BIDPA Briefing

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Overview

In this issue of the BIDPA briefing, we note that the growth in government spending may be unsustainable if not complemented by a rise in the economy's productive capacity. This reinforces the need for the country to expedite its efforts to diversify away from the high dependence on mineral sector revenue. Botswana's real interest rates continue to be well above those of its major trading partners. This trend can be explained by the use of interest rates as a monetary policy tool, as well as the weakening global environment, which has been causing other countries to lower their interest rates in an attempt to resuscitate their economies. Total bank credit has been responding to higher lending rates, as reflected by the continued decline in the growth rate of lending to business and households, the effect of which has contributed to reducing inflationary pressures and hence the inflation rate. Also in this issue, we discuss the new Southern African Customs Union Agreement, which was signed on the 19th of October 2001. The Agreement attempts to address, among other issues, the revenue sharing formula and the institutional or decision making process in the union.

Volatile Mineral Sector: Implications for Government Spending

Prior to the early 1990's, the Botswana economy grew rapidly, mainly due to the rapid growth in diamond production and the international market for the country's diamonds. Growth in diamond production and sales, along with sound fiscal management, have been the main factors behind the history of budget surpluses of the last 15-20 years. Government spending has also been growing rapidly over the same period, reflecting the Government's response to high mineral revenues. This picture might change drastically if the economy's diversification strategy does not bear positive results on the broader economy soon, and if the recent volatility in the mining sector *(see **Chart 1**)* continues. Government has had to restrain its spending mainly to ensure that revenues are spent prudently, given the limited revenue base which is especially subject to fluctuations in the international diamond markets. Past policy has also attempted to avoid aligning government spending with short-term fluctuations in revenues and business cycles in the rest of the economy, but has not always been successful.

The Government budget registered a deficit of P1.3 billion in 1998. Current budget estimates for the 2002/03 financial year predict yet another deficit of P1.6 billion, expected to be about 4.2 percent of GDP. The forecasted deficit this year largely reflects the rapid growth in government spending. Even though the deficit may not be financed through borrowing, the economy remains vulnerable to fluctuations in mineral revenues and government needs to expedite its efforts to find other sources of income.

Growth of mineral revenues ***(Charts 1 and 2)*** has recently been quite volatile, (with the economy having had to stockpile diamonds in 1998 in response to low demand in international diamond markets); and this, to a greater extent, has influenced both development and recurrent spending patterns. As a result, the budget balance has fluctuated largely in response to mining sector activities. Growth in government expenditure may be unsustainable, particularly if not complemented with a rise in the economy's productive capacity and sustainable sources of revenue. Mining sector growth is expected to decline from 19.6 percent in 2000/01 to around 2 percent in 2001/02 and 2002/03. This reinforces the concern that, despite the progress made in diversifying the economy, it still remains critical to push the diversification process further and accelerate growth rates of the non-mining, non-government sectors of the economy.

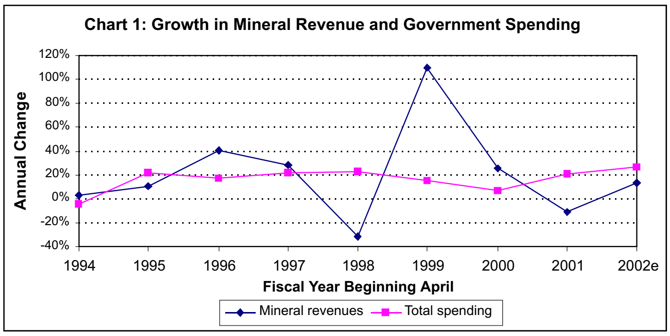


Chart 1: Growth in Mineral Revenue and Government Spending

The performance of sectors that have been identified as major sources of revenue in the diversification process has not been too impressive. Between 1999/2000 and 2000/01, the non-mining sectors experienced a slowdown in real growth from 6.2 percent to 3.9 percent. Major sectors, such as manufacturing, construction, trade, transport and services, have, in general, recorded real annual growth rates of less than 10 percent over the past seven years, despite initiatives undertaken to boost their performance and contribution to the growth of the economy. Sluggish non-mining growth has negative implications for government revenue growth, which is critical for financing additional spending and the achievement of the country's development objectives.

Growth of non-mining GDP, though low, has been relatively more stable compared to growth of mining GDP ***(Chart 2).*** This stability suggests the potential for developing more reliable sources of government revenue, which is crucial for maintaining a healthy budget balance.

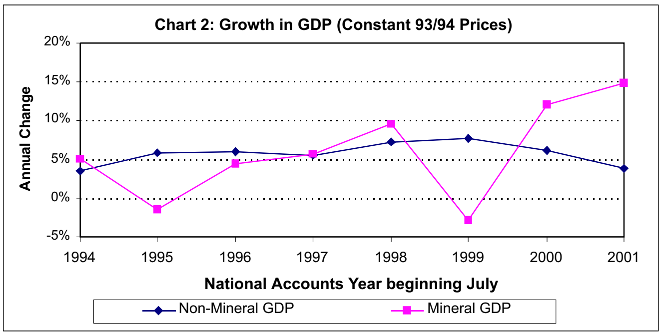
Additional sources of revenue would also contribute towards reducing uncertainties harboured by the private sector regarding government spending, and its dependency on mineral sector activities.

Interest Rates and Bank Credit

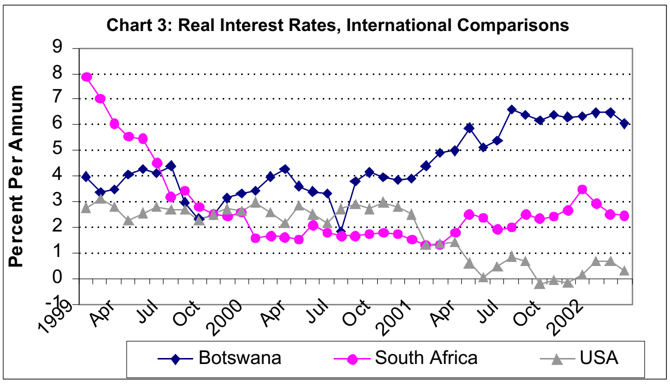
Interest Rates

The Bank Rate, which is the rate at which the Bank of Botswana is prepared to lend to other banks in the banking system, has remained at 14.25 percent since October 2000. Similarly, nominal interest rates, such as the prime rate, have remained unchanged (at 15.75 percent) in the face of falling inflation, resulting in a rise in real interest rates (measured by the nominal rate adjusted for inflation). Although the Central Bank attempts to maintain real interest rates at levels comparable to those in major international capital markets, Botswana's real interest rates (measured by the 3-month T-bill rates and BoBC rates) remain above those in countries such as South Africa and the United States (***Chart 3***).

The trend of relatively high real interest rates in Botswana vis-à-vis other countries is a result of various domestic as well as international factors. For instance, Botswana's real interest rates rose over this period as a result of falling inflation coupled with constant nominal interest rates. Real lending rates are used by the Central Bank to moderate domestic inflationary pressures that arise from factors such as credit expansion (see section on bank credit). On the international front, the difference between Botswana's real interest rates and those in other countries can be explained by



the global economic slowdown, which has led to reductions in interest rates as countries attempt to resuscitate their faltering economies. The world economy has over the past two years experienced a decline in output growth rates, which was aggravated by the aftermath of the terrorist attacks in the United States of America. In contrast, Botswana's economy recorded higher growth of 9.1 percent during 2000/2001 compared to 8.1 percent between 1999/2000, which was mainly attributed to the growth in the mining sector.



Bank Credit

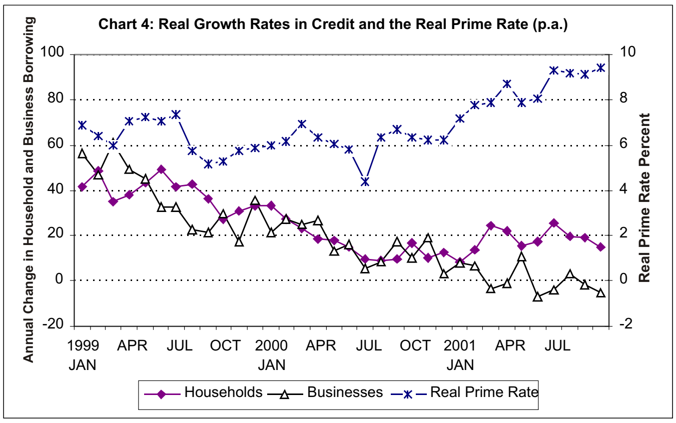
The growth rate of total bank credit has exhibited a declining trend over the past few years. Since rapid credit expansion can add to inflationary pressures, reducing household borrowing (through increases in the lending rate), curtails their ability to spend, thus reducing inflationary pressures in the domestic economy. Household credit, which constitutes the greater proportion of total bank credit, tends to finance consumption expenditures, rather than investment. As such, it plays a minimal role in expanding the productive capacity of the economy.

Increases in interest rates, particularly the increase in the prime lending rate from 14.75 percent in February 2000, to 15.75 percent in January 2001, has had an impact on lending to both businesses and households. In real terms, the prime lending rate increased from 6.5 percent in February 2000 to 7.8 percent in February 2001, and subsequently to 9.5 percent in February 2002. In response to the rise in the real prime lending rate between 2000 and 2001, the annual growth rate in household credit declined from 27.2 percent in February 2000 to 13.0 percent in February 2001. Total credit growth over the year to February 2000 was 26.6 percent. The annual rate of credit growth declined to 9.6 percent in February 2001 and subsequently to 4.7 percent in December 2001. This is a significant decline compared to the annual growth rate of more than 37 percent recorded in 1999.

There has been a reduction in both real and nominal growth of total credit in recent months. This decline in total bank credit represents a move towards achieving the central bank's target credit growth rate of between 12.5 percent and 14.5 percent (in nominal terms), which is deemed consistent with lower inflation rates in the range of 4 - 6 percent.

The ratio of total credit to non-mineral GDP, which gives an indication of the debt burden of businesses and households, has been declining since 2000 (Chart 5). The decline in the ratio of credit to non-mining GDP has been especially notable for businesses compared to households.

Though the Central Bank may have succeeded in reducing the rate of growth of lending for household consumption, high interest rates may have a negative effect on the economy by raising the cost of borrowing to potential investors and businesses. Since the annual growth rate of credit to businesses has exhibited a downward trend over the past three years,



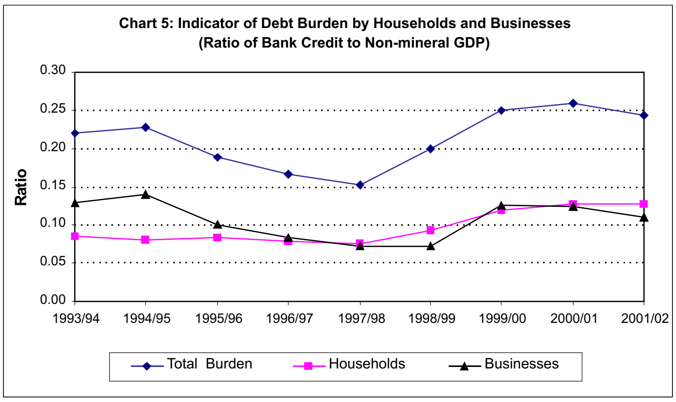
this could be worrisome in terms of the development objective of economic diversification. High interest rates, while intended to combat inflation, run the risk of contradicting the objective of fostering business investment, promoting citizen economic empowerment and creating a conducive environment for private sector development. As such, it is crucial for the Central Bank to balance the possible effects of high interest rates on households and businesses.

Inflation Rate

Botswana's inflation rate recorded a decline during the previous year, from 8.0 percent in January to 5.8 percent in December 2001. Inflation rates in January and February 2002 maintained a downward trend, (recorded at 5.7 percent in February 2002), but went up to 6.1 percent in March 2002. The slight upward shift in inflation may be linked to the inflation rates of goods classified by tradeability (non-tradeables, domestic tradeables, imported goods), which have all recorded a marginal increase during this period. However, it is still premature to interpret this recent upward shift to mean annual inflation will increase. Domestic inflation rates are influenced by domestic demand pressures, as well as international price movements in the country's trading partners, adjusted for exchange rate changes. With regard to domestic demand pressures, the previous section highlighted the decline in the growth of total bank credit over the past few years. However, the growth in government spending, which could contribute towards creating inflationary pressures, rose sharply towards the end of 2001, heralding a possible rise in inflationary pressures in 2002.

Inflation Outlook

Globally, economic growth has been weak during the period 2000 and 2001. Growth in the US economy is projected to decline to 0.7 percent in 2002 from 1.0 percent the previous year. Growth in the Euro area is also projected to decline to 1.5 and 1.2 percent in 2001 and 2002 respectively. In Africa, growth is expected to remain stable at 3.5 percent during this period. This weak outlook for global economic growth and low consumer confidence will contribute to lowering inflationary pressures worldwide. However, recent developments by oil producing countries aimed at reducing production will likely lead to an increase in average oil prices in 2002. One of the most important external influences on Botswana inflation, the South African rate of inflation, has been experiencing a decline over the major part of 2001. Inflation in South Africa stood at 7.6 percent in March 2002. This marked a rise from the previous month when it was recorded at 6.9 percent. The



depreciation of the rand against its major trading partners will increase the rand price of imports in South Africa. This is likely to have a spill-over effect on the prices of Botswana's imports from South Africa. However, the appreciation of the Pula against the South African rand should make imports from South Africa cheaper, thus reducing the effects of imported inflation. Although the Pula has appreciated significantly against the rand, the price of imported tradeable goods continued to rise by 3.9 percent over the year to March 2002.

On the domestic front, although the rate of growth of total bank credit is declining, government expenditure is projected to rise strongly over the 2002/03 fiscal year. These developments, coupled with other domestic events such as the introduction of the Value Added Tax, which will increase the price of certain consumption goods, are likely to create some additional inflationary pressures.

Thus, there are factors at work that could aggravate or ameliorate domestic inflation. Whichever of the opposing forces is greater and the nature of monetary policy response to the events in question will determine the final direction of the inflation rate. There is no doubt that monetary policy in Botswana has to continue to be stringent if it is to control and hence minimise the effects of possible domestic as well as international inflationary pressures.

The new Southern African Customs Union

The SACU Agreement provides for the removal of trade barriers, such as import quotas and tariffs between member states. These member states are Botswana, Lesotho, Namibia, Swaziland (BLNS) and South Africa. SACU harmonises trade policies towards the rest of the world through a Common External Tariff (CET).

The original SACU Agreement was signed in 1910. The independence of Botswana and Lesotho in 1966 and Swaziland in 1968 prompted the negotiation of the 1969 SACU Agreement. It was later recognised that the implementation of the 1969 Agreement was hampered by a number of factors. First, the BLNS countries were concerned that South Africa, being the most advanced economy, attracted investment at the expense of the BLNS countries. South Africa benefited from additional investment to supply the larger SACU market. South Africa also benefited from associated employment opportunities and tax income. By entering into the customs union, the BLNS countries also sacrificed part of their fiscal sovereignty, as South Africa determined the BLNS countries' trade policy.

Customs and excise duties were transferred to the revenue pool on a quarterly basis. But these would be held in the pool for some time, as transfers from the common revenue pool were based on import data of two years ago. This amounted to an interest free loan to South Africa. Although it was difficult to quantify the loss to the BLNS countries, the perceived disadvantages to them resulted in calls from the BNLS countries for compensation. As a result, a compensation factor was included in the revenue sharing formula in the revised agreement. In addition, a stabilisation factor was later included to guarantee the BLNS countries revenues of at least 17 percent but no more than 23 percent of their import values. As a result of these compensatory factors, the countries' shares of revenues have not been tied to the actual funds available in the Customs Revenue Pool (CRP).

A more pressing issue on the part of the BLNS countries was that a neutral SACU institutional structure, with representation from all the members, did not exist. The BLNS countries felt that they did not influence the SACU decision making process, as the Board of Tariffs and Trade within South Africa's Department of Trade and Industry administered SACU. Because of these concerns, the Ministers responsible for SACU matters decided, on the 11th November 1994, to re-negotiate the 1969 Southern African Customs Union agreement. However, the negotiations proceeded slowly, characterised by deadlocks over two main issues: the revenue sharing formula and the institutional arrangements. Finally, a draft agreement was reached on the 19th of October 2001.

Decision Making Process

The new agreement attempts to address some of the shortcomings identified in the 1969 agreement. A more democratic structure that allows for the representation of member states at all levels of the institutional structure is to be established. The new SACU structure will comprise a Council of Ministers, a Commission, a Secretariat to be hosted by Lesotho, Namibia or Swaziland, a Tariff Board, several liaison committees, and a Tribunal to resolve disputes.

Council of Ministers

The Council will be the highest body in the SACU institutional structure, responsible for the overall policy direction and functioning of SACU institutions, including the formulation of policy mandates, procedures and the guidelines for the SACU institutions. The Council will consist of at least one Minister from each member state and will be the supreme decision making authority on SACU matters.

Customs Union Commission

Under the new agreement, a Commission will be established and meet once a year or on request. The Commission will consist of senior officials of the level of Permanent Secretaries, Directors General, Principal Secretaries or officials of equivalent rank from member states. It will discuss matters arising out of the agreement, and report to the Council of Ministers.

Secretariat

The Secretariat will administer the day to day running of SACU. Its responsibilities will include, among others, assisting in the harmonisation of national policies and strategies of member states in so far as they relate to SACU; keeping a record of all transactions into and out of the common revenue pool; and coordinating and assisting in the negotiation of trade agreements with third parties. The Secretariat will report to the Commission.

SACU Tariff Board

The SACU Tariff Board, which will consist of experts drawn from member states, will make recommendations to the Council on the level of, and changes to customs duties, as well as anti-dumping, countervailing and safeguard measures, on goods imported from outside the Common Customs Area. The Board is expected to ensure that development strategies of the BNLS countries are supported by the tariff structure.

Technical Liaison Committees and the Tribunal

Technical Liaison Committees (e.g., Agricultural Liaison Committee, Customs Technical Liaison Committee, Trade and Industry Liaison Committee and the Transport Liaison Committee) will be formed with the mandate of assisting and advising the Commission in its work. Furthermore, a Tribunal will be formed that will adjudicate on any issue concerning the application or interpretation of the agreement or any dispute arising.

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Revenue Sharing Formula

In addition to the equal representation in the structure discussed above, a new revenue sharing formula will be used to distribute funds from the Customs Revenue Pool (CRP).

The new revenue sharing formula will take a different form from the one that has been previously used. The compensation and stabilisation factors will be removed. The new formula will consist of three components: a customs component, an excise component and a development component. The sharing of revenue will be based on the actual funds available in the Customs Revenue Pool (CRP). Customs duties will be distributed to the members according to the share of their intra-SACU imports (excluding re-exports of goods imported from within or outside of SACU). This is in contrast with the current process where they are shared according to the share of total imports into the SACU area. As a result of the new revenue sharing formula and lower CET rates, the BLNS countries are expected to receive lower amounts from the SACU revenue pool. The removal of the stabilsation factor means that the BLNS countries' revenue shares will be determined by what is available in the pool. The BNLS countries are no longer guaranteed any specific minimum amount, since the stabilisation factor has been removed. The size of the pool is expected to decline during the coming years because of free trade agreements members have entered into, such as the SADC Free Trade Agreement, and the EU-SA Free Trade Agreement, and the general trend towards trade liberalisation.

ECONOMIC FACTS AND FORECASTS

Quarterly

	1999	2000				2001				2002
(end of period)	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Interest rates (%)										
BOBC (3 month)	11.95	12.43	12.49	12.49	12.71	12.67	12.89	12.82	12.22	12.23
Prime	14.75	15.25	15.25	15.25	15.75	15.75	15.75	15.75	15.75	15.75
Inflation (%)	8.4	7.8	8.9	8.2	8.7	7.5	7.1	6.1	5.8	6.1
Rand-Pula	1.328	1.354	1.330	1.385	1.411	1.426	1.429	1.500	1.709	1.676
US$-Pula	0.216	0.206	0.195	0.190	0.187	0.177	0.174	0.167	0.145	0.148
BSE index	1399	1471	1435	1475	1454	1733	2037	2214	2455	2633

Annual

		1994	1995	1996	1997	1998	1999	2000	2001	2002
Growth (%)										
GDP (real)	*d*	4.0	3.2	5.5	5.6	8.1	4.1	8.1	9.1 *p*	4.9 *f*
Non-mineral GDP (real)	*d*	5.8	6.1	5.5	7.3	7.8	6.2	3.9	6.5 *p*	6.5 *f*
Exports (nominal)	*b*	20.6	19.0	23.1	39.7	-15.4	41.2	11.0	-1.0 *e*	10.2 *f*
Imports (nominal)	*b*	3.9	21.5	9.6	44.0	19.3	3.4	4.4	3.6 *e*	13.7 *f*
Govt. spending (nominal)	*c*	-4.6	21.5	17.3	21.6	22.4	15.0	6.6	20.9 *p*	26.8 *f*
Govt. revenues (nominal)	*c*	-16.6	22.2	35.3	12.0	-7.2	55.8	18.0	-5.4 *p*	11.9 *f*
Formal employment	*s*	1.3	1.2	2.2	-4.5	6.1	6.4	2.1	4.0	5.0 *f*
Unemployment rate	*a*	21.3	21.5	20.9	20.4	19.8	17.8	15.8	15.6 e	15.2 *f*
Domestic (bank) credit	*b*	18.2	-3.7	1.1	5.6	56.1	41.3	17.7	13.7 e	13.7 *f*
Interest rates (%)										
BOBC (3 month)	*a*	11.90	11.95	12.23	11.40	10.66	11.98	12.71	12.64	11.50 *f*
Prime	*a*	14.00	14.50	14.50	14.00	14.00	14.81	15.75	15.75	14.75 *f*
Inflation (average, %)		10.6	10.5	10.1	8.9	6.5	7.8	8.5	6.5	6.8 *f*
Rand-Pula	*a*	1.305	1.294	1.284	1.278	1.318	1.329	1.411	1.709	1.717 *f*
US$-Pula	*a*	0.368	0.354	0.274	0.263	0.224	0.216	0.187	0.145	0.140 *f*
BSE index	*a*	313	333	352	709	947	1399	1454	2455	2791 *f*
Balance of Payments (Pm)										
Exports (diamonds)	*b*	3,727	3,994	5,272	7,675	6,004	9,603	11,748	11,471 e	12,644 *f*
Exports (other goods)	*b*	1,305	1,995	2,100	2,620	2,704	2,690	1,902	2,048 *p*	2,251 *f*
Imports (goods, cif)	*b*	3,663	4,451	4,879	7,026	8,380	8,664	9,047	9,370 *p*	10,653 *f*
Current account balance	*b*	568	831	1,644	2,634	860	2,859	2,782	2,558 *p*	3,473 *f*
Foreign Reserves										
Pula m	*a*	11,961	13,249	19,076	21,619	26,485	28,852	33,880	41,182 *p*	44,687 *f*
US$ m	*a*	4,402	4,695	5,234	5,675	5,941	6,229	6,317	5,897 *p*	6,257 *f*
Govt. spending (Pm)	*c*	4,277	5,195	6,092	7,406	9,065	10,428	11,113	13,433	17,030 *f*
Govt. revenue (Pm)	*c*	4,472	5,464	7,395	8,281	7,681	11,963	14,115	13,347	15,411 *f*
Budget surplus/(deficit) (Pm)	*c*	196	270	1,302	875	-1,385	1,536	3,002	-85	-1,619 *f*
Govt. balances at BOB	*a*	6,705	6,460	7,204	15,364	19,212	20,199	24,740	31,802 e	24,372 *f*

Notes: *a end of period; b calendar year; c financial year (starts March); d statistical year (starts July)*
e BIDPA estimate; f BIDPA forecast; p preliminary data; s year to September
Details of assumptions underlying the forecasts can be obtained from BIDPA.

Sources: *CSO, Bank of Botswana, MFDP, BIDPA*

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