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Overview

In this issue of the briefing, we highlight the impressive performance of reforms in the telecommunications sector and ask whether they will set precedent for a broader microeconomic reform. We also discuss amendments to the African Growth and Opportunity Act, as well as the new sovereign credit ratings awarded Botswana. We also note that the introduction of VAT has aggravated inflation in Botswana, leading to the central bank adjusting interest rates.

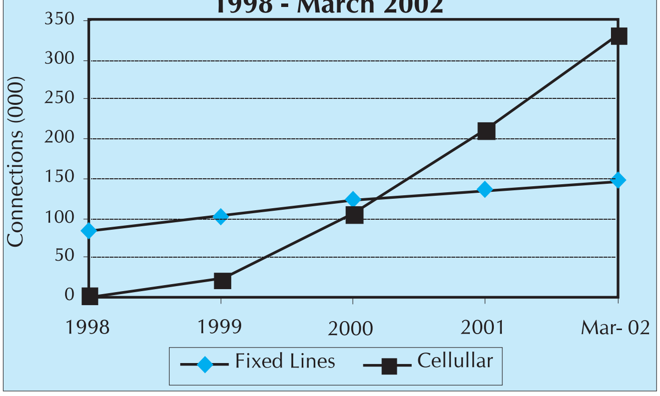
Telecommunications Reform: Will it Set a Precedent for a Broader Microeconomic Reform?

The growing globalisation of the economy has sharpened the challenges of economic management and increased the benefits likely to result from getting the macro-micro economic policy mix right. Over the years, Botswana has laid sound macroeconomic foundations for strong and sustainable growth, including a good government budget position, accumulation of healthy foreign reserves, maintenance of generally low levels of inflation, as well as a relatively stable effective exchange rate. As a result, the country has received recognition for its endeavors in pursuing sound macroeconomic policies. However, it seems the country has received less recognition when it comes to its microeconomic policies. The Government has pursued a number of microeconomic policies, but such policies have not been addressed with the same vigour and purpose as macroeconomic policies. As a result, the country has not captured the full benefits of having an appropriate macro-micro policy balance.

Macroeconomic polices are economy-wide polices, such as fiscal, monetary, and exchange rate policies, that are intended to foster economic stability and growth. Microeconomic policies are measures taken to make firms, households or specific sectors more efficient in achieving their or society's objectives. Defined broadly, microeconomic policies include all institutional arrangements that affect the economic behaviour of particular firms, industries, individuals and households. Accordingly, microeconomic policies apply to privatisation and competition, as well as to regulation and deregulation. An appropriate macro-micro policy mix is important for economic growth. For an example, a more competitive environment, which is a microeconomic policy issue, will reduce the cost of doing business in Botswana and ultimately influence macroeconomic performance by boosting Gross Domestic Product (GDP).

Examples of microeconomic policies pursued by the Government include pricing, excise taxes, industrial policy, banking regulation and telecommunications reform. For this briefing, emphasis is on telecommunications reform. The telecommunications reforms began in the 1980s with the establishment of the Botswana Telecommunications Corporation (BTC) as a parastatal. However, the interesting phase of telecommunications reform came after 1996 when the BTC's legal monopoly over the provision of all public telecommunications services was ended, and a regulator, the Botswana Telecommunications Authority (BTA), was created. In 1998, two new market entrants were licensed to provide cellular phone services.

Chart 1: Telephone Connectivity, 1998 - March 2002



Following the introduction of other market players, fixed line connectivity has grown from 85 592 in 1998 to 148 155 in March 2002. During the same period, cellular connections have increased from 3 301 in 1998 to 332 264 in March 2002. This has resulted in improved fixed line teledensity (telephone lines per hundred people), from 5.5 in 1998 to 8.8 as at March 2002, while the mobile cellular teledensity has increased from almost zero in 1998 to 19.7 as at March 2002. These levels of teledensity are impressive, and compare favourably with the rest of the Sub-Saharan Africa, where average teledensity stood at around one percent in the year 2000. The success of the telecommunications reform came about due to the effectiveness of the BTA. The BTA is one of the few regulatory bodies that enjoy complete freedom in licensing operators and in establishing and financing its operational budget.

Such impressive performance of the telecommunications sector following reforms leads to the question: Will telecommunications reform set a precedent for a broader microeconomic reform? While microeconomic reform can be a broad undertaking, it seems, in the Botswana case, the following needs immediate attention.

- Competition Policy: Government has decided to come up with a competition policy. While this is a welcome development, the process towards enacting the policy seems very slow. The process should be speeded up, especially since it is going to take some time before the implementation of the policy that is adopted takes off. In the meantime, growth in different sectors of the economy will be hindered, as competition policy reform has a central role to play in improving the competitiveness of businesses. Botswana's experience with telecommunications reform suggests that the establishment of an independent regulatory body, in the form a Competition Commission, should be given top priority.
- Privatisation: The establishment of the national privatisation agency, the Public Enterprises Evaluation and Privatisation Agency (PEEPA) is a positive step towards implementation of the Privatisation Policy adopted in 1998. However, the privatisation of Air Botswana has been delayed a number of times, which raises some concern. The recent delay was on account of the after effects of the September 11, 2001, attacks on the United States of America. The Government has since decided to "wait until the international aviation environment becomes conducive for proceeding with the privatisation of the airline". While haphazard privatisation of national assets should not be entertained, care should be taken to ensure that the entire privatisation process is not stalled by recourse to claims of a "non-conducive environment for privatisation", as it may turn out that the environment seldom becomes conducive for privatisation.
- Sector Specific Reform: While many other sectors may need microeconomic reform, it may be time to explore whether or not the positive experiences of reform and introduction of new players in the telecommunications sector can be emulated for the electricity sector. First, both sectors are technology intensive, and

are both becoming globally competitive, partly in response to technological changes. Second, the two sectors have been characterised by monopoly operators for many years. Third, both sectors possess a national grid that allows for easy interconnection by new players. Electricity reform may include maintaining electricity generation as a single unit to achieve economies of scale, as the market for electricity in Botswana is relatively small. However, there seems to be scope for liberalising the transmission and distribution functions. The reform process should also entail the establishment of a sector regulator.

Amendments to the African Growth and Opportunity Act (AGOA II)

The new act, known as AGOA II, was passed on the 6th of August 2002, and entails important amendments to the original act, AGOA , which was adopted in May 2000. AGOA is a partnership agreement between the United States of America (USA) and Sub-Saharan African countries. It essentially aims at offering beneficiary Sub-Saharan African countries increased market access into the USA, and provides quota free and duty free access for certain textiles and apparel products. The Act also offers an expanded coverage of the Generalised System of Preferences (GSP), whereby selected products originating in designated beneficiary countries can be exported to the USA at preferential tariff rates. For products to qualify under AGOA, they have to meet certain rules of origin; for example, the product must originate and be processed in beneficiary countries. Also, for textile and apparel products to be given preferential market access, they should meet the stipulated customs-related requirements; for example, the visa-requirements meant to guard against transhipment of goods and material from countries not eligible for AGOA.

The amendments to the original AGOA legislation, which essentially form AGOA II, were developed, in part, to improve, clarify and address issues not adequately dealt with in the original act. The enhancements introduced in the new act include: revisions requested by many Sub-Saharan African countries, including Botswana, to enable them to be able to effectively realise the benefits of AGOA; allowing other countries to benefit from special provisions awarded Less Developed Countries in terms of sourcing inputs; and a revision of the provisions governing apparel imports, as well as a revision of conditions regarding preferential treatment given to knit-to-shape articles and 'hybrid' apparel products.

Specifically, AGOA II provisions amending the original act:

- Allow Botswana (and Namibia) to benefit from the 'Special Provision' permitting less developed AGOA beneficiary countries to utilize fabric manufactured anywhere in the world (until September 2004). Under the Special Rule for less developed beneficiary countries, countries with a per capita gross national product (GNP) under US$1500 in 1998 were given additional preference in the form of duty free or quota free access for apparel made from fabric originating anywhere in the world. Botswana, therefore, could not benefit from this provision, since its per capita GNP exceeded US$1500.

Table 1: AGOA: Before and After

Category	AGOA I	AGOA II
Knit-to-shape	The term "fabric" interpreted by USA customs officials as excluding components that are "knit-to-shape"	Knit-to-shape apparel qualifies for AGOA benefits.
Less Developed Countries	Duty-free treatment for apparel articles assembled in less developed countries in Sub-Saharan Africa, regardless of origin of fabric	LDC apparel eligible for duty-free treatment regardless of origin of fabric and regardless of origin of yarn
Botswana and Namibia	Not treated as less developed countries because per capita GNP in 1998 exceeded $1500	Specially designated as less developed countries
Hybrid Cutting	Under USA Customs interpretation, cutting of fabric must occur either in the USA or AGOA eligible countries, but not both	Hybrid cutting (i.e., cutting that occurs both in USA and in AGOA eligible countries) does not render fabric ineligible
Volume cap on duty-free treatment for apparel made from fabric made in AGOA region or for less developed beneficiary countries from fabric made anywhere.	Applicable percentages increase through October 2007	Applicable percentages doubled

Source: The New Trade Act of 2002

Under the new AGOA, Botswana has been granted less developed country beneficiary status, thus allowing producers in Botswana to use third country fabric in qualifying apparel.

- While the initial act provided for growth of apparel imports made from fabric and yarn produced in beneficiary Sub-Saharan African countries from 1.5 percent of overall US apparel imports to 3.5 percent over an 8 year period, the new act doubles the applicable percentages of the cap. In the new act, the annual quantitative limit on apparel articles assembled in beneficiary countries from regional fabric increases from 3 percent to 7 percent over eight years. However, it does not increase the cap for apparel assembled in lesser developed beneficiary countries from third country fabric.
- The new act provides preferential treatment to knit-to-shape articles (components that take their shape in the knitting process) or "wholly assembled" apparel articles assembled from USA or from another Sub-Saharan African beneficiary country. AGOA allows knit-to-shape articles to qualify, but the knit-to-shape components have to be from the USA or from another Sub-Saharan African beneficiary country, or be knit-to-shape from yarn in an eligible Sub-Saharan African country;
- In the new act, "hybrid" apparel articles (that is, articles containing both USA and Sub-Saharan African beneficiary components and/or articles containing both fabric and knit-to-shape components) are now eligible for preference. In essence, this provides preferential treatment for apparel articles that are cut both in the United States and beneficiary countries;
- Also, in AGOA II, a technical correction is made to allow Sub-Saharan African producers to take advantage of the AGOA benefit for merino wool sweaters.

In summary, Table 1 presents a brief comparison of AGOA, before and after its revision.

Although the act is valid until 2008 and there are concerns as to what would happen if the preferential access for apparel products is terminated, modifying certain provisions of AGOA substantially expands preferential access for imports from beneficiary Sub-Saharan African countries. AGOA II clarifies and expands trade opportunities for Sub-Saharan African countries under AGOA and encourages more investment in the region, which is a matter of concern for some countries such as Botswana. The increased caps in the new act create additional incentives for investment and expansion of productive capacity in fabric production.

Botswana was one of the countries that needed the passage of AGOA II to prime and develop its apparel industries, while sourcing its inputs from anywhere in the world. In the original AGOA, Botswana was not eligible for the special treatment accorded less developed beneficiary countries. AGOA II affords Botswana the possibility of producing apparel products for export without being restricted to sourcing inputs from the USA or other AGOA beneficiary countries only. This presents an opportunity for Botswana and other countries to source inputs at lower cost, thus enhancing competitiveness and creating opportunities to increase production. The Act also presents opportunities for venturing into other export products, such as footwear, handbags, handicrafts, furniture, agricultural products, hides and leather products. Increased production and exports will add to Botswana's foreign exchange earnings, create more job opportunities and be an important step towards a more diversified export base, which is one of the major aims of the on-going strategies for accelerating sustainable economic diversification. Some companies in the Botswana textile industry have benefited from exporting to the USA and exploited market access opportunities availed under the Act. Besides benefiting from the market access opportunities in the USA, the Act presents firms in Botswana with an opportunity to develop international linkages and marketing competencies required to expand export sales beyond even the USA market.

New Credit Rating for Botswana

The Sovereign Credit Rating for Botswana by Moody's Investor Service and Standard and Poor's (S&P), which indicates the country's economic strength and credit worthiness, was released in August 2002. The ratings awarded Botswana by Moody's and S&P (Table 2) for foreign currency debt and domestic currency debt were in the top range in the rating scales used and indicate superior repayment ability for both short term and long term debt obligations. The Government's ratings for domestic currency debt by both companies indicate strong creditworthiness. The ratings awarded by both Moody's and S&P remain unchanged from the 2001 ratings.

Table 2: Botswana's credit ratings

	Foreign Currency Debt	Domestic Currency Debt
Moody's	A2 (long term) Prime-1 (Short term)	A1
S & P	A (Long Term) A-1 (Short-term)	A+

In their review, both Moody's and S&P found that Botswana was the highest rated country in Africa, exceeding the ratings of South Africa by four rating notches, and those of other countries such as Tunisia, Egypt and Senegal. According to S&P ratings, Botswana rates higher than many of the strongest countries in Central Europe, Latin America and Asia. The main driving force behind the economy's favourable credit ratings has been the sustained GDP growth and export growth, modest debt ratios and a conservative fiscal policy framework which ensured that diamond export earnings were carefully utilised.

Such an impressive credit rating will benefit individual companies and parastatals from Botswana. It will be easier and cheaper for them to borrow internationally; and the risk premium charged by those providing finance to Botswana should also be reduced. In addition, those extending finance to Botswana will be saved the expense of making their own risk assessment. These benefits should also apply to a wide range of trade finance, bond issues and bank finance. An additional benefit of the favourable credit rating is that Botswana securities will become eligible to be held by some international fund managers, although this effect will be limited by the small size of Botswana's financial markets.

While the awarded ratings make Botswana a creditworthy country and the rating outlook remains stable, there are certain challenges that the economy has to deal with in order to sustain the favourable credit ratings. It is clear that Botswana's impressive fiscal performance and overall economic stability - the main factors behind the ratings - have been the result of sustained growth of diamond production and export receipts. However, further growth of diamond production after the Orapa 2000 expansion project is not expected to be substantial, while diamond prices are expected to be more variable. Dependency on this one source of revenue and growth renders the economy vulnerable to external shocks and was the main factor behind the government fiscal deficit equivalent to about 3% of GDP in 2001. The Government is also likely to experience further pressures for increased expenditures emanating from the HIV/AIDS pandemic. Hence, without other more sustainable sources of revenue, the likely increases in government spending, especially on health care, education, and the public wage bill, could have negative implications on the country's creditworthiness.

The challenges posed for the economy are the need to diversify production and attract more FDI inflows, while at the same time putting in place strategies that seek to reduce the possible economic impact of the HIV/AIDS pandemic. Foreign direct investment inflows are important for a number of reasons, including the positive contribution they will make to the country's foreign exchange earnings which will strengthen the Government's fiscal ability to deal with spending pressures while at the same time maintaining its creditworthiness. The importance of developing non-mineral sectors, an essential component of the diversification process, cannot be over emphasised, not only to maintain the country's creditworthiness, but also to spur long term growth.

Inflation and VAT

The introduction of the 10% VAT on 1st July 2002 has undoubtedly aggravated inflation in Botswana. The national rate of inflation increased from 5.8% at the end of June 2002, before the application of VAT, to 10.1% at the end of September 2002. The hardest hit components of the Cost-of-Living-Index over the last three months since the introduction of VAT are: the fuel and power section, where prices increased by an average of 7.7%; the food section, which recorded a 7.3% increase; the alcohol and tobacco section, which registered a 7.1% increase; and the other goods section, which saw its price index rise by 5.9%. Over the three month period, the national consumer price index rose by 5.2%. Although this increase has been within the 4-6% increase in the overall consumer price index (CPI) that was expected to be caused by VAT, estimated by Bank of Botswana, it is on the high side and there may still be more price increases working their way through the economy as a result of VAT. What is also disturbing about these increases is the high increase in the food section, which includes basic foodstuffs (non-maize cereal products, vegetables, sugar, tea and coffee, all of which have seen their price indices increase by more than 8% over the past three months). These are commodities that feature prominently in the cost of living for the poor; therefore, it appears that VAT is hitting the pocket of the poor hard.

The Bank of Botswana expects a one off VAT related increase in inflation in the range of 4-6%, until mid 2003, at which point they expect inflation to start declining. Prior to the introduction of VAT, the Bank of Botswana in its 2002 Monetary Policy Statement set an inflation target range of 4-6% for the year. If that target is exceeded the Bank indicated it would take measures to further restrain inflationary pressure. This could involve increases in interest rates. Although the Bank had previously indicated that it would not combat the recent VAT related increases in inflation through hikes in interest rates, it has, however, raised the bank rate by half a percent (50 basis points) to 14.75 percent in mid-October 2002. The bank rate is the rate of interest the Bank of Botswana charges on lending to commercial banks. The Bank cited the continuing high rates of growth in commercial bank credit and government expenditure, which the Bank argues are growing at rates inconsistent with the inflation target rate the Bank has set. The Bank believes that raising interest rates will restrain demand pressures by curtailing credit growth to households and businesses, which can fuel expenditure growth. Nominal growth in total credit, for the year to June 2002, was 22%. Nominal credit to households increased by 21% and that to businesses has increased by 26% year-on-year, which the Bank of Botswana acknowledges is very high. The nominal target range for the rate of growth of credit they have set for 2002 is 12.5-14.5%. However, given the impact of VAT on prices and cashflows, the Bank should consider adjusting the target range for the rate of growth of credit.

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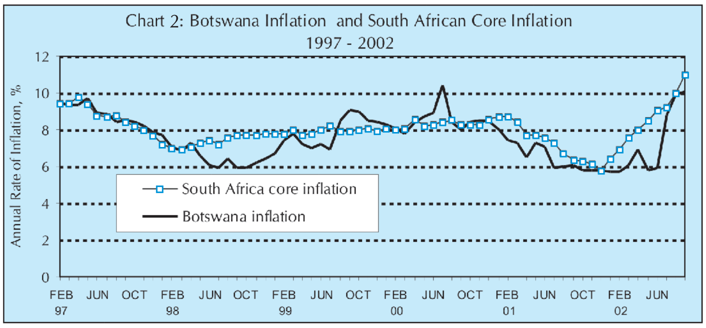
The ability of the Bank of Botswana to control inflation depends on its source. In this case, most of the inflation is due to domestic supply and external factors.

The South African rate of core inflation for September 2002 stands at 11% (see chart 2), its highest level since February 1997. For Botswana over the 12 month period, the imported tradeables price index has increased by 7.8%, the non-tradeables price index by 9.2% and the domestic tradeables price index by 14.8%. Since the beginning of 2000, non-tradeables inflation has not been below the upper bound of the 4-6% target range, which shows that the Bank, through monetary policy, has not had much success in influencing the rate of change of the average level of prices in non-tradeable goods. Given that the current inflation increase is driven by domestic supply and external pressures, it is therefore doubtful whether the Bank of Botswana can adequately combat inflation through the use of interest rates, which primarily targets domestic demand.



ECONOMIC FACTS AND FORECASTS

Quarterly

(end of period)	2000 Q1	2000 Q2	2000 Q3	2000 Q4	2001 Q1	2001 Q2	2001 Q3	2001 Q4	2002 Q1	2002 Q2	2002 Q3
Interest rates (%)											
BOBC (3 month)	12.43	12.49	12.49	12.71	12.67	12.89	12.82	12.22	12.23	12.21	12.26
Prime	15.25	15.25	15.25	15.75	15.75	15.75	15.75	15.75	15.75	15.75	15.75
Inflation (%)	7.8	8.9	8.2	8.7	7.5	7.1	6.1	5.8	6.1	5.9	10.1
Rand-Pula	1.354	1.330	1.385	1.411	1.426	1.429	1.500	1.709	1.676	1.662	1.668
US$-Pula	0.206	0.195	0.190	0.187	0.177	0.174	0.167	0.145	0.148	0.162	0.159
BSE index	1471	1435	1475	1454	1733	2037	2214	2455	2633	2540	2478

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	9.2 p	4.9 f
Non-mineral GDP (real)	d	5.8	6.1	5.5	7.3	7.8	6.2	4.0	6.5 p	6.5 f
Exports (nominal)	b	20.6	19.0	23.1	39.7	-15.4	41.2	15.9	2.1 e	2.2 f
Imports (nominal)	b	3.9	21.5	9.6	44.0	19.3	3.4	4.4	3.6 e	14.5 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	13.5 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	10.7 e	14.5 f
Interest rates (%)										
BOBC (3 month)	a	11.90	11.95	12.23	11.40	10.66	11.98	12.71	12.22	13.10 f
Prime	a	14.00	14.50	14.50	14.00	14.00	14.75	15.75	15.75	16.75 f
Inflation (average, %)		10.6	10.5	10.1	8.9	6.5	7.8	8.5	6.6	7.5 f
Rand-Pula	a	1.305	1.294	1.284	1.278	1.318	1.329	1.411	1.709	1.665 f
US$-Pula	a	0.368	0.354	0.274	0.263	0.224	0.216	0.187	0.145	0.163 f
BSE index	a	313	333	352	709	947	1399	1454	2455	2615 f
Balance of Payments (Pm)										
Exports (diamonds)	b	3,727	3,994	5,272	7,675	6,004	9,603	11,794	12,350 e	13,008 f
Exports (other goods)	b	1,305	1,995	2,100	2,620	2,704	2,690	2,457	2,207 p	1,865 f
Imports (goods, cif)	b	3,663	4,451	4,879	7,026	8,380	8,664	9,047	9,370 p	10,727 f
Current account balance	b	568	831	1,644	2,634	860	2,859	2,782	2,558 p	3,376 f
Foreign Reserves										
Pula m	a	11,961	13,249	19,076	21,619	26,485	28,852	33,880	41,182 p	38,699 f
US$ m	a	4,402	4,695	5,234	5,675	5,941	6,229	6,317	5,897 p	6,300 f
Govt. spending (Pm)	c	4,277	5,195	6,092	7,406	9,065	10,428	11,113	13,433 p	17,030 f
Govt. revenue (Pm)	c	4,472	5,464	7,395	8,281	7,681	11,963	14,115	13,347 p	15,411 f
Budget surplus/(deficit) (Pm)	c	196	270	1,302	875	-1,385	1,536	3,002	-85 p	-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	20,247 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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