



### EXPORT DIVERSIFICATION: IS IT REALLY NECESSARY FOR BOTSWANA?

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#### **I Introduction**

Even though Botswana gained independence as a very poor country in 1966, over the last three decades the country has risen to the level of a middle income developing country. The country's GDP growth averaged about 9 percent over the first three decades of independence and was thus comparable to that of the East Asian Tigers. Perhaps the only disadvantage with this impressive growth is that it was and continues to be fuelled by the primary sector, particularly diamond mining, although copper/nickel and beef were also important in the earlier years.

As early as 1982, the Government of Botswana recognized that dependence on a narrow range of exports was undesirable and could have adverse long-term consequences, and that export diversification was necessary. However, despite numerous policies aimed at achieving export diversification, it appears that there has not been much success, and while sustained high rates of economic growth have been achieved this has remained dependent upon the primary export sector, mainly diamonds. This raises fundamental questions: Is export diversification really necessary for Botswana? Could Botswana not continue into the future and achieve the ideals of

Vision 2016 through continued primary export growth? These questions will form the focus of this policy brief.

The main objective of this Policy Brief is to explore the reasons why Botswana continues to pursue the export diversification strategy in spite of its limited success over the years. The Policy Brief is based on the BIDPA-World Bank study entitled "Diversifying Botswana's Exports: An Overview", finalized in July 2005, which argues strongly that export diversification still needs to be pursued by Botswana. This policy brief will summarise the reasons advanced by the study for the pursuit of export diversification and make recommendations on the way forward.

#### **II Export Diversification – Some Definitions**

Export diversification means diversifying a country's export portfolio in such a way that the country is not dependent upon earnings from any individual product, and hence is less vulnerable to supply or demand disruptions. When this is the case, a decline in the export earnings from a particular product(s) will have less impact on overall earnings, and is more likely to be counterbalanced by an increase in export earnings from a growing export product or sector of the economy.

Export activities can be classified into three main categories, namely, the primary sector, the services sector and the manufacturing sector. Export diversification in the primary sector may take two forms. First, there may be horizontal diversification, in which a country exports several varieties of commodities so that declines in export earnings due to earnings fluctuations of some commodities are counter-balanced by stable or growing export earnings from other commodities. Thus, for a country with many primary products such as minerals and agricultural cash crops, primary export diversification may provide stability in export earnings that may be used to create long-term economic growth for a country. Second, there may be vertical diversification. This involves creating additional uses of existing and new products through value adding activities such as processing of primary products to create manufactures. This type of export diversification may have more long-term benefits, such as sustainable economic growth and development, employment creation, improved terms of trade and more stable export earnings. However, care must be taken to ensure that the processing of primary products is done in an economically viable manner, and not artificially forced in a way that can be value-subtracting from the primary products. The export manufacturing sector can also be developed on the basis of imported raw materials, and does not have to use locally-produced inputs. For the services sector, export diversification occurs when the different activities in this sector, namely, financial services, tourism, utilities, telecommunications and hotels, among others, become more developed and diverse. It is important to note that the growth of this sector, together with its stability, is generally positively related to the growth of the other two sectors.

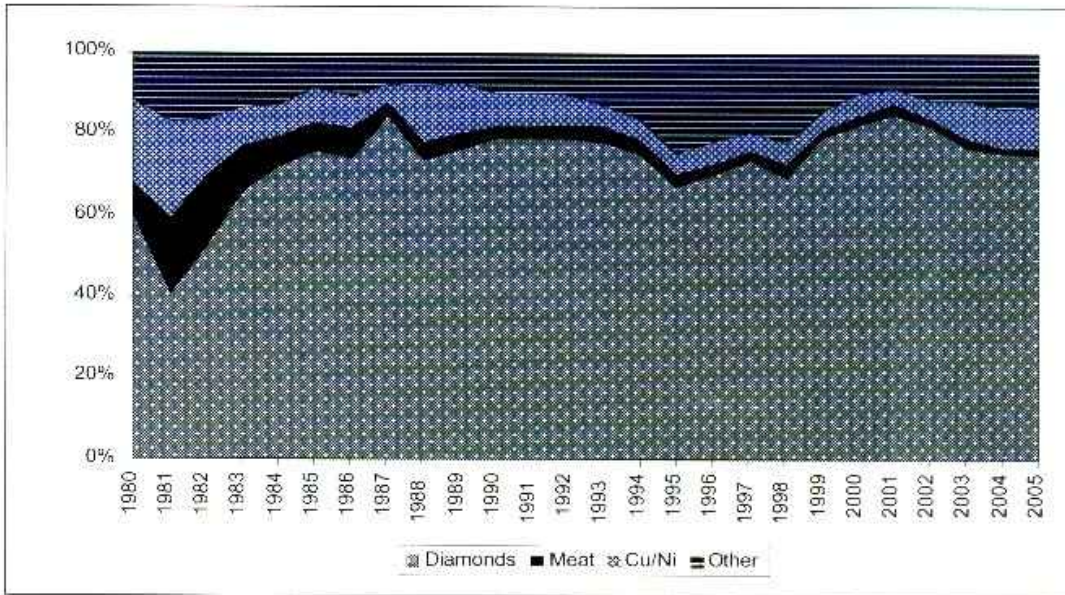
Whether export diversification is based on the primary sector, the services sector and/or the manufacturing sector, it will, if realized, have both growth- and stability-enhancing properties, albeit with varying degrees and levels of contribution.

## **The Extent of Export Diversification in Botswana**

The BIDPA-World Bank study uses various indicators to gauge the extent of export diversification in Botswana. These include the Herfindal-Hirschmann Index (HHI), the share of non-traditional exports in total exports, and sectoral shares in GDP and government revenues. Overall, these indicators suggest that the Botswana economy has become less diversified. For instance, Figure I shows that the share of beef in total export earnings has declined from 7 percent in 1980 to 2 percent in 2005, while the share of diamonds has increased from 60 percent to 75 percent over the same period. The share of non-traditional exports (i.e. excluding meat, copper-nickel and diamonds) in total export earnings has also not shown much change over this period, rising from 12 percent in 1980 to 13 percent in 2005. The overall measure of export diversification, the HHI, has risen from 0.43 in 1980 to 0.59 in 2005, indicating a more concentrated and less diversified export structure. Likewise, in terms of geographic diversification, the study shows that Botswana's primary products – beef, copper/nickel and diamonds mostly find markets in developed countries like the EU and the USA, while non-traditional exports access mainly regional markets (South Africa and Zimbabwe).

Although goods exports have become less diversified, the BIDPA-World Bank study does, however, show that services exports have been rising steadily, with an average annual growth rate of around 10 percent in real terms between 1990 and 2003 compared to 3 percent a year for goods exports. Tourism, financial services and other business services have played a key role on this growth.

**Figure 1: Sectoral Shares of Export Earnings in Total Exports**



*Source: Botswana Central Statistics Office, various years*

These results indicate that, even though the Botswana economy sustained high rates of economic growth over the last three decades, its export diversification record has not been encouraging. Such an outcome has the potential to produce complacency among policy makers, who may be tempted to think that since Botswana has had sustained high rates of primary export-led economic growth over the last three decades, this growth may be taken as long-term growth towards economic development. As we shall see in the next section, the BIDPA-World Bank study argues strongly against this policy response.

### III The Need for Export Diversification in Botswana

The BIDPA-World Bank study discusses the need for export diversification in Botswana in terms of the benefits and costs of commodity concentration. It notes that Botswana's diamond windfall has relaxed three traditional constraints to economic growth: namely the foreign exchange gap, fiscal revenue gap and domestic savings gap. This has enabled the rapid development of human,

physical and financial capital for which Botswana is well known. However, the study considers that continued long-term reliance on primary exported growth would not be advisable, due to the extensive challenges that would arise. The main challenges that the study identifies are as follows:

- there are high price and demand uncertainties in the diamond market. Based on work done by the IMF in 2004, simulating the impact of a 5 percent permanent fall in diamond prices on the Botswana economy, the study concludes that this would result in a halving of the external current account surplus within one year, with a deficit following in 2007, and the government budget shifting to a deficit close to 3 percent of GDP by 2008/9. The study posits that this could potentially come from adverse effects of synthetic ("cultured") diamonds on the demand for diamonds as well as De Beers' loss of control of rough stones market which has fallen from approximately 80 percent in the 1980s to around 55 percent in 2004; Botswana would also be at risk from a prolonged world recession;
- there are questions over whether Botswana's

- current diamond output can be sustained. Opencast mining is projected to last about another 25 years at current extraction rates. Underground mining, which is much more expensive and would yield less revenue for government, may extend the duration of diamond exports at around current levels to 40 years. However, even if output levels are maintained, growth of output will fall to very low levels, with knock-on implications for the whole economy. However, Botswana could sustain reasonable rates of growth in production if substantial new diamond deposits are identified and mined – this is possible given the amount of prospecting taking place and the fact that numerous diamondiferous kimberlites have already been identified;
- the government budget relies heavily on diamond revenues denominated in US dollars, which are unstable in Pula terms. Mineral taxes and royalties (mainly diamonds) account for approximately 50 percent of total government revenues and grants. While Botswana has pursued a prudent fiscal policy, running budget surpluses most years, the budget faces serious pressures in the long run. Customs revenues may fall because of further tariff liberalization initiatives. Demands on both the capital and recurrent budgets are high. After facing large budget surpluses for most of the 1980s and 90s, Botswana recorded significant deficits in 2001/02 and 2002/03. Combating HIV/AIDS will have long-term implications for the government budget, with treatment costs projected to rise significantly from current levels. Large sections of the rural community are dependent on welfare payments. In addition, because of fluctuations in diamond demand and exchange rates, mineral revenues are unstable – the average annual change between 1993-2003 was 28 percent, with revenues falling in three of the ten years;
  - Botswana's principal export revenues and earnings on foreign exchange reserves are denominated in dollars and based heavily on US demand for diamonds. However, imports are primarily denominated in rands, and hence currency fluctuations have a major effect on the balance of payments, the terms of trade and national income;
  - diamond production creates few direct jobs, skills or technology transfer. Diamond-mining is capital-intensive and hence represents a relatively small share of employment. Mining and quarrying has one of the smallest shares of formal employment in Botswana, having declined from about 5 percent in the early 1990s to about 3 percent currently. It is possible that diamond production could become even more capital-intensive, following increased automation at the Orapa and Jwaneng diamond mines. Botswana's unemployment rate is around 20%-25%, and more labour intensive forms of economic activity are urgently needed;
  - there are mixed views on the extent of upstream or downstream linkages associated with the diamond mining industry in Botswana. Most supplies and equipment for the mining industry are imported, although the same would apply to most industries in Botswana. Downstream linkages are also fairly weak. With strong competition in cutting and polishing from countries such as India and Armenia, Botswana has struggled to develop competitive industries to add value to its rough diamonds. However, recent initiatives to develop the diamond cutting industry suggest that it is set for considerable expansion. One area of success has been the setting up of the Botswana Diamond Valuing Company (BDVC) in 1974 to undertake the sorting and valuing of diamonds that had previously been done in London. Further, there has been some direct skills transfer from diamond industry to the rest of the economy. For example, Debswana lost nearly 25 percent

of all skilled, technical and professional manpower it trained between 1969 and 1996 and approximately 90 percent of Debswana's workforce is Batswana;

- as a small, open and net-food importing country, Botswana relies heavily on imports to meet its demand for food and manufactured goods. As part of a prudent macroeconomic policy the Government has built up foreign reserves totalling US\$6 billion (2005). These reserves equal about two-thirds of GDP and one and a half times the government's annual expenditure and lending. The main motivation behind the high reserve policy has been to cushion the potential risks to the budget and imports arising from relying so heavily on diamond revenues. However, reserves can only provide a temporary buffer against a permanent economy-wide trade shock – reserves are equivalent to about two year's of diamond exports at current rates. Botswana has successfully reduced imports as a share of GDP from about 62 percent in 1980-85 to 35 percent in 2000-04. However, food-crop production (mainly maize, sorghum, millet and beans) still provides for less than one-third of consumption;
- there is suspicion that the diamond export boom may have led to some degree of Dutch Disease in Botswana. The "Dutch Disease" refers to the process whereby economies with a booming sector (e.g. minerals and agricultural cash crops) experience an appreciation of the real exchange rate that causes a contraction of the tradeables sector. If the tradeables sector comprises both the manufacturing and agricultural cash crop sectors, the economy would experience Dutch disease-induced de-industrialisation and de-agriculturalisation. Even though the evidence for Dutch Disease in Botswana is inconclusive, nevertheless, the BIDPA-World Bank study concludes that "the process of structural change in the economy is highly consistent with Dutch Disease

predictions, with the relatively slow growth of the tradeables sectors (agriculture and manufacturing) relative to the non-tradeables (mainly services) sectors."

## V Conclusions and Recommendations

This policy brief posed a very fundamental question for policy makers in resource-based economies: if a sustained high rate of economic growth, comparable to that of the East Asian Tigers, has been achieved in Botswana over the past three decades, does Botswana really need to use its scarce and limited resources to pursue the export diversification strategy? In other words, could a primary export-led growth lead to long-term sustainable economic development?

Notwithstanding the fact that Botswana has been unsuccessful in its attempts to diversify its range of exports over the past 25 years, the Brief concludes that such efforts need to continue. Reliance on diamond exports is unlikely to generate future growth rates to match those of the past, and is unlikely to generate the kind of job opportunities that are needed in Botswana, both to provide broadly-based income and to reduce poverty. Provision of social services and infrastructure could also be affected. Continued reliance on diamond exports also exposes Botswana to unacceptable risks – resulting from structural changes in the world diamond market, or more general world recession - that high levels of foreign exchange reserves can only temporarily cushion against.

Public finances are also heavily dependent on diamond revenues. At the same time government faces challenges such as the increased number of HIV/AIDS patients who need anti-retroviral drugs, the increased numbers of orphans of HIV/AIDS related deaths who need government care, and the need to provide infrastructure in rural areas to encourage businesses to locate there in order to create employment and thus address the problem of rural-urban migration. All these mean that Government requires stable long-term sources

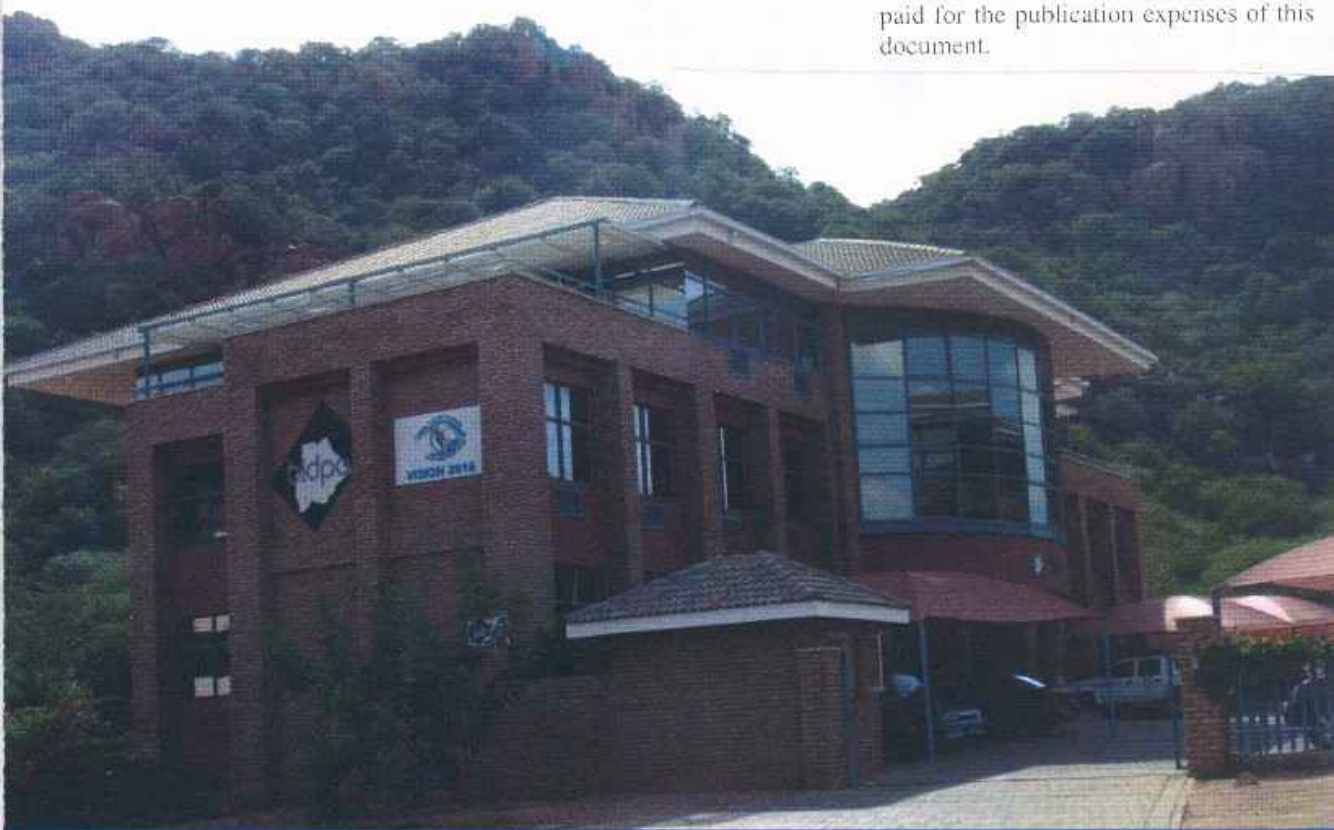
of income that only a diversified economy can provide.

All these reasons indicate that Botswana cannot afford to postpone its diversification efforts. Instead, the country must continue to face the problem head-on, and export diversification should continue to remain top on the agenda of policy makers, academics, political leaders, private sector

and civil society in Botswana. However, as another Policy Brief has shown, export diversification must be approached with caution in order to avoid the problems that are often associated with resource-based economies, namely, the develop-quick, diversify-quick and citizen empower-quick syndrome, which manifests itself in ill-conceived and poorly implemented development policies and projects.

#### **Erratum:**

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