

**EXECUTIVE  
BOARD  
MEETING**

SM/16/55  
Correction 1

April 4, 2016

To: Members of the Executive Board

From: The Secretary

Subject: **Botswana—Staff Report for the 2015 Article IV Consultation**

Board Action:

The attached corrections to SM/16/55 (3/3/16) have been provided by the staff:

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

**Pages 5, 9, 11, 14, 17, 18, 20**

Questions:

Mr. Gelbard, AFR (ext. 34418)  
Ms. Marchettini, AFR (ext. 38397)



growth more inclusive. In this connection, consultations will be taking place to finalize a new ~~five~~six-year National Development Plan (NDP11) by the end of 2016, the main goals being economic diversification and sustainable development.

**4. There has been broad agreement between the staff and the authorities on policies and reform priorities, with changes in the staff advice reflecting evolving circumstances.**

Surveillance recommendations have been closely integrated with IMF technical assistance, with substantial progress on fiscal consolidation, a medium-term expenditure framework, and financial sector regulation and supervision. Progress has been slow or less linear in broadening the tax base, rationalizing state-owned enterprises, and reducing the wage bill as a share of GDP, although the 2016/17 draft budget aims at containing the wage bill, subsidies, and transfers to state owned enterprises (SOEs) (Table 1).<sup>5</sup> Changes in the staff advice reflect changes in macroeconomic circumstances. For instance, an expansionary fiscal stance is warranted in the near-term given the sharp slowdown in demand and higher fiscal and external buffers.

## RECENT DEVELOPMENTS

*The economy has entered a period of weakness connected to a decline in the global demand for diamonds which have also affected the country's fiscal and external positions, while successful monetary and financial policies have kept inflation in check and the financial sector stable.*

**5. The economy has been slowing down, while inflation has been within the Bank of Botswana's objective range of 3-6 percent.** Following a healthy recovery after the 2009 downturn, economic growth slowed down in 2014 and is estimated to have come to a halt in 2015.

Both external and domestic factors contributed to the slowdown. Mining GDP was affected by a decline in the global demand for diamonds and copper, while non-mining GDP decelerated owing to spillovers from lower mining activity, a regional drought, electricity and water shortages, and less favorable domestic credit conditions. The decline in non-mining GDP growth was cushioned by an expansionary fiscal policy (see below). Inflation has also been in decline (the 12 month-rate of inflation was 2.7 percent in January 2016), reflecting a prudent monetary policy, lower fuel import prices, and a recent appreciation of the Pula against the South African Rand (Figure 1 and Table 2).

**6. After three years of surpluses, the government balance has turned into deficit.**

The fiscal deficit for FY 2015/16 (the fiscal year runs from April 1) is estimated to be in the order of 3 percent of GDP on account of lower mineral revenues, reduced receipts from the Southern African Customs Union (SACU),<sup>6</sup> higher wages and transfers to state-owned enterprises, and higher capital

<sup>5</sup> Botswana has 19 SOEs in a number of commercial activities including telecommunications, energy, and transport. The Botswana Power Corporation and the Water Utilities Corporation, both under the Ministry of Minerals, Energy and Water Resources, are among the most important SOEs in the country.

<sup>6</sup> SACU receipts have been declining as share of GDP since 2012, owing to a deceleration in South Africa's GDP growth (which lowered import growth) and the appreciation of the pula against the rand. Payments will fall further in FY 2016/17, reflecting a further reduction in South Africa's growth and a repayment to the SACU pool for excess transfers in FY 2014/15 (transfers for the subsequent year are based on projections and are reconciled two years later).

10. **The financial system is stable, but some vulnerabilities remain.** There are 11 banks in the system alongside several non-bank financial institutions providing a variety of modern services. Banks are well capitalized, with an average capital adequacy ratio of 21 percent and a low share of non-performing loans (4.5 percent of total gross loans) (Table 6). Nevertheless, asset quality deteriorated during the past year, profitability declined slightly, and funding conditions became more challenging, especially for smaller institutions.<sup>11</sup> While the system remains sound, a major economic contraction could raise stability risks given lenders' relatively large exposure to households (59 percent of total bank loans), which is mainly in the form of unsecured lending (about 65 percent of total credit to households).

## OUTLOOK AND RISKS

*Armed with ample savings and foreign reserves, the authorities are well-positioned to weather the current slowdown. The economy is expected to recover gradually, driven by a pick up in the global demand for diamonds and fiscal stimulus, while custom receipts are expected to remain subdued. The main risks to the outlook are sluggish external demand for minerals and slow or insufficient reforms.*

11. **The baseline scenario assumes a gradual recovery in the next three years and modest growth in the longer term.** The projection is based on the assumption of a measured recovery in global diamond and copper prices (Box 1). It also reflects the impact of higher government spending and investments in the energy and water infrastructure, together with gradual reforms to improve the business environment, which could bring real GDP growth towards 5 percent by 2019. Subsequently, the baseline projects annual average real GDP growth of around 4 percent based on the withdrawal of the fiscal stimulus and continued prudent macroeconomic policies and economic reforms. Inflation is projected to remain within the BoB's objective range.

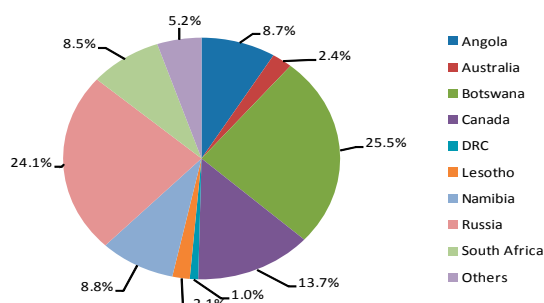
12. **The fiscal and external positions are expected to deteriorate further in 2016 and improve thereafter.** The 2016/17 budget entails a fiscal deficit of about 4 percent of GDP, the result of lower mining and SACU revenues and the continued implementation of the government's stimulus program. Fiscal consolidation is expected over the medium-term, based on a gradual recovery of the mining sector and expenditure rationalization (Tables 3b-c). On the latter, the authorities envisage containing the growth of wages and salaries and lowering transfers to state-owned enterprises, especially electricity and water. Regarding the external position, the current account surplus is projected to narrow further from 9 percent of GDP in 2015 to about 2 percent in 2016 and reverse trend thereafter, alongside a projected recovery in diamond prices and volumes (supported by a gradual pickup in global demand).

<sup>11</sup> While the shortage of liquidity has been alleviated by the reduction in the Primary Reserve Requirement and a portfolio reallocation of the [Botswana Public Officers' National Pension Fund](#) in the first half of 2015, the cost of attracting customer deposits has been on the rise, particularly for smaller institutions, and banks' funding structure remains skewed towards volatile wholesale deposits.

### Box 1. Botswana: Developments in the Diamond Industry<sup>1</sup>

Diamond production is concentrated in two major country groups: a northern one, which includes Russia and Canada, and a Southern one that includes mainly Southern African states. There is another, less significant, group that produces diamonds of lower value and includes the Democratic Republic of Congo. The top three producing countries are Botswana, Russia, and Canada, accounting respectively for 25.5, 24.1, and 13.7 percent of world output, respectively. The rough diamond market is dominated by two companies: De Beers and ALROSA, each accounting for 34 and 25 percent of the world market. On the demand side, the U.S. represents about 40 percent of the global market for polished diamonds, followed by China/Hong Kong/Macau (15 percent), India (8 percent), the Gulf Region (8 percent), and Japan (6 percent).

Diamond Production by value - Average 2013-2014



Source: Kimberley Process Certification Scheme

The global demand for polished diamonds started to fall in the second half of 2014 prompted by a slowdown in China's economy and signaling a reversal from a period of high growth (which had led to overly optimistic market expectations). This, together with a slowdown in other markets, led to an accumulation of inventories of polished diamonds and lower demand for rough diamonds. Between mid-2014 and September 2015, prices for polished and rough diamonds decreased by 12 and 23 percent respectively. Consequently, major producers started cutting production beginning in the second half of 2015. In Botswana, De Beers reduced production by about 20 percent in 2015 and announced further cuts for 2016. Debswana — the 50/50 joint venture between De Beers and the government of Botswana—put its Damtshaai mine on care and maintenance status and plans to scale down production at the Orapa 1 mine for the period 2016-2018.

Notwithstanding these negative developments, market observers coincide that with a careful management of supply, diamond prices may rebound as excess inventories clear, although uncertainties remain as to whether the recent decline in demand is transitory or structural (as diamonds are not an exchange traded commodity, information on prices and volumes is limited, which constrains the scope for analytical work on developments and prospects). For instance, Bain and Company (2015), expects demand to return to a long-term growth trajectory of 3-4 percent per year, relying on strong fundamentals in the US and continued growth of the middle classes in India and China. At the same time, the U.S. market is largely saturated, and while demographic changes in the faster growing countries would in principle favor increased demand for diamonds, consumer preferences in younger generations across the globe may be shifting. On the supply side, output is expected to decline by 1-2 percent per year through 2030, based on an analysis of existing and prospective volumes inferred from publicly announced plans by producers. Other factors that could affect market developments are, on the one hand, the recycling of diamonds and the emergence of synthetic stones and, on the other hand, the fact that ~~any~~ new diamond deposits are is could be further underground and much more costly to extract.

Lastly, the industry faces other challenges in its value chain. Cutting and polishing firms may not be robust enough to cushion against short-term fluctuations in the retail market, given their constrained bargaining power over producers and retailers and limited access to financing. In fact, lower margins are driving weaker firms out of business, most of them in Africa (in 2015, the combined market share of cutting and polishing firms in China and India rose to 85 percent while the share of African companies declined, reflecting insufficient competitiveness of the latter).

<sup>1</sup> Sources: Bain and Company *The Global Diamond Industry 2015*, December 2015; McKinsey & Company *Perspective on the Diamond Industry*, September 2014; public websites of Kimberley Process Certification Scheme and De Beers Group.

- The staff supported the efforts of the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) to implement a tiered prudential framework for large non-bank lenders by September 2016 in line with IMF technical assistance recommendations (there are close links between large non-bank lenders and the banking sector, implying contagion risks).<sup>18</sup>
- To improve access to credit and lenders' capacity to screen borrowers, the authorities agreed on the importance of expediting the reform of credit bureaus to reduce fragmentation of credit information and broaden the scope of the creditor database to both positive and negative credit data. The reform also envisages allowing lenders to enforce securities out of court through a collateral agreement in case of defaults and introducing a collateral registry for immovable and movable assets.
- Lastly, to deal with limited monetary policy pass-through, the staff noted that the authorities could consider the introduction of new liquidity and/or lending facilities at the central bank, such as open market operations involving a lengthening of the average maturity period, but this may not be needed in the short run as fiscal policy takes center stage. Over time, however, changes in banks' asset/liability management and some consolidation in the sector (the market is rather small but there are 11 commercial banks operating) may be appropriate.

## B. Enhancing the Framework for Economic and Financial Stability

*Building on a good track record of fiscal soundness and macroeconomic stability, there is scope to strengthen the framework for managing mineral revenues and safeguard financial stability.*

22. **Over the past decade, Botswana experienced higher, albeit more volatile, economic growth than other SACU members.** Prudent macroeconomic policies, a strong institutional setup, and the country's dependency on mining, especially diamonds, explain this outcome. While the share of mining in GDP has declined from 28 percent of real GDP in 2007 to 17 percent in 2014, it nonetheless remains high (Figure 3) and the exposure of other sectors to diamond market developments has actually increased as a result of the Diamond Hub Program aimed at developing the downstream segment.<sup>19</sup> Also, the fiscal and external positions are highly dependent on minerals, which account for 39 percent of government revenues and nearly 90 percent of goods' exports.

<sup>18</sup> Larger non-bank lenders are treated as 'micro lenders' under the NBFIRA Act but have business models that are more like small retail banks. However, total assets of the micro-lending sector are limited when compared to the banking sector (about 4 percent of banks' total assets).

<sup>19</sup> The downstream sector has been exposed to higher pressures than the upstream segment as, in addition to reduced prices for polished diamonds; access to lending for firms operating in the segment has declined with the closure of Antwerp Diamond Bank (the second biggest diamond bank in the world) at end-2014, adding funding constraints to reduced profitability. Since the beginning of 2015, a number of polishing and cutting firms in Botswana have closed, shedding about 1,000 jobs (out of a total of about 3,700).

## C. Diversification and Inclusive Growth

*Progress with economic diversification has so far been limited and high levels of unemployment persist, with most employment creation coming from an oversized public sector. Looking ahead, well-prioritized investments in education, energy, water, and other infrastructure will be critical, supported by reforms to improve the business environment and the efficiency of the public sector.*

27. **While poverty has been rapidly reduced in recent years, unemployment remains high and the economy remains largely undiversified.** Significant progress has been achieved in poverty reduction (which declined from 31 percent in the early 2000s to 19 percent in 2009/10)<sup>21</sup>; but unemployment remains high at about 20 percent of the labor force. This mainly reflects a diamond and public sector driven growth model with insufficient private sector job creation. Outside of mining, the services sector has grown over the past decade (particularly financial services) but the development of other sectors has been limited, while the promotion of diamond beneficiation, aimed at fostering value chains, has been challenged by global demand volatility and competition from other countries such as India.

28. **The recent electricity and water crises have limited private sector growth.** Botswana has been facing an electricity crisis owing to problems with the commissioning of a major power plant (Morupule B) and other inefficiencies in service provision.<sup>22</sup> As a result, [in 2015](#) the country had to import [more than 9039](#) percent of its electricity needs. In addition, following the end of a long-term purchase agreement with a major provider, it had to import electricity at premium tariffs and without a guaranteed supply. This contributed to shortfalls, sizable fiscal transfers to the energy company, and rising tariffs. Regarding water, a recent drought has led to shortages that are compounded by low and unreliable rainfall and high levels of evaporation. Moreover, Botswana's dispersed population and a spatial mismatch between water resources and population centers raise the costs of delivering water.

29. **A number of constraints hamper the development of the private sector.** In the 2016 Doing Business report, the World Bank ranks Botswana 72 out of 189 countries, the main shortcomings being on health, education, labor skills, water and electricity supply, and public infrastructure. Similarly, Botswana ranks 71st out of 140 countries in the 2015/16 Global Competitiveness Report (World Economic Forum), with the main challenges relating to work ethics<sup>23</sup> and education in the labor force, inefficient government, and restrictive labor regulations.

<sup>21</sup> Data based on the national poverty line as defined in the National Household Expenditures Surveys (Statistics Botswana (2011) "Preliminary Results of the Botswana Core Indicators Survey").

<sup>22</sup> The crisis is primarily linked to insufficient generation rather than distribution losses (see World Bank, Systematic Country Diagnostic, March 2015).

<sup>23</sup> Work ethic refers to reliability, discipline, responsibility, accountability, and time consciousness amongst workers.

30. **The authorities expressed their intention to accelerate steps to resolve the water and electricity crises.** On the electricity sector, three units of the Morupule A power station and four units of the Morupule B power station are being refurbished and are expected to enter into production beginning in the last quarter of 2016. In addition, the authorities plan to build two additional coal powered units at Morupule B (with the first expected to begin production by 2018). The authorities expect that, with the existing and new units at full capacity, the country's total demand of about 600 megawatts would be more than fully covered by 2019. The staff also encouraged the authorities to move ambitiously with plans to develop capacity based on solar energy in cooperation with the World Bank and actively involve the private sector in the process. Regarding the water sector, the authorities ~~hope to move forward with plans to build~~ have begun the construction of a new North-South water pipeline. Lastly, the staff welcomed the authorities' intentions to introduce water and electricity regulators to oversee tariffs, costs, and quality of service as well as other aspects of the companies and the Ministry involved in the two sectors.

31. **The authorities agreed on the need to increase efficiency and the quality of public spending.** The staff welcomed the authorities' plans to proceed with expenditure rationalization of the wage bill and transfers to SOEs in the medium-term. The authorities agreed that it would be useful to conduct an expenditure review of the seven largest spending Ministries<sup>24</sup> to identify potential savings and improve spending efficiency, including service delivery. Regarding public investment, the authorities indicated that they would consider the following staff proposals:

- Undertake a Public Investment Management Assessment to identify investment capacity constraints in the investment planning, allocating and implementing processes.<sup>25</sup> The goal would be to help identify a feasible rate of scaling up public investment in line with capacity and a plan to address capacity constraints and institutional bottlenecks; and
- Develop an annual public investment plan as part of NDP11 and in the context of the medium-term fiscal framework, containing a prioritization of projects based on cost-benefit analysis and reflecting recurrent costs (operation and maintenance) in terms of financial resources and personnel.

32. **Further steps are also needed to improve the efficiency of public enterprises, including through private ownership.** A positive development has been the launch in December 2015 of the Initial Public Offering of Botswana Telecommunications Ltd, which marks the first important public offering of an SOE in Botswana. The staff welcomed this step and the authorities' goal to improve the efficiency of SOEs and involve the private sector in their ownership structure, and encouraged them to step up efforts to improve the profitability of these companies (especially in the energy and

<sup>24</sup> These ministries account for about two-thirds of total government spending.

<sup>25</sup> PIMA is a comprehensive assessment of a country's public investment systems. It would cover the full investment cycle (planning, allocating, implementing, and monitoring), identify institutional strengths and weaknesses, and provide practical recommendations to increase the efficiency of investments.



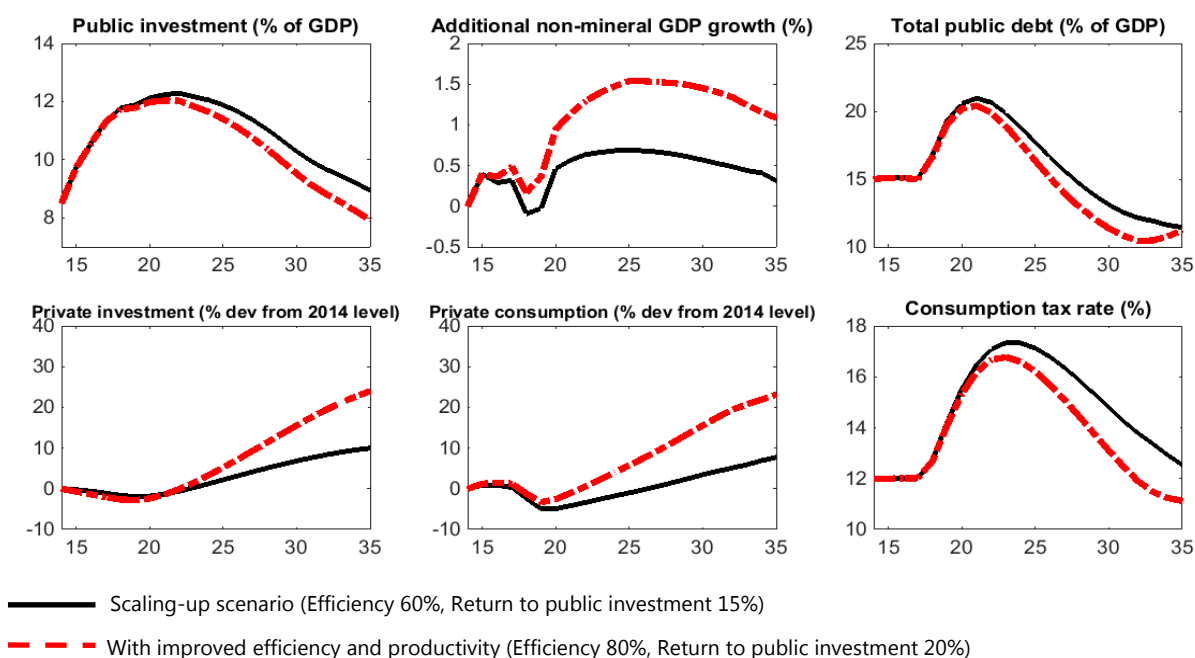
country to subscribe to the Fund Enhanced General Data Dissemination System (e-GDDS) in January 2016. While the quality of macroeconomic data remains adequate for surveillance, enhancements in the accuracy of balance of payment data (improving diamond sector data and reducing errors and omissions) and the timeliness of quarterly national accounts and the timeliness of fiscal data are needed to better assist policy formulation.

### Box 2. Botswana: Investment Scaling Up Scenario

In preparing the 11<sup>th</sup> National Development Plan, the authorities will be considering ways to promote physical and human capital formation by scaling-up investments in public infrastructure and education, with the ultimate goal of diversifying the economy and fostering inclusive growth.

In an alternative scenario using the DIGNAR1 (Debt, Investment, Growth and Natural Resources) model (calibrated to reflect features of Botswana), staff simulated the macroeconomic effects of scaling up public investment. The impact of the scaling-up depends on the strength of complementary reforms to improve the efficiency of public investment and the business environment. These factors affect the quality and effectiveness of public capital, the return on investment, and ultimately growth. The simulations show that, under such reforms and a gradual process that raises investment in infrastructure to up to 12 percent of GDP over the medium-term, the growth rate of non-mineral real GDP could increase, on average, by an additional 1.2 percentage points per year compared to the baseline (private consumption would also be higher). Financing needs could be accommodated using diamond revenues and a portion of Pula Fund reserves, a modest amount of debt, rationalized government spending, and revenue mobilization. The analysis also shows that a more aggressive, front-loaded scaling-up, would be counterproductive, as it will run into absorptive capacity constraints and reduce the efficiency of investment and its overall impact.

#### Scaling-up of Public Investment and Improved Efficiency and Productivity



Source: IMF staff estimates and projections.

1. DIGNAR (Debt, Investment, Growth and Natural Resources) is a dynamic macroeconomic framework for analyzing the effects of public investment scale-ups in resource-rich economies, capturing features such as investment inefficiencies, limited absorptive capacity, and important complementarities between public and private investment ("Debt Sustainability, Public Investment, and Natural Resources in Developing Countries: the DIGNAR model", by Melina G. S. Yang, and L.F. Zanna, IMF Working Paper No. 14/50, 2014). In this simulation, the model was extended to account for foreign direct investment.