

**EXECUTIVE
BOARD
MEETING**

SM/21/73
Correction 1

May 25, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Botswana—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/73 (5/17/21) have been provided by the staff:

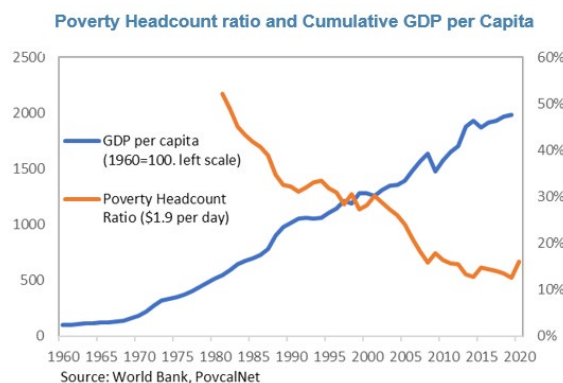
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Pages 6, 8, 11, 14, 16, 25, 26, 33, 35, 38

Questions: Mr. N'Diaye, AFR (ext. 39751)
Ms. Li, AFR (ext. 34461)
Mr. Gurara, AFR (ext. 35776)

economy, relying on diamond, tourism and “contact-intensive” services, has largely contributed to this contraction. Yet, the economy is bottoming out in the second half (-4.1 percent in Q4), led by buoyant domestic consumption, supported by the increase in public wages in July-September, and the relaxation of mobility restrictions. Diamond sales have also rebounded while tourism activity remained very slow. On annual basis, GDP growth stood at -7.9 percent, making Botswana one of the hardest hit countries in Sub-Saharan Africa.

5. The crisis has worsened social outcomes. The unemployment rate reached 24.5 percent in 2020Q4 from 22.2 percent in 2019Q4 and could increase further once the State of Emergency is lifted. Youth unemployment rate also rose from 28.8 percent to 32.4 percent. The World Bank estimates the extreme poverty rate (US\$1.9/day in 2011 Purchasing Power Parity) to have increased to 16 percent in 2020 from 12.6 percent in 2019. Forecasts suggest the poverty rate would remain above the 2019 figure until 2022. Notwithstanding the government’s support, the disproportionate impact on poorer and more vulnerable households could lead to even more inequality.



6. Inflation remains well below the Bank of Botswana’s 3 to 6 percent objective. Inflation fell to 1.9 percent in 2020, from 2.8 percent in 2019, as lower import prices, especially oil prices, more than offset higher prices for domestically produced goods and services. The rise in domestic prices reflects the effects of increases in food prices, electricity tariffs and domestic wages.

7. The external position deteriorated further, but foreign reserves remain comfortably above adequacy levels. The CA deficit stood at 10.1 percent of GDP in 2020. Diamonds net exports declined by 40 percent (in US\$), while non-diamond imports declined only by 5 percent. Exports of services also declined by 51 percent led by tourism. Despite positive valuation effects, reserves fell by US\$1.2 billion to 7.3 months of imports at end-November.¹ In response to the COVID-19 shock and given the low domestic inflation, Bank of Botswana (BoB) the authorities moved the crawl rate from -1.5 to -2.9 percent in May 2020 and the REER depreciated by 3.5 percent y-o-y in December (Table 2, Figure 3).²

8. The government put in place a large fiscal relief package that helped mitigate the economic, social and health effects of the pandemic. The government initially put in place a P4.7 billion (2.6 percent of GDP) economic COVID-relief package to mitigate the impact of the crisis on households and firms and reduce its scarring effects. In addition, P1 billion was provided as supplementary recurrent budget to the Ministry of Health and Wellness for COVID-related spending, and P1.3 billion as loan facility to benefit firms affected by the COVID-19 crisis (Text Table 1).

¹ ARA metric range is equivalent to 3¾ -5¾ months of imports.

² The same crawl rate was decided-continued in 2021.

November 2020 from 63.7 in December 2019). About 70 percent of this credit is non-collateralized and carries higher interest rates (Table 4, Figure 5).

10. **The financial sector has proven resilient this far, but some risks may be looming.**

- Commercial banks remain adequately capitalized and liquid.⁴ NPLs have declined and provisioning has improved. However, some COVID-19 relief measures, notably the 6-month loan repayment moratorium, loans restructuring, and guaranteed loans to affected sectors, may have delayed the deterioration in asset quality. Thus, banks' financial stability indicators may not fully reflect the impact of the COVID-19 shock (Table 5).⁵
- To mitigate the negative economic effects of COVID-19 on households, while also ensuring sustainability, NBFIs introduced temporary measures, including restructuring and rescheduling of loan installments, life premium and retirement contributions for at least three months; discount on insurance products; reduction of interest rates on non-bank lending; and provision of quick turnaround time for processing insurance and medical aid claims. Such measures may have negatively impacted profitability of the sector in the short term. Yet, given their strong balance sheets at the onset of the crisis, NBFIs' solvency risks remain low.

OUTLOOK AND RISKS

11. Botswana plans to vaccinate 75 percent of the adult population by end-2021. The country has made an upfront payment to COVAX, the World Health Organization's (WHO) vaccine arrangement, to acquire 940,800 vaccines under a two-dose regime, enough to cover about 20 percent of the population. In parallel, the authorities have reached agreements with vaccine manufacturers to acquire 1.9 million doses, enough to cover the entire adult population. The vaccination initiative is expected to cost a minimum of 1/3 percent of GDP.

12. Economic growth is projected to rebound in 2021, but the output losses from the crisis are expected to persist. Following an estimated contraction of 7.9 percent in 2020, real GDP is expected to grow by 8.3 percent in 2021. The recovery assumes a normalization of diamond production to pre-crisis levels in line with recent trends, the **entreey** in production of Khoemac~~eu~~ copper mine, some containment measures but no nationwide lockdowns in response to the second

⁴ BoB reduced the capital adequacy ratio from 15 percent to 12.5 percent, but most banks remain above the 15 percent threshold.

⁵ Since the implementation of the discretionary loan repayment holiday by banks, loans that have benefited from this measure accounted for 11.4 percent of the aggregate commercial banks' loans and advances, which translates into P7.3 billion (74 percent of which was business loans), as at the end of June 2020. Business loans given moratoria were mainly concentrated on those extended to commercial real estate (33 percent), "restaurants and bars" (16 percent) and "Tourism and Hotels" (13 percent), industries. At the same time, banks restructured loans amounting to P5.8 billion (9.1 percent of total credit extended by commercial banks), with private businesses accounting for the largest share (73 percent).

“efficiency gains” in grants and subventions and transfers to local government. For the remainder of NDP11, the authorities also envisage to expedite fiscal reforms, including better targeting of social spending, restructuring of parastatals, and strengthening of the public investment management framework.⁸

18. Staff welcomes the commitment to fiscal sustainability and recommends that the planned adjustment be implemented without further delay. Under the baseline, the envisaged pace and size of consolidation and the shift in spending composition are appropriate to gradually reduce the deficit and rebuild buffers. The plan will help achieve a balanced primary budget by 2026 and keep the debt below 30 percent of GDP. The fiscal consolidation plan will allow for rebuilding asset positions in the Government Investment Account and the Pula Fund, while the re-orientation of expenditures towards investment and human capital development will raise productivity, create jobs, and help diversify the economy and revenue sources. At the same time, the envisaged incentives for training and financial support to transformative sectors will facilitate the reallocation of factors to new sectors. These measures will benefit future generations and insure against volatility.

19. There is a need to maintain targeted support to firms and households still affected by the pandemic and make the support state-contingent or conditional to reduce moral hazard. The extension of the State of Emergency and the industry support facility will help households and firms cope with the crisis through end-2021. This will help address the uneven nature of the recovery across sectors and mitigate the regressive impact of planned increase in the VAT rate and other taxes and fees on the most vulnerable.⁹ Additional support would be required if the pandemic is more protracted than expected and the recovery is uneven. Given the uncertainty on the evolution of the health crisis, and that a shortfall in mineral revenue could entail a significant increase in the debt ratio and force a sharp adjustment, staff is of the view that the recommended targeted support would need to be financed through the following additional measures:

- On the revenue side, measures could include increasing progressive tax measures such as property taxes and reducing VAT exemptions while compensating the most vulnerable. In addition to the planned tax amnesty that could help reduce tax arrears, there is a need to expedite the promulgation of tax bills and continue tax administration reforms, including accelerating e-filing.
- On the expenditure side, extending the wage freeze to FY2022, means-testing of scholarships to tertiary education, and cost recovery in some public services (e.g. electricity and water tariffs) could provide savings and also lead to a better targeting of social spending.

⁸ The authorities are extending the coverage of social registry to six more districts for five social programs in cooperation with the World Bank, which will help better target social transfers. The authorities are also reviewing the design of the public work program IPELENG and implementing proxy means testing for the Destitute Persons Program.

⁹ In order to alleviate the burden on taxpayers, and reflect the impact of inflation on their purchasing power, the threshold at which income earners become liable for income tax will be raised from P36,000 to P48,000 per annum with effect from the 2021/2022 tax year. This measure however will only reach formal workers.

sheets. Given the large negative output gap and as long as expected inflation remains within BoB's objective range, staff is of the view that BoB should keep the monetary policy rate unchanged. That said, BoB should carefully monitor the second-round effects of supply shocks and administrative price changes on inflation expectations, as well as the development of credit and demand.

26. A more active liquidity management will be essential to smooth interest rate volatility and enhance the monetary policy transmission. The large fiscal deficits may entail significant swings in domestic liquidity, and potentially crowd-out private sector credit. These effects could be larger with a potential removal of Botswana from the AML/CFT Grey-listing, despite its positive effect on integration into the global financial system. Thus, staff recommends setting the reserve requirement as a buffer against the fluctuations of the autonomous factors of liquidity, conducting regular OMO at fixed-rate full-allotment, and complementing these actions with fine-tuning operations to smooth volatility. Staff welcomes the BoB's plan to replace the Bank rate with the BoB certificate rate as the main monetary policy instrument to enhance policy transmission. Staff recommends pursuing the development of the unsecured interbank and REPO markets to strengthened monetary policy transmission.

27. Despite some real depreciation in 2020, the external position remains moderately weaker than suggested by fundamentals and desirable policies. The exchange rate is assessed to be moderately overvalued (8½ percent). Under staff's baseline, the current account balance is expected to improve but remain weaker than the norm in the near term. This would exert further pressures on international reserves. Over the medium term, the anticipated fiscal consolidation together with the recovery in external demand will contribute to narrowing the gap and gradual reserves accumulation. However, this scenario hinges on favorable diamonds projections that reflect the strength of activity in the United States, India, and China.

28. The flexibility within the current exchange rate regime should continue to be used. This would allow to gradually reduce real overvaluation, help the economy adjust to shocks, and facilitate structural transformation, while avoiding de-anchoring inflation expectations. The pass-through of nominal effective exchange rates to inflation is estimated to be lower than 0.4 for the first two quarters, and below 0.5 over a year. The expected pick-up in inflation in 2021–22 hence limits the extent to which a real depreciation could be achieved through changes in the crawl rate in the near term while maintaining inflation within the 3–6 percent objective range and inflation expectations anchored. However, as inflation pressures abate and with progress on fiscal consolidation, there will be a need for a steeper crawl to help address the residual overvaluation harmful to Botswana's structural transformation.

Authorities' Views

29. The authorities broadly agree with staff's recommendations. On monetary policy, BoB indicated it will monitor closely inflation expectations and strengthen its communication to keep them well anchored. The authorities also appreciated the timeliness of the upcoming TA mission on monetary policy implementation and operations that will help with the [possible](#) transition to the BoBC rate as the monetary policy rate. On exchange rates, the authorities agreed with staff assessment but noted the important role that the objective of a stable REER has played in anchoring investors'

B. Structural Policies

32. The parliament has approved an Economic Recovery and Transformation Plan (ERTP) in October 2020. The ERTP aims at reducing the potential economic scars from the COVID-19 crisis, accelerating structural transformation, and increasing job creation and inclusiveness (citizen empowerment). To achieve this objective, the authorities will continue to focus on traditional sectors (e.g. milkcattle, tourism, mining), import substitution (local content requirement, protection), and different programs support to MSMEs. At the same time, they plan to i) boost investment in digitalization (including e-government), human capital development and R&D, ii) reduce the government footprint, iii) enhance the business environment, and iv) strengthen accountability and governance to improve implementation. Successfully implementing this strategy requires a continuous appraisal of existing sectoral programs, assessment and adaptation to changes in markets and risks and opportunities (learning externalities, environmental risks), focusing on promising sectors, tackling market and government failures, and addressing key bottlenecks in a cost-efficient manner.

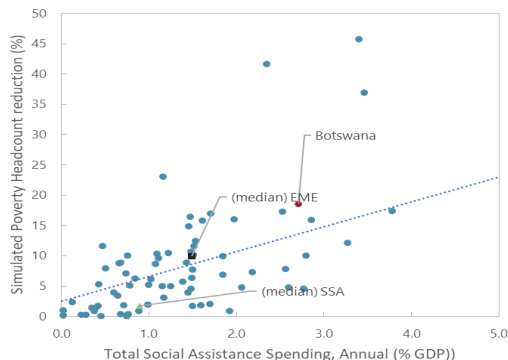
33. Diversification policies should be designed in an incentive-compatible manner. This should be done with a view to enhancing competitiveness, creating jobs, especially for the youth, and fostering productivity gains, including through innovation and technology upgrade. In particular:

- *Reduce reliance on import substitution and protectionist policies*, especially if these are not time bound and deter competition.
- *Enhance competitiveness.* Government support should be conditional on productivity gains and performance, help promote technological and quality upgrade (e.g. through certification), and foster innovation. These efforts should be complemented with a reduction of network costs through greater competition, leveling the playing field between public and private companies, enhancing the efficiency of SOEs, and spatial planning/geographic clustering to minimize costs. More targeted higher education and vocational training and promoting internships and exchanges of skills would help reduce skills mismatches.
- *Reduce information frictions and facilitate access to market* through platforms, language services, visas, open skies agreements, trade fairs, buyer-seller matching, country image, collective reputation, and relationship-building.
- *Promote regional integration and regional value chains*, which could be reciprocal reduction of non-tariff barriers, coordination of industrial policies and promotion of cross-border investment.
- *Attract FDI and knowledge transfer* (including both more advanced technology and management know-how).
- *Strengthen and clarify mandates of export and investment promotion agencies.*

Figure 6. Botswana: Social Protection and Labor Assessment

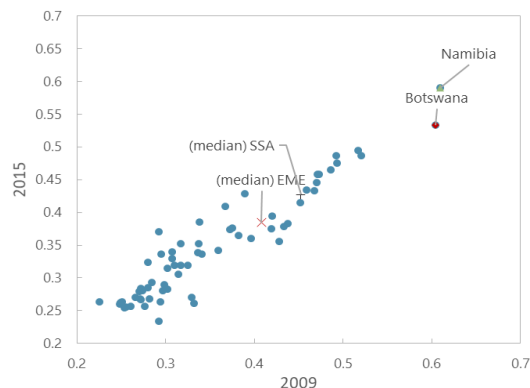
Higher spending on social assistance in Botswana has contributed to poverty reduction...

Poverty Gap Reduction
(Percent)



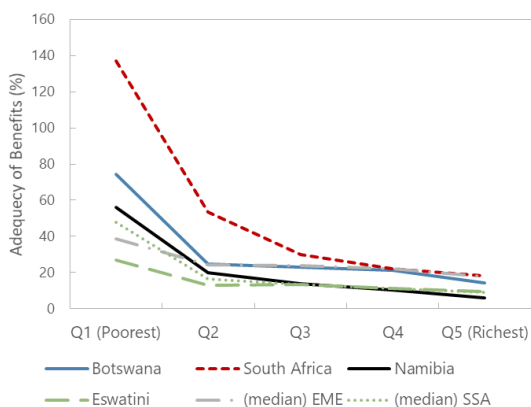
... but has not had sufficient impact on inequality.

Gini Coefficients
(2015 vs. 2009)



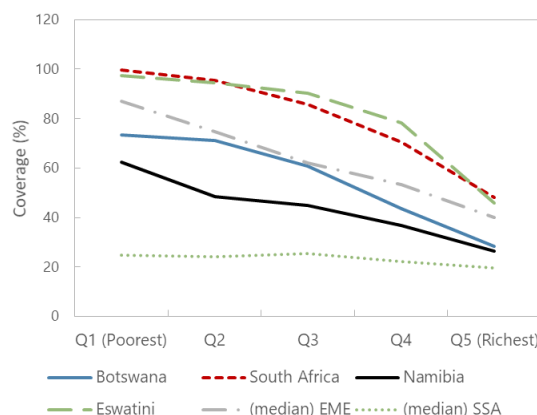
While Botswana's social assistance spending is higher than most comparators...

Adequacy by Quintile
(Percent)



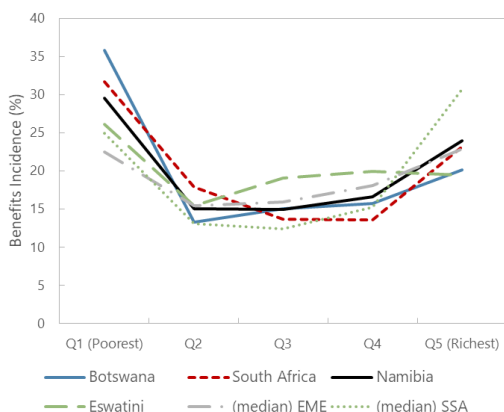
... its coverage is lower across all beneficiaries (except compared to SSA median and Namibia).

Coverage by Quintile
(Percent)



While the poorest receive the highest share of benefits, sizable SPL resources are also allocated to the richest...

Benefits Incidence by Quintile
(Percent)



... sustaining high inequality despite higher SPL spending. Better targeted SPL policies could further increase its distributional impact.

Simulated Impact Variables



Sources: IMF FAD Social Protection & Labor – Assessment Tool (SPL-AT).

Table 1. Botswana: Selected Economic Indicators, 2015–26

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
						Prel.			Projection			
	(Annual percent change, unless otherwise indicated) ¹											
National income and prices												
Real GDP	-1.7	4.3	2.9	4.5	3.0	-7.9	8.3	6.4	4.8	4.0	4.0	4.0
Mineral ²	-19.6	-3.5	-11.1	7.6	-4.1	-26.2	52.9	17.2	8.0	1.7	1.3	1.3
Nonmineral	1.7	5.5	4.8	4.1	3.9	-5.9	4.5	5.0	4.4	4.3	4.4	4.4
GDP per capita (US dollars)	6,811	7,249	7,883	8,290	7,989	...	...	...	...	...	...	...
Consumer prices (average)	3.1	2.8	3.3	3.2	2.7	1.9	4.8	5.0	4.4	4.4	4.4	4.4
Diamond production (millions of carats)	20.8	20.9	22.9	24.4	23.7	16.9	23.5	25.9	28.0	27.8	27.8	28.3
Money and banking												
Monetary Base	18.6	3.7	-13.7	17.5	5.4	-7.0	10.4	10.3	8.9	8.9	8.8	8.8
Broad money (M2)	19.9	5.4	2.7	8.3	8.0	5.9	10.4	10.3	8.9	8.9	8.8	8.8
Credit to the private sector	9.0	9.0	5.3	6.6	7.1	5.3	7.8	10.5	9.2	8.9	9.3	9.3
	(Percent of GDP, unless otherwise indicated)											
Investment and savings												
Gross investment (including change in inventories)	32.6	27.0	27.6	29.4	33.3	35.8	34.7	32.4	31.8	31.1	31.2	31.1
Public	8.8	8.5	8.2	8.0	7.1	6.2	6.2	5.9	5.5	5.3	5.1	4.9
Private	23.8	18.5	19.4	21.4	26.1	29.6	28.5	26.5	26.3	25.8	26.1	26.2
Gross savings	39.5	123.1	104.8	108.4	27.2	25.7	31.4	30.5	32.8	33.6	33.8	33.6
Public	16.1	16.2	15.2	12.5	8.8	4.9	8.8	8.1	10.2	11.5	11.6	11.9
Private	23.4	106.9	89.6	95.9	18.4	20.8	22.6	22.4	22.6	22.1	22.1	21.8
Central government finances ³												
Total revenue and grants	31.2	33.2	30.9	27.8	26.0	24.0	27.5	24.4	27.3	27.5	27.1	26.7
Total expenditure and net lending	35.8	32.5	32.0	32.4	33.9	35.0	32.0	30.2	29.2	28.3	27.6	26.6
Overall balance (deficit –)	-4.6	0.6	-1.1	-4.6	-7.9	-11.0	-4.4	-5.7	-1.9	-0.8	-0.5	0.1
Non-mineral primary balance ⁴	-18.1	-17.6	-14.3	-17.1	-17.7	-18.5	-16.5	-18.3	-13.4	-12.3	-11.2	-10.3
Total central government debt	23.2	21.3	18.1	18.6	19.2	23.5	25.7	28.9	28.5	27.3	26.0	23.7
External sector												
Exports of goods and services, f.o.b. (% change)	-24.1	14.4	-16.2	9.2	-17.5	-24.6	58.9	8.1	8.5	8.0	4.5	5.9
o/w diamonds	-28.4	24.6	-17.0	9.8	-19.9	-21.8	64.2	2.8	7.4	7.5	4.4	6.5
Imports of goods and services, f.o.b. (% change)	-10.0	-14.6	-9.8	17.0	5.2	-4.9	11.7	-3.0	5.2	5.8	4.6	4.6
Current account balance	2.1	7.7	5.3	0.6	-6.0	-10.1	-3.3	-1.9	1.0	2.5	2.5	2.5
Overall Balance	-5.4	-2.3	1.8	2.3	-8.4	-14.4	-0.7	1.8	3.3	3.4	3.1	3.1
Nominal effective exchange rate (2010=100)	94.9	95.1	95.4	95.5	...	...	...	...	...	...	...	...
Real effective exchange rate (2010=100)	105.2	104.8	105.0	105.1	...	...	...	...	...	...	...	...
Terms of trade (2005=100)	197.4	175.9	159.2	166.2	143.6	138.7	151.6	159.0	165.4	170.0	170.6	171.4
External public debt ⁵	18.4	14.3	11.6	11.7	10.5	11.1	12.4	13.0	12.4	11.1	9.9	8.7
o/w public and publicly guaranteed	5.3	4.7	4.4	4.2	4.1	4.4	3.8	3.4	3.0	2.8	2.6	2.4
	(Millions of U.S. dollars, unless otherwise indicated)											
Gross official reserves (end of period)	7,546	7,189	7,502	6,657	6,172	4,944	4,818	5,178	5,914	6,724	7,504	8,345
Months of imports of goods and services ⁶	13.1	13.8	12.3	10.4	10.1	7.3	7.3	7.5	8.0	8.7	9.3	9.9
Months of non-diamond imports ⁶	17.5	17.8	16.3	13.7	13.9	10.1	9.6	9.8	10.7	11.5	12.2	12.9
Percent of GDP	58.0	44.9	41.1	37.5	33.2	29.5	26.3	25.6	27.1	28.8	30.1	30.5

Sources: Botswana authorities and IMF staff estimates and projections.

¹ Calendar year, unless otherwise indicated.² The projection is based on current value added and projected growth rates by different types of minerals.³ Year beginning April 1.⁴ The non-mineral primary balance is computed as the difference between non-mineral revenue and expenditure (excluding interest receipts and interest).⁵ Includes central government-guaranteed debt.⁶ Based on imports of goods and services for the following year.

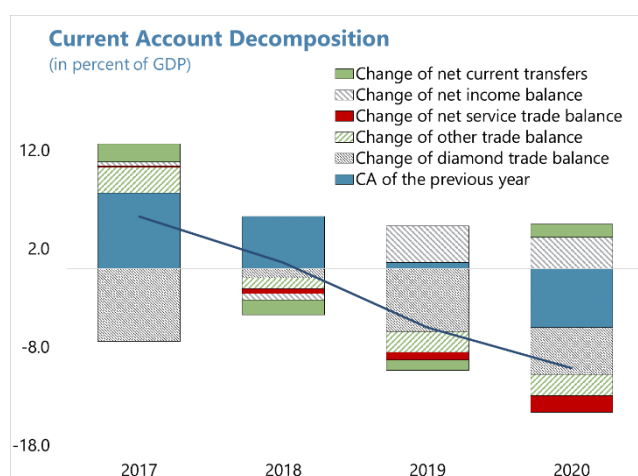
Annex I. External Stability Assessment

Botswana's external position in 2020 is moderately weaker than implied by medium-term fundamentals and desired policies. Implementing the planned fiscal consolidation, advancing structural reforms to strengthen competitiveness and promote diversification, and using the flexibility in the current crawling arrangement to allow the real exchange rate basket to respond more to changes in fundamentals will help narrow the current account gap and stabilize reserves in the medium term.

Introduction

1. Botswana's current account balance deteriorated further in 2020, largely driven by decline in diamond exports related to the COVID-19 pandemic. After a steady decline from a sizable surplus in 2016 to -6 percent in 2019, mostly due to lower demand for diamonds and fiscal expansion, the current account reached a new low at -10 percent of GDP in 2020.

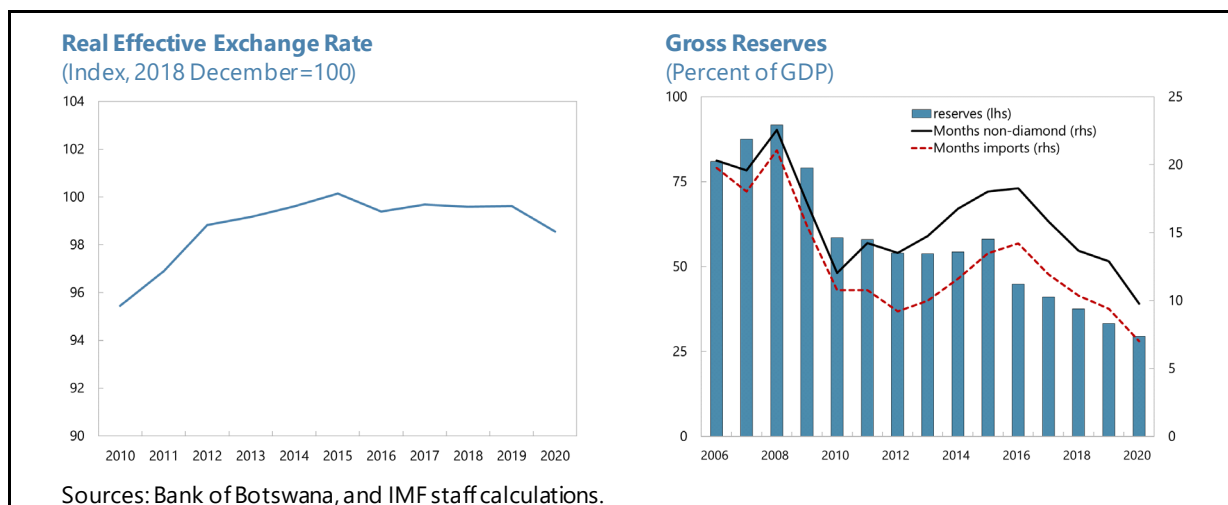
The COVID-19 crisis swiftly impacted goods and services trade flow, particularly in the second quarter of 2020. Goods exports in percentage of GDP dropped significantly mostly because of a sharp contraction in diamond production, while goods imports continue to rise especially in rough diamonds, fuel, and food imports. Services trade balance decreased moderately as reduced tourism exports more than offset lower services imports. Net investment



payments and net current transfers in percent of GDP improved owing to lower dividends distributed to nonresidents and higher SACU revenue receipts. The current account balance is expected to improve in 2021 to -3.3 percent of GDP before improving to 2.5 percent of GDP over the medium term as diamond production recovers and fiscal consolidation advances.

2. The financial account deficit increased by 2 percent of GDP in 2020, mostly owing to increased net portfolio investment abroad. Outward investment by ~~the~~ pension funds increased by almost 1 percent of GDP. Net foreign assets (NFA) have continuously deteriorated and stood at 31.6 percent of GDP, less than half their 2009 level, reflecting the drawdown of buffers to finance the fiscal expansion. NFA are expected to further deteriorate over the medium term as the current account remains in deficit until 2023 and the pension fund repatriates foreign assets to finance fiscal deficit.

3. Botswana's real effective exchange rate (REER) has depreciated only marginally despite substantial decline in diamond prices. The relative stability of the REER can be attributed to the relatively low capital mobility combined with the BoB's policy of adjusting the nominal value of the pula in line with expected inflation differentials with major trading partners and basket weights (the basket comprises the SDR and the South African rand, with a 45 percent weight for the latter). In response to the COVID-19 crisis, BoB increased the crawling rate from -1.5 to -2.9 percent in May 2020, resulting in the REER depreciation of about 4-3.5 percent y-o-y in December on average in 2020.



4. Botswana's international reserves continued to decline in 2020 but are expected to improve over the medium term. Reserves stood at about US\$4.9 billion (US\$1.2 billion lower than the previous year), equivalent to 30 percent of GDP or 7.3 months of imports.^{1,2} The impact of the current account deterioration on reserves was partially contained by stock market buoyancy and the consequent high returns on reserves investments. Under the baseline projections, the import coverage is expected to increase moderately in the medium term, as diamond production increases and the government improves its fiscal balances.

Current Account and Exchange Rate Assessment

5. The assessment of Botswana's external position employs the External Balance Assessment (EBA)-lite models for the CA and REER.³ The former approach assesses the current account relative to the position required to generate enough future returns for intergenerational equity purposes. The estimations assume that both the CA and REER are endogenous variables simultaneously determined as a function of domestic and external variables including fundamentals, policy variables, and cyclical conditions (these methodologies assess the CA and REER in

¹ The authorities concurred with the assessment that reserves exceeded their adequate level.

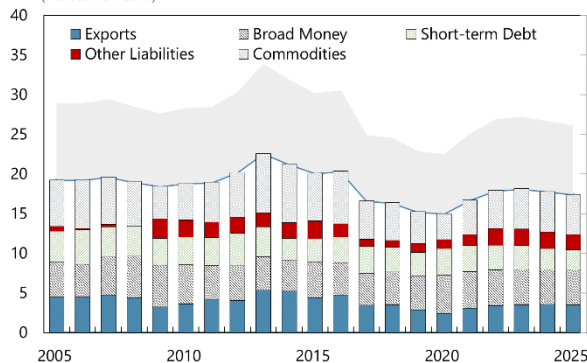
² The authorities preferred measure of reserve coverage takes the ratio to current year imports of goods and services excluding diamond imports for re-exporting purposes (which would amount to 11 months at end-2020).

³ EBA-lite is an extension of EBA methodologies, uses annual data for 190 countries for the 1995–2016 period and incorporates fundamentals for low and middle-income countries. See further details of the EBA methodology in IMF (2019).

9. Botswana has a comfortable reserve position, which stands at 184 percent of the ARA metric. According to the IMF's metric, reserves of 14 to 16 percent of GDP, amounting to 100–150 percent of the ARA metric, would be adequate, compared to the estimated level for 2020 of 29.5 percent of GDP. However, this assessment doesn't fully consider Botswana's high dependence on commodity exports. Indeed, using a weight of 25 percent for exports (instead of 10 percent) to reflect the country's dependence on volatile diamond receipts, the adequacy range would increase to 18–25 percent of GDP. Moreover, for the past twenty years the level of reserves has far exceeded the upper bound of the adequacy range.

Composition Metric

(Percent of GDP)



10. Foreign reserves are under the control of the Bank of Botswana—with 85 percent kept in a sovereign wealth fund (the Pula Fund) and 15 percent in a Liquidity Portfolio (used as a short-term liquidity buffer). Within the Pula Fund, about one-third is owned by the BoB government and two-thirds by the government-BoB as at end-2019. Foreign exchange reserves in excess of the amount required for daily foreign transactions kept in the Liquidity Portfolio (currently set at nine months of imports) are transferred to the BoB's portion of the Pula Fund. If the Liquidity Portfolio declines below three months of imports, it receives a transfer from the Pula Fund.