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Introduction

This issue of the BIDPA Briefing gives a review of FDI inflows into Botswana which have been largely dominated by investment in manufacturing activity linked to the mining sector. Although investment in the mining sector has earned high rates of return, investment in other sectors of the economy is still minimal, necessitating the Government to strengthen its efforts in attracting investment to other sectors of the economy. The potential impact of the recently introduced VAT in the generation of revenue for the Government is also discussed. We also note that although the rate of inflation has continued to rise since VAT was introduced, it still remains within the revised Bank of Botswana target range for inflation in 2002 of 8-12%. The Rand currency has stabilized against major international currencies following the instabilities observed in 2001 and 2002, which led to an appreciation of the Pula against major international currencies. In this regard we emphasize the importance of maintaining a policy environment that does not introduce an element of risk to businesses as this may hinder business planning and operations.

Foreign Direct Investment (FDI) Inflows to Botswana: A Review

Attracting investment to the other non-mining sectors of the economy is one of the main objectives of the Government's diversification strategy, which aims at attaining sustainable long term economic growth. This strategy arose because Botswana's impressive level of economic growth over the last three decades has been largely driven by developments in the mining sector, which has rendered the economy vulnerable to external shocks. Although mining still remains important to the development of Botswana, it has long been recognised that future sustainable development will have to rely on new engines of growth, other than minerals. As such, since the early 1980's, Government has taken steps to broaden the production base by encouraging FDI into other sectors of the economy. This is deemed important for Botswana, given the small size of the other non-mining industrial sectors and the relatively undiversified export base.

Foreign direct investment is influenced by a variety of factors, including the desire of the investor to access new markets and the attractiveness of incentives given to encourage investors to take advantage of the business opportunities available. In this regard, the Government, over the years, has offered specific incentives in order to attract foreign investment. Efforts have also been made to raise the level of investment in other economic sectors by encouraging direct involvement of Botswana citizens in the investment process, through programmes, such as the Financial Assistance Policy, and setting up development finance institutions, such as the Botswana Development Corporation and the National Development Bank. The Selebi-Phikwe Regional Development Programme, the Botswana Export Development and Investment Authority (BEDIA) and the Botswana Export Credit Insurance and Guarantee Company (BECI) were set up to attract export-oriented enterprises and to create a conducive environment for both domestic and foreign direct investment. Government policy has also aimed at removing existing structural bottlenecks faced by foreign investors, which could be an impediment to the flow of FDI. A One-Stop-Agency (OSA) or One-Stop-Shop (OSS) was also introduced at BEDIA to expedite the provision of support services, such as industrial land, factory premises, necessary permits, grants, provision of power and water, to investors. Policies and regulatory controls,

Table 1: FDI Inflows to Selected Countries in Africa, 1989-2001 (Millions of U.S. Dollars)

Country	1989-1994 (annual average)	1995	1996	1997	1998	1999	2000	2001
Botswana	-29	70	70	100	96	37	57	57
Lesotho	169	275	286	269	262	163	119	118
Mauritius	24	19	37	55	12	49	277	--
Mozambique	21	45	73	64	213	382	139	--
Namibia	70	153	129	84	77	111	124	--
Swaziland	67	44	22	15	165	100	-19	69
South Africa	--	--	--	3817	561	1502	888	6653
Uganda	23	121	121	175	210	222	254	5
Zimbabwe	34	--	--	--	--	59	23	--

World Investment Report, 2001

Continued overleaf

such as foreign exchange controls, have also been eased over time in order to make Botswana a more favourable investment destination.

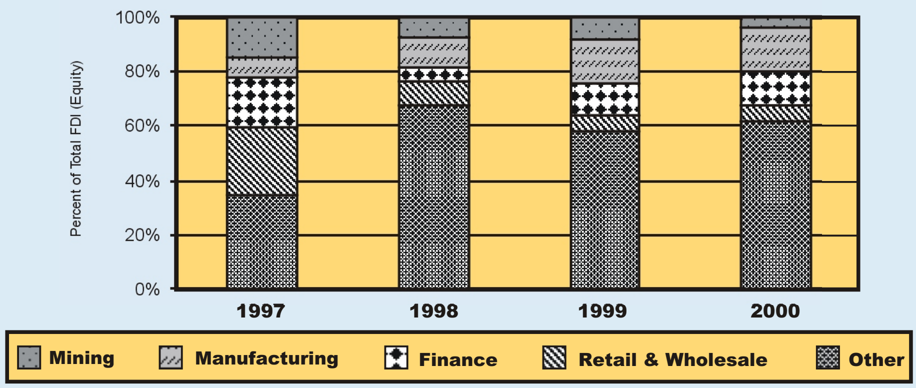
Between 1989 and 1994, FDI inflows to the economy exhibited a declining trend, but have since recovered. FDI inflows to Botswana and other countries have fluctuated in response to the cycles in the world economy (see ***Table 1***). FDI has suffered a decline over the past two years due to the slowdown in the world economy and a weakening of business confidence, both of which were accentuated by the September 11, 2001 events in the United States.

To a certain extent, Botswana has succeeded in attracting investment in manufacturing activity linked to the mining sector. For example, the private sector has shown considerable interest in cutting and polishing diamonds. The economy has also done well in attracting export-oriented foreign investment in textiles (mainly from Malaysia, South Africa and Zimbabwe) and auto industries (assembly of Volvo buses and trucks). Being a member of SACU has also played a major role in attracting investors to Botswana. This is notable in the establishment of an assembly plant for buses and trucks in Botswana by Volvo to cater primarily for the South African market and also to tap emerging car markets of neighbouring Namibia and the Democratic Republic of Congo.

One indicator of the impact that these investment promotion policies have had, as far as attracting investment is concerned, is the distribution of FDI inflows to the different sectors of the economy. The Bank of Botswana has been publishing statistics (based on its balance of payments surveys) on the levels of FDI in Botswana since 1997. The figures take a broad definition of FDI, since they include foreign liabilities of all resident companies, but exclude the foreign liabilities of government, as well as shares, bonds, loans and trade credit.

FDI inflows to Botswana by industry and country of origin have grown steadily in value from 1997 to 2000. The total stock of FDI (equity and non-equity) increased from P3.5 billion in 1997 to P7 billion in 2000, an increase of 100 percent. Most of the FDI has been concentrated in the mining sector, which has averaged 56% *(Figure 1)* of the total equity investment in Botswana by foreigners.

Figure 1: FDI Stocks (Equity) in Botswana by Industry

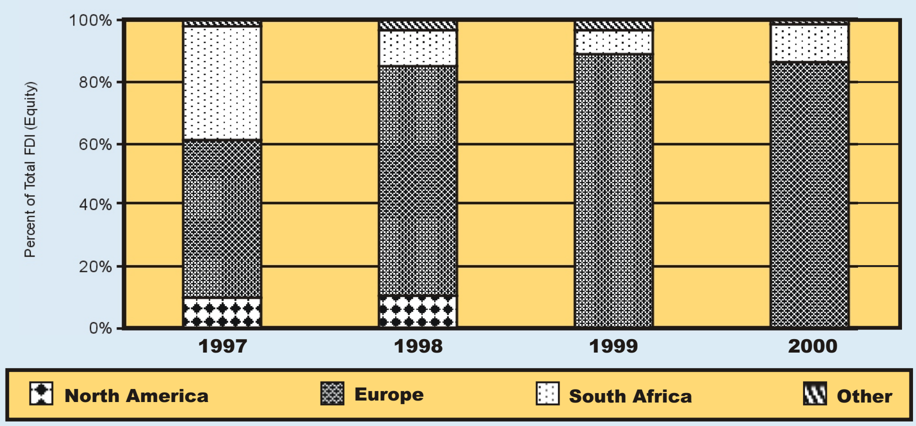


Source: Bank of Botswana Annual Reports (1997-2001)

The manufacturing sector accounted for an average of 11% of total FDI in equity over the same period, while the finance and trade sectors accounted for 12% and 13% of total equity investments, respectively. Of particular importance is the fact that other sectors besides mining, for example, manufacturing, finance, retail and wholesale trade, have started attracting investment, though still at a very modest level. This, to some extent, shows that the Government, through its policies and programmes, has played a pivotal role in influencing investment in non-mining sectors of the economy, which is critical in the diversification process.

In terms of the origin of the investment, Europe remains the main source of Botswana's FDI,

Figure 2: Stocks of FDI (Equity) in Botswana by Country



Source: Bank of Botswana Annual Reports (1997-2001) contributing, on average, 75% of the total level of FDI in Botswana over the period between 1997 and 2000 ***(see figure 2).*** South Africa takes second position after Europe, contributing, on average, 18% of the FDI in Botswana between 1997 and 2000. Botswana has also received substantial FDI from North and Central America.

Although FDI investments in the primary sectors (notably mining) has earned high rates of return, investment in other sectors of the economy has been constrained by the size of the domestic market.

Notwithstanding the Government's recent efforts to promote manufacturing activities by attracting FDI, foreign investment in manufacturing and services has averaged 10% of the total amount of FDI in Botswana over the period. In light of this, efforts to sustain economic growth through FDI in other sectors of the economy will need to focus on removing impediments that deter further inflows of FDI. This will include, *inter alia:* reducing the cumbersome industrial trade licensing procedures, streamlining the processes for the issuance of work permits, reforming other regulatory practices and addressing the scarcity of skilled labour and shortages of serviced industrial and commercial land. This would promote diversification of investment activity in other sectors and, as such, contribute to long term growth. While the quality of Botswana's infrastructure is reasonably good, the problems of very high utility rates compared with other countries in the region and of slow progress in privatisation of public enterprises need to be addressed to encourage foreign investment.

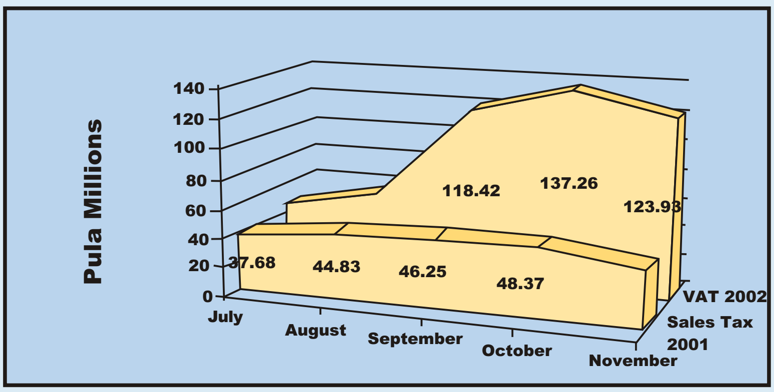
The formulation and adoption of competition policy legislation needs to be speeded up, since such legislation is one of the pillars required to create a favourable and competitive environment that could foster private investment. Through the privatisation process, the Government should also aim to reduce its direct involvement in a number of business activities. This would stimulate market activity and provide scope for local entrepreneurship and private sector initiatives in the investment process.

The Government should also continue to improve its promotional efforts. Collaboration with other countries can also play a major role, both in mounting collective promotional initiatives and in establishing sub-regional markets that are more attractive to potential investors. Government should also exploit opportunities available under various trade agreements and programmes offered by developed countries; e.g., the Cotonou Agreement with the EU to promote trade and investment in African countries and the USA's African Growth and Opportunity Act.

The Impact of VAT on Revenues

Government's revenue has largely been dominated by proceeds from diamond sales and mineral income tax, which accounted, on average, for more than 80% of total revenue. Fluctuations in mineral revenue as a result of activities in the international diamond market, over which Botswana had no control, made Government revenue to be unpredictable and to be driven by the mining sector's performance. The introduction of the value-added-tax (VAT) in July 2002, was one of the policy measures put in place to diversify sources of revenues. It was critical to have other sources of revenue since revenues from diamond mining are not expected to grow that much in the future, especially without new mines to increase production significantly. This plateauing of mineral revenues occurs at the time when the country's spending on competing and pressing needs (e.g., funding for education within the country and abroad, HIV/AIDS antiretroviral drugs and orphanage care, natural disasters - foot and mouth disease and drought, and citizen entrepreneurial development schemes) continues to increase at a rapid rate. Compounding the negative outlook for government revenues are the prospects for SACU revenues; they are expected to fall as tariffs come down.

Chart 1: Revenue from Sales Tax and VAT (July-November 2002)



Source: Monthly Cash Flow Series (MFDP)

Finding an instrument that could raise more revenues for the Government, so it could fund and sustain the programmes adopted to address the country's pressing needs, has become a matter of urgency. The sales tax (prior to VAT), which had a narrow tax base, could no longer be expected to raise the needed revenue, even if the tax rate was raised. A broad-based VAT was more of an attractive option, as it could raise more revenue for the Government at the same rate as the sales tax. VAT has other advantages. VAT credits taxes paid by enterprises on their material inputs against the taxes they must levy on their own sales. Unlike a sales tax under which tax is collected only at the point of sale to the final consumer, revenue is collected throughout the production process. Unlike a simple turnover tax, which levies tax on all sales, intermediate or final, producers can claim the tax they have been charged on their inputs. As such, VAT does not affect the prices firms ultimately pay for inputs, nor does it distort production decisions, as it does not create "cascading", the "tax on tax" that arises when tax is charged both on an input into some process and on the output of that same process.

In Botswana, only firms whose annual turnover exceeds P250,000 must pay VAT. This allows small industries, which tend to provide informal and formal employment opportunities to the unemployed, to grow. Furthermore, it is worth noting that by introducing VAT, Botswana was following the general trend worldwide and within the region. VAT has been adopted by a number of countries within SACU and SADC, and Botswana is a member of both regional bodies. These two regional bodies are strong advocates for macroeconomic policy convergence and harmonisation in the not too distant future as essential ingredients for more effective and sustained economic and political integration. This suggests that Botswana could only delay the adoption of VAT.

The primary reason for considering a VAT is its enormous revenue potential. Chart 1 demonstrates the superiority of VAT over sales tax, and its potential to raise more tax revenue for the nation, if all eligible companies register for VAT.

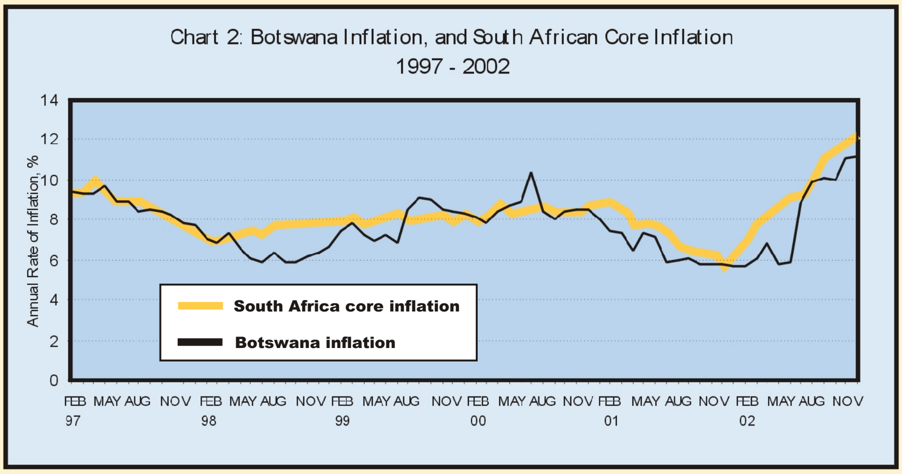
It is evident from the graph that within the short period that VAT was introduced (from the 1st of July 2002), it has raised, on average, more than twice the amount raised by sales tax per month during the same period in 2001. This suggests that VAT has the potential to raise substantially more revenue for the Government, thus serving to ease the constraint on increasing government expenditure caused by concerns of other sources of revenue that are stagnant only growing very slowly or likely to decrease. It is, as such, critical for the Government to ensure the efficient implementation of VAT and administrative systems to facilitate tax collection. This will benefit the economy in terms of the high tax collected, as well as add to the Government revenue pool.

Inflation

In June 2002, the annual rate of inflation in the National Cost-of-Living Index was 5.9%. Inflation in Botswana has continued to rise unabated since July 2002, when VAT was introduced. At the end of December 2002, the national rate of inflation was 11.2%, up from 11.1% at the end of November 2002. The component groups of the national cost of living index that have contributed most to the increase in inflation over the past three months are the food group, housing group, other goods group and the transport and communications group. The rise in the housing group index is due to increases in rentals of 1.7%, as well as an increase of 17.9% in water tariffs in rural villages. There was an increase in telephone call rates by the Botswana Telecommunications Corporation in November 2002, which raised the cost for a call per unit from twenty-five Thebe to sixty-six Thebe. This resulted in an increase in the transport and communications group index. The effect of the increase in the indices in the above commodity groups led to an increase of 2.5 percentage points in the non-tradables index, while the domestic tradables and the imported tradables indices increased only slightly.

Although the rate of inflation is relatively high compared to what it was prior to the introduction of VAT, it is still less than the upper limit of the revised Bank of Botswana target range for inflation in 2002 of 8-12%, which takes into consideration the effect of VAT. However, given the large increase (27%) in government spending in the last fiscal year and the fact that Government implements incremental budgeting, there is likely to be more inflation fuelled by government spending. The 2003/04 increase in the budget expenditure of 4%, however, may suggest that the Government has heeded the Bank of Botswana call to restrain spending. However, since it is anticipated that the effect of the introduction of VAT will have run its course by mid-year 2003, the rate of inflation by year end may be substantially lower than the current rate. The Government estimates that the average rate of inflation will be 9% in 2003 and 6% in 2004. These estimates are optimistic, however; Government spending will need to be tightly controlled, and consumer spending curbed to ensure that the inflation target for 2003 is realised.

The Bank of Botswana's task of combating inflation is not made easy by the current drought, which has affected most parts of Southern Africa, including Botswana. This has led to food shortages in the region, especially cereals, and sharp increases in food prices. Botswana, as a net food importer, has been affected, and has had to cope with higher prices for imported food. This form of inflation is not easy to deal with, since Botswana is unable to influence the level of food prices in the region and people have to satisfy their daily food requirement. Unfortunately, the recent interest rate hikes by the Bank of Botswana are not very effective in controlling food price inflation caused by drought in Southern Africa. The exchange rate movements over much of 2002 had a cushioning



effect on the impact of imported inflation in Botswana, since businesses could import goods into Botswana at lower prices.

During 2002, Botswana's rate of inflation has been consistently lower than the South African core inflation rate (see Chart 2).

Exchange Rate

In 2002, the Rand was one of the best performing currencies in the world, regaining most of the value it had lost in the second half of 2001. The link between the Rand and Pula in the currency basket to which the Pula is pegged ensured that some of the greater strength of the Rand against major international currencies in 2002 was transmitted to the Pula. As a result, the Pula appreciated by 25% against the US dollar during 2002 (to end-December), by 16% against the SDR, 8% against the Euro and 12% against the British pound, although it depreciated by 7% against the Rand (see Table 2).

Table 2: Foreign Currencies per Pula

	31.12.2001	30.12.2002	Change
US Dollar (USD)	0.1432	0.1829	27.7%
South African Rand (ZAR)	1.7188	1.5801	-8.1%
Special Drawing Rights (SDR)	0.1143	0.1356	18.6%
British Pound (GBP)	0.1319	0.1140	-13.6%
Euro	0.1617	0.1745	7.9%

Source: Annual Economic Report, 2003

The link between the Rand and the Pula has been a source of continued controversy, especially during periods of substantial exchange rate volatility. The link to the Rand is unpopular with those who would prefer that the Pula had a stronger link to the US dollar or European currencies. However, Government has maintained its exchange rate policy that fosters export competitiveness of Botswana producers, both in the domestic and foreign markets. Given that South Africa is the main competitor in the domestic market, a policy that ensures that a reasonably stable exchange rate between the Pula and the Rand is desirable. During the 1990's, producers had become accustomed to the Government, through Bank of Botswana, keeping the Pula-Rand exchange rate within a certain range. However, in the second half of 2001, as the Rand weakened against major currencies, the Pula appreciated substantially against the Rand by 22%. This has led to questions of whether the Government has abandoned its policy of keeping the Pula and Rand closely linked together. It thus casts doubt over the notion of ensuring competitiveness of Botswana producers in both the domestic market and foreign markets, especially in the region. However, in 2002, the Pula lost some of the gains it had made against the Rand in 2001, which may suggest that the Government has not completely abandoned its policy of keeping a reasonably stable relationship between the Pula and the Rand.

The exchange rate movement observed in 2 001 and 2002, which seemed to suggest a shift in Government's exchange rate policy, has led to uncertainty regarding Botswana's exchange rate policy. The current policy environment, therefore, introduces an element of exchange rate risk to businesses and thus hinders business planning and operations.

ECONOMIC FACTS AND FORECASTS

Quarterly

(end of period)	2000 Q3	Q4	2001 Q1	Q2	Q3	Q4	2002 Q1	Q2	Q3	Q4
Interest rates (%)										
BOBC (3 month)	12.49	12.71	12.67	12.87	12.65	12.51	12.51	12.51	12.54	13.72
Prime	15.25	15.75	15.75	15.75	15.75	15.75	15.75	15.75	15.75	16.25
Inflation (%)	8.2	8.7	7.5	7.1	6.1	5.8	6.1	5.9	10.1	11.2
Rand-Pula	1.385	1.411	1.426	1.421	1.502	1.719	1.687	1.667	1.675	1.580
US$-Pula	0.190	0.187	0.177	0.176	0.167	0.143	0.148	0.161	0.159	0.183
BSE index	1475	1454	1733	2036	2214	2455	2634	2533	2480	2493

Annual

		1994	1995	1996	1997	1998	1999	2000	2001	2002		2003	
Growth (%), except where specified													
GDP (real)	d	3.2	5.5	5.6	8.1	4.1	6.6	8.4	2.3	5.0	e	5.0	f
Non-mineral GDP (real)	d	5.8	6.1	5.5	7.3	7.8	4.0	4.0	5.5	4.5	e	1.0	f
Mining GDP (real)	d	-1.4	4.5	5.8	9.5	-2.8	12.1	17.2	-3.1	7.0	e	7.0	f
Exports (nominal)	b	16.2	19.7	36.9	27.8	-16.3	40.6	13.1	3.4	9.0	e	9.0	f
Imports (nominal)	b	3.2	20.4	8.2	43.8	18.7	3.7	4.9	-1.0	10.1	e	10.1	f
Govt. spending (nominal)	c	-4.6	21.5	17.3	21.6	22.4	15.0	6.6	20.9	26.8	p	4.1	f
Govt. revenues (nominal)	c	-16.6	22.2	35.3	12.0	-7.2	55.8	18.0	-5.4	10.4	p	21.6	f
Formal employment	m	1.3	1.2	2.2	-4.5	6.1	6.4	2.1	4.0	1.5		3.0	f
Unemployment rate	a	21.3	21.5	20.9	20.4	19.8	17.8	15.8	19.5	21.0	e	22.0	f
Domestic (bank) credit	b	18.2	-3.7	1.1	5.6	56.1	41.3	17.7	10.7	18.7	e	12.5	f
Interest rates (%)													
BOBC (3 month)	a	11.90	11.95	12.23	11.40	10.66	11.98	12.71	12.51	13.72		11.75	f
Prime	a	14.00	14.50	14.50	14.00	14.00	14.81	15.75	15.75	16.25		15.25	f
Inflation (average, %)		10.6	10.5	10.1	8.9	6.5	7.8	8.5	6.6	8.1		7.5	f
Rand-Pula	a	1.305	1.294	1.284	1.278	1.318	1.329	1.411	1.709	1.580		1.600	f
US$-Pula	a	0.368	0.354	0.274	0.263	0.224	0.216	0.187	0.143	0.183		0.165	f
BSE index	a	313	333	352	709	947	1399	1454	2455	2493		2500	f
Balance of Payments (Pm)													
Exports (diamonds)	b	3,727	3,994	5,272	7,675	6,004	9,603	11,748	11,471	12,644	e	13,276	f
Exports (other goods)	b	1,305	1,995	2,100	2,620	2,704	2,690	2,087	2,285	2,512	p	3,244	f
Imports (goods, cif)	b	3,663	4,451	4,879	7,026	8,380	8,664	10,613	9,607	10,577	p	11,646	f
Current account balance	b	568	831	1,644	2,634	860	2,859	2,782	3,689	2,966	p	2,400	f
Foreign Reserves													
Pula m	a	11,961	13,249	19,076	21,619	26,485	28,852	33,880	41,182	29,900	p	26,000	f
US$ m	a	4,402	4,695	5,234	5,675	5,941	6,229	6,317	5,897	5,500	p	4,800	f
Govt. spending (Pm)	c	4,277	5,195	6,092	7,406	9,065	10,428	11,537	13,671	16,642	p	17,333	f
Govt. revenue (Pm)	c	4,472	5,464	7,395	8,281	7,681	11,963	14,115	12,707	14,426	p	17,539	f
Budget surplus/(deficit) (Pm)	c	196	270	1,302	875	-1,385	1,536	3,002	-85	-2,289	p	206	f
Govt. balances at BOB	a	6,705	6,460	7,204	15,364	18,955	19,899	24,219	27,881	22,000	e	18,300	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, m year to March

Details of assumptions underlying the forecasts can be obtained from BIDPA.

Sources: CSO, Bank of Botswana, MFDP, BIDPA

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