel imports rose by 39.1 percent in 2006 given larger average fuel price increases during the year. In contrast, the value of imports of vehicles and transport equipment fell by 18.3 percent due to both lower numbers of new vehicle registrations in 2006 and a higher proportion of low cost Asian vehicles among new registrations.

Trade in services

- 3.10 Historically, the services account, covering payments related to transportation, travel and other services, has been in deficit due, in particular, to heavy dependence on imports

27. Data on major exports collected by the Bank of Botswana and published in the monthly Botswana Financial Statistics use different data sources from the external trade statistics prepared by the CSO, which results in some discrepancies.

CHART 1.10: BALANCE OF TRADE IN SERVICES (2002–2006)

Source: Bank of Botswana.

with high associated transport costs. However, revised estimates for 2005 show a small overall surplus of P164.7 million, with preliminary indications of a much larger surplus of P612.1 million in 2006 (Chart 1.10). The growing surpluses on the travel account in recent years, which is reflective of increased travel-related spending by non-residents in Botswana, has more than offset the transport deficit. Similarly, 'other services', a category which covers a whole range of services including communication, insurance, legal services, property rental, etc., has moved from chronic deficits, which had kept the overall services account in deficit, to surpluses in 2005 and 2006. However, while this may be an indication of the development of local services, a sharp fall in imports in this category in 2006 could also reflect the slowdown in the domestic economy. Notably, business services, which is the national accounts sub-sector that includes many of the other service categories, recorded negative growth in 2005/06.²⁸

Income Account

- 3.11 The income account registered a deficit of P3 870 million in 2006 compared to P4 148 million in 2005. The credit side of this account is mainly the

earnings from the foreign exchange reserves and the pension funds' investments abroad. Dividends and profits constitute the largest share of the debit components and include actual remittances and retained earnings. However, while contributing substantially to income debits over the past few years, the retained earnings are matched by an equivalent imputed inflow, representing an investment, in the financial account.

(ii) *Capital and Financial Accounts*

- 3.12 Although modest, the capital account, which mainly comprises capital grants to government and the transfer of migrants' assets, continues to record surpluses. The financial account, made up of direct investment, portfolio investment and 'other' investment, shows an estimated net outflow of P1 693 million, mainly driven by continued large outflows of portfolio investment assets. Using pension funds data, a net outflow of P2 938 million was estimated for portfolio investment in 2006, an increase of 48.1 percent over 2005. This could be explained by good performance in world equity markets, together with limited domestic investment opportunities which has led asset managers to invest more offshore. A P228.3 million net outflow was recorded with respect to 'other investment'.

- 3.13 Direct investment into Botswana in 2006 is estimated at P1 592 million, which is mostly the imputed counterpart to retained earnings, which are shown as outflows in the income account.

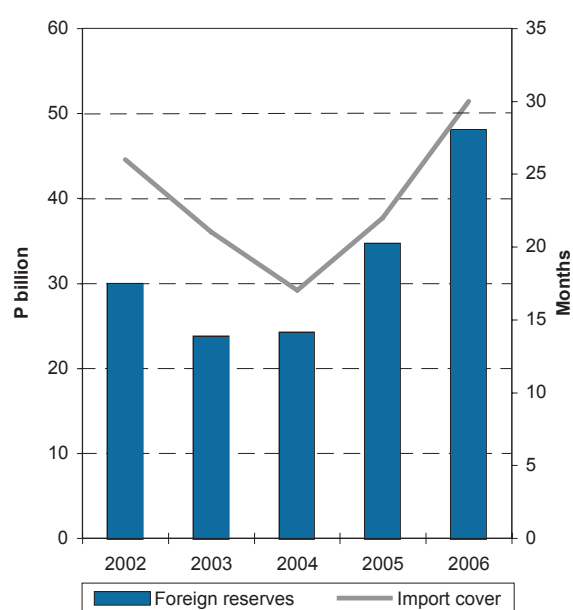
(iii) *Foreign Exchange Reserves*

- 3.14 Official foreign exchange reserves were P48

28. It should be noted that there is a significant margin for error in the data for this item which relies on monthly data on purchases and sales of foreign exchange submitted by the commercial banks. These should detail the purpose of all the transactions. This was possible in the past, prior to the abolition of exchange controls. However, the quality of information has since deteriorated, as there is no legal requirement to produce any documents stating the purpose of transactions. The Bank of Botswana has now introduced a survey on international services which, during 2007, will run parallel with the commercial banks' reports in order to establish a valid method of data collection.

billion at the end of 2006, an increase of P13.4 billion from P34.6 billion in December 2005, and representing 30 months of imports of goods and services (Chart 1.11). In US dollar and SDR terms, the reserves grew by 26.7 percent and 18.4 percent, respectively. The substantial difference between the total increase in reserves and the balance of payments surplus over the same period is due to significant unrealised valuation gains resulting from both the gradual depreciation of the Pula during 2006 against the currencies in which the reserves are held, and the good performance of world equity markets, particularly in the second half of the year.

CHART 1.11: FOREIGN EXCHANGE RESERVES AND IMPORT COVER



Source: Bank of Botswana.

(c) International Investment Position (IIP) and Foreign Investment

3.15 Detailed data for the IIP, which records the stock of foreign financial assets and liabilities, are available up to 2005. For 2006 only major aggregates have been estimated.

(i) International Investment by Botswana

3.16 Total foreign assets (i.e., Botswana-owned assets held abroad) rose by 42.9 percent in

2005 to P56 billion. There was strong growth across all major categories, but the increase from P39.2 billion in 2004 was driven by portfolio investment and reserve assets. Portfolio investment increased by 60.4 percent, from P9 billion to P14.4 billion, while reserve assets grew by 43 percent from P24.2 billion to P34.6 billion. Direct investment abroad by Botswana grew by 7.9 percent to P4.4 billion, while the other investment category rose by 34.6 percent, due mainly to an increase in lending and trade credit.

3.17 The increase in foreign assets in 2006 is provisionally estimated at P18.6 billion, raising the total by 33.3 percent to P74.6 billion. This was dominated by growth in reserve assets from P34.6 billion to P48 billion, an increase of 38.7 percent, resulting from the widening overall surplus on the balance of payments which was, in turn, driven by the large trade surplus, as well as the good performance in international financial markets. Portfolio investment increased by P4.4 billion, which is the same Pula value as in the previous year, but at a much reduced growth rate of 30.9 percent. Other investment assets rose from P2.6 billion to P3.3 billion (an increase of 26.9 percent), while direct investment abroad is estimated to have increased slightly from P4.4 billion to P4.5 billion.²⁹

(ii) Investment in Botswana by Industry and Country Classification

3.18 Tables 1.4 and 1.5 show Botswana's stock of foreign liabilities (i.e., investment from abroad in Botswana) at the end of 2005 classified, respectively, by industry and country.³⁰ Mining continues to dominate total foreign direct investment and accounts for 60 percent of the total, followed by the finance sector at 29 percent. As in 2004, Europe continued to be the principal source of direct investment,

29. FDI by Botswana abroad mainly consists of the Government stake in a major international mining company which is large enough to be classified as direct investment.

30. These figures are based on the 2005 Balance of Payments Survey conducted by the Bank of Botswana.

TABLE 1.5: LEVEL OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY, END OF 2005 (P MILLION)

Industry	Direct Investment			Other Investment		
	Equity	Non-Equity	Total	Equity	Non-Equity	Total
Mining	2 522	126	2 648	0	2 732	2 732
Manufacturing	98	48	146	0	212	212
Finance	1 040	250	1 290	3	1 328	1 331
Retail and wholesale	9	120	129	0	239	239
Electricity, gas and water	0	0	0	0	176	176
Real estate and business services	94	0	94	2	54	56
Transport, storage and communication	30	67	97	0	32	32
Construction	0	1	1	0	4	4
Hospitality	15	8	23	0	1	1
Public administration	0	0	0	0	2 189	2 189
Other	1	16	1	0	38	38
Total	3 809	636	4 445	5	7 105	7 110

Source: Bank of Botswana.

TABLE 1.6: LEVEL OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY, END OF 2005 (P MILLION)

Country	Direct Investment			Other Investment		
	Equity	Non-Equity	Total	Equity	Non-Equity	Total
North and Central America	14	0	14	0	267	267
of which:						
United States	8	0	8	0	267	267
Europe	3 121	78	3 199	2	2 743	2 745
of which:						
United Kingdom	576	8	427	0	47	47
Netherlands	48	5	53	0	0	0
Luxemburg	2443	3	2446	0	54	54
Germany	0	0	0	0	2 093	2 093
Other Europe	0	62	0	0	549	549
Asia Pacific	30	123	153	0	529	529
Africa	602	410	1 013	0	1 229	1 229
of which						
South Africa	558	382	940	0	1 037	1 037
Middle East	33	23	56	0	56	56
Other	4	2	6	3	2 281	2 284
Total	3 804	636	4 440	5	7 105	7 110

Source: Bank of Botswana.

accounting for 72 percent, with Luxemburg contributing three quarters of Europe's direct investment. This reflects the residence status of the major mining investors in Botswana.

- 3.19 In 2005, Germany became the dominant source of 'other investment', due to a loan extended to the mining industry, as underscored by the largest proportion of the 'other investment' in the

mining sector of 38 percent of the total figure. This was followed by the Government's external debt, classified under public administration at 31 percent. The finance sector, covering mostly currency and deposits, accounted for 19 percent, up from only 3 percent in 2004.

- 3.20 In 2006, total foreign liabilities are estimated to have increased by 21 percent from P12

billion to P15 billion. This increase is reflected in the value of all the three components: direct investment, portfolio investment and other investment. The 2006 net international investment position is estimated at P60 billion, compared to P43 billion in 2005.

4. MONEY AND CAPITAL MARKETS

(a) Monetary Policy and Liquidity Management

- 4.1 The objective of monetary policy is to achieve low, predictable and stable inflation, which contributes towards stability of the REER and, in turn, supports the international competitiveness of domestically produced goods and services. In 2006, the Bank of Botswana, through the *Monetary Policy Statement* (MPS), maintained the annual inflation objective of 4–7 percent. This objective range was increased from 3–6 percent following the mid-year review of the 2005 MPS in order to accommodate part of the direct impact on inflation of the May 2005 devaluation and other cost adjustments.
- 4.2 For 2006, it was anticipated that inflation would remain significantly above 7 percent, even after the effect of the devaluation began to drop out of the inflation calculation, and that it would be much higher than the average inflation in trading partner countries. An important policy development announced in the 2006 MPS was the introduction of the medium term inflation objective (3 years to 2008). The 3–6 percent medium-term inflation objective was introduced in recognition of the fact that the monetary policy transmission process from interest rates to the ultimate objective of price stability takes time. The objective is intended to anchor inflation expectations beyond the short-term, while the medium-term horizon would also provide the Bank with sufficient time to direct the policy actions to the sources of inflation that are directly under the influence of monetary policy. Furthermore, it was considered that

the medium-term inflation objective would provide scope for more effective broad policy discussion and coordination with stakeholders, with a view towards achieving low and stable inflation.

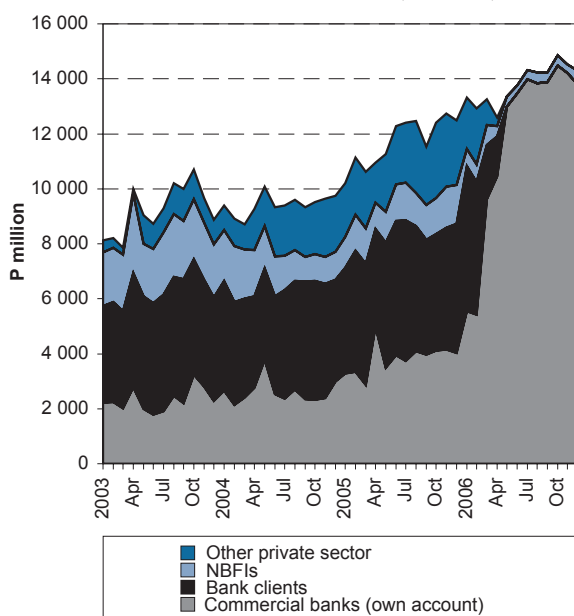
- 4.3 Inflation rose at the beginning of the year mainly as a result of the re-introduction of tuition fees in public secondary schools and the increase in meat prices.³¹ As a result of the negative inflation outlook, and to signal the commitment to achieving low inflation and restrain possible second-round effects, as well as influence inflation expectations, the Bank Rate was increased by 50 basis points to 15 percent in February 2006.
- 4.4 In May 2006, inflation began a downward trend as the impact of the May 2005 devaluation started to dissipate. Domestic demand pressures were generally moderate during the year. Despite the sustained increase in the growth rate of credit to the private sector, it was only in the final quarter that this exceeded the Bank's target range while, at the same time, growth in government expenditure was significantly lower than the budgeted increase of 14.9 percent for 2006/07. Globally, despite the generally higher international oil prices, economic activity remained robust while global inflation increased modestly. Global inflation was restrained by the pre-emptive tightening of monetary policy, productivity gains and increased market competition.
- 4.5 In order to manage excess liquidity in the domestic banking system, the Bank conducted open market operations to ensure that short-term interest rates, particularly yields on Bank of Botswana Certificates (BoBCs), were consistent with the restrictive monetary policy stance. As a result, the nominal 3-month BoBC rate ranged between 12.20 percent and 12.74 percent in 2006, while the 14-day

31. Expectations of higher inflation may have intensified following the publication of data which initially included erroneously high estimates of the impact on the overall price level of the re-introduction of secondary school fees.

BoBC³² rate fluctuated between 12.27 percent and 12.77 percent, and registering the highest yield in April.³³ In addition, a one-year BoBC was re-introduced in March 2006 with the objective of accommodating unmet demand for longer-dated securities and, in the context of an inverted yield curve, to reduce the costs of absorbing excess liquidity. The yield on this instrument was lower, at 11.89 percent, during 2006.

- 4.6 The market value of outstanding BoBCs was P14 303 million in December 2006, an annual growth of 14.5 percent compared to an increase of 28.1 percent in 2005. Effective March 1, 2006, the primary counterparty status in dealing on BoBCs was confined exclusively to commercial banks and African Banking Corporation of Botswana Limited (ABC, merchant bank), with a view to enhance the efficacy of market operations and effective liquidity management.

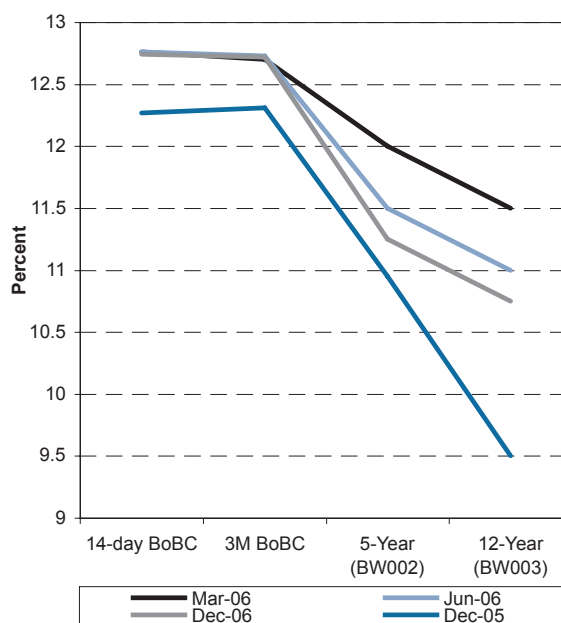
CHART 1.12: OUTSTANDING BANK OF BOTSWANA CERTIFICATES (BoBCs)



Source: Bank of Botswana.

32. The 14-day BoBC was introduced in November 2004 to enhance liquidity absorption at the short-end of the domestic money market.
33. The 14-day, 3-month and 364-day BoBC rates are weighted averages of the winning bids at auctions.

CHART 1.13: YIELD TO MATURITY ON BoBCs AND GOVERNMENT BONDS



Note: The interest rates for the BoBCs and government bonds of all maturities were unchanged from September to December 2006.

Source: Bank of Botswana.

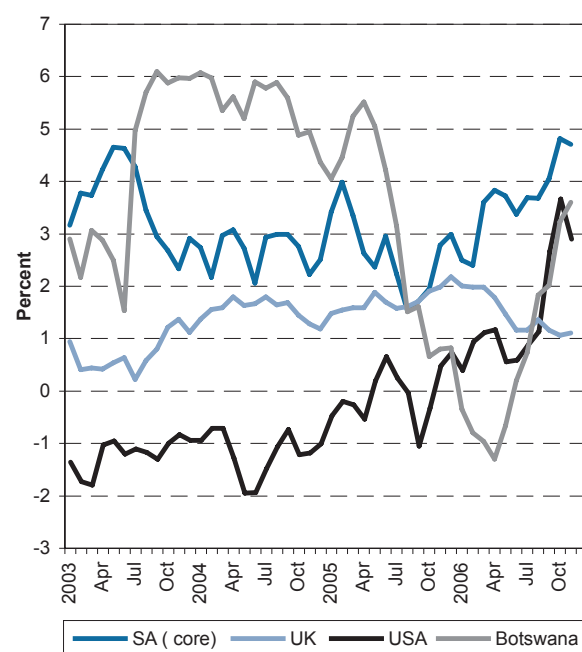
(b) Interest Rates

- 4.7 In response to the increase in the Bank Rate by 50 basis points, from 14.50 to 15 percent in February 2006, commercial banks increased their prime lending rates by an equivalent amount to an average of 16.50 percent from 16 percent. During 2006, the average interest rate paid by commercial banks on 88-day deposits rate fell to 8.38 percent from 8.93 percent in December 2005. This was despite the generally higher yields on BoBCs, and appears to be due, in part, to the largely passive response by the banks in developing competitively-priced new savings products following the surge in deposits that resulted from restricting BoBC holdings to banks only, as well as the impact of the increase in reserve requirements from 3.25 percent to 5 percent.

- 4.8 As was the case in the previous year, real interest rates varied widely during 2006, trending up over the year as a whole on account of the decline in inflation together with the restrictive monetary policy that was

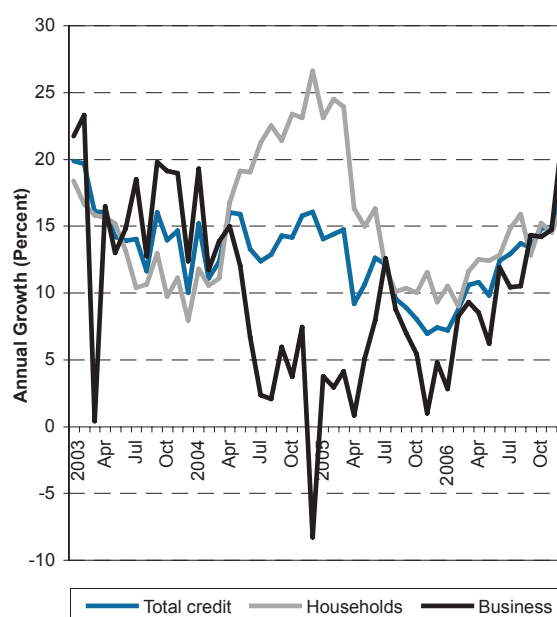
maintained throughout the year. The real 3-month BoBC rate ranged between -1.3 percent and 3.9 percent and averaged 1 percent in 2006, compared to a range of 0.7 percent to 5.5 percent and an average of 3 percent in 2005 (Chart 1.13). At the end of 2006, the real commercial bank prime lending rate was 7.4 percent, compared to 4.1 percent in December 2005.

CHART 1.14: REAL INTEREST RATES – INTERNATIONAL COMPARISONS



Source: Bank of Botswana.

CHART 1.15: COMMERCIAL BANK CREDIT



Source: Bank of Botswana.

(c) Banking System

(i) Domestic Credit

- 4.9 The annual growth rate for commercial bank credit rose substantially from 7.4 percent in December 2005 to 18.8 percent in December 2006. Although the trend was generally upward, for most of the year, the rate of expansion was within, and at times below, the 11–14 percent range that the Bank considered to be consistent with the inflation objective for 2006. The sharp increase in December was due mainly to the increase in credit to businesses, which accelerated to 21.7 percent from 14.2 percent in November, and was confined to a few large companies. The annual rise in lending to businesses was 4.8 percent in December

2005. Lending to households, which accounts for about 60 percent of total commercial bank credit, also increased annually at 16.7 percent, in December 2006, compared to 9.3 percent a year earlier. Growth in household borrowing was stimulated partly by the 8 percent increase in civil service salaries which raised demand for loans across a range of categories,³⁴ while there was intense marketing by commercial banks of household lending products.

(ii) Monetary Aggregates

- 4.10 At the beginning of 2006, the monetary survey conducted by the Bank of Botswana was expanded into a *depository corporations survey*, which covers commercial banks and other deposit-taking institutions.³⁵ This was accompanied by refinements to the various

34. Reported levels of lending to households for motor vehicles fell during 2006 (Table 3.21 in the statistical section of the Report). However, this may have been due to the increased demand for cheap second hand imports from Asia, which some banks have been reluctant to finance through standard vehicle finance schemes.

35. Specifically, merchant banks, the Botswana Building Society and Botswana Savings Bank are now included in the expanded survey. This is in line with international practice as set out in the International Monetary Fund's *Monetary and Financial Statistics Manual*, 2002.

monetary aggregates, including discontinuing the use of M4 following the inclusion of foreign currency accounts (FCAs) in other aggregates as determined by the maturity of deposit categories. Given the decision to restrict holdings of BoBCs to banks, M3 is currently equivalent to M2. However, M3 continues to be shown separately as it could, in principle, include other securities issued by depository corporations that are not subject to the same restrictions of BoBCs.

- 4.11 Using the new monetary aggregate measures, growth in broad money (M3) during 2006 was 8.8 percent, down from 14.3 percent in 2005. The increase in money supply in the year to December 2006 was due to a 35.8 percent growth in net foreign assets, while the 63.8 percent increase in government deposits at the Bank of Botswana was contractionary. By component, there was a substantial 81.8 percent growth in non-transferable deposits (other than current account deposits) as non-banks switched from holding BoBCs. At the same time, foreign currency deposits increased by 113.6 percent in Pula terms in 2006 and accounted for more than a quarter of total deposits. Unlike in 2005, when the introduction of the crawling band exchange rate mechanism resulted in rapid growth in current and call categories of foreign currency deposits, the increase in 2006 was concentrated in longer-term deposits, thus indicating diversification away from Pula-based investments following the new restrictions on BoBC holdings.

(iii) *Bank of Botswana*

- 4.12 Total assets/liabilities of the Bank of Botswana grew by 48.4 percent to P48.3 billion in 2006, from P34.9 billion in 2005. This was the second successive year of rapid balance sheet expansion, following an increase of 42.4 percent in 2005. The 2006 expansion was mostly due to the significant growth in Government deposits at the Bank which rose by 60.1 percent to P21.3 billion, and the revaluation reserve, which increased by 56.8 percent due to currency revaluation gains as

the Pula depreciated against the currencies in which the reserves are held.

(iv) *Commercial and Merchant Banks*

- 4.13 During 2006, the number of commercial banks operating in Botswana increased from 5 to 6, with the licensing of Bank Gaborone Limited in February. The bank is majority owned by Capricorn Limited, the parent company for Bank Windhoek, a Namibian bank. Also, as product competition in the financial sector increased, the Bank of Botswana approved an application for the introduction of Islamic Finance products by First National Bank Botswana Limited and granted Barclays Bank of Botswana Limited permission to provide insurance services to its customers across banking hall counters.
- 4.14 Total assets and liabilities of commercial banks increased by 64.8 percent to P29.3 billion in 2006, compared to 19.7 percent growth in 2005. The main reason for rapid growth was the new policy restricting holdings of BoBCs to banks only. The BoBCs previously held by non-banks were converted into deposits at the commercial banks, following which the banks initially acquired additional BoBCs, which rose from P4 010 million to P13 504 million, an increase of 236.7 percent. Overall, total bank deposits increased by 74.6 percent, from P13.2 billion to P23.1 billion, the bulk of which was in fixed deposits of up to six months maturity.
- 4.15 Total assets/liabilities of ABC, the only merchant bank operating in Botswana, increased by 24.9 percent in 2006, compared to 20 percent in 2005. Loans and advances grew by 45.9 percent, reversing a decline of 35.3 percent in 2005. The main source of additional expansion was the US\$20 million in long term financing from the African Development Bank (ADB), channelled through the National Development Bank (NDB) in Botswana. Deposits from the public were virtually unchanged over the year, rising by only 1.7 percent to P768 million, while holdings of BoBCs, fell year-on-year by 6.5 percent.

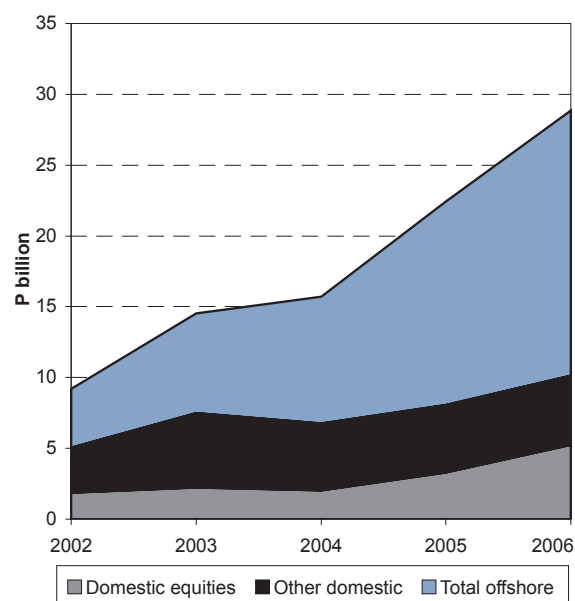
(d) Non-Bank Financial Institutions

4.16 The total assets/liabilities of the Botswana Building Society (BBS) increased by 33.3 percent in 2006, compared to 16.1 percent in 2005. Loans and advances, which are predominantly mortgage loans, rose by 24.9 percent, to P906.7 million. Cash and deposits at other banks increased by 416 percent, largely attributable to the switch from BoBCs to bank deposits. For the Botswana Development Corporation (BDC), assets/liabilities increased by 7.2 percent in the twelve months to September 2006 to reach P1 683.2 million, in contrast to a slower growth rate of 4.4 percent in 2005. The rise in assets was due to a 15.3 percent increase in investments in related companies, while loans, advances and leasing fell by 4.9 percent in the same period. The Corporation's deposits in commercial banks increased from virtually zero to P386.6 million, again due to the switch from BoBCs. In the case of NDB, total assets/liabilities grew by 3.1 percent in 2006, following a much faster growth of 29.7 percent in 2005 and was mostly driven by a 29.2 percent increase in loans and advances. Assets of the Botswana Savings Bank (BSB) rose by 12.7 percent, compared to 6.2 percent in the previous year.

4.17 During 2006, pension fund assets grew by 30.5 percent from P22.3 billion at the end of 2005 to P29 billion (Chart 1.16). Of this total, about 81 percent comprised assets of the Botswana Public Officers Pension Fund (BPOPF). The strongest growth of 45.7 percent was in holdings of equities, the domestic component of which rose by 78.1 percent, while the offshore investment increased by 30.9 percent and amounted to 64.8 percent of the total investment by the BPOPF.³⁶

4.18 The domestic companies index (DCI) of the Botswana Stock Exchange (BSE) rose sharply in 2006, as the already strong demand for shares (the index rose by 23 percent in

CHART 1.16: BOTSWANA-PENSION FUND ASSETS (2002–2006)



Source: Ministry of Finance and Development Planning.

2005) was fuelled by funds previously held in BoBCs. The DCI gained 2 636.4 points, or 74.1 percent, to end the year at 6 195.5 while market capitalisation grew at a higher rate of 77.2 percent to P23 777 million over the same period. In US dollars, the DCI rose by 59 percent. The foreign companies index was also significantly up by 57.3 percent during 2006, although the rate was slower than the 78 percent in 2005. Trading was very active by historical standards, with 87.2 million shares valued at P415 million traded, compared to only 44.1 million at a total value of P239 million in the previous year.

4.19 The number of domestic companies listed on the BSE at the end of 2006 was 19, unchanged from 2005. However, the composition changed as Afrotourism Limited was de-listed from the exchange in September (trading in its shares had been suspended since July 2004), while Imara Holdings, a financial services group, was listed in October. The number of foreign companies on the local exchange rose from 9 to 12, with all new entrants engaged in minerals related operations. The number of domestic companies on the Venture Capital Board (VCB) of the BSE was unchanged

36. Pension Funds are not permitted, as a prudential measure, to invest more than 70 percent of their portfolio offshore.

at two while the number of foreign listings increased from four to six, bringing the total on the VCB to eight.

- 4.20 As of December 2006, the par value of the two outstanding Government bonds was P1.75 billion, with original maturities of 5 years and 12 years and yields at auction of 11.25 percent and 10.75 percent, respectively. In the 2007 Budget Speech, it was announced that the 5-year bond will be rolled over upon maturity in 2008 in support of capital market development and provide funds for the Tertiary Education Development Fund. During 2006, secondary market activity for the bonds was negligible at P37.5 million, compared to P662 million in 2005. There were no transactions involving the 12-year bond, while trading in the 23 non-government bonds listed on the BSE was also minimal. The absence of trading in the bond market points to substantial demand for longer-dated securities, especially among institutional investors, and was in contrast to increased liquidity in the trading of shares where investor sentiment appears to be driven by shorter term considerations. At the same time, higher and more variable inflation may have further reduced interest in bond trading.
- 4.21 Among the best performers on the BSE during 2006 was Letshego, a consumer finance company. Its shares rose by 125 percent during the course of the year due to strong loan book growth of 35 percent and expansion both locally (as satellite branches successfully opened in Botswana) and regionally, with operations established in Tanzania, Swaziland and Uganda and scheduled for Zambia in 2008.
- 4.22 Four new IFSC companies were issued with exemption certificates, bringing the number of IFSC entities granted regulatory approval to 17. The centre also plans to establish a pan-African commodities exchange in Botswana. Six new bureaux de change were licensed and one was closed, bringing the number of operational bureaux de change at year end to 42.

(e) Credit Rating

- 4.23 In 2006, and for the sixth time since 2001, the international rating agencies, Moody's Investors Service (Moody's) and Standard and Poor's (S & P), both conducted annual reviews of Botswana's sovereign credit ratings. In the case of Moody's the ratings were maintained at A2 for long-term foreign currency debt, Prime-1 (P-1) for short-term foreign currency debt and A1 for domestic currency debt, as well as the stable outlook. In addition, the highest possible rating for long-term debt issued in Botswana by non-government entities, such as parastatals or private sector companies, was adjusted upwards from A2 to Aa3 following a change in the methodology.³⁷ S & P reaffirmed Botswana's original sovereign credit rating of A/A-1 for foreign currency and A+/A-1 for local currency credit ratings. The relatively high ratings reflect Botswana's continued strong financial position, a well-managed and growing economy and political stability. The agencies were positive about progress made in implementing economic reforms necessary to diversify the economy. However, the ratings remain constrained by several factors including, in particular, the narrow economic base that is still heavily reliant on mining as a source of additional growth and government revenue, as well as the fiscal pressures associated with the costs of tackling the HIV/AIDS pandemic.

(f) Other Financial Sector Developments

- 4.24 In December 2006, Parliament approved the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) Bill, which will place the supervision of all non-bank financial institutions under one regulatory authority. The establishment of the authority is in response to the growth of non-banks, which now dominate the financial sector. For example, the assets of the pension funds have grown to be comparable

37. Previously, the highest rating available to non-government borrowers had been constrained by that awarded to governments.

to those of the commercial banks at about P29 billion at the end of 2006 while the assets of the insurance industry were approximately P12.4 billion. The NBFIRA will have powers to license, regulate and inspect, as well as initiate legal action on behalf of claimants who have suffered losses; and its powers will extend to the supervision of smaller operations, such as brokers and money lenders. However, in some cases the authority may make provision for a more arms-length approach where qualifying institutions can be declared self-regulatory. NBFIRA is expected to be operational by the end of March 2008.

- 4.25 During 2006, there was a major reform in the National Payments System (NPS), which entailed the implementation of the Botswana Interbank Settlement System (BISS), commonly known as the Real Time Gross Settlement (RTGS) system. BISS became operational in November 2006, with the system allowing funds transfer between banks and customer accounts within Botswana without any paper-driven instructions. All instructions are electronically conducted with the SWIFT network as the message carrier. The system helps manage and mitigate credit, liquidity and settlement risks, thus providing a platform for a vibrant and expanding economy to enter into both regional and global financial markets with a high level of confidence in its payments system. It facilitates compliance with the Bank for International Settlements' Core Principles for Systematically Important Payments and Securities Settlement systems.

CHAPTER 2

CURRENT ECONOMIC CHALLENGES IN BOTSWANA

1. INTRODUCTION

- 1.1 As Botswana celebrated forty years of independence in 2006, there continued to be intense public debate about the state of the economy. Among others, the debate reflects concerns about the decline in the growth rate of the country's economy, persistent high rates of unemployment, which includes the emerging incidence of unemployment among university graduates and the related problem of poverty, slow progress towards economic diversification and inadequate foreign direct investment (FDI). Invariably, there is lack of public consensus on the assessment of the economic situation, its outlook and the appropriateness of policies. Consequently, in recognition of persistent and growth-limiting economic problems and the need to refocus policies, the Business and Economic Advisory Council (BEAC) was set up towards the end of 2005, with the mandate to advise the Government on policies and programmes for sustainable long-term economic diversification and growth, employment generation, attraction of significant flows of FDI and reduction of poverty. BEAC submitted its report to the Government in November 2006.
- 1.2 Botswana's economy is continually undergoing transformation and, as a result, the challenges that the country faces evolve and become increasingly complex, particularly in the context of competitive global production centres and markets, as well as greater demand for access to information and transparency. It is, therefore, appropriate that the 2006 Bank of Botswana *Annual Report* theme topic reviews the economic challenges facing the country and suggests possible policy options to sustain robust economic performance and ensure rising living standards for Botswana in the years ahead.
- 1.3 It is recognised that despite the country's economic achievements in the past 40 years, some

of the initial development challenges remain. These include heavy reliance of the economy on the dominant mining sector, perceptions of inadequate economic empowerment of citizens, high levels of poverty, skewed wealth and income distribution, and insufficient job creation in the formal sector. Moreover, new challenges have inevitably emerged during the economic transition from low- to middle-income status. Among the emerging issues that require attention are changes in the external environment, such as the increase in global competition for resources, markets and hosting of production centres, as well as challenges relating to the increased global access to information and the country's capability to adapt to fast-changing technologies. In addition, the HIV/AIDS epidemic threatens to reverse many of the socio-economic achievements made since independence. Section 2 of this review briefly outlines the challenges that the country faced at independence and the progress made in developing the economy, while Section 3 discusses the more enduring and emerging challenges and their impact on the economy and growth prospects.

- 1.4 In examining possible solutions to these challenges, Section 4 of the theme chapter outlines several policy initiatives, structural reforms and efforts towards improving implementation and success of new policies. In turn, Section 5 evaluates the relative success of these initiatives, while Section 6 examines possible alternative reforms and improvements to recent initiatives that could mitigate the persistent challenges and enable the country to effectively harness opportunities that arise from them. Section 7 provides a conclusion on the issues addressed in the report.

2. SUMMARY OF ECONOMIC CHALLENGES AND PROGRESS SINCE INDEPENDENCE

2.1 At independence in 1966, Botswana was among the poorest of the world's least developed countries. The country's development budget and a significant part of its recurrent budget were funded through foreign aid, including grants mainly from the United Kingdom.¹ There was marginal exploitation of mineral resources for development, while industry was almost non-existent, comprising little more than the Lobatse abattoir and a small manufacturing sector based mainly on the livestock industry. The necessary infrastructure to support economic development was also inadequate. Other than the railway line from South Africa passing through Botswana to Zimbabwe (then Rhodesia), there was very little basic infrastructure, with limited availability of telecommunications and transport.

2.2 Outside agriculture, employment opportunities were also very limited. Out of a population of about half a million, less than 30 000 persons were engaged in salaried employment in the country; and, of these, the few well-paying jobs in government were mainly held by expatriates due to low levels of education among Botswana. Notably, salaried or wage employment was less than the estimated 32 000 migrant Botswana workers mostly employed in the South African mines in 1965. Informally, however, there were almost 230 000 people employed in agriculture, mainly traditional pastoral and arable farming. The limited income generating opportunities both at individual and national level, as reflected in real per capita gross domestic product (GDP), measured in 2004/05 prices, of about P2 000 (US\$460)² in 1966, led to widespread poverty and low standards of living.

2.3 The contribution of human resources to eco-

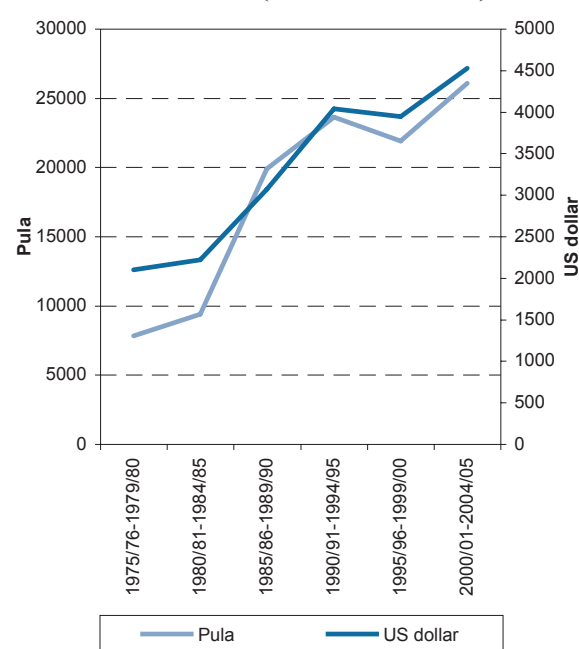
nomics was also hampered by the minimal health and education facilities, creating an unattractive climate for industrialisation and making it difficult to diversify the economy away from agriculture. For example, while there were 250 primary schools with an enrolment of 72 000 pupils, at independence, there were only 9 secondary schools with 1 500 students. In 1965, secondary schools produced just 16 students of sufficient standard to undertake higher education, and the number of Botswana degree holders was only about 40.

2.4 Broadly, at independence, Botswana had an undiversified economy that was heavily reliant on a poorly performing agricultural sector which, in turn, was vulnerable to recurring droughts. The country also lacked infrastructure, as well as social amenities and services, which contributed to low levels of income, poor standards of living and a high incidence of poverty. In the circumstances, the Government undertook a development programme aimed at raising living standards through employment creation and the provision of infrastructure and social services, underpinned by prudent and growth supporting macroeconomic policies. Essentially, the country adopted a mixed economy model that recognised the need for free market capital and enterprise to exploit economic opportunities and generate employment, while the Government ensured wider provision of infrastructure and services to enable broad-based development and social harmony. This approach is clear from the initial development plans that guided implementation of the country's development strategy and is also encapsulated in the national principles of democracy, development, self-reliance and unity.

2.5 The attainment of the country's development goals was helped significantly by the development of mines in the early 1970s, notably of copper/nickel and, most importantly, diamonds, which substantially enhanced Botswana's economic performance.

1. For more detail on the situation in Botswana at the time of independence, see the 'Bechuanaland Protectorate Development Plan 1963/68' and the 'Transitional Plan for Social and Economic Development 1966'.

2. Source: Bank of Botswana.

CHART 2.1: FIVE-YEAR AVERAGE PER CAPITA INCOME (2004/05 PRICES)

Source: Central Statistics Office and Bank of Botswana.

Chart 2.1 shows that since the 1970s, real GDP per capita measured in 2004/05 prices, had risen substantially, with the five-year average

rising from P7 815 (US\$2 098) for the period 1975/76–1979/80 to P26 072 (US\$4 526) for 2000/01–2004/05.

2.6 The faster growth in the mining sector, driven mainly by diamonds, led to its share in GDP rising from virtually zero in 1966 to 12 percent in 1971/72 and further to 40 percent in 2003/04. Meanwhile, the contribution of agriculture to GDP declined from 39 percent in 1966 to 19 percent in the latter half of the 1970s; it fell further to 6 percent in the late 1980s and averaged just above 2 percent between 2000/01 and 2004/05. This is indicative of sustained stagnation over a long period, despite substantial assistance to farmers by the Government.³ Apart from the more substantial changes in the shares of mining and agriculture in GDP, there has been an increasing importance of financial and business services and a modest rise in government participation in the economy, while the share of manufacturing in the country's output has declined. Table 2.1

TABLE 2.1: SECTORAL SHARES AS A PERCENTAGE OF TOTAL GDP

Economic Sector	YEAR ¹					
	1975/76– 1979/80	1980/81– 1984/85	1985/86– 1989/90	1990/91– 1994/95	1995/96– 1999/00	2000/01– 2004/05
Agriculture	20.0	9.5	5.4	4.4	3.2	2.2
Mining	19.5	32.0	46.6	36.5	37.9	40.0
Manufacturing	5.9	5.8	5.2	4.7	4.9	3.9
Water and Electricity	2.6	2.4	2.4	2.1	1.9	2.3
Construction	8.4	6.1	5.2	6.8	5.7	4.8
Trade, Hotels & Restaurants	7.4	6.5	6.2	7.0	9.9	10.4
Transport	2.7	2.5	2.6	3.5	3.4	3.2
Banks, Insurance & Business Services	7.2	6.8	6.4	9.4	10.3	10.2
General Government	14.6	15.7	12.8	14.9	14.7	15.4
Social and Personal Services	3.5	3.2	3.0	4.2	3.8	3.5
Adjustment items of which:						
FISIM ²	–1.8	–2.0	–2.1	–2.4	–3.0	–3.5
Taxes on Imports	9.0	10.8	6.2	8.1	5.8	4.6
Taxes on Products	1.1	1.1	0.4	1.3	1.8	3.4
Subsidies on Products	–0.1	–0.2	–0.5	–0.4	–0.5	–0.5

1. National accounts years run from July to June of the following year.

2. Financial Intermediation Services Indirectly Measured.

Source: Bank of Botswana.

3. Over the three decades covered in Table 1, value added in the agricultural sector grew by just 7 percent.

compares the distribution of real GDP by type of activity from the mid-1970s to the early 2000s, and shows the significant changes in the structure of the economy over the years.

- 2.7 The rapid growth of diamond output also impacted significantly on government revenue, helping to drive the development process through investment in basic physical infrastructure and development of human resources through increased outlays on health and education. Notably, from less than 10 kilometres of tarmac road in 1966, a network of tarred roads now links all the major population centres with extensive coverage of other settlement areas. The development of the road infrastructure significantly improved

- 2.8 Such improvements impacted positively on human lives; life expectancy at birth rose from 46 years in 1966 to 65.3 years in 1991. The infant mortality rate fell from 108 per 1000 live births in 1966 to 48 per 1000 live births in 1991, while the adult literacy rate rose from 34 percent in 1981 to 78.1 percent in 2001. However, the health gains have been eroded, to a significant extent, by the scourge of HIV/AIDS, which continues to have a devastating impact on prospects for social and economic development in Botswana. Table 2.2 shows that life expectancy fell from 65.3 years in 1991 to 55.6 years in 2001,⁴ while the infant mortality rate rose from 48 per 1000 live births to 56 per 1000 live births over the same period.

TABLE 2.2: SOCIAL INDICATORS FOR BOTSWANA

Year	Life Expectancy at Birth (Years)	Adult Literacy Rate (Percent)	Population without access to safe water (Percent)	Population without access to health services (Percent)	Infant Mortality Rate (Per 1000 Live Births)
1971	55.5	...	...	...	97
1981	56.5	34.0	11.0	...	71
1991	65.3	54.0	7.0	15.0	48
2001	55.6	78.1	5.0	12.0	56

Note: ... indicates that data were not available to the Bank of Botswana at the time of publication.

Source: CSO.

transportation of goods and services, as well as passenger services. Investment in education resulted in an increase in the number of primary schools to 761, with an enrolment of 333 000 in 2002. Meanwhile, secondary schools grew from 9 to 281 between 1966 and 2002, with the number of pupils increasing 100-fold to 156 000. In the same period, the number of health centres increased from about 100 at independence (most of which were partly manned dispensaries) to 1 426. In addition, sufficient government revenue and the country's growing international financial standing enabled the funding of parastatals to develop infrastructure by way of, for example, providing housing, electricity and telecommunications, as well as reticulation of potable water.

- 2.9 It is important to recognise that, although diamonds had a significant impact on the development of the country, this was within the context of political stability and prudent macroeconomic policy management, both of which contributed to Botswana's economic success, and facilitated balanced and orderly execution of plans and use of resources. Botswana has, over the past four decades, created a democratic political dispensation that fosters freedom of expression, while appropriate economic policies have mainly supported sustainable economic growth. Moreover, it was recognised that the revenues were derived from a non-renewable resource and should, therefore, be used to fund lasting

4. CSO figures are quoted when referring to life expectancy.

investments which would sustain economic and social development going forward.

2.10 To facilitate a balanced and broad-based utilisation of mineral revenues, a minerals policy was formulated, which both vested the benefits of mining output with the nation as a whole and allowed for the establishment of mutually beneficial partnerships with international mining companies, notably De Beers. This framework has been kept up to date, with Botswana acknowledged as having one of the most attractive investment climates for mining in the world.⁵ In turn, and due to its strong institutions, Botswana has successfully avoided the 'resource curse', where an abundance of natural resources harms a country's growth prospects due to competing interests that lead to conflicts or inappropriate policies and wasteful expenditure.

2.11 For Botswana, fiscal policy has been disciplined and implemented in the context of National Development Plans (NDPs), guided by national principles, policies and development priorities. The outcome was planned expenditure based on assessed economic and social benefit and covered by current revenue, grants and borrowing, most of which was on concessional terms. Given low expenditure relative to revenue, there has been an accumulation of substantial government savings and, in turn, foreign exchange reserves, which provided the country with an important cushion against negative shocks, such as droughts, price and volume volatilities in the international diamond market, while enabling the build-up of a strong base of financial assets to support future development. Monetary and banking policies contributed to macroeconomic and financial sector stability. The exchange rate policy was used to support the emergence of non-traditional exports and import-competing production and alternatively, on occasion, to moderate inflation. Overall, the exchange

rate policy mitigated the dangers of an overvalued currency that often accompany abundant mineral revenues, such as the 'Dutch disease'.⁶

2.12 As a result of robust economic growth and improvement in social development indicators, Botswana graduated from being one of the poorest countries in the world to a middle-income country, which is a unique position for an African country. The recently published *World Development Report (WDR)* of 2007 classifies Botswana along with Gabon, Equatorial Guinea, Mauritius, Mayotte and South Africa as upper-middle income countries in Sub-Saharan African⁷. Furthermore, Botswana has, since 2001, been awarded an investment grade and stable credit ratings outlook by both Moody's Investors Service and Standard and Poor's, which are the highest in Africa. The ratings reflect the country's strong fiscal position, as well as political and macroeconomic stability. In 2006, the Heritage Foundation rated Botswana thirtieth out of 157 countries, and the first in Africa, with respect to economic freedom,⁸ while Transparency International continued to rate Botswana as the least corrupt country in Africa.

2.13 Despite the generally good economic performance and positive governance attributes indicated above, other indices, such as the World Bank's ranking for 'Ease of Doing Business' and the World

5. See the annual *World Risk Survey* of the global mineral sector produced by Resource Stocks, a mining industry publication.

6. Dutch Disease refers to the adverse effect on a country's other industries that occurs when one industry substantially expands its exports, causing a real appreciation of the country's currency.

7. Different organisations use different criteria to group countries by their level of development. For instance, the World Bank classification in 2005 was GNI per capita of US\$875 or less for low income countries, US\$876 to US\$3 465 for middle income countries, US\$3 466 to US\$10 725 for upper-middle income countries and US\$10 726 or more for high income countries.

8. The measure of economic freedom is based upon information on trade policy, fiscal burden on government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation and informal market activity.

Economic Forum's 'Global and Business Competitiveness Indices', are less reassuring, as they show Botswana falling behind other countries in Africa and globally. Specifically, while the rankings for overall governance and macroeconomic management have been maintained, the performance of the country in other aspects of the business environment, including government regulations and the readiness of the private sector to engage successfully in modern business, are deteriorating relative to other countries. The next Section addresses the challenges that underlie these declining rankings.

3. PERSISTENT AND EMERGING ECONOMIC CHALLENGES

- 3.1 As indicated above, Botswana stands out in Africa and globally as a country that has experienced remarkable and consistent growth and is widely recognised for its prudent macroeconomic management. In turn, credit ratings place the country at par with some of the best performing emerging market economies. However, despite Botswana's achievements, the country still faces numerous problems, some of which have persisted since independence, while others are emerging.

Lack of Economic Diversification

- 3.2 While Botswana's overall output growth has been buoyant over the past four decades, the economy remains undiversified as it is dominated by the mining sector, which is the main influence on annual output growth rates. Chart 2.2 shows a measure of concentration of economic production in Botswana, the 'Herfindahl Index'⁹ which, although falling from a peak of 0.30 in 1988/89, has subsequently averaged 0.21. Charts 2.3 to 2.6

show the dominance of the primary sector and, within that, the dominance of mining compared to agriculture. Conversely, the share of the secondary sector in the country's output has declined over time with significant decreases in the contributions of manufacturing and construction. These trends should, however, be viewed in the context of the phenomenal growth of mining which tends to mask even a respectable growth of the other sectors. It is notable, however, that except for trade, hotels and restaurants, all components of the services sector have increased their share of GDP, and this indicates much faster development in this category compared to the secondary sector.

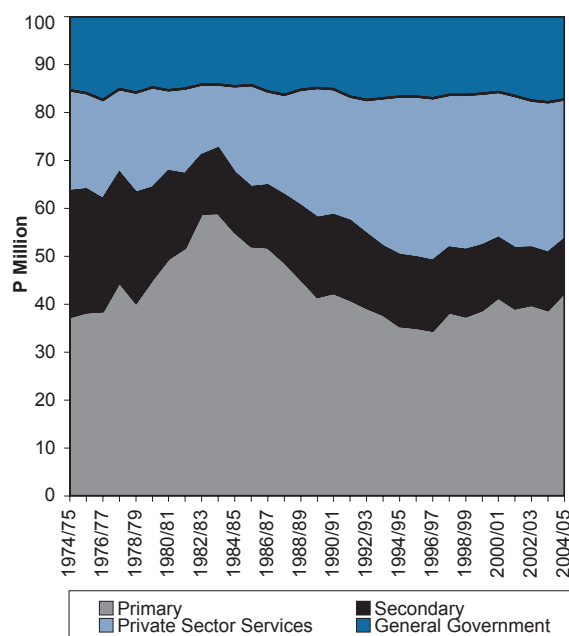
CHART 2.2: HERFINDAHL INDEX – A MEASURE OF CONCENTRATION OF PRODUCTION IN BOTSWANA (1974/75 – 2004/05)



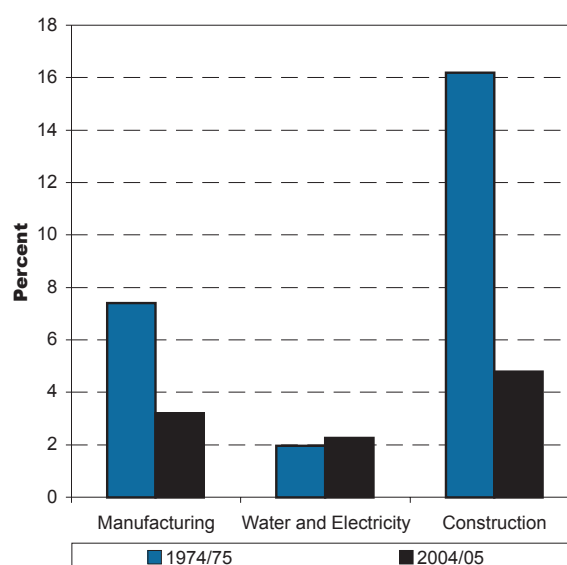
Source: Bank of Botswana.

9. The Herfindahl Index ranges between zero and one; a small index (below 0.10) indicates an unconcentrated/diversified economy while a larger index (above 0.18) indicates an economy which is concentrated. The index was developed 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 use of the Herfindahl Index in the Bank of Botswana Annual Reports 1993 and 2000.

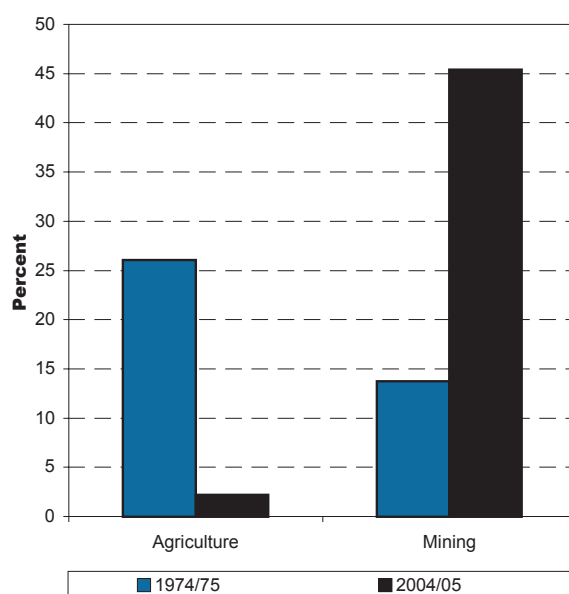
- 3.3 The dominance of diamond mining also features in other economic indicators; for example, diamonds accounted for about 77 percent of total exports in 2005, and made up more than 90 percent of the mining sector's contribution of 43.2 percent to total GDP in 2004/05. In addition, as at the end of 2005, 59 percent of the stock of FDI was concentrated in the mining sector. The lack of diversification and dependence on the mining sector has

CHART 2.3: SECTORAL SHARE IN GDP

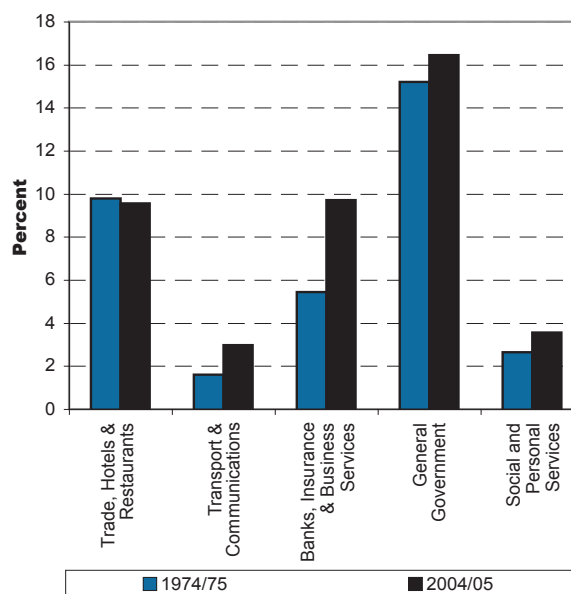
Source: CSO.

CHART 2.5: SECONDARY SECTOR SHARE IN GDP: 1974/75 AND 2004/05

Source: CSO.

CHART 2.4: PRIMARY SECTOR SHARE IN GDP: 1974/75 AND 2004/05

Source: CSO.

CHART 2.6: SERVICES SECTOR SHARE IN GDP: 1974/75 AND 2004/05

Source: CSO.

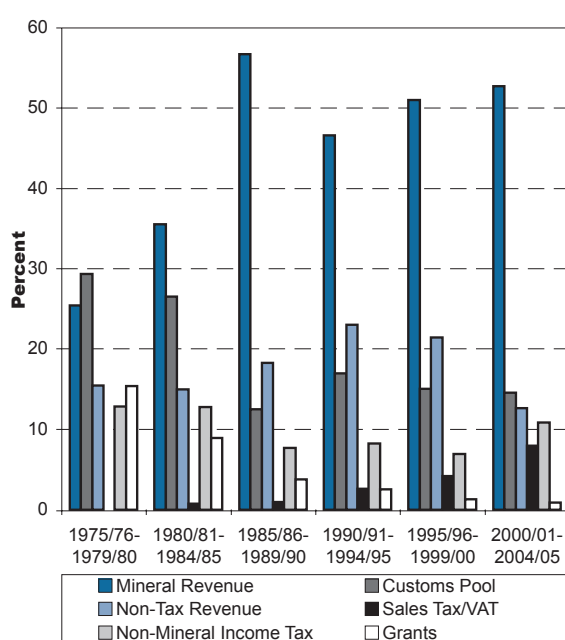
significant implications for the Botswana economy, particularly in terms of sources of economic growth, vulnerability to external shocks, government revenues, employment creation, poverty alleviation and reducing inequality.

Undiversified Sources of Revenue

- 3.4 Diamond output similarly dominates in contributing to government revenue. As shown in Chart 2.7, mineral-related taxes, royalties and dividends, which mainly derive from diamonds, accounted for about 50 percent of total government revenues in 2005/06. From

the late 1960s, customs revenues grew; first, due to the new SACU revenue sharing formula introduced in 1969; and, subsequently, because of large scale importation of capital equipment for mining development. As a result of this development, mineral revenues became the dominant source of government revenues. In addition, the resulting large surpluses on both the Government budget and balance of payments led to the accumulation of foreign exchange reserves, the earnings from which fed back into government revenues.

CHART 2.7: SELECTED SOURCES OF GOVERNMENT REVENUE AS A PROPORTION OF TOTAL REVENUE



Source: Ministry of Finance and Development Planning

- 3.5 Government initiatives to diversify revenue sources include, among others, the introduction of sales tax in 1982, which was gradually extended to cover a wider range of goods and services and was later replaced by value added tax (VAT) in 2002. This broadening of the tax base resulted in an increase in the volume of taxes and their share in total government revenue. Between the 2001/02 and the 2002/03 fiscal years, which covers the transition to VAT, revenue obtained through sales tax and VAT more than doubled, thus indicating the benefits of moving to the broader based

tax, while the non-mineral income tax also increased rapidly. In 2006/07, VAT and non-mineral income tax were projected to reach P2.19 billion and P3.40 billion, representing 8 percent and 13 percent of budgeted revenues, respectively, compared to 4 percent and 9 percent in 2001/02, the year before VAT was introduced. However, the effective rate of taxation of diamond mining activity remains much higher than in other sectors, including elsewhere in the mining industry.

Unemployment

- 3.6 Although diamond production continues to play a key role in fostering economic growth and contributing substantially to government revenue, this has not been matched by equally significant employment creation in the economy. This is largely a result of the capital intensive nature of the diamond mining in Botswana and the previous absence of beneficiation. The problem of insufficient productive employment opportunities in the domestic economy has, therefore, persisted since independence, despite the substantial exploration and exploitation of minerals. Overall, unemployment has remained high as people continued to move away from subsistence agriculture and acquire skills suited to formal sector employment.
- 3.7 Generally, unemployment worsened from the 10.2 percent in 1981 to 13.9 percent in 1991, and further to 19.6 percent in 2001.¹⁰ Meanwhile, data from the Botswana AIDS Impact Survey (BAIS) in 2004 showed unemployment to have risen to 24.6 percent. However, the most recent data, from the 2005/06 Labour Force Survey, show a lower unemployment rate of 17.6 percent, with the substantial reduction due, in large part, to increased employment in subsistence agriculture, most likely arising from the favourable rains in 2006. Despite the reported reduction, the unemployment rate is relatively high and is still a major challenge for Botswana, possibly resulting from a

10. Data as reported in the respective Population and Housing Censuses for 1981, 1991 and 2001.

combination of limited economic activity, wage policies and employment practices. In an environment of migrant labour supply, which tends to push down wages, higher reservation wages are another possible source of rising unemployment levels.

increase in unemployment (Bank of Botswana *Annual Report*, 2004). It is also notable that the highest rates of unemployment are in the urban villages. These are communities which have moved substantially away from agriculture,¹¹ while, at the same time, they have not fully

TABLE 2.3: SELECTED INDICATORS OF UNEMPLOYMENT IN BOTSWANA

Census/Survey	Unemployed	Employed	Labour Force	Unemployment Rate (Percent)
1981 Census	32 226	277 828	310 054	10.2
1984/85 LFS	57 863	310 023	367 886	15.7
1991 Census	61 265	379 938	441 203	13.9
1993/94 HIES	107 723	391 804	499 527	21.6
1995/96 LFS	94 528	345 405	439 933	21.5
1998 DS	115 703	441 187	556 890	20.8
2001 Census	109 518	449 234	558 752	19.6
2002/03 HIES	144 460	462 366	606 826	23.8
2004 BAIS	185 816	570 329	756 145	24.6
2005/06 LFS ¹	114 422	548 594	651 465	17.6

1. For 2005/06, the figures for employed and unemployed do not add to the total labour force as the number of employed covers workers from 7 years of age while the number for the labour force only includes people from 12 years of age.

Source: Central Statistics Office.

3.8 By location, the 2002/03 Household Income and Expenditure Survey (HIES) recorded the highest unemployment rate of 30 percent in the urban villages compared to 19 percent for cities and towns and 23 percent in the rural areas. Over time, this high unemployment in rural areas (including urban villages) has led to rural-urban migration as people move in search of perceived better opportunities in terms of higher-paying jobs and superior working conditions in the urban areas.

3.9 The extent to which the problem of unemployment has been exacerbated by the move away from subsistence farming, which previously absorbed much of the labour force, is indicated in the most recent census information. Between 1991 and 2001, the increase in the number of jobs in the formal and informal sectors of 121 000 was almost equal to the 118 000 growth in the labour force. However, over the same period, the number of workers in traditional agriculture declined substantially, largely accounting for the

made the transition to the urban economy, where unemployment is much lower.

3.10 Of late, concerns have been expressed about the perceived high unemployment rate of tertiary education graduates. However, the results of the 2002/03 HIES show that graduate unemployment has continued to be much less severe than for those with lower levels of education. For example, only 0.5 percent of degree holders were unemployed and actively looking for work (Tables 2.4 and 2.5). At the other extreme, 77.5 percent of those aged 15–19 years with senior secondary school as their highest level of education were reportedly unemployed, although this proportion falls rapidly for older age groups.

3.11 While graduate unemployment is relatively small, it remains a legitimate concern, especially for recent graduates, who possibly

11. As well as having a population of more than 5 000, urban villages are defined as communities where at least three quarters of the labour force are not employed in agriculture.

constitute a larger proportion of those in this category who cannot find jobs. Positively, however, it is recognised that those with higher education continue to have a distinct advantage over other job-seekers, as indicated by the relatively lower unemployment rate for those with tertiary education, including degree holders.

TABLE 2.4: UNEMPLOYMENT RATE BY HIGHEST EDUCATION LEVEL ACHIEVED (PRIMARY AND SECONDARY) AND AGE GROUP

Age Group (Years)	Primary ¹	Junior Certificate ²	GCSE ³
15–19	24.6	62.8	77.5
20–24	33.4	46.2	60.4
25–29	29.0	30.7	20.1

1. 1 generally means 7 years of primary education, while 2 and 3 refer to junior and senior secondary education, respectively.

Source: 2002/03 HIES, CSO.

TABLE 2.5: UNEMPLOYMENT RATE BY HIGHEST EDUCATION LEVEL ACHIEVED AT TERTIARY INSTITUTIONS

Certificate	Diploma	Degree
10.7	1.3	0.5

Source: 2002/03 HIES, CSO.

Poverty

3.12 The extent of unemployment combined with an insufficient skills base and aptitude for rewarding self-employment contributes to the relatively high incidence of poverty in the country. In the circumstances, poverty continues to be an obstacle to the realisation of sustainable socio-economic development and its alleviation is, therefore, one of the most difficult challenges facing Botswana. However, in contrast to the unemployment trend, the incidence of poverty has declined significantly over time in response to the development of both physical and social infrastructure through which productive employment has expanded and access to social

services increased (Section 2, above) as shown in the successive income and expenditure surveys. These show a sustained decline in the proportion of the population living on incomes below the poverty datum line (PDL) 59 percent in 1985/86, 47 percent in 1993/94 to 30 percent in 2002/03.

3.13 By location, there was faster reduction in poverty in cities and towns, from 29 percent in 1993/94 to 10 percent in 2002/03. In contrast, rural poverty started at higher levels and fell more slowly from 55 percent to 45 percent, over the same period. The faster poverty reduction in the urban areas reflects higher levels of economic activity and the existence of infrastructure, which facilitates creation of both employment and business opportunities. This is apparent from the relatively lower unemployment level in urban areas. In this sense, at least the mineral-dominated growth in the Botswana economy has benefited the poor, with poverty reduction sustained by infrastructure development and greater access to education and health services. This conclusion is also supported by progress in rural areas, where, despite higher levels of unemployment and a relatively low level of economic development, there has also been a sustained reduction in poverty rates.

3.14 The success achieved in reducing poverty, especially in urban areas, compares favourably with that of other developing countries. When compared to other SADC countries, the position of Botswana in terms of poverty and human development with 23.5 percent of its population living below US\$1 per day is only worse than South Africa which has absolute poverty levels of 10.7 percent while Zimbabwe has a much higher poverty rate of 56.1 percent (Table 2.6). A continuation of this trend would ensure that Botswana is on target to meet the country's *Vision 2016* goal of effectively eradicating absolute poverty.¹² However, forty years after independence, poverty rates remain

12. And, as an intermediate objective, of halving the rate of poverty from 47 percent of the population in 1993/94 to about 23 percent by 2007.

high and further reduction remains a major challenge. In particular, there is a significant number of people who live in 'extreme poverty' where households or individuals have a level of income that is insufficient to cover basic food requirements; this is referred to as food poverty. Out of 59 percent of the households classified as poor in 1985/86, 33 percent lived in extreme poverty, and this declined to 23 percent of the 38 percent of the households in poverty in 1993/94. Given this high incidence of extreme poverty, particularly in the rural communities, the Government continues to develop infrastructure in the rural areas, as well as provide social and community development programmes and social safety nets. For example, it was indicated in the 2005/06 Budget Speech that a large proportion (at least 65 percent) of capital budget would be spent in rural areas, while during the 2006/07 fiscal year, an estimated budget of P1 billion¹³ out of P5.8 billion was provided for infrastructure development in rural areas.

with poverty, has long been a concern since the days of the 'Transitional Plan for Social and Economic Development' which was published in 1966, and endorsed in successive NDPs and in Vision 2016. This underscores the fact that Botswana has been committed to achieving a more equal income distribution, with numerous policies and initiatives aimed at mitigating inequality. The reduction of inequality is consistent with the principle of 'kagisano' (social harmony), which is one of the four guiding principles of national planning.¹⁴

3.16 A commonly-used measure of income inequality is the Gini Coefficient, a summary statistic which ranges between zero and one, with a higher value indicating greater inequality. Using this measure Botswana is shown to have high levels of income inequality even when compared to other SADC member states (Tables 2.7 and 2.8). As a rough guide, a Gini Coefficient greater than 0.5 is generally considered to

TABLE 2.6: SELECTED MEASURES OF POVERTY

Country	HDI Rank ¹	GDP per capita (PPP US\$ 1000) 2003	Population living below US\$1 a day 1990–2003 (Percent) ²	Pop. living below national poverty line 1990–2002 (Percent) ²	Under-nourished population 2000–2002 (Percent) ³
Mauritius	65	11.3	...	10.6	6
South Africa	120	10.3	10.7	...	...
Namibia	125	6.2	34.9	...	22
Botswana	131	8.7	23.5	30.3	32
Zimbabwe	145	2.4	56.1	34.9	45

1. The Human Development Index survey wherein 177 countries were involved.

2. Most recent year within period for which data are available.

3. Period average.

Note: ... indicates that data are not available, either because information was not available to the Bank of Botswana at the time of publication, or that a facility, institution, classification, etc., did not exist.

Source: UNDP, Human Development Report 2005.

Income Inequality

3.15 Inequality refers to the disproportionate distribution of income among individuals and groups within a society, as well as among nations. For Botswana, inequality, along

reflect high inequality and, at a national level, Botswana's Gini Coefficients have clearly remained above this threshold. However, inequality is much lower when income in kind is included in cash income.

13. These exclude other national projects, such as education, agriculture, and health, that are also implemented in rural areas.

14. The other three principles are: Rapid Economic Growth, Economic Independence and Sustained Development.

The importance of non-cash sources of income, which in Botswana consist mainly of transfers of goods between households through extended families and consumption of own produce rather than government welfare programmes, has been declining over the years as the economy has moved from reliance on subsistence activities. Nevertheless, in 2002/03, by including income in kind, the Gini Coefficient is reduced from 0.63 to 0.57, indicating the continued importance to the most needy of such sources of income.

special weight to the least well off in the distribution.

- 3.18 While income distribution is frequently linked with poverty, it should be recognised that there is a difference; for instance, an economy can display a high degree of inequality while successfully combating poverty. This appears to be the case in Botswana where there has been a sustained reduction in poverty since independence, but overall income inequality has changed very little. Conversely, incomes can be largely equal, while poverty remains

TABLE 2.7: GINI COEFFICIENTS IN BOTSWANA

Category	Cash Income			RIDS 1974/75	Total Income ¹		
	HIES 1985/86	HIES 1993/94	HIES 2002/03		HIES 1985/86	HIES 1993/94	HIES 2002/03
National	0.70	0.64	0.63	...	0.56	0.54	0.57
Urban	0.56	0.55	0.51	...	0.54	0.54	0.50
Rural	0.67	0.59	0.62	0.52	0.48	0.41	0.52
Urban Villages	...	0.55	0.55	...	...	0.45	0.52
1.	Total income is the sum of cash income and income in kind. Income includes earned income (in cash or in kind), unearned income (e.g., gifts and welfare payments) and the value of goods produced, mainly food, for own consumption.						
Note:	... indicates that data are not available, either because information was not available to the Bank of Botswana at the time of publication, or that a facility/institution/classification, etc., did not exist. Urban villages were grouped with rural areas in the 1985/86 HIES.						
Source:	1993/94 and 2002/03 HIES.						

- 3.17 Although widely used in analysis, the Gini Coefficient has limitations as an indicator of inequality. Different measures of income and of basic units within the distribution (individuals or households, for example), as well as differences in population structure,¹⁵ make comparisons difficult, especially in the international arena. More fundamentally, as a summary statistic, it cannot fully describe the income distribution and can assign similar values to distributions which may differ markedly in their underlying characteristics. For example, the Gini Coefficient gives no

high. Indeed, when most people are poor there may be little point in focussing on inequality. Thus, the Transitional Plan considered that a more equitable distribution of income was a long-term objective.

- 3.19 The supposed link between poverty and inequality is strengthened by a continued belief that it is possible to make significant changes to the distribution of income through, for example, taxation and welfare payments, wages policies and even the allocation of jobs. However, extensive programmes of redistribution run the risk of prejudicing the wealth creation process that is the source of all incomes. In recognition of this, Vision 2016 is explicit that the reduction of income inequality is to be achieved mainly through encouraging job creation rather than through redistribution,

15. For example, young people generally have lower incomes. Therefore, a predominantly young working population will tend to show greater inequality than one where the age distribution among the labour force is more equal, even if other characteristics within age groups (e.g., wages and employment rates) are similar.

TABLE 2.8: INCOME INEQUALITY AMONG SADC COUNTRIES

Country	UN Richest 10% to Poorest 10%	UN Richest 20% to Poorest 20%	UN Gini Index	UN Survey Year
Angola	...	...	...	...
Botswana	77.6	31.5	63	1993
DRC	...	...	...	...
Lesotho	105	44.2	63.2	1995
Malawi	22.7	11.6	50.3	1997
Mauritius	...	...	...	...
Mozambique	12.5	7.2	39.6	1996–97
Namibia	128.8	56.1	74.3	1993
South Africa	33.1	17.9	57.8	2000
Swaziland	49.7	23.8	60.9	1994
Tanzania	9.2	5.8	34.6	2000–01
Zambia	13.9	8	42.1	2002–03
Zimbabwe	22	12	50.1	1995

Note: ... indicates that data are not available, either because information was not available to the Bank of Botswana at the time of publication, or that a facility/institution/classification, etc., did not exist.

Source: UNDP HDR 2006.

which has a potential disadvantage of exacerbating the problem of over-dependence on government.¹⁶

3.20 Overall, it is considered that well-crafted economic policies can be supportive of both greater equality and growth. For instance, social welfare programmes can help build support for crucial economic reforms. By giving people more confidence that their living standards can be improved, they will be more likely to accept the flexibility required in a dynamic, market-driven economy. Conversely, ignoring wide income disparities can result in a reversal of the benefits of economic growth. The socio-economic problems associated with high income inequality that can undermine development efforts include polarisation of society, unemployment, as well as increased crime and corruption.

3.21 It should be recognised, however, that there will inevitably be potential trade-offs between growth and equality as the nature of the market economy is that inequalities will emerge, and that these are largely accepted in return for

higher overall standards of living. In conditions that encourage rapid growth from which all benefit, concerns about inequalities tend to diminish. For Botswana, it is notable that the focus on inequality and citizen economic empowerment has strengthened in recent years as GDP growth has slowed. The fundamental challenge is to make the market economy work in favour of all sections of society. This approach can, however, be undermined by redistributive policies that interfere with the workings of markets through, for example, tying welfare payments to particular jobs or economic activity and abrupt increases in taxation.¹⁷

Citizen Economic Empowerment

3.22 The Government has consistently recognised that citizens of Botswana should be the major beneficiaries of economic development in the country. However, in recent years there have been increasing demands for specific pro-

16. Vision 2016 also calls for effective social safety nets, but these are to be restricted to those 'who are genuinely unable to obtain a minimum standard of living through their own efforts'.

17. This is not to say that market economies cannot function well in conjunction with extensive programmes of redistribution financed through taxation. Some countries in Europe may provide good examples of such systems; but these systems cannot simply be transplanted to other countries, where social conditions inevitably vary considerably, without the threat of considerable disruption.

grammes of citizen economic empowerment, given impetus by perceived unfair advantages that expatriates and larger foreign-owned businesses have.¹⁸ Nevertheless, as citizen economic empowerment continues to be an issue of public debate, its meaning is often misunderstood.

- 3.23 The 1999 paper prepared by the Botswana Institute for Development Policy Analysis (BIDPA) on 'Economic Empowerment in Botswana' defines the concept of citizen economic empowerment as 'a socio-economic process through which Botswana are encouraged to improve their abilities to control their own resources and to unleash their creative and productive energies to achieve sustainable improvement in their living standards'. The paper also reviews some of the commonly held views of the concept among Botswana. These include the view that citizen economic empowerment denotes a set of policies or programmes designed to benefit a specific segment of Botswana society. Other interpretations include exemptions from some business rules or obligations, such as exposure to competition, provision of security on loans, and protection against legal action arising from non-fulfilment of contractual obligations. In addition, citizen economic empowerment is considered to mean an entitlement to a share in government-owned companies. Lastly, citizen economic empowerment is at times understood to mean the creation of an indigenous business elite to rival the more successful foreign business interests in the country that are perceived to have the advantage of superior financial strength and business skills.
- 3.24 These various interpretations of economic empowerment, some of which diverge significantly from the conventional definition adopted in the development literature, represent a challenge for policy makers in

Botswana. As noted in the 2006 State of the Nation Address, recent calls for empowerment are largely misconceived since they are based on narrow demands for transfer of resources, and ignore empowerment in its broader sense, notably through good governance, education and economic dynamism.

- 3.25 Against this background, it is evident that there is need for a common understanding of the role of the Government in citizen economic empowerment as that of a facilitator to enhance access of citizens to economic opportunities. Conversely, over-dependence on government for subsidies, reservation of certain economic activities for local enterprises, protection, excessive regulation and any form of unrequited entitlement does not lay a solid foundation for a prosperous and globally competitive private sector. Moreover, the multi-layered assistance that results is inherently inefficient and costly to administer. Overall, facilitating the acquisition of skills and knowledge that will motivate and enable citizens to take steps to improve their own lives is a significant effort in empowerment. The Government has, however, gone beyond this by establishing several institutions and policies to transfer economic resources and benefits to citizen-owned enterprises. Nevertheless, the challenge in this respect is that some of the policies invariably engender inefficiencies and long-term costs to the economy.

Globalisation

- 3.26 Globalisation has economic, political and cultural dimensions, all of which have a social impact in Botswana. As an economic process, globalisation is the integration of national economies through trade, capital and financial flows, and trans-national labour mobility. Globalisation is not in any way a recent phenomenon; it dates back thousands of years, driven by exploration, the search for resources, and improvements in transport and communications.
- 3.27 However, there was a significant break in the process in the 20th century due to protectionist

18. The efforts in South Africa to advance Black Economic Empowerment (BEE) programmes are also likely to have heightened the debate on citizen economic empowerment in Botswana.

economic and immigration policies arising from the Great Depression, the two World Wars and the subsequent Cold War. Thus, the renewed acceleration of globalisation in the 1980s appeared to be a new phenomenon driven by increasing liberalisation of international trade, capital and financial flows, as well as rapid change in transport and communication technology. In addition, there has been enhanced mobility of workers, as well as internationalisation of production, distribution and marketing of goods and services. This results from production patterns based on trade across stages of production, the development of a global telecommunications infrastructure and greater trans-border data flow, using technologies such as the Internet, where considerations of cost and volume are increasingly no longer an obstacle.

3.28 For Botswana, globalisation implies at least four interrelated imperatives, which are:

- (a) expansion of trade;
- (b) attraction of FDI;
- (c) raising productivity and competitiveness as a way of diversifying the economy; and
- (d) institutional restructuring in order to be better placed to face global competition and sustain future economic growth.

3.29 One of the characteristics of globalisation is the increase in international trade flows. In recent years, merchandise exports across the world have exceeded 20 percent of global GDP, up from less than 15 percent in 1990. Botswana's trade relationships are largely influenced by location of markets for its primary products, its membership of SACU and its proximity to a much larger and economically more developed South Africa. There are efforts to expand trade in the Southern African Development Community (SADC) through a free trade protocol that will effectively establish a regional free trade zone. Other trade relationships derive from the Cotonou Agreement, which accords products from

the African, Caribbean and Pacific (ACP) countries preferential access to the European Union (EU) (especially beef) and the African Growth and Opportunity Act (AGOA), which allows Botswana to sell textiles, clothing and many other products duty free to the United States of America. These agreements may potentially improve the level of Botswana's participation in world trade and integration into the borderless and interlinked global economy. However, working in an environment of multiple, and sometimes overlapping trade agreements can be costly for both the Government and businesses, which is an especially important consideration for a small country such as Botswana. Moreover, there is a risk that the main effect of such agreements is merely to divert existing trade flows rather than expand trade through the creation of new relationships.

3.30 In the circumstances, developing countries, such as Botswana, are often not able to fully utilise opportunities provided by improved market access resulting from involvement in the many existing international trade agreements. For example, reports by the United Nations Conference on Trade and Development (UNCTAD) highlight a number of internal and external constraints that have led to the inability of developing countries, Botswana included, to maximise their development gains from trade. These include the following:

- (a) narrow export base;
- (b) severe shortage of enabling infrastructure, including trade-related infrastructure;
- (c) minimal diversification into new and dynamic sectors of manufacturing and services;
- (d) lack of necessary productive supply capacity and international competitiveness; and
- (e) failure to attract FDI, especially into the service sectors.

3.31 Furthermore, despite the supposed benefits

of globalisation, developing countries still face a number of market access barriers ranging from tariff restrictions, agricultural subsidies to selected sectors in developed countries, complex and expensive product standards and safety requirements, as well as restrictive rules of origin. Another aspect of globalisation is the increase in international capital flows that include portfolio and direct investments. The former refers to investment in securities such as foreign stocks, bonds, or other financial assets, while the latter entails investment in the domestic economy that includes physical assets (property, plant and machinery), as well as substantial (strategic or controlling ownership) investment in existing enterprises and creation of new ones.¹⁹ The principal difference between FDI and portfolio investment is the extent of control. A direct investment is one in which the investor obtains a lasting influence in, and a degree of influence over the management of, a business enterprise. Such investors are likely to take an active interest in the management of the business, including the provision of additional skills and technology, which are among the main benefits of FDI. Portfolio investment is all other investment, including investments in financial assets without the expectation of significant management control of the real assets on which the financial assets are based.

- 3.32 FDI brings development benefits to the host economy, such as employment creation, promotion of forward and backward linkages, development of human capital, poverty reduction, increased tax revenues from profits of successful foreign-owned firms and technological transfers. FDI is also less volatile since it is generally in the form of equity invested in fixed assets, such as plant, buildings and equipment, which are not

easily repatriated in times of crisis. Likewise, portfolio investment is vital for economic growth and development. Among others, it adds to national savings, helps broaden and deepen financial markets in developing countries, broadens the array of instruments available to both savers and borrowers, promotes large-scale investments that capture economies of scale, and stabilises economies by spreading risk.

- 3.33 Among the important determinants of FDI are:

- (a) size, openness and competitiveness of the domestic market;
- (b) the availability and quality of natural resources;
- (c) quality of physical infrastructure (roads, telecommunications network, transport networks, electric power);
- (d) stability and predictability of the political environment, a favourable macroeconomic environment (for example, rapid economic growth, low and stable inflation rates, low budget deficits);
- (e) a well-functioning capital market, especially for equities;
- (f) the availability of skilled human capital;
- (g) low transaction and business costs, including trade and labour regulations and rules of entry into and exit from markets;
- (h) favourable tax structures; and
- (i) an efficient and dependable legal system.

- 3.34 Despite the disadvantages associated with a sparsely populated and land-locked country, which inevitably increases some of the costs of doing business, Botswana fares relatively well in most of the above determinants of FDI. However, notwithstanding Botswana's relatively good investment climate (that is, among others, good governance, good labour relations, a record of prudent macroeconomic policy management, relatively low crime, favourable tax and financial incentives), the country has been less successful

19. The standard statistical definition used to compile data on international capital flows includes as FDI any foreign shareholding in a domestic business exceeding 10 percent, with stakes above this threshold judged to be strategic rather than speculative. It should also be stressed that, unless sourced from a parent company, investment funded by foreign loans is *not* included as part of FDI even if it is used to fund international investment.

TABLE 2.9: LEVEL¹ OF FOREIGN DIRECT INVESTMENT IN BOTSWANA BY INDUSTRY (P MILLION)

Industry	Year					
	2000	2001	2002	2003	2004	2005
Mining	7 792	7 714	2 957	2 688	2 494	2 648
Manufacturing	343	274	185	295	151	141
Finance	619	729	731	873	931	1 290
Retail and Wholesale	773	651	609	826	239	92
Electricity, Gas and Water	0	0	9	37	39	0
Real Estate and Business Services	161	115	93	118	93	94
Transport, Storage and Communications	105	162	155	183	134	97
Construction	16	15	13	10	28	1
Hospitality	17	135	129	154	57	23
Public Administration	0	0	0	0	0	0
Other	0	1	1	1	38	1
Total	9 826	9 696	4 882	5 187	4 204	4 387

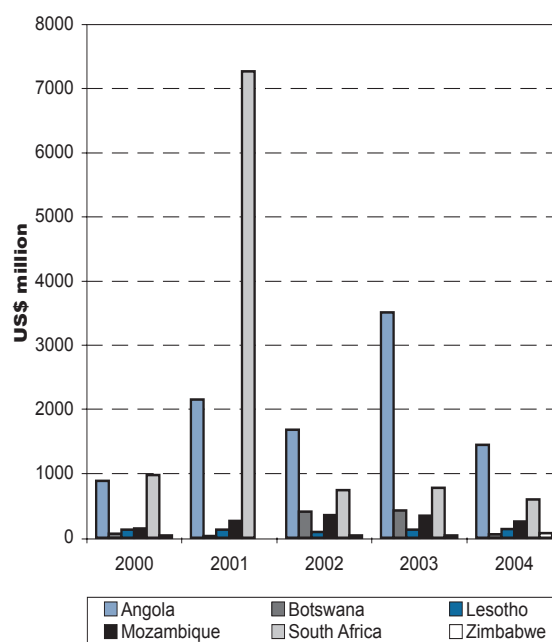
1. Refers to the total amount (i.e., the stock) of FDI at the end of each year, not new investment (the flow) during the year.

Source: Bank of Botswana.

in attracting significant FDI outside the mining, financial and retail sectors (see Table 2.9). The total stock of FDI was equivalent to 22 percent of GDP in 1994 and this grew to 28 percent in 2000. The moderate growth was largely attributable to mining-related developments: in particular the expansion of output at both the Orapa and Jwaneng diamond mines, together with the continued financial difficulties of the BCL copper/nickel mine, where failure to repay loans to foreign shareholders was counted as additional inflows of foreign investment. The latter effect resulted in a distortion of the FDI data and its removal in 2002²⁰ resulted in a sudden reduction of the FDI stock, which fell by 52 percent between 2001 and 2002. By 2005, the stock of FDI was only 7 percent of GDP.

3.35 In comparison, Botswana has lagged behind other Southern African countries, with Angola receiving the largest FDI, due mainly to the rapid development of the oil industry, while

the South African economy operates on a much larger scale (Chart 2.8). Perhaps the most interesting comparison is with Lesotho, also landlocked and with a similar population size, but without such a widely acknowledged track record of sound governance and

CHART 2.8: FOREIGN DIRECT INVESTMENT

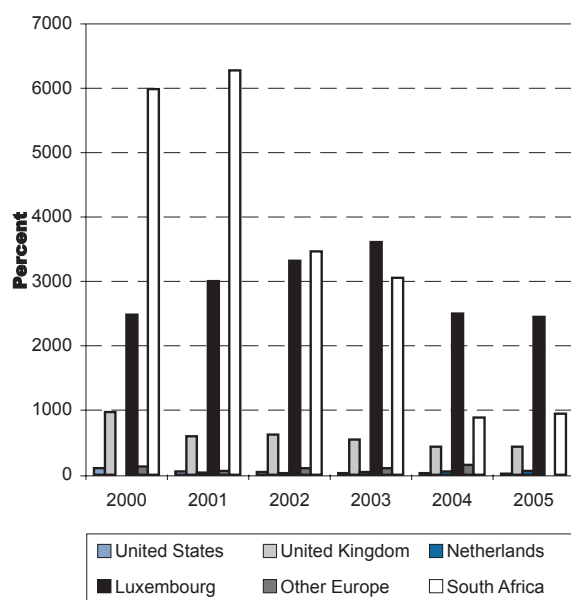
Source: World Bank (www.devdata.worldbank.org/data-query).

20. In 2002, a change in private shareholding in BCL involved shareholder liabilities becoming debts to the Botswana Government, and thus being re-classified as domestic debts. Prior to this the non-equity component in the mining sector had accounted for more than 50 percent of the total stock of FDI.

economic management (using the investment grade credit ratings awarded to Botswana as a benchmark, for example). For most of the years shown in Chart 2.8, Lesotho has, nevertheless, received more FDI than Botswana, mainly in textile manufacturing.

- 3.36 It is apparent that the commonly cited advantages of macroeconomic and political stability and high credit ratings do not necessarily provide a decisive advantage for a country to attract significant FDI. For example, Botswana has only managed to attract substantial amounts of FDI only from a few countries (see Chart 2.9). This might suggest that the country needs to put in place additional incentives to increase FDI, such as productivity improvement and related progress in developing labour skills, attitudes to work and technological development, as well as a lowering of domestic input costs, including wages and utilities.

CHART 2.9: LEVEL OF FOREIGN DIRECT INVESTMENT IN BOTSWANA BY COUNTRY



Source: Bank of Botswana.

(a) Skills development

- 3.37 In recognition of the critical importance of skilled human resources, especially in

an increasingly technology-driven global economy, in attracting FDI, the Government of Botswana continues to address the challenges facing tertiary education, such as funding, relevance of curricula, remuneration and motivation of trainers, as well as the readiness of secondary school leavers to enter tertiary institutions. Most of the tertiary education institutions in Botswana currently depend almost exclusively on government funding. In 2004, public expenditure on education was about 24 percent of total government expenditure, of which a third was on tertiary level education.²¹ It is apparent that, while important, the provision of education is increasingly costly to Government. Going forward, it would be necessary to enhance cost sharing between the Government and the other beneficiaries of education, such as students and future employers. Such cost sharing has the inherent benefit of providing an incentive to succeed as well as motivation for self-development and training in relevant areas.

(b) Cost of inputs and regulations

- 3.38 As well as the challenges of human skills development, in attracting FDI, there continues to be a perceptible over-dependence on government patronage and contracts in some sectors, notably construction, manufacturing and services. This is despite government efforts to promote a private sector led competitive market economy. The most frequently cited problems that limit growth of the private sector and faster employment creation include the small domestic market, inadequate infrastructure, limited access to appropriate financing, the high cost of utilities and competition, particularly from South Africa and other SACU members, as well as the more productive Asian countries. Transport costs in landlocked Botswana are relatively high since road haulage and air transport are both considerably more expensive than

21. Including the funding of students studying overseas, but excluding vocational training.

shipping. Furthermore, the costs of transport, communications and utilities are higher for Botswana with a small and widely distributed population while there is less scope for achieving economies of scale and productivity increases associated with large-scale urban development.²² There is, therefore, a need for the costs of communication and distribution, including the associated bureaucracy and administration, to be reduced to the economic minimum if these obstacles to competitiveness are to be successfully overcome.

- 3.39 The 2004 Foreign Investment Advisory Service (FIAS) study,²³ which provides a basis for evaluating the extent to which the investment climate is conducive to new investors in Botswana, identified several obstacles that local and foreign businesses encounter. The report outlines the top ten regulatory and administrative barriers to businesses seeking to operate or expand their businesses in Botswana. Among the firms that were surveyed, 44.4 percent cited the cumbersome process of obtaining work and residence permits as an obstacle they have to confront, while the same proportion saw access to land as an impediment. Tender regulations and the lack of competition law were cited by 38.2 percent and 34.8 percent, respectively.

(c) *Access to land*

- 3.40 Land is an important input in commercial production and if its allocation is not subject to the influence of market forces the overall effectiveness of a market-based economy may be undermined. However, the pursuit of other social objectives of land allocation, such as restricting concentration of ownership, should be considered. Access to undeveloped land in Botswana is not easy due to the fact that a large proportion of land (even close to urban

areas) is classified as tribal land rather than state or freehold land;²⁴ hence it is not subject to free market transactions. For example, in 1998, tribal land constituted 71 percent of total land.²⁵ The process of converting land use is complicated and slow, and can cause delays in setting up businesses. Furthermore, in the absence of title deeds, it is difficult for individuals to either sell tribal land to others or use the land as collateral to finance development. The problem of difficult access to land is further exacerbated by the fact that the Government is the main provider of serviced land, and it has not been able to cope with the increasing demand. Even when freehold land is available, it is not always distributed in accordance with commercial demand.²⁶ In addition, failure by the relevant authorities to speed up the conversion of agricultural land to business or industrial use has aggravated the situation.

High Prevalence Rates of HIV/AIDS

- 3.41 The spread of HIV/AIDS has become one of the critical challenges facing the country. The epidemic is deepening poverty, reducing human development achievements, eroding the ability of government to provide essential services, reducing labour productivity and supply and, overall, putting additional constraints on sustained economic growth. The 2004 Botswana AIDS Impact Survey II (BAIS II) reported a national prevalence rate of 17.1 percent. The prevalence rates were concentrated among the most productive age

22. Recent research suggests that productivity in a city of 10 million people is as much as 40 percent higher than in a city of only 100 000 people.

23. The title of the study is: 'Further Improving the Regulatory and Procedural Framework for Encouraging Private Investment'.

24. The three categories of tribal, state and freehold land were inherited or adopted from the colonial administration and constitute the rules, provisions and procedures which govern the rights and responsibilities of groups and individuals in the use and control of land and its resources. They define who controls the land, the security one has on the land, who has access to it and how.

25. While this is true for initial allocation of undeveloped land, holders of registered title deeds for this land can sell such land in the free market after developing it.

26. One clear example of this inefficiency in action is the 'Central Business District' in Gaborone which lies largely undeveloped more than a decade after the project was first launched.

groups of persons aged 20–55 years, with prevalence rates between 19 percent and 40.2 percent. By location, the highest prevalence rate was recorded in towns, with 21.3 percent of the population infected, followed by cities, urban villages and rural areas with rates of 20.2 percent, 17.4 percent and 15.6 percent, respectively.

- 3.42 During 2005, government expenditure on HIV/AIDS was P1.14 billion (approximately 7 percent of total government expenditure), of which the Government directly funded P900 million (79 percent).²⁷ This is equal to the recurrent budget of the Ministry of Health (spending for HIV/AIDS is channelled through the Ministry of State President and the National Aids Coordinating Agency (NACA)). Donors provided 20 percent of the funding, while the private sector contribution was only 1 percent, which excludes the costs to private business of their own programmes. The Government is focused mainly on treatment and care, including programmes for associated vulnerable groups such as orphans, while donors concentrate on human resource and programme development. Given this balance and with the continuing extension of the Anti-Retroviral (ARV) programme, these costs can be expected to increase substantially.
- 3.43 The epidemic has also put pressure on the Government to commit more funds towards mitigating the effects of AIDS. For example, the total development expenditure on HIV/AIDS programmes for the Ministry of State President, increased from P200 million in 2002/03 to an initial budget of P896 million in 2007/08. As a proportion of total development expenditure, costs on HIV/AIDS programmes accounted for 5 percent in 2002/03 and rising to 10 percent in 2003/04 and 12 percent in the 2007/08 budget.
- 3.44 Many sectors of the economy are already affected by HIV/AIDS at the macroeconomic

level, as the epidemic reduces or weakens skilled professionals charged with production of national output in various sectors of the economy. The epidemic affects staffing, replacement and training needs, employment policies, contracts, employers' liabilities, costs, delivery and quality of output. From the business perspective, uncertainty about the adequacy of labour supply increases the risks associated with investment. It also has adverse effects on the already fragile situation regarding food security, potentially affecting subsistence and small-scale agriculture, rural livelihood strategies, and household and community support systems.

- 3.45 At the household and micro level, HIV/AIDS results in increased healthcare and funeral expenses. The virus erodes the capacity to work, depletes accumulated wealth and increases the number of vulnerable people, e.g., the sick, orphans and caretakers. This translates to loss of income and depletion of savings as assets, such as land and cattle, are sold to cover the costs associated with HIV/AIDS. The epidemic may also affect the structure of the family through the struggle to cope with lost members, orphans and the sick. HIV/AIDS increases dependency, which is a principal cause of poverty.
- 3.46 The Government, therefore, faces a big challenge of having to mitigate such effects, which have to be addressed simultaneously. Such efforts put great strain on the government budget and its implementation capacity. This results in the diversion of resources, from development projects and recurrent spending, towards mitigating the effects of AIDS in order to preserve the labour force and ensure the survival of future generations. The scourge also has an adverse impact on investment, which is critical to economic growth, by creating an environment that poses greater risks and uncertainty for investors. This could lead investors to opt for countries which have a healthier workforce that promises higher productivity and better returns.

27. As reported by AIDS Care Watch.

4. POLICY INITIATIVES TO ADDRESS BOTSWANA'S ECONOMIC CHALLENGES

- 4.1 As highlighted in the preceding Section, Botswana is classified as a middle income country, but it has not been able to successfully overcome the socio-economic problems of unemployment, poverty and a skewed income distribution. This partly reflects limitations with respect to the exploitation of opportunities and creation of viable economic activities in the country. In response, the Government has put emphasis on economic diversification as a key strategy for durable growth and sustainable economic development, by undertaking various policy initiatives and strategies aimed at developing and expanding the country's economic base to facilitate diversification and broad-based growth.

Industrial Development Policy

- 4.2 The Industrial Development Policy, which was formulated in 1984, focused on promoting economic diversification and reducing the economy's dependence on the mining sector. One of the policy's main strategies for achieving diversification was to expand production for the domestic market and promote import substitution. This strategy was deemed appropriate for the then relatively closed economies of Southern Africa and supported the objective of reducing dependence on South Africa, which at the time was under apartheid rule. In the context of international sanctions on South Africa and possible retaliatory or punitive actions on Botswana, there was a significant risk of supply disruptions which could have been detrimental to economic activity. However, as a result of changing economic circumstances arising from globalisation, together with the new democratic political dispensation in South Africa, the policy thrust was shifted from import substitution to export-led economic growth in the late 1990s (Government Paper No.1 of 1998). It was considered that an outward-looking strategy offered a better

opportunity for expanding the productive base given the potentially much larger export market compared to the domestic market. Moreover, competitiveness in the export markets would necessitate improvements in domestic productivity with long-term benefits for the country.

Financial Assistance Policy (FAP)

- 4.3 In addition to the National Policy on Economic Opportunities²⁸ and the Industrial Policy of the early 1980s, the Financial Assistance Policy (FAP) was introduced in 1982, to foster economic diversification and expand economic opportunities and sources of employment through government subsidies. It was envisaged that the programme of financial assistance would facilitate the development of enterprises that produced tradeable goods (either exports or import substitutes), while creating employment opportunities, especially for unskilled citizen labour. While the framework varied according to the scale, location, citizenship and gender of the business owner, the principal form of assistance was through grants, both to help cover start-up costs and subsidise wages. The policy was administered by a government committee comprising mainly of public servants. The FAP was evaluated four times over its life and, while modifications were made, it became increasingly apparent that, as the size and complexity of businesses applying for assistance increased, funds were being provided without proper scrutiny. There were growing administrative problems and the grant element of the scheme provided opportunities and incentives for manipulation, abuse and fraud. Concluding that the FAP was no longer effective in achieving its objectives, and that

28. The National Policy on Economic Opportunities of 1982 was a result of the Presidential Commission on Economic Opportunities aimed at investigating the effectiveness of relevant policies at promoting the participation of Botswana in the economy through asset ownership, entrepreneurship and employment. The principal objective of the Policy was to recommend measures to improve the participation of Botswana in economic activities.

it was not addressing the main constraint to investment and the development of sustainable enterprises, the fourth review of the policy in 2000 recommended that the scheme be terminated. In 2001, FAP was terminated and replaced by the Citizen Entrepreneurial Development Agency (CEDA).²⁹

- 4.4 While it was finally concluded that FAP was not succeeding in its objectives, it possibly facilitated the significant increase in manufacturing licences between 1985 and 1990 in activities such as dairy and agro products, textiles, metal products and building materials. Moreover, it is notable that the manufacturing sector grew at an average annual growth of 5.3 percent between 1979/80 and 1989/90. It follows, however, from the negative assessment of the performance of FAP that the viability and durability of most of these activities was low.

Citizen Entrepreneurial Development Agency (CEDA)

- 4.5 Even with the problems encountered with the FAP, it was considered important to continue preferential assistance to citizen entrepreneurs and to support high-risk businesses that showed potential long-term benefits to the economy. CEDA was, therefore, introduced in 2001 to aid the development of competitive and sustainable citizen-owned businesses and expand employment opportunities.³⁰ The support by CEDA is in the form of loans at subsidised interest rates and mentoring services for client businesses. The inclusion of mentoring services recognises that financial assistance on its own was unlikely to improve the success rate of citizen-owned businesses. Moreover, CEDA, unlike FAP, operates outside government structures. The agency, however, received substantial government subventions

in the early years of operation, with a view to eventually having a revolving fund, with new lending financed by loan repayments. In addition to the loan scheme, the CEDA Venture Capital Fund (VCF) was established in 2003, which facilitates joint ventures of citizens with non-citizen investors.

- 4.6 As at the end of September 2006, CEDA had approved loans amounting to P819 million covering 1 468 projects that had 8 913 employees. The current survival rate of CEDA financed projects, defined as businesses that survive beyond 3 years, is 67 percent. The agency attributes failure of their client businesses to a lack of sound financial management, inability to quickly service and restore usage of equipment, problems in implementation, incapacity or death of owners and labour problems. Many business plans are also too dependent on winning contracts from government for their viability. At the same time, however, it has been suggested that there is need to substantially improve monitoring of projects by CEDA. Meanwhile, the access to business development services and collaboration with other business support organisations such as the Local Enterprise Authority (LEA) and Botswana Bureau of Standards (BOBS) should enhance the success rate of CEDA projects. The agency is also evaluating its business model and products with a view to making appropriate recommendations to ensure its sustainability. Meanwhile, by September 2006, the VCF had invested P118.3 million in 12 projects in various sectors of the economy, including air and road transport services, information and communication technology, diamond polishing, leather tannery, dairy, investment banking and construction/building materials supply. This has resulted in the securing of 717 jobs in both start-up projects and business expansions while there were 19 prospective applications under consideration.

- 4.7 While the number of approved projects and the size of the portfolio indicate some progress for both CEDA and the VCF, the impact on

29. Since its establishment, CEDA also handled the disbursement of funds to projects approved prior to the termination of FAP. Assistance from FAP finally came to an end in 2006.

30. FAP, except for the component specifically designed for small-scale businesses, had been open to non-citizen-owned and joint-venture businesses.

the economy is expected to be felt at a later stage when most of the financed projects have fully matured. There continues to be reports of difficulties in accessing funding from CEDA; between 2001 and September 2006, three quarters of all applications (representing 63 percent of the total value) had been rejected. Similarly, for the VCF, of 322 applications valued at P2 623.2 million, 139 were rejected, while 126 projects were withdrawn. However, to put these concerns in perspective, the launch of a new business is inherently risky and it is likely that a sizeable proportion of proposals is not approved for funding.

Botswana Export Development and Investment Authority (BEDIA)

- 4.8 As a follow-up to the recommendations made in the 1982 National Policy for Economic Opportunities to establish a 'one-stop shop' centre for new business ventures, the Trade and Investment Promotion Agency (TIPA) was established in 1984 to provide information and advice on investing in Botswana as a way of encouraging investors to set up in the country. However, TIPA was largely ineffective as a department within the then Ministry of Commerce and Industry, as it was not able to effectively coordinate the investment issues that cut across ministries; it was also constrained from attracting suitable staff given the unattractive government salary structure and schemes of service. In 1999, it was replaced by BEDIA, an autonomous body, which was mandated to encourage, promote and facilitate the establishment of export-oriented enterprises and provide selected services, with special emphasis on attracting foreign investors.
- 4.9 BEDIA supports businesses and investors by identifying investment opportunities in the country and export markets for local products, providing investment advice, identifying joint venture partners, and organising visits and meetings between economic operators in the country and potential investors. Furthermore, BEDIA assists private businesses to obtain factory shells, complete pre-investment clearances, such as work and residence permits, and acquire licences, as well as providing economic data such as trade statistics. It organises both inward and outward investment missions to familiarise potential investors with the investment climate in the country, as well as fairs, exhibitions and contact missions to market Botswana products abroad. In addition, BEDIA operates a One-Stop Service Centre (OSSC), which liaises with both the Government and parastatals to help investors quickly secure the necessary clearances to operate a business in Botswana. BEDIA has also commissioned studies on viability and export potential of various products (textiles, glass and glass related products, and beef and beef by-products, for example) for the information of both local and foreign entrepreneurs and investors.
- 4.10 In order to help position Botswana favourably in the face of intensifying global competition for FDI inflows, the agency has been developing a national FDI strategy which articulates the country's investment climate and will be launched by the Ministry of Trade and Industry (MTI) in 2007. Additionally, BEDIA facilitated the development of the Export Development Programme to enhance the export competitiveness of local small and medium scale manufacturing enterprises. Meanwhile, a National Export Strategy has been developed which seeks to increase exports through targeted policy and institutional assistance to key priority sectors. The initial focus is on meat products, leather products, creative industries (arts and crafts) as well as gems and jewellery. To further support and give momentum to efforts towards attracting FDI and developing export markets, BEDIA has been overseeing and coordinating a national branding exercise to create a comprehensive 'Brand Botswana' strategy for Botswana, which is scheduled to be launched in early 2007.

Support for Small, Medium and Micro Enterprises (SMMEs)

- 4.11 SMMEs potentially play a significant role in fostering economic diversification, entrepreneurial development, broad-based employment creation and poverty alleviation. Since most citizen-owned businesses are in this category, SMMEs are considered a vehicle for citizen economic empowerment. For Botswana, one of the main constraints to private sector development is the shortage of local entrepreneurs, while the SMMEs are the main source from which entrepreneurial and business management skills will develop. The Government has assisted SMMEs in a variety of ways over time, including through FAP and the Integrated Field Services (IFS) Division of MTI.
- 4.12 In recognition of SMMEs importance, a policy was approved by Parliament in 1998, to encourage the development of a competitive and sustainable SMME community that will foster citizen entrepreneurship and empowerment, economic diversification and create sustainable employment opportunities. In turn, the Small Business Council and the Small Business Promotion Agency (SBPA) were established to implement the policy. Subsequently, a special assistance fund to provide loans to SMMEs was established in 1999, administered initially by the National Development Bank and later merged with the operations of CEDA. In recognition of the need to rationalise support and improve service delivery to SMMEs, the Local Enterprise Authority (LEA) was established in 2003 and started operations during 2006, thus amalgamating and consolidating the training and technical support programmes provided by the SBPA, IFS and Enterprise Botswana.

Other Supporting Policies

Competition Policy

- 4.13 In 2005, Parliament approved a competition policy for Botswana, which included a provision for legislation to regulate anti-

competitive behaviour. Anti-competitive behaviour can frustrate the country's diversification objective by hindering entry of new firms and inhibiting innovation, development of new products and associated improvements in productivity. Thus, while the principal objective is consumer protection, the policy is also part of the broader strategy aimed at fostering enterprise development by assuring firms and potential investors of a largely unrestricted business environment. The policy promotes enterprise efficiency and broadens choice by providing the best means of ensuring that the economy's resources are allocated and used efficiently. In a competitive market there are always incentives for good performers, encouraging firms to improve productivity and reduce prices. This will, in turn, reward consumers through a wider choice of goods and services at affordable prices. Anti-competitive behaviour will be prohibited by means of levelling the playing field for all participants, including competitive neutrality for government business and removal of state subsidies. The policy also stipulates the separation of industry regulations from industry operations where dominant firms will not be allowed to set technical standards for new entrants. The drafting of the competition legislation, the centrepiece of which is the establishment of a National Competition Authority, commenced in 2006. The envisaged legislation is largely similar to that found in many other countries, although it will be necessary to ensure that the scale of the proposed authority is appropriate to the size of the economy and that it has adequate resources to undertake detailed investigations which may form the basis of legal action if necessary.

National Incomes Policy

- 4.14 The National Policy on Incomes, Employment, Prices and Profits was introduced in 1972 and subsequently revised in 1990 following the report of the Presidential Commission on the Review of the Incomes Policy. Among other provisions, the policy provided for the setting

of minimum wages in most sectors of the economy to prevent exploitation of workers by overly powerful employers.³¹ The other elements of the policy included:

- (a) regulation of wage and salary structures with a view to rewarding skills, experience and responsibility, as well as encouraging increased productivity;
 - (b) monitoring the employment and remuneration of expatriates and training citizens for localisation;
 - (c) regulating prices to minimise monopolistic exploitation;
 - (d) encouraging local retention and reinvestment of profits;
 - (e) promoting local ownership and control of businesses.
- 4.15 A further review of the national incomes policy was undertaken in 2003 and 2004, and this was mainly directed at supporting the national objective of sustainable economic development, taking into account the structural changes that have occurred since the 1990 review and anticipated future developments. The major objectives of the revised policy include the need to moderate wage growth to promote international competitiveness and expansion of productive employment opportunities as a means of ensuring that the benefits of development are widely distributed in a bid to encourage citizen empowerment. The extension of minimum wages to the domestic service and agricultural sectors was recommended as a way to contribute towards poverty alleviation. It was further recommended to merge the work and residence permits into one document in order to minimise delays in employing expatriates. The recommendation to de-link parastatals from public sector remuneration should increase the range of measures that these institutions can undertake to increase productivity and better serve the rest of the economy.

31. Among other sectors, agriculture was excluded as it was believed that enforcement of minimum wages, even for formal sector workers, would be impractical.

Privatisation Policy

- 4.16 Privatisation is generally considered to improve output growth by stimulating entrepreneurship and investment. It can promote efficiency in service delivery, facilitate technological transfers through FDI, minimise politicisation of service delivery/rent seeking and improve commercial linkages, strategic alliances and rationalisation of business activities. Against this background, a Privatisation Policy was adopted by Parliament in 2000, following the report of a national commission. Subsequently, the Public Enterprises Evaluation and Privatisation Agency (PEEPA) was established to implement strategies for privatisation and commercialisation of public services. Following its establishment, PEEPA engaged in an extensive process of consultation with stakeholders, which resulted in publication of the Privatisation Master Plan (PMP) in 2005.
- 4.17 The plan is designed to guide implementation of the privatisation process and lists the main candidates for privatisation or commercialisation that had been identified based on the criteria of feasibility and desirability as indicated in the Privatisation Policy. For these parastatals and public entities, the PMP specifies the strategy and process of privatisation or commercialisation. Moreover, the plan outlines the principles and practices to be followed in the privatisation process as well as the regulatory, institutional and legal reforms required during implementation.
- 4.18 It is envisaged that privatisation will be implemented through a rolling plan, in four-year phases, starting from 2005/06 to 2008/09, and will be revised after every two years. Only two or three major parastatals are to be privatised in each of the four-year periods. Plans are already underway to privatise Air Botswana during 2007, Botswana Telecommunications Corporation (BTC) by 2009, and the involvement of the private sector in the expansion plans of the Botswana Vaccine Institute (BVI) has been approved. The Government intends to proceed with the sale of its stake in the Botswana

Building Society and has instructed PEEPA to proceed with the privatisation of the National Development Bank (NDB).

4.19 Despite extensive consultation by PEEPA and the national commission before it, privatisation remains controversial in Botswana, and this may explain why the Government has appeared to move cautiously towards implementation. The principal concerns are that privatisation could result in job losses in the affected enterprises and limited provision or curtailment of services, especially to poorer households and the more remote and less populated areas. The other concern relates to the sale process, particularly in regard to who will be able to buy the privatised assets and how the proceeds will be used.

4.20 While there is a legitimate basis for these concerns, given the examples of undesirable consequences of privatisation in some other countries, the negative results can, however, be overstated. In particular, improved efficiency in the provision of utilities should have a positive effect on employment once the impact on the wider economy is taken into account, while the interests of poorer customers and remote communities can be specially catered for through contractual agreements with the private suppliers. Concerns about the sale process should be addressed by ensuring that it is transparent, and priority should be given to new owners who can provide the necessary resources in terms of technological know-how and funding to ensure the continued provision of efficient services over the long term. In addition, special financial vehicles or instruments are normally created to facilitate ownership by special interest groups, such as employees and citizens. Where privatisation has not worked well, it has usually been in cases where the newly privatised entity is not subject to appropriate market discipline through competition or, in its absence, adequate regulation.

4.21 Apart from parastatals and other government-run institutions, some government activities that are considered likely to be performed

more efficiently by the private sector have been identified in NDP 9. It is envisaged that such services may be provided by the private sector through Public-Private Partnerships (PPPs),³² while ultimate responsibility for service provision will remain with the Government. In some cases, PPPs may help to overcome shortages of funds and lack of implementation capacity in government. They also provide an opportunity for private sector development in that they can attract FDI and citizen entrepreneurship, at the same time improving efficiency in service delivery. One area where such opportunities may exist is in the construction and maintenance of public infrastructure projects, including, for example, office blocks and roads. These would seem particularly relevant given the slow pace of development spending by the Government in recent years, together with the substantial surplus of private institutional savings looking for opportunities for safe long-term investments.

Information and Communication Technology (ICT) Policy

4.22 In the modern economy, the technology for information transfer with its speed and robustness is a real-time input into the production process. Remaining current with information and communications technology developments is, therefore, crucial in ensuring sustained industrial development, improved service provision, and higher overall levels of productivity and competitiveness. Increasingly, ICT is also crucial in social upliftment and poverty alleviation. In recognition of this, the Ministry of Communications, Science and Technology (MCST) was established in 2002 to give greater focus to the implementation of the ICT strategies. In 2004, the Government adopted 'Maitlamo', a national ICT policy. The broad objective of Maitlamo (which means 'commitment')

32. PPP is a system where a government or private business venture is funded and operated through a partnership of government and private sector entities.

is that 'Botswana will be a globally competitive, knowledge and information society where lasting improvements in social, economic and cultural development are achieved through effective use of ICT'. Maitlamo further intends to make Botswana a regional technology development hub that would make ICT in the country competitive in the global market.

- 4.23 In support of the development of the ICT programme, more investment is being directed at upgrading the country's communications network with new technology, particularly access to the satellite network, which will ease connectivity throughout the country. In addition to equipment and network upgrading, a phased programme of further liberalisation of the telecommunications sector was announced in 2006 to increase competition in the sector and enable operators to take full advantage of emerging technologies.
- 4.24 There are also plans to promote Botswana as a centre for science and technology through initiatives such as the establishment of the Botswana International University of Science and Technology (BIUST), which is due to open in 2009, and the development of an innovation hub. The innovation hub is intended to foster development and use of ICT through institutionalising processes for nurturing product development, commercialisation and transfer of knowledge. The hub is also expected to include the Botswana campus of a Malaysian university, the Limkokwing University of Creative Technology, which specialises in technology-related courses. As well as providing state of the art communication services, investors in the hub can expect tax and trade related incentives similar to those already provided for businesses in the International Financial Services Centre (IFSC).

Policies for Financial Sector Development

- 4.25 The 2005 Bank of Botswana Annual Report addressed the Financial Sector Development Strategy (FSDS), which was first outlined in

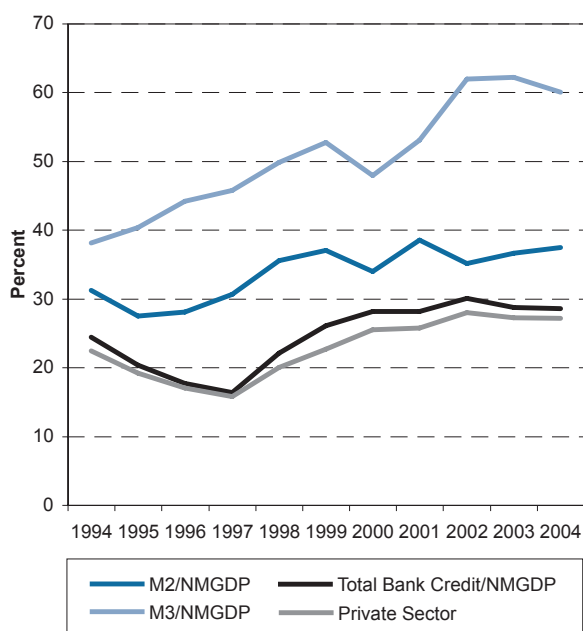
NDP 7 (1991–1997). The report articulated a long-term strategy premised on the need for improved financial intermediation to promote savings mobilisation and investment allocation to support private sector-led growth and diversification. Future development of the financial sector was, therefore, to be guided by three basic criteria:

- (a) efficiency of the intermediation process;
- (b) soundness of policies, institutions and practices that guide the sector; and
- (c) adaptability of the financial system to changes in international circumstances.

- 4.26 In line with these objectives, several initiatives were undertaken in the 1990s and early 2000s to broaden the financial sector beyond the existing commercial banks and to wean parastatals from reliance on the Public Debt Service Fund (PDSF). The promulgation of the Botswana Stock Exchange Act in 1994 has underpinned the subsequent rapid growth of the stock market. Financial sector development has also been aided by the issuance of three domestic government bonds in 2003, and the securitisation and sale to private investors of the commercial part of the PDSF loan book. In addition, the widespread change towards defined contribution pension schemes, including the effective privatisation of government pensions following the establishment of the Public Officers Pension Fund, contributed to growth and increased activity of the non-bank financial sector. In the circumstances, the Government recognised the need to improve the financial regulatory framework, and a bill to establish the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) was approved by Parliament in December 2006.
- 4.27 An assessment of the performance of the financial sector since 1991 shows that, although it is a middle-income country with a relatively low level of financial sector development, Botswana has a wide range of institutions, products and services, thus indicative of the widening and deepening of the

country's financial system.³³ Chart 2.10 shows movements in various indicators of financial sector development for Botswana,³⁴ which capture the degree of financial intermediation and monetisation of the financial system, as well as the role of banks in allocating funds. All the indicators of financial development have generally increased from the mid-1990s as financial services grew more rapidly, relative to the rest of the economy, but have levelled off in the most recent period, and this indicates that financial sector growth is largely in tandem with non-mining output growth.

CHART 2.10: FINANCIAL INTERMEDIATION AND MONETISATION RATIOS



Source: Bank of Botswana

33. As well as the 2005 Bank of Botswana Annual Report, the 2001 Report Theme Chapter on 'The Role of the Financial Sector in Economic Development' covered extensively the reforms and performance of the banking sector since the reform period. Other reports for 1994, 1997, 1998, 1999 and 2000 also addressed some of the issues pertaining to the financial sector.

34. The four indicators used are: M2/NM GDP, M3/NM GDP, Total bank credit/NM GDP and Private sector credit/NM GDP. M2 = M1 (Currency outside banks plus demand deposits) plus call, savings, notice and time deposits. M3 = (M2 plus BoBCs), which also includes BoBCs held by the non-bank private sector. NM GDP is non-mining GDP and it is used to avoid distortions brought about by the fluctuations and dominance of the mining sector in the Botswana economy.

Macroeconomic Policies

4.28 Monetary, exchange rate and fiscal policies are used to guide the direction of the economy and promote growth, while maintaining overall economic balance. The main aim of monetary policy in Botswana continues to be price stability, defined as a sustainable, low and predictable level of inflation. While the monetary policy framework has evolved since the establishment of the Bank of Botswana in 1976, the introduction of an annual Monetary Policy Statement (MPS) in 1998 explicitly placed the objective of controlling inflation as central to the policy regime. Subsequently, an objective range for inflation for the year ahead was published in the MPS in 2002. In 2006, a medium term (three-year) objective range for inflation was introduced in the MPS, in recognition of the long lags, typically extending beyond a year, inherent in the process of monetary policy transmission.

4.29 The current monetary policy framework incorporates some important elements of 'inflation targeting', such as transparency and communication of the inflation objective and its link to the economic outlook, intermediate targets and policy response. However, it falls short of being a full-fledged inflation targeting framework: most notably that the inflation objective is set by the monetary authority itself, and there is no specified course of action if the objective is not met.³⁵ While there is no commitment yet with respect to the transition to an inflation targeting regime, other elements of this framework, including scheduled monetary policy meetings and inflation forecasting capability, are in place and subject to constant review. Overall, however, the monetary policy framework and its operation is broadly successful if it underpins the formation of low inflation expectations and contributes to non-inflationary economic growth.

35. Under inflation targeting, the target is set for the monetary authorities, usually by the national government. As a further measure to ensure accountability, the target is typically accompanied by a specified course of action and the central bank is given instrument independence.

4.30 The major thrust of the exchange rate policy in Botswana is the maintenance of a stable and competitive real effective exchange rate (REER) of the Pula, which seeks to support the international competitiveness of local producers of tradeable goods and services. In order to increase compatibility between monetary and exchange rate policies, the fixed peg was replaced with a crawling band exchange rate mechanism in May 2005 (in both cases the exchange rate is set against a trade-weighted basket of currencies). It was considered that the crawling-band regime would support an active monetary policy framework that focused on the price stability objective, and facilitates a more orderly response to changes in economic fundamentals by avoiding large and unpredictable discrete adjustments to the exchange rate. In the past, sizeable discrete devaluations aimed at improving competitiveness have resulted in short-run spikes in inflation, with a negative impact on inflation expectations and the price stability objective, thus potentially contributing to continuing deterioration of competitiveness. In the crawlingband exchange rate mechanism, the nominal exchange rate crawls at a predetermined rate that is equivalent to the differential between Botswana's inflation objective and forecast inflation of trading partner countries, with both the crawl and the achievement of the inflation objective contributing to stability of the REER.

4.31 Fiscal policy generally refers to a government's choice in the use of taxation and public spending to influence both aggregate economic activity and its composition. The influence of fiscal policy is most commonly associated with its impact on aggregate demand, but the structure of taxes and government spending can also affect the supply side of the economy.³⁶ Historically, Botswana's fiscal

policy has been characterised by prudence. However, despite recurring surpluses, with the focus on infrastructure development, social upliftment and the relatively large size of government, government spending generally has an expansionary impact on the economy. Fiscal policy has also been influenced by the concern that the externally generated revenue windfalls could encourage excessive spending. In view of this, government policy is that mining-related revenue should mainly be used for development expenditure. Furthermore, in order to strengthen the commitment to fiscal prudence, and as part of the Mid-Term Review of NDP 9, the Government adopted a 'fiscal rule' in 2005, which limits Government expenditure to 40 percent of GDP. At the same time, and in line with the need to provide the necessary public infrastructure to support economic growth, the balance of government expenditure is to be shifted in favour of additional development spending. As a result, in the 2006/07 budget, development expenditure was budgeted to grow by 35.6 percent compared to an increase of only 9.1 percent for recurrent spending.

4.32 The Government also continues to rationalise its budget as the economy develops and incomes grow. The sale of most of the PDSF loan book in 2004 potentially makes funds (that would have otherwise been used to finance parastatals) available for other government development priorities. Moreover, while the Government remains committed to broad-based provision of infrastructure and social services, it has instituted a cost recovery programme to increase the public's contribution to the cost of services and infrastructure development and maintenance. The cost recovery measures should enhance the efficiency of resource allocation and use, particularly as the public becomes sensitised to the true cost of services and, in turn, demand better quality for the price they pay. For example, revenue from higher road licence fees and other related levies should contribute significantly towards road maintenance. As at the end of 2006, 11 out of the 14 government ministries

36. As two examples of the latter, high rates of taxation may negatively affect the incentive to work and invest, while the provision of public infrastructure may improve the viability of private sector businesses.

were either partially or fully implementing cost recovery measures. Some of the areas of cost recovery include:

- (a) training of entrepreneurs by MTI;
- (b) transport permits, vehicle licences, driving licences, vehicle inspections, driving tests by the Ministry of Works and Transport;
- (c) animal vaccinations, plant and animal laboratory services by the Ministry of Agriculture; and
- (d) school fees and repayment of study loans by tertiary institution graduates in the Ministry of Education.

- 4.33 Going forward, identification of more areas from which costs can be recovered, and improvement in the implementation of cost recovery measures, should enhance service delivery in the country.

Facilitating Trade and Market Access

- 4.34 Generally, Botswana's trade policy aims at facilitating growth of exports and diversification of the economy. The policy objective has been pursued through regional and bilateral trade negotiations and arrangements, as well as through participation in multilateral trade arrangements, as outlined in Box 2.1.

- 4.35 Botswana's continued participation in these arrangements will in the long run be an important element of a broader package of initiatives that can contribute towards productivity improvement, an increase in incomes and ultimately accelerate the country's economic growth. This is because expansion of international trade and commerce is an important channel through which competition and choice can be enhanced, thereby benefiting both consumers and producers. In addition, the rapid expansion of trade, particularly in manufacturing, can occur with large investments in capital, technological advancement and the acquisition of new skills and knowledge, all of which will further boost productivity and ultimately promote new sources of

income and employment.

Poverty Reduction

- 4.36 The 2003 National Poverty Reduction Strategy outlined the framework for alleviating poverty through, among others, the following programmes:

(a) *Health and Nutrition Programmes* mainly take the form of direct welfare transfers to the beneficiaries. For example, in 1999, the Government introduced an assistance programme for orphans³⁷ to mitigate the effects of the HIV/AIDS epidemic among children. Orphans and vulnerable children are provided with necessities, such as food, clothing and school uniform. There is also a destitutes policy that facilitates assisting the needy with food and financial allowance to ensure their good health and welfare.

(b) *Entitlement Programmes* include the Old Age Pension scheme for citizens on attaining 65 years of age and the World War II Veterans allowance.

(c) The Labour Based Drought Relief Programme is a *public works programme* initiative through which the Government creates employment during drought years to compensate for income loss and absence of subsistence production. Another example is the Labour Intensive Public Works Programme that creates employment by using labour intensive methods and simple tools to carry out project implementation and maintenance of public facilities.

(d) *Other Programmes* include the Remote Area Development Programme to provide basic infrastructure and promote economic development in the country's remote areas. For example, rural area dwellers are given support to use local resources for employment creation and generation of income, through wildlife and tourism.

37. Referred to as the 'Short-Term Plan of Action'.

BOX 2.1: BOTSWANA'S MAJOR TRADING AGREEMENTS

African Growth and Opportunity Act (AGOA)

The main purpose of AGOA is to improve trade and economic cooperation between the USA and eligible countries in Sub-Saharan Africa (SSA). The life span of AGOA is 2000–2008. AGOA provides duty free access for over 6 500 products from SSA to the United States. Botswana benefits mainly from AGOA provisions for textiles and apparel, which allow producers to use third country inputs in manufacturing textiles and apparel for export to the US. Access to these benefits was initially constrained by Botswana's classification as a middle-income country. However, under AGOA II which was passed in 2002, in recognition of the countries' narrow resource base, Botswana and Namibia were reclassified as LDCs for a period of two years, and this was subsequently extended to 2007.

Botswana/Zimbabwe Trade Agreement

Zimbabwe is one of Botswana's largest regional trading partners. The Botswana/Zimbabwe Trade Agreement provides for mutual duty and quota free bilateral trade for goods, provided they meet the 25 percent local content requirement. Local content requirements are calculated as the cost of local materials and labour. Under the provisions of the agreement, exports of textile and clothing products are subject to a quota of P7.2 million per annum.

Cotonou Agreement

The Cotonou Agreement succeeded the Lomé IV Convention in 2000. The Agreement allows export of products from African, Caribbean and Pacific (ACP) countries to the European Union (EU) market, free of customs duties and, in certain instances, at preferential rates of duty. Some of Botswana's products that benefit from the trade provisions of the Cotonou Agreement include beef, textiles and clothing. The Cotonou Agreement is being renegotiated with the aim of creating free trade areas between the ACP and the EU. SADC Member states will negotiate an Economic Partnership Agreement (EPA) with the EU. The EPAs are scheduled to come into effect by January 2008, and will constitute long-term trade and economic relations between ACP regions and the EU.

Southern African Customs Union (SACU)

SACU is an economic bloc comprising South Africa, Botswana, Lesotho, Namibia, and Swaziland. The new SACU Agreement, which included a new revenue sharing formula and more democratic decision making, was concluded in October 2002 and came into effect in 2005, replacing the 1969 Agreement. Beyond being a customs union, SACU's aims are to advance the economic development of its member countries, to diversify their economies and to afford all parties equitable benefits arising from intra-union and international trade.

Southern African Development Community (SADC)

Botswana is a founding signatory to the SADC Treaty of August 1992. Currently, SADC has 14 members with an estimated population of 208 million (2001 estimate). One principal aim of SADC is to coordinate and harmonise socio-economic policies and plans of its member states in order to ensure sustainable economic development and growth in the Southern African region. The objective of the SADC Trade Protocol is to promote trade between the member states through progressive trade liberalisation, leading to formation of a free trade area by 2008.

The World Trade Organisation (WTO)

The World Trade Organisation was established in 1995 as a successor to the General Agreement on Tariffs and Trade (GATT) to advance the process of trade liberalisation through a series of negotiations called 'rounds'. While GATT only covered merchandise trade, the WTO also covers trade in services and intellectual property rights. The WTO was formed following the conclusion of the 'Uruguay Round'. The WTO is responsible for implementing the negotiations under the yet to be concluded 'Doha Round'. The WTO is the final arbiter in trade disputes between its 150 members. Under plans to create a market-oriented agricultural trading system, Botswana and its SACU partners will have to decrease tariffs by 24 percent over 10 years. The SACU members also have to phase out quota restrictions on developing countries' textile exports.

4.37 A full time poverty alleviation advisor was appointed in 2005; and during 2006, a review of social safety nets was completed, with a recommendation for improving the scope and efficiency of service delivery. Implementation of the recommendations accepted by government will commence in the 2007/08 financial year, including the following:

- (a) creation of databases to track beneficiaries and indicators of risk and vulnerability;
- (b) accelerated outsourcing of food distribution programmes;
- (c) development of a coupon-based system of assistance; and
- (d) rationalisation of the coverage of assistance packages in the overall context of the household.

Managing the HIV/AIDS Epidemic

4.38 The overall goal of government policy on HIV/AIDS is to control the spread of the disease, provide care and support for those infected and to mitigate its public health, social and economic impact. Programmes to mitigate the effects of the epidemic include the comprehensive ARV programme, routine testing in hospitals, research, early detection, new treatment therapies, and vaccine trials. In the late 1980s, when the epidemic was still in its early stages, the focus was on the screening of blood to prevent HIV transmission through blood transfusion. Subsequently (from 1989 to 1997), information, education and communication programmes, principally aimed at changing sexual behaviour, were emphasised. Unfortunately, the response was inadequate, in part, because the responsibility for dealing with the epidemic was vested only in the Ministry of Health (MoH), which already shouldered other onerous responsibilities. Recognising that the epidemic was beyond the scope of MoH a more comprehensive, multi-sectoral approach to addressing and reducing the impact of the disease was employed from 1997 and encompasses prevention, treatment, care, support and research programmes.

4.39 To further strengthen the developmental and multi-sectoral approach, NACA was established in 2000 to coordinate the overall response to the epidemic. Moreover, the national response to HIV/AIDS has been aligned with the goals and objectives of NDP 9 and Vision 2016, and there is more focus on preventing new infections through advocacy, condom distribution, behavioural change, education and communication and targeting members of the public considered particularly vulnerable to infection. The home-based and orphan care programmes were introduced, the former to cater for the increasing number of terminally ill patients so that they could be cared for at home, given the already crowded hospitals. The provision of free ARV therapy is also in place to extend lives of the infected, although the extent to which the medication will increase life expectancy is still not known. However, while the provision of ARV medication is a welcome development, there is a risk of moral hazard where people engage in risky behaviour just because there is free medication. Accordingly, therefore, more emphasis should continue to be put on the 'Abstain, Be faithful and Condomise' (ABC) campaign.

4.40 There is also the provision of free AZT drugs to HIV-infected expectant mothers through the 'Prevention of Mother-To-Child Transmission' (PMTCT) scheme while infant formula is provided to their children. To prevent tuberculosis infection to HIV/AIDS infected people, the Government put in place the Isoniazid Preventive Therapy (IPT) programme. These efforts are an indication of strong commitment by the Government in prevention and treatment, not only because they save lives and reduce human suffering, but also because they moderate the future impact of the epidemic on human development, and poverty reduction efforts.

5. PERFORMANCE OF THE POLICY FRAMEWORKS

5.1 It is apparent from the preceding Sections that

there has been a variety of initiatives aimed at encouraging citizen entrepreneurship, private sector development and the diversification of the Botswana economy and an overall, broad-based increase in living standards. However, the fact that there are still concerns over these aspects of economic development implies that the policy menu might be deficient and unable to provide an effective solution to the challenges. What follows is a consideration of some of the possible deficiencies and constraints that may have hindered the success of government initiatives aimed at mitigating the challenges highlighted in Section 3.

The Need for Prioritisation

- 5.2 It is possible that the simultaneous introduction of policies and the potential proliferation of implementing institutions might impede their effectiveness and performance, particularly in view of the scarcity of manpower resources and capacity for executive oversight. Moreover, additional bureaucratic impediments to development may emerge in instances where institutional responsibilities overlap.
- 5.3 Once initiated, policies are difficult to discard even when they have outlived their usefulness. For example, it might be appropriate to review the role of an incomes policy in a modern market-based economy, especially since such a policy is no longer common in other countries. Key elements of the incomes policy, such as minimum wages, can be implemented outside the context of an all-embracing policy which may encourage an overly interventionist approach to wage determination at the cost of productivity and employment creation.
- 5.4 Despite extensive publicity, key strategies may remain inadequately explained or poorly executed in view of the multiple policies and institutions. For example, while there have been several rounds of consultation and PEEPA has been established as a focal point for implementation, the basic aims of the Privatisation Policy do frequently appear to be poorly understood.
- 5.5 Key development strategies can, therefore, be vulnerable to negative comment due to lack of understanding and dissatisfaction arising from inadequate explanation, especially if there are problems with implementation. This suggests a need to improve on ranking and advocacy in favour of key priorities. If the overarching objective is to reduce unemployment and poverty (and hence the negative aspects of income inequality) through economic diversification based on export-led growth, then the merits of this objective should be fully articulated to achieve widespread public understanding and commitment. This should minimise advocacy for other social goals that may be a distraction or could be at odds with the principal objective.

Financial Assistance Is Not a Panacea

- 5.6 One of the most prominent characteristics of policies that support economic diversification in Botswana is the emphasis on provision of subsidised loans and grants by the Government, as well as financial policies that require minimal collateral or equity contributions by the project owners. This approach appears to be partly influenced by the availability of substantial government financial resources and the perception that commercial interest rates are too high. However, subsidised loans, especially those given as help to a select category of potential businesses, have a tendency to inhibit proper project costing and appraisal by prospective entrepreneurs and lenders, and indiscipline in financial management. In addition, there is evidence that subsidised financial support is insufficient if other fundamentals of viable business planning are not in place. Moreover, as shown by the experience of FAP, provision of subsidised capital fosters low-return projects that will not be viable when the subsidies are no longer available.
- 5.7 In the case of CEDA, borrowers are encouraged, but not required to make equity contributions. While this arrangement is meant to ease the equity capital requirement constraint

on small borrowers, there is an inherent moral hazard, possibly to the detriment of longer-term private sector development. The absence of equity contribution might indirectly act as a disincentive for entrepreneurs to strive for the success of their businesses as there is no financial risk to them that is linked to failure of the business.

- 5.8 The provision of loans on generous terms using government funds may also result in crowding out of the private financial sector in the credit market. If the borrowing terms from government-supported institutions are both easier and expose the lender to greater risk relative to the borrower, the latter has a clear incentive to borrow more from government than elsewhere. Thus, it is possible for institutions such as commercial banks and non-governmental financial institutions to lose their potential customer base to government-supported institutions. Although there is a perception in Botswana that the commercial banks are ill-equipped, and often unwilling to provide funding for potentially risky business start-ups and expansions, it is also likely that a proportion of the jobs 'created' by CEDA could also have been financed by private financial institutions, while the presence of CEDA-type institutions might obviate the need for private sector innovation to meet the apparent demand for start-up capital, especially among citizen entrepreneurs.
- 5.9 Private lenders are profit oriented and are likely to have better skills and greater motivation to fully monitor projects to minimise default risk than it is the case with the Government. A more vigilant surveillance of borrowers by lenders can encourage entrepreneurs to ensure that their businesses succeed. Hence, leaving the provision of investment funds to the private markets has the potential to enhance a more sustainable private sector.

Businesses Reserved for Citizens

- 5.10 The desire to broaden economic opportunities for citizens motivates the reservation of certain economic activities for them. Such activities

include butchery and fresh produce, general trading, petrol filling stations, supermarkets (excluding chain stores and franchise operations) and bars (other than those related to hotel establishments), as well as a variety of small-scale tourist-related operations. While the appeal of such regulations is clear, any benefits are likely to be short term. A more comprehensive and durable approach to private sector development would recognise the benefits of encouraging migration of entrepreneurs from other parts of the world (even operating in the generally small-scale and 'low-tech' activities covered by the reservations policies). By excluding foreigners from some aspects of the country's economic activity, there is a potential danger that Botswana will miss the opportunities to benefit from foreign expertise and finance, as well as the global production and marketing linkages that are increasingly a common characteristic of enterprises.

Inadequacies in Implementation

- 5.11 Lack of implementation is another widely cited problem undermining government policy initiatives and programmes. To some extent, this may be due to a lack of synergy among government departments and other related institutions in providing services. In some instances, the various agencies often have differing agendas, which sometimes make their objectives incompatible; while others tend to pursue similar and related objectives, therefore resulting in a duplication of efforts. Furthermore, power differentials may arise among the various stakeholders as a result of differences in resource levels, operational capacity and political influence, thus contributing to poor implementation. In the past, implementation has also been weakened by lack of indicators for monitoring progress in the execution of government programmes, although this is now being addressed by the introduction of more rigorous performance management systems. Moreover, capacity problems, including lack of resources and inappropriate skills, are often some of the key impediments to implementation.

- 5.12 With respect to HIV/AIDS, there are currently a number of participants, such as the Government, donor agencies, NGOs, community based organisations, private businesses, affected communities and individuals. Some of these different stakeholders could potentially compete and duplicate each other's efforts and may, therefore, present difficulties in governance, coordination and harmonisation, and work against a systematic approach in the fight against HIV/AIDS.

6. THE WAY FORWARD

- 6.1 In order for Botswana to maintain the relatively high growth rates achieved in the past and to effectively address its socio-economic challenges, there is need to improve the business environment in support of enterprise development and productivity improvement. This should contribute to economic diversification and help mitigate the interrelated problems of high unemployment, poverty and income inequality. As indicated above, this prognosis is well recognised and the various aspects of sustaining economic development and social upliftment are outlined in the themes for the two most recent NDPs, which point to diversified development and participation of citizens in economic activity as the primary means to achieve international competitiveness and raise living standards. In addition, the recent annual Budget Speeches are clear about the need to integrate technology, innovation and a global approach to performance as key to achieving competitiveness, diversification and the economic and social upliftment envisaged in Vision 2016.³⁸
- 6.2 In charting the way forward, the issues ad-

ressed below recognise the national objectives, and the path that has so far been taken towards achieving them, while making suggestions for overcoming the limitations identified in Section 5. Broadly, there is emphasis on the extent to which free market competition can make a major contribution to alleviating the country's development challenges. This view is premised on the evidence that free markets generally provide better outcomes. It is recognised, nevertheless, that markets can fail, thus providing a basis for the Government to play a role in the economy, but mostly in the form of guidance, provision of basic physical and social infrastructure, public goods and services, market regulation and explicitly-targeted subsidies. For Botswana, which is considered to have a mixed, but relatively free-market economy, it is possible that the level of dependence on the Government and the expectations with respect to government assistance are relatively high.

Creating an Investor Friendly Environment

Role of Government

- 6.3 The Government has a major role to play in the provision of infrastructure and social services, legislation and a regulatory framework required for private sector development and sustainable economic diversification. In addition, it should support entrepreneurship, the drive for efficiency, competitiveness and private sector-led growth. The Government also has a role of protecting and expanding access by disadvantaged groups to basic social infrastructure and services such as water, health and education. Relevant legislation needs to be in place to ensure continuing

38. The theme for NDP 8 was 'Sustainable Economic Diversification', while for NDP 9 it was 'Towards Realisation of Vision 2016: Sustainable and Diversified Development through Competitiveness in Global Markets'. The respective themes of the Budget Speeches for the period 2003–2007 were: 'Towards Realisation of Vision 2016: Sustainable and Diversified Development through Competitiveness in Global Markets' (2003); 'Improving Economic

Performance: A Vehicle for Sustainable and Diversified Development' (2004); 'Meeting the Millennium Development Goals and Vision 2016 Through a Participatory Approach to Development' (2005); 'Building an Innovative Economy for the 21st Century' (2006); and 'Improved Productivity – The Key to Sustainable Economic Diversification and Global Competitiveness' (2007).

soundness of the business environment, effective competition, market regulation, consumer and environmental protection, as well as conformity with social standards and good business practice.

6.4 The Government already stresses the importance of promoting an enabling environment for private sector development and, therefore, economic diversification. However, despite this commitment, as already discussed in Section 2, recently published international rankings suggest that Botswana is regressing in terms of international competitiveness. This is principally due to a combination of bottlenecks (shortage of serviced land, for example) and a multiplicity of regulation and permits. Apart from being an administrative burden and time consuming, regulations provide a potential for influence peddling and corruption, especially in key areas such as land allocation. It is, therefore, important that procedures be streamlined and simplified in order to make the investment climate more conducive for investors. This could help the country to succeed in attracting the desired volume of foreign investment and nurturing citizen entrepreneurship. In this context, the legislation that was put before Parliament in December 2006 to update the Industrial Development Act, which included measures to streamline licensing procedures and encourage greater competition is welcome.³⁹

6.5 The emphasis on reduced regulation does not, however, suggest an immediate and complete elimination of rules and regulations, as this would be both impractical and, more fundamentally, undesirable. There will always be a need for a body of regulation where businesses are restrained from engaging in activities that impose wider costs on society, such

as the costs of anti-competitive behaviour, environmental pollution and unsafe working conditions.

Work and Residence Permits

6.6 There continue to be concerns about perceived difficulties involved in obtaining work and residence permits by foreign investors and workers despite the reduction in the processing time for applications. This potentially impacts negatively on the ability of the country to both attract and benefit fully from foreign investment. It is considered that approval of the proposal in the draft revised Incomes Policy to merge work and residence permits into one document will ease some of the administrative burden for foreign investors and workers, thus making the investment and working environment more conducive to both foreign and local entrepreneurs who may need expatriate labour. Automatic issuance of work permits for expatriate labour already occurs in some sectors/areas, and this should be extended to other areas where there is shortage of domestic skills. Over the long term, economic expansion, as well as the technology and skills transfer derived from foreign investments and workers, will help to create employment opportunities and reduce poverty.

6.7 BEDIA's OSSC, which aims to avail an expedited service to investors with respect to obtaining clearances and approvals, is also expected to improve service delivery. However, the efficacy of the OSSC might be enhanced by extending its powers to include the actual issuance of licences in some identified critical areas to further speed up the overall process of setting up businesses.

Acquisition of Land

6.8 The Government recognises the need to deal with the problem of insufficient serviced land as a matter of urgency. A comprehensive review of all land-related laws and policies was begun in 2006 with the explicit aim of establishing a conducive environment

39. These included proposals to remove the requirement for annual renewal of business licences (although there will still be annual fees), discontinue the issuance of exclusive licences, and align the industrial development legislation with the Trade Act, which also includes institutional arrangements for issuing licences.

for investors. The review should match the land allocation system with the dynamics of population, economic structure, development and growth. This will require reform of the rules, with a view to minimising the constraints to switching land from one use to the other to allow owners to exploit business opportunities as they arise, provided other health and environmental requirements are met. Easier access to land and ability to alter its usage can contribute to more rapid growth of a healthy private sector, as landowners will continuously assess use of their land and align it to projects that yield a higher return or are more viable, thus contributing to the national objective of economic diversification.

- 6.9 A move towards competitive determination of the price of land, that is currently bureaucratically allocated, could lead to more efficient allocation, as well as its usage for the more economically viable activities. This does not preclude social and equity considerations to land allocation, including limiting concentration of ownership and ensuring access for those not currently economically endowed or that prefer traditional approaches to land use in selected areas. At the same time, a transparent system of price-based allocation is more effective in ensuring that land is directed towards its most productive use, while reducing both the likelihood of delays and opportunities for influence peddling and corruption. In contrast, as with subsidies that encourage low-return investments, giving land for free, as in the case of tribal land, results in land remaining undeveloped for a long time and technically illegal sale of undeveloped land.

Physical Infrastructure Development

- 6.10 Infrastructure development is one area where appropriate government-led action can make a difference, especially as the private sector is unlikely to invest adequately in infrastructure development on its own. Lack of good infrastructure inhibits investment and increases the cost of doing business in Botswana.

While successive government budgets have included significant funding for infrastructure development, there have been deficiencies in implementation, which include projects not being carried out timely, poor construction and, therefore, inferior quality, as well as the abandonment of projects. This has apparently been due to a combination of deficiencies in project monitoring and management, as well as inadequacies of contractors.

- 6.11 Increasingly, in the context of economic liberalisation and privatisation across the world, as well as emerging profit opportunities, the private sector is being involved in infrastructure development, not only as contractors, but ultimately as owners and managers of the infrastructure. Among the various formulae are public private partnerships (PPPs), where the private sector takes the initiative and participates in the provision of infrastructure and counterpart funding for major projects; a good example is the construction of toll roads in some countries. Given the long-term benefit and incentives provided by the Government, the private sector is increasingly willing to participate even when the resource involvement is too high or the short-term profit incentive too low.
- 6.12 Another aspect of economic liberalisation to improve efficiency and delivery of services is privatisation, especially to reduce relative costs and speed up the modernisation of infrastructure. A joint study by BIDPA and the World Bank⁴⁰ has noted that passenger air travel costs are generally high in Botswana, and this has a negative impact on tourism as well as exports of business and financial services which often involves cross-country travelling by consultants and experts. This puts into perspective the need for the privatisation of Air Botswana to proceed as quickly as possible as well as the implementation of further measures, including deregulation, to further reduce the costs of air transport.

40. 'Prospects for Export Diversification in Botswana', 2006.

6.13 In another area, telecommunication systems in Botswana are generally reliable, and the advent of cellular telephones has rapidly increased their availability to people from all areas and income levels. Nevertheless, the further development of telecommunication services has apparently been held back by excessive regulation which has added to the perception that costs are exorbitant and, consequently, hampering the ability of businesses to conduct operations efficiently and competitively. The proposed liberalisation of the telecommunications industry should lead to efficiency gains and better and cheaper services. This is particularly crucial for the country's ambitions to develop in several areas, including financial services, ICT, science and technology, as well as the logistics of production and distribution.

6.14 Apart from involvement of the private sector, being land-locked makes it imperative for Botswana to rigorously pursue strategies for regional cooperation on infrastructure development and integration as a means of developing more active trade routes and to further expand market access. In 1998, the Trans-Kalahari Highway was completed to provide easy access to Namibia. It also makes game reserves and other tourist attraction areas easy to access. The Kanzungula Bridge is another milestone towards regional integration in the SACU region that will link Botswana, Zimbabwe and Zambia, by easing transport constraints and improving trade links among these countries. Furthermore, the leasing of part of the Walvis Bay Port in Namibia is expected to enable Botswana to export and import goods quicker and cheaper from abroad through the Namibian seaport.

The Legal Framework

6.15 A credible legal and regulatory framework is important for investor confidence, while the institutional set up should be transparent and accessible, with a capacity to formulate and enforce laws relating to property rights, competition, copyrights and bankruptcy,

among others. The protection of business and property rights engendered by a reputable legal system is critical in the drive towards attracting foreign investment, as well as being an incentive for artistic and business creativity and entrepreneurship generally. This will be increasingly important with innovation, research and development, as well as science and technology becoming crucial activities in sustaining the country's development and growth. An innovative firm requires reassurance that its inventions and creations will not be copied or adopted by its competitors without the necessary permission; it seeks to ensure that profits from the invention accrue to the rightful beneficiary. Such assurances include confidence that the legal system will function with due speed and, in this context, there is need to speed up the process of commercial justice in Botswana.

Availability and Dissemination of Economic Data

6.16 Statistics are critical to the development of the private sector, as such information is incorporated in investment decisions. At the same time, statistics are, in large part, a 'public good' and, as such, vulnerable to limited investment in their production. In this context, it is important for official agencies, such as the Central Statistics Office, Bank of Botswana and relevant government departments, to provide economic, financial and other related data. The data should be of good quality, up-to-date and disseminated efficiently and equitably to all users. In particular, producers of statistics should be responsive in terms of providing baseline data on the economy that can help investors prepare viable business plans.

6.17 Botswana's commitment to producing good quality statistics is shown by its current subscription to the General Data Dissemination System (GDDS) of the International Monetary Fund (IMF). In November 2006 the IMF undertook a rigorous assessment of the standard of official statistics in the country, and

the Botswana authorities are also considering the modalities of moving to the higher Special Data Dissemination Standard (SDDS), which sets more stringent requirements. However, for this effort to be successful, a commitment of additional resources is required.

- 6.18 While government should ensure that its relevant departments keep proper records of data and make them accessible to users, the private sector also has a role to play. This is both through active participation in surveys conducted by official agencies and also by taking advantage of commercial opportunities to fill information gaps by collecting and selling data to improve availability and dissemination.⁴¹

Human Resource Development

- 6.19 The development of skills and adoption of knowledge is an indispensable component of a successful economic development strategy. In the new economy led by the private sector rather than the Government, there is a need to match the quality of the labour force with the private sector needs and requirements of employers and consumers who are more global in outlook. In response to the growing shortage of professionals in the science and technology fields, the Government has approved the establishment of the BIUST. The BIUST council was appointed in December 2006, and Howard University in Washington DC (USA) will help develop the university to the targeted world-class standards. The new university may also address training needs that would, in future, enable the country to successfully develop the proposed innovation hub. Thus, in addition to catering for current needs, curricula in training institutions have to be forward-looking in order to produce professionals that are relevant for emerging or future economic needs. While two national universities should be sufficient to provide a secure foundation for national tertiary
- education, both the Government and the private sector will need to be proactive in institutional development to accommodate future requirements for professionals that are suited to the technological needs of the envisaged dynamic economy. Furthermore, efficiently executed local training programmes have the potential to provide a cheaper option to external training.
- 6.20 In October 2006, the Tertiary Education Council (TEC) registered the Limkokwing University of Creative Technology of Malaysia to establish a branch (the Botswana Limkokwing University) in Gaborone, with strong linkages to the proposed innovation hub. This indicates that the willingness of the Government to invest in education can itself be used to sell Botswana as a viable place to establish institutes of tertiary education. The economic and political stability of the country and the increasing number of students completing senior secondary education at a standard high enough to progress to tertiary education, can be used to attract both foreign and domestic investors to venture into institutes of higher learning. Encouraging the establishment of reputable private institutions would offer more access to quality tertiary institutions by a large number of students, reduce costs of training abroad and also offer competition to public institutions, hopefully to the benefit of the quality and standards of education and training in the country.
- 6.21 Moreover, there is scope for training to be designed in a manner that prepares graduates to assume technical positions with minimal supervision or on-the-job training, particularly in technical institutions, thus making them immediately productive and, therefore, better rewarded at the workplace. To complement this, the Government and the private sector must work together to revive the apprenticeship system. Pending a more thorough review of the failed system, the recent overhaul and relaxation of regulations to make it easier for employers to access tax incentives for employer training programmes

41. One of the main causes of delays in producing statistics is the poor response rate to surveys.

is a welcome development. But the previous problems in administering such tax incentives further underline the case for simplifying the tax system wherever possible, rewarding successful businesses with low and predictable taxes.

- 6.22 Furthermore, through its representative groups, the private sector can take the initiative without government incentives to contribute to the improvement of the quality and standard of labour in the country by establishing their own training centres to serve their needs. The Botswana Institute of Bankers and the International Financial Services Centre Apprenticeship Programmes are examples of a combination of private institutions with public sector support playing a more active role in developing skills for their benefit. The creation of more such programmes might lead to improved productivity and a more efficient service delivery. The private sector can also help to fill the gap in knowledge about the skills that are available among potential employees, where research indicates that the information collected by government is inadequate. This is especially the case for graduates of higher education who have not been supported by government sponsorship to complete their studies. Currently, the IFSC maintains a *curricula vitae* database, and recruitment agencies also help fulfil this function.
- 6.23 Botswana should also embrace the notion of 'lifelong' training, which is the latest trend to be incorporated in training and learning policies. This involves institutional training that is structured such that it enables the labour force and entrepreneurs to be innovative and adapt to new technologies and enhance the efficient use of the available inputs of production to improve competitiveness. According to the International Labour Organisation (2000), 'lifelong learning ensures that the individual's skills and competencies are maintained and improved as work, technology and skill requirements change the personal and career development of workers, results in increases in aggregate productivity and income, and improves social equity.' Botswana's education policy should accommodate 'lifelong' learning to facilitate employment stability and labour mobility across industries as market conditions evolve with time. Thus, even though industry-specific training is essential, human capital development should also focus on emerging sectors to ensure the potential for the workforce to be employable in the new industries.
- 6.24 In accordance with the spirit of self-reliance, the public should continue to contribute more of the costs towards their training expenses, while at the same time the Government should continue to progressively reduce education grants for those who can afford to pay. Even though a well-trained and productive labour force will contribute to economic growth, improving the standards of living of the general public, the benefits of high-level training mainly accrue to those who have been trained. As a result, human skills development at this level is more of a private good; hence it is justified for trainees to bear more of the costs. Encouraging trainees to bear the costs also helps solve the problem that private businesses will tend to under-invest in training as they cannot be sure of reaping the full benefits. In addition, the current training policy, which shifts the bulk of the cost burden to the Government, might not be sustainable in the long run due to budgetary constraints. In recognition of the huge expenditure necessary for the development of human capital, the cost recovery exercise aimed at those who received government loans or bursaries to pursue education and training should be carried out vigorously.
- 6.25 Meanwhile, in an environment of high unemployment, it is important that those completing education should be adaptive and flexible in seeking employment opportunities. In the circumstances, even tertiary education graduates should be willing to accept relatively low wages in order to gain work experience, as well as undertake work away from the area of academic specialisation, and be self-employed.

Taking volunteer roles while searching for jobs is also a way of self-development and gaining the necessary experience required in graduate professions. However, for this to succeed, potential employers will also need to show greater willingness to accept trainee labour. This would improve the employability and productivity of potential workers.

Role of the Private Sector

- 6.26 Although the Government has the overarching responsibility for development of infrastructure and the broad policy framework to support economic diversification, the private sector also has a role to play in the process. A more conducive business environment and an unobtrusive regulatory framework should enable private businesses to be more proactive in creating lasting jobs, enhancing productivity and contributing to improvements in living standards. In addition, the private sector should take advantage, be more innovative and seek opportunities availed by initiatives for diversifying the economy and opening up export markets, especially in areas where Botswana has a comparative advantage. The private sector should, therefore, strive to become internationally competitive by improving the quality of products and services that embody the uniqueness of the country. The endeavour to improve competitiveness should also be supported by ongoing research and development and expansion of linkages throughout the economy. There should be less reliance on government patronage, which should not be the underlying determinant of viability of business proposals, while subsidies and other forms of financial assistance should be the exception rather than the norm.

Government Financial Assistance

- 6.27 Going forward, private sector initiatives and long-term sustainability of businesses are more likely to be helped by a reduced role of government assistance in determining the viability of business plans. Moreover, the Government does not necessarily have to fill

the gap for equity or collateral requirement, by assuming the role of a lender. Citizens need to be encouraged to provide equity for their business investments while pooled financial and labour resources may also be a better strategy as opposed to heavy reliance on government assistance. The Government can assist with policies and structures to encourage and support the pooling of resources needed to raise collateral or equity required by private credit providers.

- 6.28 Rather than becoming directly involved in the issuance of credit, this function can be undertaken by specialised private financial institutions, with the Government focusing on policy formulation, monitoring and implementation to create a favourable environment for private institutions to lend to various categories of borrowers. Private or more independent lenders have a greater incentive to accurately estimate return in relation to risk, such that only the commercially viable and high-return businesses would be funded, leading to a more stable and sustainable business environment. It is also evident that the stand-alone type of business ventures that are common among domestic entrepreneurs are not strong enough to compete with foreign firms that are generally more financially established, have greater business experience and are able to attract the variety of skills needed for their operations, as well as more likely to be part of an integrated business and supply chain. Therefore, encouraging partnerships between foreign and local investors for the purpose of anchoring their operations to broaden business network, raising equity and collateral, as well as securing more positive credit references, can contribute to development of citizen entrepreneurs.

Participation of Foreigners in the Economy

- 6.29 While there is growing advocacy for globalisation and free trade across the world, foreigners tend to be viewed with suspicion, in both the developed and less developed

countries, particularly in relation to perceived unfair economic benefit they derive in terms of taking away employment and business opportunities from citizens. Botswana is no exception in this regard. It is notable, however, that to ensure competitiveness and sustainable growth, other countries have tended to succeed in using selective immigration policies (the USA, for example), allowing highly skilled foreigners to drive professionalism and innovation, while low-skilled workers are allowed in to provide cheaper input to lower level production and services. Moreover, the developed countries, in particular, continue to attract teachers and health workers from other parts of the world to sustain the provision of high quality social services.

- 6.30 Botswana has also benefited significantly from an expatriate workforce and operation of foreign firms in a wide variety of economic and social sectors. It appears, nevertheless, that after 40 years of independence, there is a feeling of 'maturity' encouraged by the now sizeable number of citizen entrepreneurs and unemployment among graduates, leading to suggestions for curtailment of foreign participation in the Botswana economy. This approach can, however, be detrimental to the country's growth prospects which, in turn, will be the main determinant of job creation. In contrast, it should be recognised that the business and other skills of foreigners are a developmental resource that can be harnessed to foster a vibrant private sector, as well as sustain global business linkages and benchmarking with respect to the professions, service and competitiveness. These aspects of foreign participation would, as the experience of other countries has demonstrated, continue to be relevant even if there is no notional shortfall in citizen entrepreneurship and skills.
- 6.31 It is also important to recognise that self-reliance is not the same as self-sufficiency. Botswana should actively welcome the benefits of free trade and, where possible in the context of its international obligations, move

unilaterally to achieve them. These benefits include access to cheaper imports, while the approach of protecting local businesses from competition tends to restrict consumer choice and inhibit innovation to achieve the same level of competitiveness. Ironically, where there is no incentive for local producers to raise their productivity, this approach would tend to work against the country's export competitiveness objective.

Improving Policy Implementation

- 6.32 Government policies and initiatives are generally appropriate in terms of objectives and focus on the development needs of the country. Nevertheless, to a significant degree the achievement of objectives has been frustrated by problems with implementation. There is a possibility that prolonged delays between the enactment of policies and the actual time of implementation may render the policy irrelevant due to changes that may have occurred during the interim period. Thus, it is crucial that policies are implemented expeditiously to be relevant to prevailing economic circumstances. Policy makers have to be concerned about the relevance of implemented policies to situations they are meant to address. For example, even though PEEPA was formed in 2000, the Privatisation Master Plan was only published in 2005. It is possible that during that five-year period, conditions might have changed, making the criteria and ordering of parastatals that were earmarked for privatisation irrelevant. Furthermore, the fact that only two or three parastatals are to be privatised in four-year block periods is relatively slow, given that the potential candidates for privatisation have already been identified. Even though Government might be justified in moving rather slowly and cautiously in implementing the privatisation policy due to some existing negative sentiments about the exercise, there needs to be some sense of urgency which can help the credibility of the Government's commitment to privatisation.

- 6.33 Broadly, there is a need to initiate and undertake a strategy where details relating to how policies will be implemented are given adequate attention as early as the policy formulation stage. The need for prioritisation is paramount because attempts at accelerated or simultaneous implementation can easily prove self defeating. In addition, transparency and timeliness in implementation are critical to overall policy effectiveness; and this can be achieved by instituting a framework for briefing Parliament and the Executive on the status of implementation of policies, programmes and projects.

Addressing HIV/AIDS

- 6.34 Earlier in the chapter, the magnitude of the challenge was made clear, together with the policy initiatives the Government has put in place. These policies are both widely admired and appear to be leading to some success in combating the pandemic. In regard to the social and medical programmes in place, the Government should continue its effort to educate people to increase their HIV/AIDS awareness and its devastating effects. The campaign should also be extended to school syllabi in order to instill knowledge on the epidemic at an early age.

7. CONCLUSION

- 7.1 This chapter has highlighted the low level of development of Botswana at independence forty years ago, when a large proportion of the population was poor and mostly engaged in subsistence agriculture. The available infrastructure, revenue sources and level of skills were inadequate to support the industrial development necessary to generate economic growth and an increase in living standards. The development of diamond mining from the early 1970s significantly improved government revenue and enabled the Government to undertake an extensive programme of physical and social infrastructure to address the initial development challenges. In addition, utility parastatals and development finance

institutions were established to support industrial and business development, while also benefiting the wider community. Notably, the development programme was undertaken in a relatively free market business environment and a pragmatic approach to macroeconomic policy formulation.

- 7.2 In formulating fiscal policy, it was recognised that the dominant diamond revenues were generated from a non-renewable resource, hence the need to prudently invest the budget surpluses, as well as to avoid wasteful expenditure and to limit pressure on prices in an environment of limited capacity. In addition, the country avoided the resource curse and Dutch Disease phenomena that are common in other resource rich countries, through the maintenance of effective democratic institutions and by ensuring that, despite the recurring positive external balance, the Pula was not allowed to appreciate to the extent of reducing the profitability and competitiveness of the non-diamond mining activities. Monetary policy has also been largely effective in sterilising the excess liquidity arising from the large revenue flows and influence demand conditions to be in line with the price stability objective.
- 7.3 While noting the significant progress in physical and social infrastructure, as well as sustaining macroeconomic stability, this chapter also highlighted the persistent challenges of lack of diversification, high incidence of poverty, inequality and the HIV/AIDS epidemic. Among others, it is widely considered that these challenges could be addressed by improving the microeconomic environment in which business operates, which could lead to growth in FDI and enhance private sector participation in the economy. As indicated in Section 4, the Government has undertaken a number of initiatives through, among others, the establishment of BEDIA which, *inter alia*, attempts to ease start-up and search costs as well as expand product development and export potential of the economy. It is also considered that privatisation would improve competitiveness and service delivery, given

the potential for an increase in private sector investment (FDI and domestic investment) encompassing superior business operation and management skills and quicker integration of modern technology. Beneficiation due to extending the downstream activities arising from diamond mining is also expected to contribute to broadening economic activity across a variety of sectors.

7.4 In discussing the initiatives on citizen empowerment, the review noted the potential for raising the viability of citizen-owned small and medium scale businesses. However, there is concern that misinterpretation of the strategy could elevate and entrench a culture of entitlement for narrow interest groups and resultant over-dependence on Government, which can inhibit creativity and the ability to compete globally. In particular, low cost financing relative to the true economic costs generally leads to a proliferation of low return enterprises that will not be viable in the long-term. It is considered that financial sector and capital market development would benefit from a scaling down of programmes of subsidised financial support from Government, as specialised private financial institutions and instruments that cater for the diverse needs of private sector businesses would emerge. This, in turn, should strengthen the viability of businesses.

7.5 Quite apart from the perceived entitlements to low cost finance and government procurement, the provision of education and health services that lead to human development are empowering. These social programmes potentially contribute to the development of productive and self-reliant professionals and entrepreneurs that are able to adapt and integrate modern technology and business operations and compete globally. Within the social programmes, the response to the HIV/AIDS epidemic should alleviate the negative impact of the disease on productivity and the country's growth prospects. It appears at this stage that new infection rates are declining, while there has been a significant increase in

the number of people who know their status; medication is also prolonging the lives and economic contribution of the infected.

7.6 It has also been noted in this chapter that while citizen empowerment and development of indigenous businesses are important, foreigners should continue to be viewed as supporting the country's development as they help sustain the relevance of skills in a globally connected business, social and governance environment. At lower levels, the movement of labour across borders also tends to align local costs to those of global production and, hence, helps to sustain competitiveness of local industry and contribute to price stability.

7.7 The review of progress in implementing the development agenda identified the potential for friction and inefficiency due to a proliferation of institutions that pursue similar or overlapping objectives, and compete for the same limited resources. This is particularly apparent in the various government and government-supported research, financial, entrepreneurial development and FDI promoting agencies. It is possible that these could be streamlined and benefit from economies of scale, without a loss of functional capability. The limitation on access to land, which is compounded by the onerous process for obtaining and transferring title on tribal land, was also identified as a constraint to business development. In this regard, the intention to conduct a comprehensive reorientation of land policy towards the needs of investors should improve the situation.

7.8 In addition to improving the microeconomic environment, it is important that the macroeconomic policy framework continues to evolve in order to remain supportive of economic diversification and sustainable growth. Continuing to reinforce the impact of monetary policy on price stability should encourage productivity improvements as sources of profitability and growth. Similarly, the focus on a competitive exchange rate raises the export potential of the economy. The recent fiscal policy initiatives that include a

bias towards development expenditure should ensure continuing infrastructural support for private sector activity while outsourcing of non-core operations will reduce the relative size of recurrent expenditure. There is also further scope for the Government to increasingly involve the private sector in infrastructure development and, in this respect, progress is being made with the recent launch of PPPs.

7.9 In summary, the scale of Botswana's economic challenges has been well articulated and the commitment to address them is demonstrated by the various policy initiatives and institutional developments undertaken by the Government and other policy making bodies. Going forward, it is suggested that the following measures could enhance capacity in addressing the country's economic challenges:

- (a) prioritisation with respect to institutional development and policies in order to achieve focus on long-term development objectives and economise on the use of scarce resources, which might also enhance effectiveness;
- (b) improvement of implementation through enhanced monitoring systems, ensuring availability of resources and timely sanctions for non-performance. There is also a need to avoid creating additional institutions and designing new policies in a bid to address sub-standard performance;
- (c) addressing economic empowerment of citizens in a way that ensures long-term viability of the private sector, for example, through maintenance of high standards of business performance and ensuring that there is no discrimination in enforcing requirements of business operations, including obligations to financiers and clients;
- (d) continuing to address the microeconomic impediments to business efficiency and viability. This is important in facilitating access to viable business opportunities for both citizens and foreign investors, thus maximising the extent and range of

benefits arising from further development of the domestic economy;

- (e) reducing government activity in the economy through privatisation, outsourcing and cost recovery measures. This presents business opportunities for the private sector which should lead to improvement in the provision of services, while contributing to the attainment of the national objective of economic diversification and sustainable growth; and
- (f) sustaining macroeconomic balance which is supported by a formal and legal framework for prioritisation of policy objectives and their coordination.

If the authorities remain committed to pursuing a development programme which encompasses one or all of the initiatives mentioned above, there is a strong possibility that the successful development of the Botswana economy, which has characterised the last four decades since independence, could be maintained.

