

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

MASTER FILES

ROOM C-120

01

SM/85/86

CONTAINS CONFIDENTIAL
INFORMATION

March 12, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Botswana - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 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.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Gunjal, ext. 8755.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

BOTSWANA

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the
1984 Article IV Consultation with Botswana

Reviewed by the Committee on Article IV Consultations
Approved by A.D. Ouattara and S. Kanesa-Thasan

March 12, 1985

I. Introduction

The 1984 Article IV consultation discussions with Botswana were held in Gaborone during the period January 18-31, 1985. 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), D. Scheuer, T. Oyama, U. Gunjal and Ms. E. Fundafunda (secretary), all of the African Department. Mr. E. Mtei, (Executive Director for Botswana) attended some of the policy discussions.

Botswana continues to avail itself of the transitional arrangements under Article XIV.

II. Recent Economic and Financial Developments and Policies

After a decade (1971-80) of virtually uninterrupted growth, and favorable economic and financial developments, Botswana's performance deteriorated sharply in 1981. Following a weakening of prices due to a recession in the world diamond trade, Botswana's exports dropped sharply. As a result, the current account deficit almost tripled to nearly 22 percent of GDP, and the overall balance of payments showed a deficit (SDR 61.0 million, equivalent to 7.8 percent of GDP) for the first time since 1972. Moreover, reflecting mainly the shortfall in mineral-related revenues, the Central Government budget experienced a turnaround from a position of virtual balance in the fiscal year 1980/81 (March-April) to a deficit equivalent to 2.4 percent of GDP in 1981/82.

During 1982 the authorities adopted fiscal, monetary, exchange rate, pricing, and incomes policies aimed at correcting the external and budgetary imbalances. However, the impact of these policies was overshadowed by the coming-on-stream of the new Jwaneng diamond mine that substantially enhanced the volume of production, exports, and mineral-related revenues. Consequently, both the balance of payments and the budget improved. The overall balance of payments recovered to record a surplus of SDR 50 million in 1982, and SDR 118 million in 1983 (Table 1). In the fiscal area, the rebound in mineral-related receipts, combined with a general wage freeze in the public sector, helped to reduce the 1982/83 budget deficit slightly; the deficit was more than covered by external financing. The improvement was consolidated in the fiscal year 1983/84, when the continuing growth in mineral-related receipts, and a substantial underspending on projects in drought-stricken areas, enabled the Central Government to record a budgetary surplus of P 103 million, equivalent to nearly 9 percent of GDP. Following successive additions to Government deposits, the Government's net creditor position with the banking system strengthened by 80 percent in 1983, on top of the significant improvement of 64 percent in 1982. As the growth in credit to the private sector remained modest, the level of net domestic credit declined in both years. Despite this contraction, broad money expanded at an average annual rate of 31 percent, reflecting the rapid increase in net foreign assets. The rate of increase in the consumer price index decelerated from 16 percent in 1981 to 10 percent in 1983.

In 1984, growth in real GDP declined from an average annual rate of 14 percent during 1982-83 to an estimated 11 percent, largely due to the slower expansion in output from the Jwaneng diamond mine, as it reached the full capacity level of production. The construction, trade and services, and manufacturing sectors, showed positive rates of growth, but output in the agricultural and livestock sectors, which continued to be adversely affected by the persistent drought, declined; grain production fell to a historic low of about 7,000 tons, equivalent to only 5 percent of domestic requirements, while the livestock population was depleted further by 5 percent. The drought also hampered construction activity in the private sector.

The depressed level of activity in the agricultural and construction sectors adversely affected wage employment. Despite an increase in the manufacturing, government, and services sectors, total recorded employment is estimated to have registered virtually no change during 1983 and 1984. The rate of inflation decelerated from 10 percent in 1983 to 7 percent in 1984, mainly as a result of the appreciation of the pula against the rand, but also due to prudent monetary and fiscal policies.

Table 1. Botswana: Selected Economic and Financial Indicators, 1980-84

	1980	1981	1982	1983	1984 Est.
(Annual percent change, unless otherwise specified)					
National income and prices					
GDP at constant prices	13.2	7.6	11.8	17.1	11.4
GDP deflator	8.8	-2.2	1.7	9.0	12.0
Consumer prices	13.7	16.1	11.5	10.3	7.4
External sector (in terms of SDRs)					
Exports, f.o.b.	22.5	-18.3	21.8	44.0	7.6
Imports, f.o.b.	35.4	26.3	-9.5	8.8	-6.5
Nominal effective exchange rate (depreciation -)	-1.1	3.8	-8.9	2.5	7.9
Real effective exchange rate (depreciation -)	-1.7	4.3	-7.9	0.9	6.2
Government budget 1/					
Total revenue and grants	23.4	5.0	22.0	43.0	32.7
Of which: Customs Union	27.2	2.3	9.6	37.2	0.1
mineral revenue	32.0	-23.8	29.1	95.0	87.7
Total expenditure and net lending	35.5	10.5	21.5	10.9	29.6
Money and credit					
Domestic credit	1.9	700.9	-38.4	-89.1	-1,987.9
Government 2/	14.4	-33.4	64.0	80.0	103.1
Private sector	12.9	47.4	2.8	19.2	34.7
Money and quasi-money	19.0	-4.4	7.9	30.9	14.1
Interest rates (end of year)					
Bank of Botswana lending rate	5.75	8.5	12.0	10.5	9.0
Commercial banks					
Prime lending rate	9.0	11.0	14.5	13.0	11.5
Savings deposit rate	3.5	7.5	11.0	9.5	8.0
(In percent of GDP)					
Central government budget					
deficit (-)					
Excluding grants	-5.2	-7.6	-7.2	4.6	7.7
Including grants	-0.2	-2.4	-2.2	8.6	10.2
Domestic bank financing	0.6	1.6	-4.3	-9.2	-12.1
Foreign financing	1.4	1.5	6.2	1.7	3.2
Gross domestic investment	44.0	46.0	38.1	30.4	...
Gross domestic savings	26.9	16.7	13.7	27.0	...
External current account deficit (-)					
Excluding grants	-22.0	-37.4	-21.2	-12.1	-4.9
Including grants	-8.3	-22.2	-7.2	0.2	4.9
External debt	16.1	17.8	24.6	22.5	...
Debt service ratio (in percent of exports of goods and services and private transfers)	1.6	1.4	2.1	2.8	4.4
(In millions of SDRs, unless otherwise specified)					
Overall balance of payments (deficit -)	71.9	-61.0	50.1	117.9	122.0
Gross official reserves (months of imports, c.i.f.)	5.9	4.2	5.3	6.8	10.0

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

1/ Fiscal years (April-March).

2/ The Government of Botswana is a net creditor vis-a-vis the banking system; the percentages shown are the changes in this net creditor position.

The sharp improvement in budgetary performance that began in 1983/84 continued in 1984/85 (Table 2). Total revenue and grants are expected to increase by nearly 33 percent, due largely to the considerable expansion in diamond receipts arising mainly from the appreciation of the U.S. dollar (the currency in which payments for diamond exports, taxes and dividends are denominated) vis-à-vis the pula. Total expenditure and net lending are anticipated to increase by nearly 30 percent, reflecting substantial increases in current expenditure and net lending. Outlays on education and drought relief accounted for about 23 percent of the increase, and net lending for an additional 29 percent, most of which is attributable to an increase in on-lending to parastatals. The expected budgetary surplus of P 151 million (compared with P 103 million in 1983/84), combined with net external financing of P 48 million, will result in a large increase in government deposits with the Bank of Botswana. Consequently, despite a 35 percent increase in private sector credit, mainly to the mining and commerce sectors, total net domestic credit declined to minus P 109 million at end-December 1984. There was an increase in net foreign assets of P 274 million in 1984, and money and quasi-money rose by 14 percent.

Against the background of a strong external position, a comparatively low domestic rate of inflation, the existence of surplus liquidity in the banking system, and the need to stimulate the expansion and diversification of investment, effective January 1, 1984, the Botswana authorities reduced interest rates by 1.5-2.0 percentage points. Although interest rates have continued to remain positive in real terms (about 2 percentage points on fixed deposits and 4 on commercial bank prime lending), there was a real interest rate differential of roughly 5-9 percentage points in favor of South Africa vis-à-vis Botswana. This differential in interest rates has stimulated demand for domestic credit and resulted in the substitution of local borrowing for foreign loans, including trade credits.

On the basis of preliminary data, the overall balance of payments is estimated to have registered a surplus of SDR 122 million in 1984, slightly higher than in 1983. The current account surplus increased sharply to SDR 52 million in 1984, equivalent to about 5 percent of GDP, reflecting an 18 percent increase in diamond exports and a decline in imports of 7 percent in SDR terms. The surplus on capital account fell as a result of a lower level of foreign borrowing, following near completion of major parastatal sector projects, particularly the Gaborone dam expansion, construction of the Morupule power station, and the Gaborone international airport. Gross official reserves at end-December 1984 were SDR 465 million, equivalent to more than 8 months months of projected 1985 imports.

The Botswana authorities have continued to exercise a flexible exchange rate policy. Effective July 7, 1984, the pula was devalued by about 5 percent against Botswana's currency basket, consisting of the SDR

Table 2. Botswana: Summary of Overall Fiscal Operations of the Central Government, 1980/81-1984/85, ^{1/}

(In millions of pula)

	1980/81	1981/82	1982/83	1983/84	1984/85		1985/86	
					Budget	Expected outturn	Prelim. budget	Revised budget ^{2/}
Total revenue and grants	307.3	322.8	393.7	563.0	648.8	747.0	696.9	933.7
Tax revenue	193.2	211.3	220.1	308.4	430.3	423.4	430.5	542.6
Of which: Customs Union	(102.0)	(104.3)	(114.3)	(156.8)	(180.5)	(157.0)	(142.5)	(153.9)
mineral receipts	(50.0)	(61.6)	(40.4)	(61.5)	(153.2)	(169.6)	(201.3)	(302.0)
Nontax revenue receipts	74.3	71.7	126.4	206.4	186.3	237.6	237.9	348.3
Of which: mineral revenue	(51.1)	(15.4)	(59.0)	(132.3)	(136.7)	(194.1)	(167.0)	(250.5)
Grants	37.8	39.8	47.2	48.2	32.2	36.0	38.5	42.8
Total expenditure and net lending	309.0	341.6	414.7	460.1	603.6	596.5	721.9	779.8
Current expenditure	166.8	200.0	227.3	272.0	346.8	339.6	402.0	430.8
Wages and salaries	(80.9)	(91.7)	(101.4)	(109.2)	(145.1)	(140.0)	(158.7)	(158.7)
Other current expenditure	(85.9)	(108.3)	(125.9)	(163.4)	(201.7)	(199.6)	(243.3)	(272.1)
Capital expenditure	104.6	108.6	156.6	136.3	168.3	166.7	186.2	185.5
Net lending ^{3/}	37.6	32.8	30.8	51.2	88.5	90.2	133.7	163.5
On-lending to parastatals	(--)	(--)	(--)	(--)	(28.2)	(28.2)	(59.6) ^{4/}	(89.4)
Overall surplus or deficit (-)	-1.7	-18.6	-21.0	102.9	45.2	150.5	-25.0	153.9
Financing	1.7	18.6	21.0	-102.9	-45.2	-150.5	25.0	-153.9
External financing (net)	10.9	11.8	58.9	20.0	39.2	48.0	54.6 ^{5/}	81.9
Domestic financing (net)	-9.2	6.8	-37.9	-122.9	-84.4	-198.5	-29.6	-235.8
Banks	(4.2)	(12.0)	(-40.5)	(-109.1)	(-84.4)	(-179.0)	(...)	(...)
Other	(-13.4)	(-5.2)	(2.4)	(-13.8)	(--)	(-19.5)	(...)	(...)

Source: Data provided by the Botswana authorities.

^{1/} Fiscal year April 1-March 31.

^{2/} Adjusted for effects of exchange rate changes; assumes P 1.00 = R 1.13 and P 1.00 = US\$0.50.

^{3/} Includes equity participation in Jwaneng of P 16.8 million in 1980/81, P 12.2 million in 1981/82, and P 2.8 million in 1982/83, P 0.7 million in 1983/84, and P 0.2 million in 1984/85.

^{4/} Of this amount, P 13.1 million is to be negotiated.

^{5/} Excludes P 29.6 million to be negotiated.

and the rand. Subsequently, effective August 1, 1984, the number of units of currencies in the basket was changed to restore the weight of the rand to 50 percent. During the second half of 1984, the pula appreciated by about 15 percent against the rand, reaching a level of R 1.32 = P 1, on January 8, 1985. On January 9, 1985 the pula was devalued by 15 percent against the basket (to the equivalent of R 1.13 = P 1), and the weight of the rand in the basket of currencies was increased to 75 percent. These recent changes have reduced the real effective exchange rate of the pula by about 3 percent below the level existing a year ago, and are expected to improve the competitiveness of Botswana's non-mineral exports in its main markets, enabling the authorities to pursue their policies of import substitution and export diversification more effectively.

III. Report on the Discussions

Despite three years of persistent drought, the economic and financial situation in Botswana has improved steadily since 1981, due partly to an increase in diamond production, but also to good financial management on the part of the Botswana authorities. However, the economic base is still narrow and vulnerable to exogenous developments, and there is a need to consolidate the progress that has been made so far, and to diversify the economy over the medium term. Therefore, the consultation discussions focused on the prospects and policies for 1985 and the medium term, particularly in regard to financial, prices and incomes policies, the external sector, and development planning.

1. Prospects and policies for 1985

The prospects for the economy in 1985 will depend to a large extent on weather conditions and the state of the diamond market. On the assumption of a return to normal weather conditions, a moderate improvement in the diamond market, and the continuation of flexible policies, particularly exchange rate policy, there should be a further strengthening in the balance of payments and budgetary positions. However, it is estimated that the rate of economic growth will decelerate to about 8 percent in 1985, reflecting the attainment of a plateau in diamond production, but expansion in the agricultural, manufacturing, and services sectors.

The overall balance of payments surplus is forecast to more than double to SDR 263 million in 1985 (Table 3). On the assumption of no significant change in the US\$/SDR rate, exports are projected to increase by 14 percent in SDR terms, reflecting some improvement in the quality of diamonds sold, while imports are envisaged to rise by only 3 percent. Consequently, the external trade surplus is expected to be SDR 184 million, 72 percent higher than in 1984, and the current account surplus is estimated to increase by 79 percent to SDR 93 million,

Table 3. Botswana: Projection of Balance of Payments, 1985-90

(In millions of SDRs)

	1984 Prelim. Actuals	1985	1986	1987	1988	1989	1990
Current account	52.3	93.4	-1.6	-26.6	23.4	13.0	-58.6
Exports, f.o.b.	645.1	735.6	788.8	855.6	940.3	1,032.6	1,133.0
Of which: diamonds	(467.0)	(575.5)	(621.6)	(671.0)	(724.8)	(782.9)	(845.3)
beef	(60.6)	(49.9)	(49.9)	(54.8)	(60.3)	(66.2)	(73.3)
cooper-nickel matte	(56.9)	(60.8)	(60.8)	(65.1)	(70.0)	(74.9)	(79.8)
Imports, f.o.b.	538.2	552.1	663.4	723.1	741.6	817.6	956.6
Externally-financed	...	179.7	235.1	230.7	175.4	166.1	207.4
Other imports	...	372.4	428.3	492.4	566.2	651.5	749.2
Trade balance	106.9	183.5	125.4	132.5	198.7	215.0	176.4
Services (net)	-158.4	-165.0	-209.0	-244.3	-264.9	-293.2	-330.6
Of which: shipping, other trans- portation and travel	(-31.8)	(-35.8)	(-52.1)	(-57.0)	(-52.7)	(-58.6)	(-75.5)
investment income	(-108.4)	(-112.4)	(-136.8)	(-164.0)	(-185.7)	(-203.6)	(-219.9)
migrant remittances	(18.9)	(13.6)	(13.6)	(13.6)	(13.6)	(13.6)	(13.6)
Private transfers (net)	-0.8	-0.5	-0.5	-0.5	-0.5	-1.1	-1.1
Official transfers (net)	104.6	75.5	82.5	85.8	90.1	92.3	96.6
Capital account and errors and omissions	69.8	169.9	231.8	219.3	141.2	116.2	154.2
Of which: Sua Pan soda ash project	(--)	(23.9)	(51.0)	(91.2)	(36.9)	(3.8)	(--)
<u>Overall balance</u>	<u>122.0</u>	<u>263.3</u>	<u>230.2</u>	<u>192.7</u>	<u>164.6</u>	<u>129.2</u>	<u>95.5</u>
<u>Memorandum items:</u>							
Debt service payments	37.1	49.9	68.4	92.8	116.7	137.3	151.5
Amortization	19.7	20.1	23.3	30.4	43.4	57.5	67.9
Interest	17.4	29.8	45.1	62.4	73.3	79.8	83.6
Debt service ratio	4.4	5.5	7.0	8.8	5.4	10.9	11.0
Gross official reserves in months of imports, c.i.f. of the following year	8.4	11.0	13.3	15.5	16.1	15.1	--
SDR per pula	0.7581	0.5429	0.5429	0.5429	0.5429	0.5429	0.5429

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

1/ Imports linked to foreign grants, loans, and direct investment.

equivalent to nearly 13 percent of GDP. Net capital inflows are forecast to rise substantially, on account of higher external borrowing by public enterprises, and the expected direct investment in the Sua Pan soda ash project. Gross official reserves are expected to rise to SDR 728 million at the end of 1985, equivalent to 11 months of projected 1986 imports.

The preliminary budget estimates for 1985/86 provided to the staff representatives, which formed the basis for the budget presented to Parliament at the end of February 1985, were formulated on the basis of exchange rates prevailing in mid-1984, and did not incorporate subsequent movements, including the 15 percent depreciation that occurred on January 9, 1985. When the prevailing exchange rates are applied to the preliminary estimates, total revenue and grants are expected to increase by 25 percent over 1984/85; expenditure and net lending are estimated to rise by 31 percent on account of higher levels of both current and capital expenditure. Thus, instead of the small deficit originally envisaged, the staff is now estimating an overall surplus of P 154 million, slightly higher than the expected outturn in 1984/85.

The staff representatives cautioned, however, that because of the uncertainties regarding the diamond market and future movements in exchange rates, particularly, the US\$/SDR and pula/rand rates, budgetary and balance of payments developments might diverge from those outlined above, and the authorities should be prepared to implement appropriate adjustments in policy as they have done in the past.

2. Financial policies

(a) Budgetary policy

The Botswana authorities said that over the medium term, it was likely that, in the absence of new revenue measures, budgetary deficits would begin to emerge toward the end of the Sixth National Development Plan (NDP VI) period (1985/86-1990/91). In real terms, NDP VI envisaged no growth in revenues during the plan period, but projected an increase in total expenditure and net lending of 4.7 percent annually. Current expenditures were expected to expand by nearly 7 percent annually, reflecting larger outlays for maintenance of development projects and higher expenditure on social services. No real growth in development expenditure is targeted over the period. However, substantial investment is expected to take place in the private and parastatal sectors.

The staff representatives emphasized the need to broaden the revenue base and improve the tax structure in order to reduce the current dependence on mineral-related revenues. The Botswana authorities recognized the need to broaden the revenue base, although in the present circumstances, there was little scope to do so. Receipts from the Southern African Customs Union as a proportion of total revenue had

declined steadily since 1981; the sales tax which was introduced in 1982, and subsequently modified, was still in place; efforts had been made in 1984 to improve enforcement of the company income tax; and proposals for increased taxation of the livestock sector were considered regressive and had not been implemented. Therefore, any significant increase in revenues would depend on the extent of diversification achieved in the economy. In view of these difficulties, the Government intended to submit a request for technical assistance from the Fund to study the country's revenue base and the tax structure.

On the expenditure side, the sharp growth in current expenditure should be carefully monitored and appropriate measures taken to contain it. Particular attention should be paid to investment in social services and infrastructure, which were typically characterized by high maintenance requirements. With regard to the need to control current expenditure, the Government had already established certain guidelines for this purpose. Specific areas had been identified as priority areas-- education, water facilities, Financial Assistance Policy (FAP), roads, and grants to local authorities-- and the associated current costs in these areas would be allowed to grow in excess of 7 percent annually in real terms. Therefore, growth of current expenditure in non-priority areas would be restrained. In addition, the Government was attempting to identify development projects with no recurrent cost implications for the budget, and self-amortizing projects with proven returns to Government.

(b) Monetary and credit policies

Monetary and credit developments in 1985 will be influenced by the prospective large balance of payments surplus, the sharp increase in government deposits implied by the substantial budgetary surplus, and the government's policy to increase credit to the private sector with a view to expanding productive investment and diversifying the economy.

The Botswana representatives said that they expected demand for private sector credit to increase by about 30-35 percent in 1985 to reflect the higher cost of imports arising from the devaluation of the pula, and the large amount of prospective investments. However, as the expansion in private sector credit was likely to be more than offset by the increase in government deposits, total net domestic credit would continue to be negative, as in the previous year. On the other hand, broad money was expected to expand sharply, reflecting the balance of payments surplus.

The staff representatives indicated that this development was likely to generate additional surplus liquidity in the banking system and increase the need for financial instruments in which these surpluses could be invested. In view of the lack of suitable local investment

opportunities, the commercial banks had little incentive to attract savings by offering higher deposit rates. Instead, depositors with amounts in excess of P 50,000 were generally turned away. The Botswana authorities acknowledged that there was a gap in their financial system that needed to be filled, if surplus funds held by the banking system were to be channeled into productive investment. At present, most commercial bank loans were for short or medium-term purposes. At the same time, the parastatal organizations obtained financing from the Government on more favorable terms (at 10 percent rate of interest for 25 years) than could be obtained from the commercial banks. A proposal by the Botswana Development Corporation to issue its own paper which could be held by the commercial banks was still under discussion. However, the issue of providing suitable financial instruments and developing a money market was now under consideration by the authorities. At present, in view of the large balances accumulated by Government with the Bank of Botswana, there was no immediate need to issue government debt instruments. Therefore, the emphasis would have to be on the development of financial instruments for the private sector.

Commenting on the large differential in real interest rates between the two countries, and its implications for capital movements, the Botswana authorities indicated that there had not been any significant private capital outflows from Botswana in response to the higher real interest rates in South Africa. Moreover, real interest rates in Botswana were already positive, and would have to be raised substantially to match interest rates in South Africa, which would have an adverse impact on investment in Botswana. The staff representatives noted that in 1984, the widening exchange rate differential between the pula and the rand, the uncertainty regarding future exchange rate developments, and the consequent risk of foreign exchange losses, probably had a deterring effect on capital outflows. However, with the recent devaluation of the pula, and the reduced risk of exchange rate losses, the incentive to take advantage of the large real interest rate differential existing between South Africa and Botswana had been strengthened. Therefore, the Botswana authorities should monitor capital movements carefully and adopt a flexible interest rate policy as warranted.

3. Price and wage policies

With respect to pricing policy, the Botswana authorities have traditionally followed a liberal and pragmatic approach. Considerable emphasis has been put on price incentives to encourage crop production. Since October 1980, producer prices have been announced on a preplanting basis, but the successive droughts of 1981-83 have made it difficult to ascertain the impact of those and other supporting policies on agricultural performance. The authorities have followed the practice of aligning producer price for maize, the principal staple crop, with the landed cost of maize imports from South Africa. More recently, sorghum prices have been set higher than maize prices, in order to promote the

production of sorghum, which is more drought resistant. The system of seasonal variations in cattle prices which was introduced by the Botswana Meat Commission (BMC) in 1982 will be continued. Price incentives are often supplemented by other packages such as the Arable Land Development Program (ALDEP) and the Financial Assistance Policy (FAP) to stimulate increased production. The Botswana authorities emphasized that the Government does not provide consumer subsidies. Only three consumer items are subject to price ceilings (sugar, petroleum, and certain beef products), while for others only maximum percentage markups exist, which are not monitored very closely. Public utility tariffs are periodically reviewed to ensure that major parastatal enterprises at least break even in their financial operations.

A similar flexibility is adopted with respect to incomes policy. In fiscal year 1982/83, when domestic demand had to be restrained to ease emerging pressures on the budget and balance of payments, a wage freeze in the public sector was instituted, which provided a guideline for wage decisions in the private sector. In 1983/84, when conditions improved, an 8 percent general wage increase was granted (virtually no increase in real terms). This was followed in 1984/85 by a general wage increase of 10 percent (about 3 percent in real terms) for public sector employees. The staff representatives urged the Botswana authorities to continue to exercise wage restraint, not only to contain budgetary expenditure, but also to maintain the competitiveness of Botswana's enterprises, and to expand employment.

4. External sector prospects and policies

In assessing the evolution of the balance of payments in the medium term, particular attention was paid during the discussion to the policies, investment projects, and financing proposed under the NDP VI. The balance of payments projections of the staff which are summarized in Table 3, were based on the following important assumptions. First, export earnings are expected to expand at an annual rate of 9 percent, with diamond exports increasing by about 8 percent annually. Reflecting the current outlook for inflation in industrial countries, diamond prices are expected to rise by about 4 percent. However, the average unit value of diamond exports is expected to increase by an additional 4 percent as a result of an improvement in the quality mix of the diamonds sold. Diamond receipts are projected to constitute 77 percent of export earnings during 1985-90 compared with 60 percent during 1979-84. The value of imports is expected to rise by an average of 9 percent annually (5 percent in real terms). Within imports, externally-financed imports, which are assumed to constitute 85 percent of gross inflows linked to foreign grants and loans and private direct investment, show a particularly uneven growth, peaking during 1986-87, and declining during 1988-89. Other imports are estimated to show a growth of 15 percent a year, reflecting a more or less steady relationship with projected GDP. Third, foreign borrowing contracted by the Government and

parastatal sector as assumed in NDP VI is expected to materialize as scheduled. Private capital inflows for the Sua Pan soda ash project will be substantial in 1986-87, and will decline thereafter, while direct private investment other than for the Sua Pan project is envisaged to grow by 10 percent a year. On the basis of these assumptions, the balance of payments is forecast to register surpluses over 1985-1990. Gross official reserves, in terms of months of imports, c.i.f. are expected to increase from 11 months at end-1985 to about 15 months at end-1989.

The Botswana authorities recognized the sensitivity of export earnings to diamond market conditions and to fluctuations in the US\$/SDR rate. They explained that the strength of the U.S. dollar was partly responsible for the recent depressed sales of high quality diamonds in Japan and West Germany, the second and third largest markets for diamonds after the U.S.A. At the same time, persistently high, though declining real interest rates, had adversely affected the demand for diamonds in the USA, which accounted for approximately 55 percent of the world retail sales of diamonds, as U.S. financial securities had become more attractive investments than diamonds. Another contributory factor to the depressed diamond market was the selling of polished diamonds by the U.S.S.R directly onto the European market instead of the usual practice of selling through the Central Selling Organization in London. In 1985 and over the medium-term, the Botswana authorities expected that, inter alia, lower real interest rates would improve the market for Botswana's better quality gems and result in higher unit values and exports.

Over the medium term, in order to reduce the dependence on diamonds, the Botswana authorities intended to intensify their efforts to diversify exports. Beef exports, for which there is a lucrative and assured market in the EC, were expected to decline in 1985 as livestock owners rebuilt their herds following the severe drought of the past three years, but were then anticipated to increase by 10 percent annually thereafter. Exports of copper-nickel-matte were envisaged to expand moderately, reflecting mainly an improvement in world prices, but other exports, mainly textiles and other manufactures, were projected to increase by about 15 percent annually. The feasibility studies on the Kgase Coal project, which have now been completed, indicate that, at the existing low prices for coal, the project would not be financially viable. Therefore, Shell Coal has recommended that the project be shelved for the time being. However, pilot studies of the Sua Pan soda ash project by British Petroleum are still underway, and a decision on whether to proceed with construction is expected about the middle of the year. Before a final decision is made, however, negotiations with the South African Government to secure the South African market will have to be finalized. At full operating capacity, the project is expected to yield about SDR 40 million in export earnings in 1990.

The Botswana authorities said that they intended to continue the flexible exchange rate policy they have been pursuing recently. They felt that their objective of maintaining the competitiveness of Botswana's non-mineral exports in its main markets, while pursuing a policy of import substitution and export diversification, had necessitated the recent actions to depreciate the pula vis-à-vis the rand, and to increase the weight of the rand in the currency basket. Such a policy is aimed at promoting import substitution in agriculture and manufacturing, and emergent exports, especially those destined for the Customs Union area. Although the output of these industries is still small, they employ a large number of people, and have encouraging growth prospects. They recognized, however, that the closer alignment with the rand would allow the persistently higher rate of inflation in South Africa to be transferred to Botswana through the cost of imports. They emphasized the difficulties of exchange rate management in Botswana, considering the openness of Botswana's economy, and the dominant influence of South Africa and recent sharp fluctuations in the latter's exchange and interest rates.

The staff representatives commended the Botswana authorities on their prudent approach to debt management and on the establishment of a system to monitor more closely the level and evolution of government and parastatal debt. The debt service ratio, which was estimated at 4.4 percent for 1984, was projected to rise to 11 percent by 1990. They stressed, however, that the issue of debt management could not be entirely separated from foreign exchange reserve management. Botswana had built up large foreign exchange reserves and the forecast was for continuing accumulations over the medium term. It was essential, therefore, to strike a judicious balance between reserve accumulation and increased foreign borrowing. The Botswana authorities said that the Government's policy as summarized in the 1984 budget speech is that, "Government's strategy is to chart a development course consistent with the best allocation of the nation's growing supply of skilled manpower, to build up foreign exchange reserves and government revenues in good years and to stick to our steady development course in bad years by running down the reserves accumulated in good years". They indicated that a level of reserves equivalent to about six months of imports could be considered adequate; this would enable the Government to provide for current imports and to cushion the shocks arising from exogenous factors. In securing finance for development, the Government would continue to depend mainly on concessionary finance and would eschew commercial borrowing, which would impose a higher debt burden. The authorities intended to keep debt service developments under careful review, particularly in view of the narrow and volatile export and revenue base of the economy.

The staff representatives commended the Botswana authorities for their adherence to a liberal trade and payments system and urged them to continue this policy.

5. Development planning and policies

The principal objectives of the completed Fifth National Development Plan (NDP V-1979/80-1984/85), employment creation and rural development, had been broadly attained, notwithstanding the setbacks suffered by the agricultural and livestock sectors on account of drought. On a sectoral basis, real growth in manufacturing, transport and communications exceeded the targets but was lower for water and electricity, trade and agriculture. Employment targets were exceeded in most sectors, the only notable shortfalls being in mining and general government. Overall, real GDP growth is estimated to have averaged 13 percent during the plan period compared with the target of 10 percent, while employment growth is estimated at about 8 percent, compared with a target of 7 percent.

The medium-term objectives as set out in NDP VI (1985/86-1990/91) are to increase employment, accelerate rural development, and continue to diversify production and exports. The strategy to achieve these objectives involves an expansion of the absorptive capacity of the economy, and the attainment of an appropriate level and mix of infrastructural and directly productive investments, without exerting undue strain on the available resources. Therefore, additional emphasis will be placed on manpower development, improving the transportation network, expanding electricity 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.

Gross fixed capital formation during NDP VI is projected at P 3,275 million in constant 1985/86 prices. On the basis of the projected investment, real GDP is expected to grow at an average annual rate of slightly less than 5 percent, substantially lower than the 13 percent attained under NDP V. The highest rates of growth are projected for the manufacturing, water and electricity, financial, and government sectors. Wage employment is estimated to expand at an annual rate of 5 percent, with manufacturing, agriculture, electricity and water, showing the largest rates of increase. Implementation of the National Food Strategy which was begun under NDP V would be continued. It would provide a framework for increasing crop production, and ultimately achieving self-sufficiency in food grains, and raising incomes and creating employment in the rural areas. The Arable Land Development Program (ALDEP), which was introduced in 1980, has since been modified to meet the needs of small farmers, and is expected to make a major contribution toward an improvement in productivity and incomes of small farmers. Medium and large scale farmers have already begun to respond to the incentives for agricultural investment (mainly grants and subsidy loans) provided under the Financial Assistance Policy (FAP). In order to expand the cultivable area in Botswana, the Government was considering the development of the Okavango and Chobe

areas for crop farming by irrigation. Feasibility studies and pilot schemes would need to be completed first, and production is not likely to begin until toward the end of NDP VI.

The manufacturing sector has achieved impressive growth in the last three years and the Botswana authorities felt there was scope for further development. They intended to continue their policy of licensing to encourage the establishment of units in areas where there were adequate markets; they also would continue the policy of actively seeking foreign investment. They felt that limiting factors, such as the small size of the domestic market, and high transport costs, were outweighed by more positive factors, such as, political stability, a liberal exchange control regime, favorable access to neighboring markets, relatively low rates of corporate taxation, and provision of financial incentives. In addition to the soda ash project mentioned above, new feasibility studies of several industrial projects had been completed and negotiations for financing some of them were already underway. These projects included a crust leather tannery, a wheat flour mill, a toilet soap factory, and several textile mills.

6. Timing of the next Article IV consultation

In discussing the timing of the next Article IV consultation mission, the authorities indicated their strong preference for the 12-month cycle. They stated that notwithstanding Botswana's record of prudent economic and financial management, and favorable medium-term prospects, they regarded these consultations as an important input in their policy making.

IV. Staff Appraisal

Despite three years of persistent drought, which adversely affected certain sectors of the economy, particularly the agricultural sector, including livestock, Botswana's economic and financial performance continued to be highly favorable. Growth in real GDP still reached 11 percent in 1984 and the Central Government's budget and the overall balance of payments recorded large surpluses. This favorable performance was due in large measure to the continued, albeit slower, growth in diamond exports as well as good economic management on the part of the authorities, particularly the pursuit of prudent fiscal and monetary policies, in conjunction with a flexible exchange rate policy.

While recognizing that the prospects for 1985 will depend to a large extent on weather conditions and the state of the diamond market, it is currently envisaged that there should be a further strengthening of the balance of payments and budgetary positions, but a deceleration in the rate of economic growth to about 8 percent. Nonetheless, the authorities expect to continue their policy of wage restraint during

1985/86 and monitor revenue and expenditure developments carefully with a view to implementing appropriate policy adjustments, should the circumstances warrant it.

Notwithstanding the impressive economic and financial performance, Botswana's economic base is still very narrow, dependent largely on diamonds, and there is a need to diversify the economy and strengthen the balance of payments. The Government's policies, as set out in NDP VI (1985/86-1990/91), are intended to achieve these objectives by expanding the agricultural and manufacturing sectors, but the authorities are proceeding cautiously, particularly in the selection of projects. The authorities are also dealing prudently with the problem of achieving an appropriate level and mix of infrastructural and directly productive investments within the limitations of the present narrow and volatile export and revenue base of the economy. The existing level of foreign exchange reserves is very comfortable, and the balance of payments prospects in the medium term appear to be reasonably bright. The authorities have, nevertheless, rightly decided to continue their prudent approach to debt management, and to achieve a judicious balance between accumulation of reserves and foreign borrowing.

Although budgetary surpluses are envisaged over most of the NDP VI period, deficits are likely to emerge during the final two years. In the light of this, and the uncertainties that relate to the diamond market, the staff would urge that the authorities make serious efforts to contain the rate of growth of expenditures, which in the past two years has averaged over 30 percent annually. In that context, special care should be given to investment in social services and infrastructure, which are likely to generate a high level of additional current expenditure. At the same time, there is a need to broaden the revenue base, and improve the tax structure, in order to reduce the current dependence on mineral-related revenues.

In the monetary sector, reflecting the large balance of payments surpluses, the rate of growth of broad money exceeded the rate of growth of the economy without generating inflationary pressures, reflecting the absorption of this liquidity in interest-bearing deposits and the liberal trade and exchange systems. Nevertheless, the surplus liquidity in the economy poses a risk, and the authorities should give serious consideration to developing alternative financial instruments to immobilize it. The existing lower level of real interest rates in Botswana compared with South Africa did not result in a capital outflow in 1984 because of uncertainties regarding the pula-rand exchange rate. However, the authorities would have to be watchful of the potential effect of their interest rate policy on capital flows, which could have adverse effects on domestic investment.

The staff concurs with the authorities' approach to the exchange rate. While Botswana's balance of payments position and outlook are strong, the authorities are understandably concerned to reduce the preponderant reliance on a depletable resource like diamonds and to promote export diversification and import substitution. Continued exchange rate flexibility would be an important instrument in support of that objective.

The Botswana authorities have adhered to a relatively liberal trade and payments regime and intend to maintain it. Continued application of prudent financial policies and a flexible exchange rate would be important in this context.

The staff proposes that, as requested by the authorities, Botswana continue on the 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 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 - Relations with the Fund
(As of January 31, 1985)

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 pulas	9.8	44.3
(c) Use of Fund Credit	--	--
(d) Reserve position in the Fund	12.3	
(e) Operational budget December 1984 - February 1985 (maximum designation)	2.90	

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 quota
IV. <u>SDR Department</u>		
(a) Net cumulative allocation	4.4	100.0
(b) Holdings	8.5	195.7
V. <u>Trust Fund Loans Outstanding</u>	--	--
VI. <u>Overdue Obligations to the Fund</u>	--	--

BOTSWANA - Relations with the Fund (concluded)
(As of January 31, 1985)

B. Nonfinancial Relations

VII. Exchange rate arrangement

The Botswana pula is determined on the basis of a basket of SDR and the South African rand. The intervention currency is the U.S. dollar. The representative rate on February 28, 1985 was P1 = US\$0.5488.

VIII. Last Article IV consultation and consultation cycle

The 1983 Article XIV consultation discussions took place in Gaborone during November 3-16, 1983. The Executive Board discussed the reports (SM/84/11 and SM/84/28) on February 10, 1984. The following decision was taken:

1. The Fund takes this decision in concluding the 1983 Article IV consultation with Botswana, in the light of the 1983 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 three experts recruited by the Central Banking Department, who are currently serving at the Bank of Botswana as Advisors for Bank Supervision, Training, and Foreign Exchange and Exchange Control Operations.

BOTSWANA - Financial Relations with the World Bank Group

Botswana has had 17 IBRD loans and six IDA credits totaling US\$234.8 million, of which IDA credits have amounted to US\$15.9 million. There are currently in effect seven loans, for livestock, urban development, education, power, water supply, Development Finance Companies, and health and population. Some US\$72.0 million is undisbursed. The IBRD is considering future prospects for land tenure reform, livestock development, water supply, education, vocational training and technical assistance. It is discussing with the Government possible technical and financial assistance for arable agriculture and irrigation. The last Bank economic mission to Botswana was in December 1983, and its report will be discussed with the Government in March 1985.

Botswana--Statistical Issues

There is a generally well-established statistical base in Botswana. The main sources of statistics used in the report are the Central Statistics Office, the Bank of Botswana, and the Ministry of Finance and Development Planning. During the past year the reporting of data by the Botswana authorities to the Bureau of Statistics has been satisfactory.

1. Real sector data

Official national accounts data are available with a two-year 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 policy makers, the mission suggested to the Central Statistics Office that consideration be given to the possibility of issuing "flash" estimates of GDP for more recent years.

The cost of living index, constructed on the basis of price quotations collected from urban and semiurban sectors, is published every month.

To collect data on wages and employment, the Central Statistics Office 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. Data on wages and employment thus collected is published with a six months lag.

2. Fiscal and monetary data

The available central government statistics include actual data through the 1983/84 fiscal year, provisional estimates for 1984/85, and budget projections for 1985/86. No data are provided on the extra-budgetary 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 and the monetary data are sufficiently sectorized to derive financing of the central government budget. A number of outstanding questions relating to money and banking statistics have been discussed with the authorities by a technical assistance mission from the Bureau of Statistics in February 1985.

3. External sector data

The authorities provided the mission with actual data on balance of payments through 1983 and provisional estimates for 1984. However, because of the heterogeneous nature of Botswana's main export commodity, viz diamonds, and Botswana's membership of the Southern African Customs Union that requires little documentation for imports, no reliable terms

of trade data are available. The Botswana authorities are aware of this weakness in their trade data, and have requested a technical assistance mission from the Bureau of Statistics. Also, in the area of external debt, the authorities were not able to provide any official data to the mission and, as a result, the report had to depend on data drawn from the Debt Reporting System of the World Bank.

4. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published on the country page for Botswana in the February 1985 issue of IFS.

			<u>Latest Data in February 1985 IFS</u>
Real Sector	- National Accounts: Total GDP		1983
		Details of GDP	1982
	- Prices		June 1984
	- Production		Q4 1983
	- Employment		n.a.
	- Earnings		n.a.
Government Finance	- Deficit/Surplus		July 1984
	- Financing		July 1984
	- Debt		1982 (annual data only)
Monetary Accounts	- Monetary Authorities		Sept. 1984
	- Deposit Money Banks		Sept. 1984
	- Other Financial Institutions		n.a.
External Sector	- Merchandise Trade: Values--Exports		Sept. 1984
		Values--Imports	Aug. 1984
	- Merchandise Trade: Prices		n.a.
	- Balance of Payments		1983
	- International Reserves		Nov. 1984
	- Exchange Rates (period average)		Dec. 1984

BOTSWANA - Basic Data

Area, population, and GDP per capita

Area	581,370 square kilometers
Population: Total (1984 mid-year estimate)	1,051,000
Growth rate	3.8 percent
GDP per capita (1983/84)	SDR 996

	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u> Est.	<u>1983/84</u> Est.	<u>1984/85</u> Proj.
<u>National accounts (July-June)</u>					
					(In millions of pula)
GDP at current market prices	770.9	772.1	997.1	1,256.7	1,557.0
GDP at constant (1979/80) market prices	775.4	807.0	968.9	1,107.6	1,233.9
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u> Est.

<u>Prices</u>					(Percentage change from preceding year)
Cost-of-living index	13.7	16.1	11.5	10.3	7.4

	<u>1980/81</u>	<u>1981/82</u>	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u> Est.
<u>Central government finance</u>					
(April-March)					(In millions of pula)
Total revenue and grants	307.3	322.8	393.7	563.0	747.0
Of which: Customs Union	102.0	104.3	114.3	156.8	157.0
mineral revenue	101.1	77.0	99.4	193.8	363.7
Total expenditure and net lending	309.0	341.6	414.7	460.1	596.5
Of which: current expenditure	166.8	200.0	227.3	272.0	339.6
capital expenditure	104.6	108.6	156.6	136.3	166.7
Overall surplus or deficit (-)	-1.7	-18.6	-21.0	102.9	150.5
External financing	10.9	11.8	58.8	20.0	48.0
Domestic financing	-9.2	6.8	-37.8	-122.9	-198.5

BOTSWANA - Basic Data (concluded)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
<u>Money and credit (end-year)</u>					
	(In millions of pula)				
Foreign assets (net)	254.5	217.7	312.5	456.9	730.8
Domestic credit	10.8	86.5	53.3	5.8	-109.5
Claims on Government (net)	(-87.3)	(-58.1)	(-95.3)	(-171.4)	(-348.2)
Claims on private sector <u>1/</u>	(98.1)	(144.6)	(148.6)	(177.2)	(238.7)
Money and quasi-money	237.2	226.7	244.5	320.1	365.1
Money	(90.9)	(114.9)	(133.6)	(151.6)	(176.4)
Quasi-money	(146.3)	(111.8)	(110.9)	(168.5)	(188.7)
<u>Balance of payments</u>					
	(In millions of SDRs)				
Exports, f.o.b.	419	342	416	599	645
Of which: diamonds	(235)	(137)	(216)	(394)	(467)
Imports, f.o.b.	-463	-585	-529	-576	-538
Trade balance	-45	-243	-113	24	107
Services (net)	-114	-49	-51	-139	-158
Transfers (net)	98	118	109	117	104
Current account balance	-60	-174	-56	2	52
Private long-term capital	100	90	59	70	52
Official capital	15	1	41	17	18
Short-term capital, allocation of					
SDRs, and errors and omissions	18	22	5	29	-1
Overall balance	72	-61	50	118	122
<u>Gross official foreign reserves</u>					
(end-year)					
Total	276	226	266	378	465
In number of months'					
imports, c.i.f	5.9	4.2	5.3	6.8	10.0
<u>External public debt</u>					
Debt service as percent of					
exports of goods and services					
and private transfers	1.6	1.4	2.1	2.8	4.4

1/ Includes parastatals and local governments.

