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March 24, 1986

To: Members of the Executive Board

From: *The Secretary*

Subject: Botswana - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Botswana. A draft decision appears on page 18.

This subject will be brought to the agenda for discussion on a date to be announced.

Mr. Callender (ext. 8750) or Mr. Gunjal (ext. 8755) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

BOTSWANA

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the 1986
Article IV Consultation with Botswana

Approved by G. E. Gondwe and S. Kanesa-Thasan

March 21, 1986

I. Introduction

The 1986 Article IV consultation discussions with Botswana were held in Gaborone during the period January 17-31, 1986. The Botswana representatives included the Honorable P.S. Mmusi, Vice-President and Minister of Finance and Development Planning; Mr. C. Kikonyogo, the Governor of the Bank of Botswana; Mr. B. Gaolathe, Permanent Secretary of the Ministry of Finance and Development Planning; and other senior officials of ministries and agencies concerned with economic and financial matters. The staff representatives were Messrs. C.V. Callender (head), E. Martey, U. Gunjal, J. Kinyua, and Mrs. B. Nairn (secretary), all of the African Department.

In the last Board discussion on Botswana, Directors commended the authorities for their good economic and financial management. They welcomed the flexible approach to exchange rate management adopted by the authorities as part of their overall effort to diversify the economy. On budgetary policy, they urged the authorities to contain planned expenditure growth, and develop new sources of revenue to broaden the present revenue base. They also emphasized the importance of achieving a more coordinated management of foreign debt and reserves while introducing financial instruments to absorb the excess liquidity in the economy.

The staff of the Fund and the World Bank have cooperated closely in providing advice to Botswana on economic and financial issues. In September 1985 a Fund staff member participated in a World Bank mission to review Botswana's six-year (1985/86-1990/91) public expenditure program.

Botswana became a member of the Fund on July 24, 1968 and continues to avail itself of the transitional arrangements under Article XIV. Summaries of Botswana's relations with the Fund and the World Bank Group are attached.

II. Recent Economic and Financial Developments and Policies

Between 1971 and 1980, Botswana enjoyed virtually uninterrupted growth and favorable economic and financial developments: the annual rate of growth of real GDP averaged more than 10 percent. The main impetus to growth was large-scale expansion in mining and in exports of diamonds, whose contribution increased to about one quarter of GDP, over one half the value of exports, and about one third of fiscal revenues. Botswana has also benefitted from a substantial inflow of foreign capital, the bulk of which was obtained on concessional terms. Together with prudent domestic and external financial policies, these factors contributed to the attainment of a comfortable balance of payments position, low debt servicing, and a moderate rate of inflation. The growth process, however, created a domestic production structure that left the economy highly dependent on one depletable resource, namely, diamonds, and vulnerable to external developments. Consequently, the strategy for economic development and planning in Botswana, as reflected in the National Development Plans (NDP) V and VI, has in recent years focussed on diversification of the economy in conjunction with policies to promote rural development and employment.

Despite persistent drought which adversely affected certain sectors of the economy, particularly the crop and livestock sectors, the economy of Botswana continued to grow at an impressive rate, averaging 12 percent per annum in real terms, during the four-year period 1981-84 (Table 1 and Chart 1). There was, however, a considerable year-to-year variation in the rate of growth, the balance of payments, and central government finances, as a result of fluctuations in the output and export of diamonds. After a substantial deterioration in 1981, the balance of payments recovered from an overall deficit of SDR 62 million in 1981 to a surplus of SDR 125 million in 1984 (Table 2), due to large increases in diamond exports. In a parallel development, the central government budget improved from a deficit (including grants) of P 19 million, equivalent to 2.3 percent of GDP in 1981/82 (fiscal year April-March) to a surplus of P 188 million, equivalent to 12.6 percent of GDP in 1984/85), reflecting the sharp expansion in mineral-related revenues.

The staff estimates indicate that real GDP grew by about 11 percent in 1985, compared with 14 percent in 1984, despite a decline in agricultural output due to the persistence of drought conditions in many areas of the country. Manufacturing activity was adversely affected both by a decline in meat processing and by a fall in textile output following the reduction by Zimbabwe of the ceiling on Botswana's textile

Table 1. Botswana: Selected Economic and Financial Indicators, 1981-85

	1981	1982	1983	1984	1985 Est.
(Annual percent change, unless otherwise specified)					
National Income and prices					
GDP at constant prices	3.1	10.4	21.3	14.3	10.9
GDP deflator	-1.9	2.1	9.9	12.3	11.7
Consumer prices	16.1	11.5	10.3	7.5	8.7
External sector (in terms of SDRs)					
Exports, f.o.b.	-18.3	23.0	42.5	11.3	5.4
Imports, f.o.b.	26.3	-9.5	8.8	-0.3	-14.0
Nominal effective exchange rate (depreciation -)	3.8	-8.9	2.5	7.8	-9.1
Real effective exchange rate (depreciation -)	4.3	-7.9	0.9	3.1	-12.6
Government budget ^{1/}					
Total revenue and grants	5.0	21.2	44.0	42.6	32.6
Of which: Customs Union	(2.3)	(9.6)	(37.2)	(-0.6)	(-4.2)
mineral revenue	(-23.8)	(29.1)	(95.0)	(94.3)	(67.3)
Total expenditure and net lending	10.5	21.5	10.9	33.6	21.9
Money and credit					
Domestic credit ^{2/}	38.2	21.8	1.8	-30.0	-71.4
Government ^{3/}	-33.4	64.0	79.9	106.2	73.6
Private sector	47.4	2.8	19.2	34.7	-6.2
Money and quasi-money	-4.4	7.9	30.9	14.1	49.5
Interest rates (end of year)					
Bank of Botswana lending rate	8.5	12.0	10.5	9.0	9.0
Commercial banks					
Prime lending rate	11.0	14.5	13.0	11.5	11.5
Savings deposit rate	7.5	11.0	9.5	8.0	8.0
(In percent of GDP)					
Central government budget deficit (-) ^{1/}					
Excluding grants	-7.2	-7.1	4.5	10.0	16.2
Including grants	-2.3	-2.5	8.5	12.6	17.9
Domestic bank financing	1.1	-4.2	-9.0	-13.7	...
Foreign financing	1.5	6.1	1.6	2.3	1.1
External current account balance (-)	-22.0	-5.4	0.2	0.9	13.2
External debt ^{4/}	17.6	23.9	22.0	24.9	...
Debt service ratio (in percent of exports of goods and services)	4.1	2.8	4.4	6.6	4.3
(In millions of SDRs, unless otherwise specified)					
Overall balance of payments (deficit -)	-61.9	50.1	117.8	124.9	240.2
Gross official reserves (months of imports, c.i.f.)	4.0	5.1	6.6	8.5	17.0

Sources: Data provided by the Botswana authorities; and staff estimates.

^{1/} Fiscal years (April-March).

^{2/} As a proportion of money and quasi-money.

^{3/} The Government of Botswana is a net creditor vis-à-vis the banking system; the percentages shown are the changes in this net creditor position.

^{4/} Medium- and long-term, public and publicly guaranteed, disbursed and outstanding.

Table 2. Botswana: Balance of Payments, 1984-90

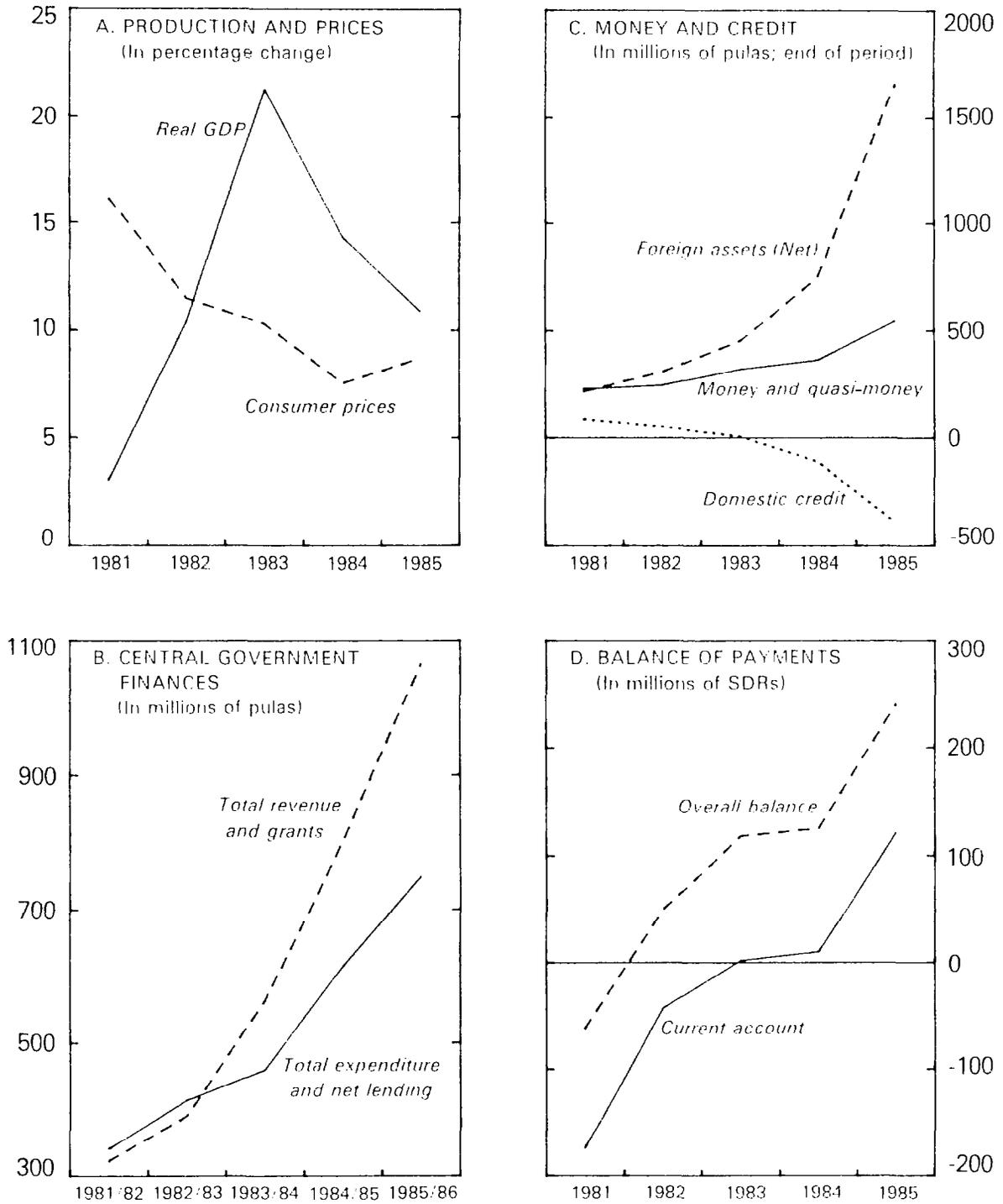
(In millions of SDRs)

	1984 Actual	1985 Est.	1986	1987	1988 Projections	1989	1990
Exports, f.o.b.	667.1	703.0	709.1	774.3	813.7	891.6	977.5
Imports, f.o.b.	-574.3	-493.9	-622.1	-750.4	-898.8	-1,007.1	-1,061.4
Externally-financed imports	(-117.5) ^{1/}	(-97.3) ^{1/}	(-139.0)	(-152.8)	(-216.9)	(-232.5)	(-181.8)
Other imports	(-456.8) ^{1/}	(-396.6) ^{1/}	(-483.1)	(-597.7)	(-681.9)	(-774.6)	(-879.7)
Trade balance	<u>92.8</u>	<u>209.1</u>	<u>87.0</u>	<u>23.9</u>	<u>-85.1</u>	<u>-115.5</u>	<u>-83.9</u>
Services and income: Debit	192.0	165.7	225.4	269.0	289.0	318.0	348.3
Services and income: Credit	-374.9	-332.4	-343.7	-396.7	-441.3	-475.6	-504.2
Services and income (net)	<u>-182.9</u>	<u>-166.7</u>	<u>-118.3</u>	<u>-127.7</u>	<u>-152.4</u>	<u>-157.6</u>	<u>-155.9</u>
Transfers (net)	100.0	78.2	90.2	103.2	116.0	126.3	132.4
Official (net)	(107.3)	(83.3)	(95.9)	(109.2)	(122.1)	(132.7)	(139.0)
Private (net)	(-7.3)	(-5.2)	(-5.6)	(-6.0)	(-6.1)	(-6.4)	(-6.6)
Current account balance	<u>9.9</u>	<u>120.6</u>	<u>58.9</u>	<u>-0.6</u>	<u>-121.5</u>	<u>-146.7</u>	<u>-107.4</u>
Capital account balance	<u>115.0</u>	<u>119.6</u>	<u>119.6</u>	<u>129.1</u>	<u>193.6</u>	<u>201.8</u>	<u>135.2</u>
Direct private investment (net)	61.4	51.8	14.1	30.0	122.4	127.0	33.0
Public sector borrowing (net)	54.5	54.9	105.5	99.1	71.2	74.8	102.3
Disbursement	(93.2)	(80.8)	(127.0)	(125.7)	(108.3)	(121.1)	(154.5)
Amortization	(-38.7)	(-25.9)	(-21.5)	(-26.7)	(-37.1)	(-46.3)	(-52.2)
Short-term capital ^{2/} (net)	-0.9	12.9	--	--	--	--	--
Overall balance	<u>124.9</u>	<u>240.2</u>	<u>178.5</u>	<u>128.5</u>	<u>72.1</u>	<u>55.1</u>	<u>27.8</u>
<u>Memorandum items:</u>							
Gross official reserves							
(Millions of SDRs)	481.6	712.7	891.2	1,019.7	1,091.7	1,146.8	1,174.7
(Months of imports, c.i.f.)	8.5	17.0	17.8	17.4	15.6	15.0	15.1
Debt service as a percent of exports of goods and services	6.6	4.3	6.5	7.8	9.0	9.1	8.9

Sources: Data provided by the Botswana authorities; and staff projections.

^{1/} Staff estimates.^{2/} Includes errors and omissions (net).

CHART 1 BOTSWANA SELECTED ECONOMIC INDICATORS



Source: Data provided by the Botswana authorities



exports, which had been established under a preferential trade arrangement. The proportion of investment in GDP, which had declined from 45 percent in 1981 to 21 percent in 1984 following the completion of major mining and infrastructural projects, remained relatively stable in 1985. The rate of inflation, as measured by the urban and semi-urban cost of living index, rose from 7.5 percent in 1984 to nearly 9 percent in 1985, reflecting mainly increases in the prices of imports from South Africa. Because of the appreciation of the pula vis-à-vis the rand, however, Botswana's inflation rate was much lower than that of South Africa.

The Botswana authorities continued to pursue conservative fiscal policies in 1985/86. The budget surplus increased from P 188 million (12.6 percent of GDP) in 1984/85 to a record level of P 315 million in 1985/86, equivalent to 18 percent of GDP (Table 3). Total revenue and grants were 33 percent higher than the outturn for 1984/85, while total expenditure and net lending were 22 percent higher. Current expenditure, which increased at an average annual rate of 20 percent in the three-year period 1982/83-1984/85, rose by 26 percent in 1985/86.

Following the substantial budgetary surplus and a large buildup in government deposits, the Government's net claims on the banking system rose substantially in 1985. This increase, together with a 6 percent decline in credit to the private sector, resulted in a sharp reduction in total net domestic credit. As net foreign assets increased substantially, however, broad money expanded by 50 percent; the increase was largely in deposits held by the diamond company (Debswana) and the parastatal sector with the central bank.

The overall balance of payments is estimated to have registered a record surplus of SDR 240 million in 1985, compared with SDR 125 million in 1984. The current account surplus rose sharply to SDR 121 million in 1985, reflecting both a considerable increase in diamond exports and a 14 percent decline in the value of imports due to the depreciation of the rand vis-à-vis the SDR. The volume of imports increased, however, by about 18 percent. The surplus on the capital account increased slightly. Gross official reserves rose to an estimated SDR 713 million at end-December 1985, equivalent to nearly 17 months of 1985 imports, c.i.f.

The Botswana authorities have continued to pursue a flexible exchange rate policy, with the objective of striking a balance between the need to promote economic diversification and the need to combat imported inflation. Given these considerations, in January 1985 the pula was devalued by 15 percent against the basket of composite currencies in the SDR and the rand, and the weight of the rand was raised from 50 percent to 75 percent. On January 20, 1986, however, changes were effected in the amounts of the rand and the SDR, which resulted in a reduction in the weight of the rand in the basket from

Table 3. Botswana: Summary of Overall Fiscal Operations of the Central Government, 1981/82-1986/87

(In millions of pula)

	1981/82	1982/83	1983/84	1984/85	1985/86			1986/87
					Budget	Rev.Est.	Exp.Outturn	Budget
Total revenue and grants	322.6	391.1	563.0	802.9	708.4	1,015.1	1,064.3	1,194.7
Total revenue	283.0	346.5	514.8	763.4	679.9	985.7	1,035.1	1,153.5
Tax revenue	211.3	220.1	308.4	420.6	442.0	461.1	(474.3)	695.4
Of which: customs union receipts	(104.3)	(114.3)	(156.8)	(155.8)	(154.0)	(145.4)	(149.2)	(193.5)
mineral tax receipts	(61.6)	(40.4)	(61.5)	(168.4)	(201.3)	(227.1)	(276.7)	(385.8)
Nontax revenue	71.8	125.6	206.4	342.8	237.9	524.6	560.8	458.1
Of which: mineral income receipts	(15.4)	(59.0)	(132.3)	(208.1)	(167.0)	(333.2)	(353.0)	(299.9)
Grants	39.6	44.6	48.2	39.5	28.5	29.4	29.2	41.2
Total expenditure and net lending	341.4	414.8	460.1	614.7	722.0	772.7	749.4	902.3
Current expenditure	200.0	227.4	272.6	344.7	402.0	431.4	435.0	528.2
Wages and salaries	(91.7)	(101.6)	(109.2)	(143.6)	(158.7)	(163.4)	(166.9)	(203.4)
Interest	(5.4)	(10.9)	(13.1)	(19.2)	(18.5)	(22.4)	(22.4)	(28.1)
Other	(102.9)	(114.9)	(150.3)	(181.8)	(224.8)	(245.6)	(245.7)	(296.7)
Capital expenditure	121.3	160.4	140.7	209.7	250.0	269.9	270.0	300.0
Net lending	20.1	27.0	46.8	60.3	70.0	71.4	44.4	74.1
Overall surplus or deficit (-)	-18.8	-23.7	102.9	188.2	-13.6	242.4	315.0	292.4
Financing	18.8	23.7	-102.9	-188.2	13.6	-242.4	-315.0	-292.4
Foreign (net)	11.8	58.8	20.0	33.8	54.6	25.6	19.5	51.9
Drawing	(13.0)	(62.1)	(34.3)	(58.6)	(77.7)	(65.0)	(60.0)	(75.0)
Amortization	(-1.2)	(-3.3)	(-14.3)	(-24.8)	(-23.1)	(-39.4)	(-40.4)	(-23.0)
Domestic	7.0	-35.1	-122.9	-222.0	-41.0	-268.0	-334.5	-344.3
Bank	(8.6)	(-40.2)	(-109.1)	(-203.7)	(...)	(...)	(...)	(-341.3)
Other	(-1.6)	(5.1)	(-13.8)	(-18.3)	(...)	(...)	(...)	(-3.0)

Sources: Republic of Botswana, Financial Statements, Tables and Estimates of Consolidated and Development Fund Revenues, 1984/85-1985/86; data provided by the Botswana authorities; and staff estimates.

75 percent to 65 percent. The authorities felt that this revised basket would more appropriately reflect Botswana's strong balance of payments position and their objective to combat inflationary pressures, particularly those resulting from the weakening rand. During 1985, in terms of the currency basket, the effective exchange rate of the pula depreciated by 9 percent in nominal terms and 13 percent in real terms (Chart 2).

III. Report on the Discussions

Despite Botswana's impressive economic and financial performance in recent years, the economy remains vulnerable to exogenous developments because of its marked dependence on the diamond sector. Cognizant of the need to diversify production and exports and to broaden the revenue base, the Botswana authorities have begun implementing measures to attain this objective. Prospects for diversification have been seriously undermined, however, by the persistent drought and the recent uncertainties in Southern Africa. The consultation discussions focussed on the prospects and policies for 1986 and the medium term, particularly with regard to fiscal, monetary, and price and incomes policies, the external sector, and development planning.

1. Prospects and policies for 1986

The prospects for the economy in 1986 will depend importantly on weather conditions and the diamond market. On the assumption of better weather conditions, continued improvement in the diamond market, and the continuation of prudent fiscal and monetary policies, there should be a large balance of payments surplus in 1986 and a substantial budgetary surplus in 1986/87, but a reduction in the rate of economic growth to about 6 percent in 1986. The decline in economic growth will be due to the leveling off in diamond production, stagnation in copper/nickel output, and a decline in beef production following years of persistent drought. In contrast, construction activity is expected to increase and nonmeat manufacturing output is forecast to expand. Investment, as a proportion of GDP, is estimated to remain at about the same level as in the previous year, as spending on telecommunications, railways, electric power, schools and hospitals continues to compensate for the shortfall resulting from the decline in the mineral sector.

The budget estimates for 1986/87, which were presented to Parliament in February 1986, show an overall budgetary surplus of P 292 million, about 7 percent lower than the expected outturn for 1985/86. Total revenue and grants are estimated to be 12 percent higher than the expected outturn for 1985/86, reflecting moderately higher mineral revenues, a 30 percent increase in customs union receipts, and larger grants. Expenditure and net lending are estimated to be 20 percent higher than the expected outturn for 1985/86. Growth in capital expenditure will be held to 11 percent, while current expenditure is estimated to rise by 21 percent; however, the estimates for current

expenditure do not reflect a prospective increase in salaries and wages recommended by a Salary Review Commission and expected to be introduced on April 1, 1986.

The overall balance of payments is forecast to record a surplus of SDR 178 million in 1986, compared with SDR 240 million in 1985. The value of exports is projected to increase slightly, while that of imports is expected to rise by 26 percent from the relatively low level in 1985. The current account surplus is projected to fall to SDR 59 million, about one half of its 1985 level. Although net public sector borrowing is expected to double, the capital account surplus is estimated to remain unchanged as private sector retained earnings are expected to be remitted. Gross official reserves are projected to rise to SDR 891 million at the end of 1986, equivalent to nearly 18 months of 1986 imports, c.i.f.

2. Medium-term prospects and policies

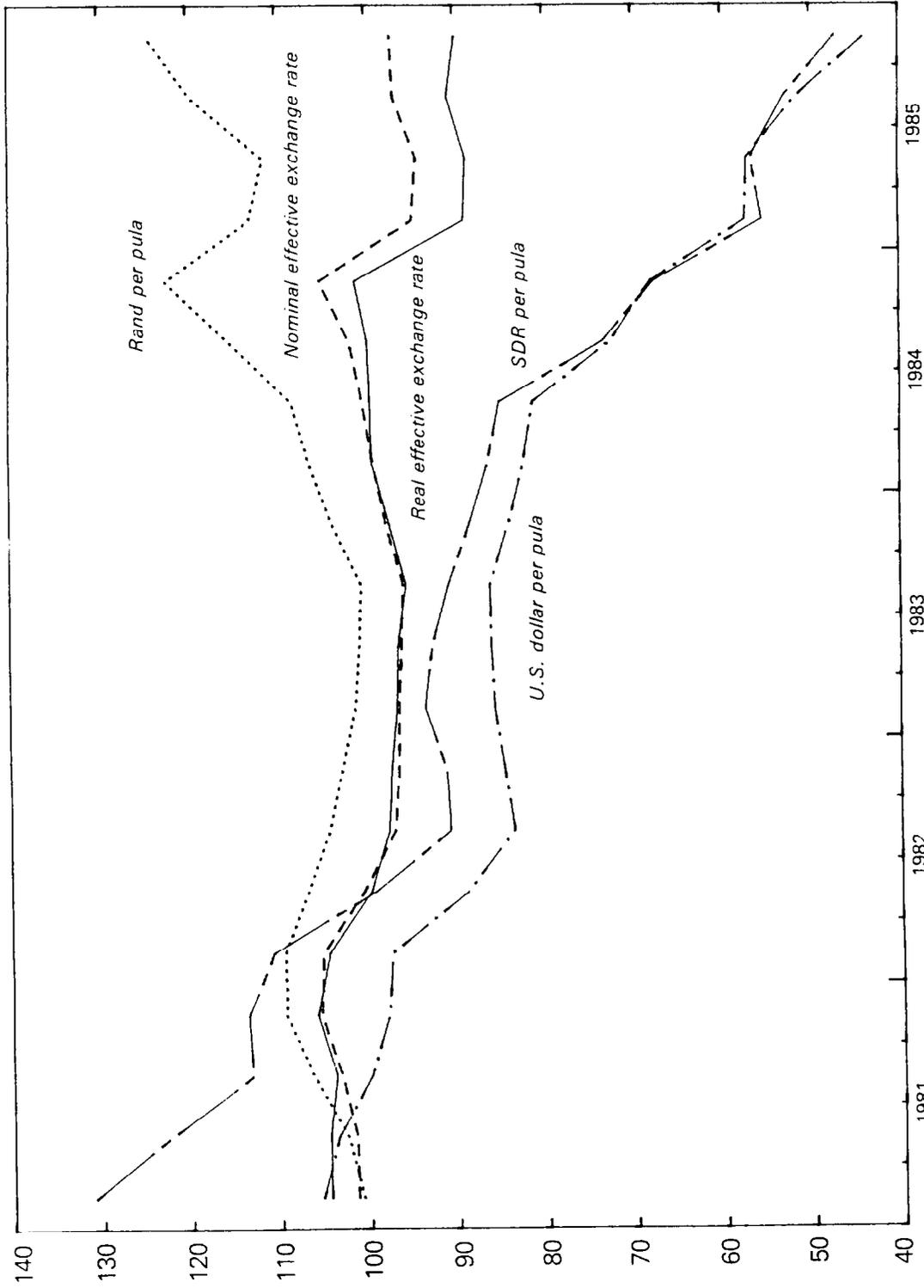
In the medium term, Botswana's economic and financial prospects seem to be relatively bright. Both the balance of payments and the budget are projected to show substantial surpluses; however, real economic growth is expected to decline from its previous high level, reflecting a slowdown in the mineral sector.

a. Fiscal policy

Since 1983/84 Botswana has achieved increasingly larger budgetary surpluses primarily due to an expansion in mineral-related revenues, but also because of the pursuit of conservative fiscal policies. In the absence of new revenue measures, however, it is projected that the budgetary surpluses will shrink and a deficit will emerge in 1990/91.

The staff representatives noted that, notwithstanding the very comfortable financial position of the Government over much of the NDP VI period, there were certain fiscal issues which deserved attention, namely, the recent acceleration in the growth of recurrent expenditure, and the increasing reliance on mineral-related revenues. Recurrent expenditure had expanded from an average annual rate of 18 percent during the three-year period 1981/82-1983/84 to 25 percent during 1984/85-1986/87. Most of this expansion stemmed from outlays on social services, agriculture, and electricity and water. Moreover, although NDP VI projected only a 2 percent real increase in development expenditure during 1985/86-1990/91, a large proportion of such outlays would be on hospitals and schools, and on infrastructure, which are likely to generate large recurrent costs that may not be easy to reduce. Therefore, the growth of such expenditure needed to be carefully monitored and controlled. Other categories of recurrent expenditure that needed careful scrutiny were transfers to districts and

CHART 2
 BOTSWANA
 DEVELOPMENTS IN EXCHANGE RATE OF THE PULA, 1981-85
 (1980 = 100)



Sources: IMF, *International Financial Statistics*; and staff estimates.



town councils, which have recently been increasing rapidly, the various subsidies associated with drought relief, and transfers to a few loss-making parastatals.

The Botswana representatives agreed with the staff that growth in recurrent expenditure should be kept under constant review, and that, where feasible, expenditures which generate large recurrent costs, such as on health services, should be spread out over a longer period. They said that they intended to reduce, as soon as circumstances permitted, the current subsidies for drought relief. With respect to the parastatals, they explained that although public enterprises in Botswana had traditionally operated on a sound financial basis, the Botswana Telecommunications Corporation (BTC) and the Botswana Housing Corporation (BHC) have been incurring losses recently, partly because their charges were not based now on the principle of full-cost recovery on a current basis. Instead, because of the large capital investment undertaken by these enterprises, charges were applied to recover their costs over the medium term. However, the Government intended to undertake a study of the tariff and cost structures of the BTC and BHC, with a view to improving their future operations.

Commenting on the need to broaden the revenue base and improve the tax structure in order to reduce the increasing reliance on mineral-related revenues and to provide greater stability to the fiscal system, the staff representatives pointed out that such revenues had increased their share of the total from 38 percent in 1980/81 to an estimated 59 percent in 1986/87, while the share of customs union receipts had declined from 53 percent to 17 percent during the same period. They urged the authorities to implement, where feasible, the proposals of the September 1985 FAD technical assistance mission, which included the introduction of a broad-based sales tax on goods and selected services, withdrawal of certain income tax concessions to the cattle sector, and an increase in the company tax rate. The Botswana representatives said that they would study the proposals carefully with a view to implementing them where feasible. They stressed, however, that any significant increase in revenues would continue to depend on the extent of diversification achieved in the economy.

b. Monetary and credit policies

Monetary and credit developments in 1986 and beyond will be dominated by the balance of payments and budgetary surpluses, and by pressures to increase productive investment and diversify the economy. Because of the co-existence of excess liquidity and the scarcity of short- and medium-term bankable projects, the commercial banks had little incentive to attract savings by offering higher rates on deposits. Instead, commercial banks generally turned away deposits in excess of P 50,000 and deposited their excess liquidity with the Bank of Botswana at a 3.5 percent rate of interest compared with a minimum rate of 5 percent that they offered to their own depositors. Larger deposit

accounts (for example of Debswana and some parastatals) were maintained directly with the central bank, which alleviated the excess liquidity problem of the commercial banks.

The staff representatives observed that there were several private sector and parastatal projects which needed longer-term financing, some of which were being financed from external sources or directly by government loans. Therefore, it was desirable to develop financial instruments of suitable maturities to facilitate the transfer of surplus liquidity into investment finance. In this context, the staff representatives urged the Botswana authorities to consider implementing some of the proposals suggested in the Central Banking Department's report on "Liquidity and Monetary Instruments and Development Finance in Botswana." As a first step toward developing a capital market, the Government should consider reintroducing the issue of treasury bills, while the parastatal organizations should be encouraged to issue their own paper to tap domestic resources, instead of borrowing abroad or directly from the Government. Should these policy initiatives be implemented, the demand for domestic credit might rise and the commercial banks might reconsider their policy of turning away large deposits, particularly if a more flexible policy with respect to interest rates on deposits was also pursued, and the process of financial intermediation could be improved. The staff representatives stressed that the drawdown of foreign reserves instead of nonconcessional external borrowing, the development of a capital market, and interest rate flexibility were interrelated and should be considered within an integrated perspective.

The Botswana authorities emphasized that the excess liquidity stemmed largely from the Debswana and parastatal enterprises on the supply side and limited absorptive capacity in the economy on the demand side, and that, owing to the instability of the commercial banks' deposit base, the banks were reluctant to risk lending on a long-term basis. At present, in view of the large government balances with the Bank of Botswana, there was no immediate need to issue government debt instruments, which would only increase budgetary expenditures. The authorities were, however, currently examining ways of developing suitable debt instruments with appropriate maturities for the private and parastatal sectors. For example, a consultant group was examining the possibility of the Botswana Development Corporation issuing its own securities, and a government-guaranteed mortgage scheme for commercial properties was currently being considered for commercial bank financing. In addition, the Bank of Botswana was considering a proposal to place with the commercial banks a ten-year deposit for providing long-term credit. Commenting on the possible decontrol of interest rates, the Botswana representatives said that because of the oligopolistic nature of the commercial banking system, minimum deposit interest rates were necessary to protect the interests of a large body of depositors. Moreover, even with the mobilization of additional deposits, bank lending would not necessarily expand because demand for credit would continue to be constrained by the limited absorptive capacity of the

economy. However, the Bank of Botswana had recognized the seriousness of the problem and had recently circulated a questionnaire to the commercial banks that would enable the authorities to get a better grasp of the problem and design solutions.

c. Price and wage policies

The Botswana authorities have continued to use price incentives to encourage agricultural production. Producer prices for the main staples, sorghum and maize, have been announced on a pre-planting basis. The producer prices for these food grains are determined on the basis of the landed costs of comparable imports from South Africa; transport costs are then added to these base producer prices to determine the producer prices for individual zones. In recent years, the producer price of sorghum has been increased relative to those of maize, groundnuts, and other food crops with a view to promoting the production of sorghum, which is drought-resistant. There was a notable increase in sorghum production in the 1984/85 crop year mainly due to improved rainfall in certain agricultural areas, but also due to increases in producer prices and greater availability of complementary agricultural inputs. However, the persistent drought had made it difficult to assess the full impact of price increases and other incentives on production.

The Botswana representatives emphasized that the Government did not provide consumer subsidies and that only prices of petroleum products were being directly controlled at the retail level; maximum percentage markups ranging from 10 to 50 percent were allowed on other goods. Recently, the Government temporarily suspended the issue of import licenses for sorghum to private traders who, as a result of a 60 percent decline in the price of imported sorghum from South Africa, reduced their purchases of domestic sorghum and increased imports from South Africa.

Botswana has generally followed a policy of wage restraint in recent years. Wage increases, which have averaged 6.5 percent annually during the last four years, have represented partial adjustments for inflation. However, on the recommendations of a Salary Review Commission, a new wage structure will be established over the next three years, beginning on April 1, 1986. At the time of the discussions, the new structure had not yet been finalized, but the Botswana representatives indicated that important considerations in the Government's decision were the desirability of reversing the erosion of real incomes that had occurred in recent years, and the need to retain and attract technical and managerial skills in the upper echelons of the civil service. The staff representatives commented that while it may have been necessary to make adjustments to the wage structure, especially with a view to providing wage incentives for skills that are in short supply, the Government should consider carefully the impact not only on the budget, but also the pressures it could generate for wage increases

in the private sector, and the implications for the competitiveness of Botswana's nontraditional exports and the Government's objective of expanding employment.

d. External sector policies

In assessing the evolution of the balance of payments in the medium term, particular attention was paid during the discussions to the policies, investment targets, and financing outlined in NDP VI; but, in view of the changed circumstances, the inflation and exchange rate assumptions that were used differed from those contained in NDP VI. The staff projections of the balance of payments were based on the following important assumptions. During the period 1987-90, the value of total exports is projected to expand by an average of 8 percent annually, with diamond exports also increasing at an average rate of 8 percent. Diamond receipts are estimated to constitute 76 percent of total exports in 1990, compared with 79 percent in 1987. The export unit value of diamonds is expected to increase in terms of U.S. dollars, reflecting higher world prices as well as an improvement in the quality of the carats sold.

The value of imports is projected to rise at an average rate of 14 percent annually. Externally financed imports, which are assumed to be the counterpart of 85 percent of gross capital inflows, are projected to increase between 1987 and 1989, and to decline in 1990. Other imports, which are estimated at about 80 percent of total imports, are projected to grow by 16 percent a year (nearly 5 percent a year in real terms), reflecting a more or less steady relationship with GDP, and a moderate degree of import substitution. It is assumed that foreign borrowing by the Government and the parastatal sector will materialize as scheduled; that direct capital investment for the Sua Pan soda ash project will be substantial in 1988-89 and will decline sharply in 1990, but that there will be no growth in other direct private investment throughout the period.

The balance of payments is projected to continue to register large, though diminishing, surpluses throughout 1987-90. Gross official reserves are projected to increase in absolute terms, but to decline in terms of import cover from the equivalent of nearly 18 months' imports (c.i.f.) in 1986 to 15 months' imports in 1990. At the same time, the debt service ratio is projected to approximately double from 4 percent in 1985 to 9 percent in 1990.

The Botswana representatives said that they intended to continue to pursue a flexible exchange rate policy in the medium term. Changes in the rate will be determined mainly by their concern for the competitiveness and profitability of import-competing and nontraditional export industries, a commitment to maintain a congenial investment climate, and the need to moderate the impact of imported inflation from South Africa on the cost of living in Botswana. They recognized that these objectives may at times be conflicting. In an effort to strike a balance

between these objectives, especially following the sudden and sharp depreciation of the rand against the major international currencies, the Botswana authorities had reduced the amount of rand in the basket, which, when calculated in terms of U.S. dollars, resulted in weights of 65 percent and 35 percent for the rand and the SDR, respectively, in the basket. In determining the new relative weights in the basket, emphasis was given to total trade and payments rather than to only imports as was previously the case. However, the authorities anticipated that the pula/rand relationship would continue to be dominant in any consideration of exchange rate policy and that the currency basket would also be subject to periodic review.

The staff representatives suggested that although Botswana's debt service ratio was still relatively low, the authorities should begin substituting international reserves for external borrowing, because the yield on international reserves had declined recently while the overall cost of external borrowing had increased, following the rise in the proportion of Botswana's nonconcessional external loans. They pointed out that the level of reserves could be reduced substantially and still provide a comfortable cushion for Botswana's requirements, while permitting a more efficient management of Botswana's foreign assets and external debt. The Botswana representatives agreed with the staff and indicated that they intended to coordinate their reserve and external debt management more closely in future by utilizing reserves instead of external borrowing, where possible, to finance projects. They cautioned, however, that they needed to examine carefully the relative earnings and maturity structure of existing official foreign assets as well as the existing contracts for external loans.

The staff representatives commended the Botswana authorities for their adherence to a liberal trade and payments system, and suggested that Botswana's strong external position provided the Government with an opportunity to liberalize its exchange arrangement fully and to move from Article XIV to Article VIII status. The Botswana representatives said that although Botswana had achieved large balance of payments surpluses in recent years, the structure of the balance of payments, with its heavy dependence on diamonds, remained weak, and, in view of the present uncertainties in the region, it would not be prudent for Botswana to move to Article VIII status at this time.

3. Development planning and policies

The Sixth National Development Plan (1985/86-1990/91) was approved by Parliament in late 1985. The medium-term objectives are to increase employment, accelerate rural development, and continue to diversify production and exports. Consequently, the plan places additional emphasis on manpower planning, improvement in the transportation network, expansion of electric and water facilities, including increasing the supply of available water through supplementary irrigation in order to expand crop production, and expansion of the manufacturing sector.

The outturn of the first year of NDP VI (1985/86) was somewhat different from what was originally envisaged. Both resources and outlays were higher than anticipated. The larger resources in pula terms reflected mainly the depreciation of the pula, while higher expenditure was due to the drought, increased security costs, and cost overruns. Moreover, expenditures on railway construction and rolling stock and on the Morupule electricity facility had been brought forward. In contrast, investment on the Sua Pan soda ash project, which was scheduled for 1985/86, had to be postponed because financing arrangements had not yet been completed.

The Botswana representatives said that they would intensify their efforts to diversify production and exports and increase employment opportunities. Despite the drought, the Government's agricultural policy had achieved some success. The modified Arable Land Development Program (ALDEP), which incorporated a larger grant element than the original package, had begun to have an impact on the productivity and incomes of small farmers. A new program, the Accelerated Rainfed Arable Program (ARAP), which was introduced in September 1985 to assist farmers in procuring draft power and seeds for planting, was expected to show results within the next year or two. However, because of the drought, the Tribal Grazing Land Policy (TGLP) was not successful, and farmers had accumulated substantial repayment arrears. In addition, lack of suitable water had prompted farmers to move from commercial areas to the communal grazing areas, resulting in overgrazing in the communal areas. The Government was proceeding with its plans to develop irrigation facilities and had already hired consultants to undertake a feasibility study to assess the possibilities of expanding crop production in the Okavango area; a similar study for the Chobe area will be undertaken later. The Botswana representatives felt that the successful implementation of these schemes would make a significant contribution to agricultural development.

The Botswana representatives expected the manufacturing sector to continue to expand, though at a slower rate than in recent years. The Government's industrial policy aimed at promoting nonmeat manufacturing industries producing for export, and import substitution industries. This was to be achieved within the framework of the customs union through the imposition of import tariffs on selected products such as beer and soap, the use of import permits to regulate the flow of specific imports, and liberal licensing of industries with a minimum local content. In addition, there were several organizations such as the Botswana Development Corporation, the Trade and Investment Promotion Agency, the National Development Bank, and the Business Advisory Services, which provided finance, promotional activities, and technical expertise to the industrial sector. The Government was actively trying to increase the share of non-rand direct investment in Botswana.

The Botswana representatives indicated that another area which was receiving increasing attention was the tourist sector. Hotels and lodges were being expanded and upgraded, game reserves were being

improved, and transportation facilities, including air transport, were being developed further to serve the tourist areas. They said that the number of tourists visiting Botswana had increased by nearly 50 percent between 1981 and 1984, with the majority of tourists coming from the United States. Their policy was to attract a greater proportion of tourists from outside the region.

4. Timing of the next Article IV consultation

In discussing the timing of the next Article IV consultation mission, the Botswana authorities argued strongly that, in view of the present uncertainties in the region, and the importance they attached to the Fund's annual assessment of Botswana's economic and financial performance, prospects, and policies, the 12-month cycle was more appropriate to their needs.

IV. Staff Appraisal

Botswana's economic and financial performance in 1985 continued to be impressive, reflecting not only the buoyancy of the mineral export sector, but also good economic management. GDP grew by about 11 percent in 1985, despite a decline in agricultural output, and the Central Government's budget and the overall balance of payments recorded large surpluses. The rate of inflation accelerated largely due to increases in prices of imports from South Africa.

The prospects for the economy in 1986 will depend importantly on weather conditions and the diamond market. Nevertheless, it is currently envisaged that there should be a large balance of payments surplus in 1986, a substantial budgetary surplus in 1986/87, but a reduction in the rate of economic growth to about 6 percent in 1986. The new wage structure of the civil service, scheduled to be introduced in April 1986, might help to retain and attract managerial and technical skills and thereby improve Botswana's administrative absorptive capacity. However, the authorities should monitor carefully not only the impact of these wage adjustments on the budget, but also the resulting pressures for wage increases in the private sector, and the implications for the competitiveness of Botswana's nontraditional exports and for employment creation.

Over the medium term, Botswana's economic and financial prospects appear to be relatively bright. The balance of payments is projected to show large, though declining, surpluses between 1986 and 1990. The current account is projected to register large deficits during 1988-90, but these will be more than offset by capital inflows tied to project execution. The debt service ratio is projected to rise from 4 percent in 1985 to 9 percent in 1990. Gross reserves will remain at a minimum of 15 months of imports throughout the period.

Notwithstanding Botswana's comfortable financial position and prospects, there are certain areas which deserve critical attention. The policy of accumulating large foreign exchange reserves while increasing nonconcessional external borrowing needs to be reviewed in the face of the relatively limited absorptive capacity and the prospective higher debt profile. The recent decline in the yield on foreign investments, moreover, strengthens the case for closer coordination of external reserves and debt management on the part of the authorities, and for utilizing reserves instead of nonconcessional external borrowing, where possible, to finance projects.

Although budgetary surpluses are envisaged until 1989/90, the size of these surpluses is expected to shrink sharply and a deficit to emerge in the final year of NDP VI. In light of this, and the uncertainties relating to the diamond market, the staff would urge the authorities to contain the growth of recurrent expenditure, which has averaged 24 per cent annually during the last three years. In that context, the Botswana authorities should monitor carefully outlays on social services and infrastructure, which are likely to generate large recurrent costs and which may not be easy to reduce, should circumstances change. Expenditure on such projects should be spread out over a longer period of time. At the same time, the Botswana authorities should implement the recommendations of the FAD technical assistance mission for broadening the revenue base and reducing the dependence on mineral-related receipts.

The budgetary surpluses and the large private sector deposits associated with diamond sales have given rise to a buildup in liquidity of the banking system, well in excess of the absorptive capacity of the economy. At the same time, there is a scarcity of long-term credit, and parastatal and other enterprises are borrowing abroad to finance investment. In these circumstances, the staff would urge the Botswana authorities to intensify their efforts to develop financial instruments through which some of the existing excess liquidity could be transferred to investment finance. The issue of financial instruments with appropriate maturities, together with the adoption of a more flexible interest rate policy on deposits, could improve the process of financial intermediation and reduce incentives for external borrowing by parastatals.

Botswana has continued to maintain a flexible exchange rate policy, aimed at striking a balance between the need to promote economic diversification and to maintain an attractive climate for foreign investment, and the need to combat imported inflation. Developments with respect to Botswana's major trading partners, particularly those affecting the South African rand, are bound to have a large impact on Botswana's exchange rate policy. The staff agrees broadly with the authorities' approach to the exchange rate and would urge them to continue to review the currency basket in the light of changes in the external environment.

The Botswana authorities have adhered to a relatively liberal trade and payments regime and intend to maintain it. Payments and transfers for current international transactions are permitted freely except for relatively liberal limits which apply to private and business travel and remittances abroad maintained in accordance with Article XIV, Section 2. While Botswana's balance of payments position and outlook are favorable, and its external reserve position comfortable, given their heavy dependence on diamonds and the present uncertainties in the region, the authorities do not feel that it would be prudent for Botswana to change its status from Article XIV to Article VIII at this time.

The staff proposes that, as requested by the authorities, the next Article IV consultation with Botswana be held on the standard 12-month consultation cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1986 Article XIV consultation with Botswana and in the light of the 1986 Article IV consultation with Botswana conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Botswana continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions except for relatively liberal limits which apply to private and business travel and remittances abroad that are maintained in accordance with Article XIV, Section 2. The Fund encourages Botswana to remove these remaining restrictions as soon as possible.

BOTSWANA -Relations with the Fund
(As of February 28, 1986)

I. Membership status

- (a) Date of membership: July 24, 1968
(b) Status: Article XIV

A. Financial Relations

II. General Department (General Resources Account)

- (a) Quota: SDR 22.1 million

	Amount (In millions of SDRs)	Percent of quota
(b) Total Fund holdings of Botswana pula	9.7	43.8
(c) Use of Fund credit	--	--
(d) Reserve position in the Fund	12.4	56.2

III. Current stand-by or extended arrangement
and special facilities

Botswana has not made use of Fund resources to date under any arrangement or facility.

	Amount (In millions of SDRs)	Percent of allocation
IV. <u>SDR Department</u>		
(a) Net cumulative allocation	4.4	100.0
(b) Holdings	10.0	230.7
V. <u>Trust Fund loans outstanding</u>	--	--
VI. <u>Overdue obligations to the Fund</u>	--	--

BOTSWANA - Relations with the Fund (concluded)
(As of February 28, 1986)

B. Nonfinancial Relations

VII. Exchange rate arrangement

The exchange rate of the Botswana pula is determined on the basis of a basket consisting of the SDR and the South African rand. The intervention currency is the U.S. dollar. The representative rate on January 31, 1986 was
P 1 = US\$0.6068.

VIII. Last Article IV consultation and consultation cycle

The 1984 Article IV consultation discussions took place in Gaborone during January 18-31, 1985. The Executive Board discussed the reports (SM/85/86 and SM/85/88) on April 10, 1985. The following decision was taken:

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Botswana, in the light of the 1984 Article IV consultation with Botswana conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Botswana continues to maintain an exchange system that is virtually free of restrictions on payments and transfers for current international transactions.

Botswana is on a standard 12-month cycle for Article IV consultation.

IX. Technical assistance

There are five experts recruited by the Central Banking Department, who are currently serving at the Bank of Botswana as Directors of Research and Operations, and Advisors for Bank Supervision, Training, and Foreign Exchange and Exchange Control Operations.

BOTSWANA - Financial Relations with the World Bank Group
(as of December 31, 1985)

	(In millions of U.S. dollars)		
	Disbursed	Undisbursed	Total
Fully disbursed loans and credits	112.34	--	112.34
Effective loans	<u>51.35</u>	<u>89.35</u>	<u>140.70</u>
Urban	6.72	1.28	8.00
Education	11.29	36.21	47.50
Power	15.74	16.76	32.50
Water supply	17.51	1.19	18.70
Development finance	0.03	12.27	12.30
Health	0.06	10.94	11.00
Livestock	--	10.70	10.70
Total	<u>163.69</u>	<u>89.35</u>	<u>253.04</u>
Repayments and adjustments for exchange rate changes	-36.36		
Total borrower's obligation	127.33		

Botswana--Statistical Issues

1. Outstanding Statistical Issues

There is a generally well-established statistical base in Botswana. The main sources of statistics used in this report are the Central Statistics Office, the Bank of Botswana, and the Ministry of Finance and Development Planning.

a. Real sector data

Official national accounts data are available with an 18-month lag, but are subject to revisions, particularly because the valuation of diamond stocks is a highly complex issue. To enhance the usefulness of national accounts to the policymakers, the mission suggested to the Central Statistics Office (CSO) that consideration be given to the possibility of issuing "flash" estimates of GDP for more recent years. The CSO is currently working toward reducing the time lag to 6 months.

The consumer price index, constructed on the basis of price quotations collected from urban and semiurban sectors, is published every month, with about a four-week time lag.

Monthly data on production in the mining and energy sectors and quarterly data on animals slaughtered are compiled and published. A survey of the manufacturing sector is conducted annually to provide data for the compilation of national accounts, but no index of manufacturing production is published. Recommendations on conducting a monthly survey of a sample of establishments and developing an index of manufacturing production were made by a Bureau of Statistics technical assistance mission to Botswana in November 1985.

To collect data on wages and employment, the CSO conducts an employment survey annually. A questionnaire is sent to all local government authorities and to a sample of private and parastatal businesses drawn from its Enterprises and Establishment Register. Annual data on wages and employment thus collected are published on national statistics with a six-month time lag.

b. Fiscal and monetary data

The available central government statistics include actual data through the 1984/85 fiscal year and provisional estimates for 1985/86. No data are provided on the extrabudgetary operations of the Central Government or on operations of the local government. Data on money and banking are generally available with a reporting lag of less than two months. A number of outstanding questions relating to money and banking statistics were discussed with the authorities by a technical assistance mission from the Bureau of Statistics in February 1985.

c. External sector data

The authorities provided the mission with actual data on balance of payments through 1984 and provisional estimates for 1985. However, because of the heterogeneous nature of Botswana's main export commodity, viz., diamonds, and Botswana's membership in the Southern African Customs Union that requires little documentation of imports, no reliable terms of trade data are available. The export and import unit value indices calculated by the CSO suffer from a number of weaknesses and are usually published with a one-year time lag. The Bureau of Statistics mission of November 1985 made a number of useful recommendations aimed at improving the compilation of export and import trade price data.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Botswana in the February 1986 issue of IFS. The data are based on reports sent to the Bureau of Statistics by the Bank of Botswana; they have been provided on a timely basis.

Status of IFS Data

		<u>Latest Data in February 1986 IFS</u>
Real Sector	- National Accounts	1983 (GDP only, 1984)
	- Prices	October 1985
	- Production (Mining)	Q3 1984
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	July 1985
	- Financing	July 1985
	- Debt	1983
Monetary Accounts	- Monetary Authorities	July 1985
	- Deposit Money Banks	August 1985
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade	
	Values: Exports	August 1985
	Imports	August 1985
	Prices	n.a.
	- Balance of Payments	1984
	- International Reserves	December 1985
	- Exchange Rates	December 1985

BOTSWANA - Basic DataArea, population, and GDP per capita

Area	581,370 square kilometers
Population: Total (1984 mid-year estimate)	1,091,000
Growth rate	3.8 percent
GDP per capita (1985 estimate)	SDR 912

	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u> Est.	<u>1984/85</u> Est.	<u>1985/86</u> Proj.
<u>National accounts</u> (July-June)	(In millions of pula)				
GDP at current market prices	779.2	1,024.3	1,269.0	1,572.6	1,952.3
GDP at constant (1979/80) market prices	742.5	917.5	1,095.5	1,205.5	1,348.5
	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u> Est.	<u>1985</u>

<u>Prices</u>	(Percentage change from preceding year)				
Cost-of-living index	16.1	11.5	10.3	7.5	8.7
	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u> Expected Outturn

<u>Central government finance</u> (April-March)	(In millions of pula)				
Total revenue and grants	322.6	391.1	563.0	802.9	1,064.3
Of which: Customs Union	(104.3)	(114.3)	(156.8)	(155.8)	149.2)
mineral revenue	(77.0)	(99.4)	(193.8)	(376.5)	(629.7)
Total expenditure and net lending	341.4	414.8	460.1	614.7	749.4
Of which: current expenditure	(200.0)	(227.4)	(272.6)	(344.7)	(435.0)
capital expenditure	(121.3)	(160.4)	(140.7)	(209.7)	(270.0)
Overall surplus or deficit (-)	-18.8	-23.7	102.9	188.2	315.0
External financing	11.8	58.8	20.0	33.8	19.5
Domestic financing	7.0	-35.1	-122.9	-222.0	-334.5

BOTSWANA -Basic Data (concluded)

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
<u>Money and credit (end-year)</u>	<u>(In millions of pula)</u>				
Foreign assets (net)	213.7	307.6	452.2	750.7	1,656.0
Domestic credit	86.5	53.3	5.8	-114.8	-389.8
Claims on Government (net)	(-58.1)	(-95.3)	(-171.4)	(-353.5)	(-613.6)
Claims on private sector	(144.6)	(148.6)	(177.2)	(238.7)	(223.8)
Money and quasi-money	226.7	244.5	320.1	365.1	546.0
Money	(114.9)	(133.6)	(151.6)	(176.4)	(206.8)
Quasi-money	(111.8)	(110.9)	(168.5)	(188.7)	(339.2)
<u>Balance of payments 1/</u>	<u>(In millions of SDRs)</u>				
Exports, f.o.b.	342	420	599	667	703
Of which: diamonds	(137)	(216)	(396)	(467)	(543)
Imports, f.o.b.	-585	-529	-576	-574	-494
Trade balance	-243	-109	23	93	209
Services and incomes (net)	-49	-41	-139	-183	-167
Transfers (net)	118	106	117	100	78
Current account balance	-174	-43	2	10	121
Private long-term capital	76	19	24	61	52
Official capital	21	65	43	54	55
Short-term capital and errors and omissions	15	9	49	--	13
Overall balance	-62	50	118	125	240
<u>Gross official foreign reserves (end-year)</u>					
Total	218	266	378	482	713
In number of months ¹ imports, c.i.f.	4.0	5.1	6.6	8.5	17.0
<u>External debt</u>					
Debt service as percent of exports of goods and services	4.1	2.8	4.4	6.6	4.3

1/ Actual data for 1981-84 and estimates for 1985.

