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COST BENEFIT STUDY OF LIBERALIZING FOREIGN EXCHANGE CONTROL REGULATIONS IN BOTSWANA

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COST BENEFIT STUDY OF LIBERALISING FOREIGN EXCHANGE CONTROL REGULATIONS

Executive Summary

INTRODUCTION

1. Botswana's present system of exchange controls (ECs) dates back to the introduction of an independent currency, the pula, in 1976. Strong economic performance since that time has enabled the country to maintain one of the most liberal exchange control regimes (ECRs) in Africa, and to follow a policy of progressive liberalisation. Nevertheless, by the early 1990s there was increasing concern that the system was no longer appropriate to the country's economic needs, particularly in the context of widespread exchange control liberalisation in neighbouring countries and in the world economy as a whole. The Government, the Bank of Botswana (BoB), and the private sector have all been considering ways to reform Botswana's exchange control system. As part of its contribution to this process, the private sector, through BOCCIM and the Botswana Development Corporation, commissioned Phaleng Consultancies to conduct the present review of the costs and benefits of liberalising Botswana's exchange controls. USAID agreed to finance the study through its Botswana Private Enterprise Development (BPED) project.

2. The Terms of Reference for the study required that the consultants consider a number of issues. These included, examining the origins and operation of the present system; its impact in terms of the costs and benefits to business and the national economy; possible ways of reforming and improving the system, with consideration being given to removing remaining current account controls and moving to IMF Article VIII status, and also to the possibility of complete removal of exchange controls. In analysing the impact of possible reforms the consultants were required to examine the resulting potential for attracting greater inflows of foreign investment to Botswana, thus contributing to job creation and economic growth; the impact on the macroeconomic management of the economy, and in particular the effect on management of interest rates and the exchange rate; the impact on Botswana's foreign exchange reserves, on tax revenue, and other associated issues. Recommendations were to be made for reform of the ECR, and the timing and sequencing of any such reform. Possible reforms include removing the few remaining controls on current account (trade and services) transactions and moving to IMF Article VIII status, and more ambitiously liberalising or removing controls on capital account (savings and investment) transactions. Work on the study was conducted between September and December 1993, by a team of five consultants from within Botswana and overseas.

THE ORIGINS AND EXTENT OF EXCHANGE CONTROLS IN BOTSWANA

3. Prior to introducing the pula in August 1976, Botswana operated South African exchange controls as part of its membership of the Rand Monetary Area. Following Pula Day, Botswana introduced its own system of controls. The main principles behind the ECR adopted were that:

- foreign currency should be as freely as possible available for current account transactions, so that most imports of goods and services were allowed, as were dividend payments to foreign shareholders of businesses in Botswana and interest payments on foreign loans.

- relatively tight control over capital outflows, so that Residents were not in general permitted to maintain foreign bank accounts and keep their savings overseas, or indeed to own any other kind of foreign financial asset.

4. There were a number of sound objectives behind these principles. Firstly, there was considerable uncertainty regarding the level of confidence that would be shown in the new currency, and a concern that allowing Residents to hold foreign currencies would undermine the pula. Secondly, a large proportion of domestic assets was foreign owned. Therefore there was a danger that if many of these foreign owners moved their capital out of the country over a short period of time, Botswana's foreign reserves would fall sharply and there would be a shortage of local savings to finance local investment. Thirdly, such an outflow of capital would reduce the base on which to tax savings and investments. Fourthly, ECs were used to regulate the amount of local borrowing by foreign owned companies, and to ensure that such companies brought in a certain amount of capital from external sources. Finally, under the Southern African Customs Union (SACU) Agreement, the revenue due to Botswana is directly related to the value of its imports, and the fact that importers had to record details of all import transactions, under EC rules, helped Botswana to receive its fair share of revenues.

5. Unlike many other African countries, Botswana did not use ECs to maintain an overvalued exchange rate, nor to determine which imports would be permitted.

6. Since 1976 the exchange control system has been progressively liberalised. An increasing range of transactions has been delegated to the commercial banks as Authorised Dealers, which considerably speeds up the processing of foreign exchange applications. Some large importers are permitted to maintain rand bank accounts for trade transactions. Allowances on various service payments (such as remitted dividends) have been made more generous, as have Residents' travel allowances and rules regarding the use of foreign credit cards. The most recent announcement of such liberalisations occurred in December 1993.

7. One of the few remaining restrictions on current account transactions relates to insurance. Under EC current regulations, Resident companies and individuals are not permitted to purchase insurance outside Botswana. The aim has been to protect and build up the local insurance industry, an objective which has arguably now been largely achieved. However, this is in practice a trade restriction rather than an exchange control restriction.

8. In contrast to current account liberalisation, capital account controls have remained very restrictive. One exception relates to the Botswana Share Market, where the purchase of shares by foreign portfolio investors is permitted, within limits. Another is that pension funds and life insurance companies in Botswana are permitted to invest abroad up to 50 percent of their assets. However, there is evidence that the capital account controls are relatively "leaky", thus undermining their effectiveness. This is partly a result of the openness of the economy and the ease of disguising capital account transactions as current account transactions. Such a situation is regressive, in that the largest economic agents (both companies and individuals) can find ways around the controls, whilst smaller and less wealthy agents cannot.

THE COSTS OF EXCHANGE CONTROLS

9. The sum total of the above is that Botswana boasts an ECR that is more liberal than that of most other countries in sub-Saharan Africa, at least in practice if not on paper. Also in contrast to other countries, the system is in general quite efficiently administered. Nevertheless, over time it has become apparent that ECs do impact on the economy in a variety of ways, many of which involve costs to private sector businesses and to individuals.

10. Firstly, there are direct costs, including the salaries of the considerable number of staff engaged in administering exchange control in the Bank of Botswana and the commercial banks, the time which firms devote to dealing with exchange control matters, and in some cases the costs to firms of employing outside professionals in this regard. There are also the costs (in terms of bank charges and commissions) of extra foreign exchange transactions when firms engaged in foreign trade have to convert export receipts to pula and then back to foreign currency to pay for imports. In a few cases, there are also lengthy delays while firms have to wait for exchange control decisions (relating to complex share deals or payment for the import of services) to be made by the Bank of Botswana.

11. Exchange controls have also acted as a constraint on inward foreign investment in Botswana, in that some new investments have not taken place as a direct result of the restrictions on business activity imposed by ECs. The number of such lost investments is inherently difficult to quantify, because it relates to "what might have been". However, the present system of controls does effectively preclude inflows of foreign investment in certain areas of economic activity. While there has probably not been a major loss of investment in the manufacturing sector - because other constraints are considered to be much more serious - this finding does not apply to services, where exchange control constraints are important. This has inhibited Botswana's development both as a regional administrative centre for international companies operating in southern Africa and as a potential financial "safe haven" in the region. These represent lost opportunities of exploiting Botswana's economic strength and political stability during the (elsewhere) politically and economically turbulent 1980s, and without EC liberalisation will continue to do so in the future.

12. The main concrete examples of potential inward investments deterred by ECs which were found during the course of this study, related to services investment by companies considering the use of Botswana as a base for regional operations. This would involve large numbers of service-related foreign currency transactions conducted through a Botswana office. The present ECR makes this largely unworkable. Firstly, it preferably requires the ability to operate foreign currency bank accounts, which is not permitted. Secondly, and in the light of this prohibition, a large number of transactions in and out of pula would be required, and being service (rather than trade) related they are subject to particular scrutiny by the Bank of Botswana. Thirdly, a regional base would bring tax-exempt income from foreign operations into Botswana, but would be subject to Botswana withholding tax on profits remitted outside of the country, even if such profits were attributable to operations which were originally tax-exempt. All of these factors serve to undermine the attraction - stemming from economic stability and strength of the currency - of using Botswana as a regional base.

13. There have also been costs to firms through restrictions on the way in which they can conduct their business, for instance preventing some kinds of contracts, restricting the amount of

local borrowing by foreign controlled firms (although the limits are generous), and the discouraging of foreign firms from bringing in capital in the form of shareholders' loans.

14. Exchange controls have been a major source of the excess liquidity which has characterised the financial sector for the past decade, through the "bottling up" of funds which Residents cannot invest outside of Botswana. This resulted in low real interest rates and a partial breakdown in the intermediation function of banks, which at times refused to accept large deposits.

15. The combination of low domestic real interest rates and restrictions on investing abroad through the acquisition of foreign currency financial assets, has in the past resulted in a significant financial penalty (effectively a tax) on local savers (both individuals and firms), as foreign financial assets have generally offered higher real rates of return than those denominated in pula. This penalty has now largely disappeared with the raising of real interest rates by the Bank of Botswana.

16. Domestic savers have more generally been prevented from engaging in wealth protection by exercising private portfolio diversification through the acquisition of foreign assets, although this is done on their behalf by the authorities (in investing the foreign exchange reserves) or by life insurance and pension companies.

17. Low real interest rates and excess liquidity are examples of a more general mis-pricing of domestic capital assets which result from ECs. Another example has been severe upward pressure on property prices, resulting in the over-pricing of housing; property has been one of the few assets offering attractive returns to savers, given low interest rates and no possibility of directly investing abroad. This mis-pricing, especially the over-pricing of domestic capital assets, may have itself deterred inward investment.

18. On a more general level, the very existence of ECs presents a bad impression internationally, being typically associated with a poorly-managed economy with an overvalued currency and facing severe economic problems, where investing or doing business is highly risky. Botswana has suffered through being (incorrectly) classified into this category.

OTHER EFFECTS OF EXCHANGE CONTROLS

19. On a more positive note, there have been some benefits from ECs, most of which accrue to the government. Tax revenues have been enhanced, by enabling the taxation of interest on local financial assets, whereas some of this would have been lost if under capital account regulations the acquisition of foreign financial assets by Residents had been permitted (earnings from outside of Botswana are not taxable).

20. The official foreign exchange reserves, held by the Bank of Botswana have been slightly higher than they would have been without exchange controls.

21. The government and the Bank of Botswana have benefited from their monopoly control of foreign financial assets, given that the real returns paid to holders of pula savings have been much lower than those earned, on average, by the BoB on the reserves, for most of the period since 1976. In other words, the "tax" penalty on savers mentioned in para 15 above has contributed to government revenues, although this contribution has now all but disappeared given the relatively high interest rates which are paid to holders of BoB Certificates (BOBCs).

22. Exchange controls have enabled greater independent control over interest rates and exchange rates by Botswana's monetary authorities.

THE CURRENT ROLE OF EXCHANGE CONTROLS

23. Although they probably played an important role in the early years after the introduction of the pula in 1976, the original reasons for exchange controls have now fallen away. As a result of Botswana's diamond earnings and good economic management, the pula is a strong currency, and the country has a very high level of foreign exchange reserves. Domestic savings have been very high, and even though they may in the very long run be insufficient to finance investment, Botswana is in a strong position to raise overseas loans or attract direct foreign investment. In view of the costs identified above, our conclusion is that the present exchange control system is out of date and largely unnecessary. This suggests that there are likely to be benefits in a major liberalisation, and eventual total removal, of exchange controls.

THE LIKELY BENEFITS OF EXCHANGE CONTROL LIBERALISATION

24. The first benefit would be a saving, to the private sector and to the economy as a whole, of the direct financial and time costs of exchange controls. The private sector would also benefit from greater freedom in its business affairs. Both would contribute to improved efficiency.

25. Secondly, removal of ECs would clearly identify Botswana's distinction from other sub-Saharan African countries in the eyes of international investors. It would mark an improvement in Botswana's investment climate, and therefore lead to an increase in inward investment. Whilst this would probably not be very large in the manufacturing sector, it would have a greater impact on investment in services and finance. It would open up the possibility of Botswana developing as a regional headquarters for international companies, as a hub for regional transport operations, and also as a financial services centre, for instance by permitting inward portfolio investors to use Botswana as a base for outward investment in the region. If Botswana were one of the first countries in the region to abolish ECs, large businesses in South Africa and Zimbabwe would want to have representative offices here.

26. The banking system would enable the commercial banks to enter new areas of business, develop new products and skills, whilst competition from overseas would encourage innovation and competition. These developments are required as the economy becomes more complex and are a prerequisite for Botswana to develop as a regional or international financial centre.

27. There should also be a positive net effect on job creation, in the long run, as a result of such inward investment. Some posts would disappear in the exchange control sections of the banking system, but given the general shortage of skilled personnel in Botswana, and the likelihood that new banking and financial activities would develop, we anticipate that all of the individuals affected would be redeployed.

28. Cost savings and inward investment would have a positive impact on economic growth.

29. For Botswana to be attractive to companies seeking regional headquarters, the abolition of exchange controls would be a major step towards meeting the necessary conditions for such inward investment. As a complementary step it would be necessary to change the taxation regime,

to create a "follow through" system. The objective would be that a Botswana company with non-taxable income (e.g. from foreign subsidiaries and associates) should not be required to withhold Botswana income tax on dividends paid to its own foreign shareholders, when those dividends arise from non-taxable company income.

30. The possibility of establishing Botswana as a financial services centre, whether on a regional or broader international basis, has received significant attention recently, from the Bank of Botswana and others. This strategy, if successful, would contribute to a major transformation of the economy and provide a future source of employment and economic growth. Such a centre could encompass a number of activities, ranging from offshore banking to international finance-related services such as leasing, insurance and reinsurance, pension and mutual fund management, and consultancy. The abolition of exchange controls is an absolutely necessary precondition for the establishment of such activities, as is wider economic stability and a strong currency - both of which Botswana possesses. However, there are a range of other requirements in which Botswana is less well endowed, of which the need for a broad range of well established financial institutions, and availability of relevant skills, are perhaps the most important.

31. Examples of the type of financial investment activity which Botswana could hope to attract fairly quickly, if capital controls were removed, include:

- regional or international companies wishing to invest in the region could raise the finance for that investment in Botswana, thus contributing to establishing Botswana as both an administrative and financial centre in the region; besides providing Botswana with a future source of foreign exchange earnings, this has the attraction of matching Botswana (which has plenty of money but few investment opportunities) with other countries of the region (which have investment opportunities but a shortage of finance).
- developed country (emerging market) funds seeking investments in the region channel their investments through Botswana; part of the funds remain in Botswana (e.g. in BOBCs or shares) whilst the remainder flows outward to neighbouring countries (e.g. the Zimbabwe and Johannesburg stock exchanges). Botswana would benefit from a net inflow of funds as well as demand for supporting administrative and professional functions.
- representative offices of large South African and Zimbabwean companies.

32. It is worth noting that Mauritius is embarking upon an international financial centre strategy, on the basis of a financial sector which until recently was hardly more developed than that of Botswana. Although it is too early to assess the success of this strategy, preliminary indications are that there is substantial international interest in the Mauritius initiative, and that a large part of the interest in offshore financial activity stems from South Africa. This augurs well for Botswana, given the much greater ease of business links and communications between South African and Botswana, as compared to Mauritius. Botswana's main problem may however be one of timing. The neighbouring states of Zimbabwe and South Africa have much more developed financial sectors, upon which regional or international activity could be based; what they currently lack is macroeconomic stability and a strong and stable currency. In addition, South Africa has relatively tight ECs over international capital account transactions. If political and economic reforms currently taking place in these countries prove successful, Botswana will be hard pressed to compete with them. As a result, Botswana's "window of opportunity" may be quite short -

probably less than five years. Liberalisation of exchange controls would have to be achieved well ahead of this if it is to have the desired beneficial impact for Botswana.

33. The issues surrounding the development of international financial services in Botswana are complex and cannot be fully explored in this study. However the potential gains are large, and despite some drawbacks the issue merits much closer examination of the costs, benefits and constraints, and this is something the government should embark upon without delay. Whilst the abolition of exchange controls is a necessary step, it would be unrealistic to expect that this alone will enable Botswana to develop in this direction; there are many other elements of the strategy which need to be put in place.

34. The need to attract foreign investment cannot be overemphasised. It is widely acknowledged that minerals in general and diamonds in particular will be unable to lead economic growth in Botswana as they have in the past, and the task of economic diversification and the accompanying job creation lies at the centrepiece of NDP7 and the government's broad economic development strategy. Given the small size of the economy and the domestic market, future leading sectors will need to be export oriented. Foreign investment is important here, partly because of the lack of domestic entrepreneurial resources and experience. Although Botswana does not particularly need financial resources (given the available stock of savings), it is the technical and managerial expertise that foreign investors bring, and their marketing skills and contacts giving access to overseas markets, that are crucial at this stage of Botswana's development.

35. Although recent emphasis has been on developing an export-oriented manufacturing sector, such as in garments and textiles production, the record to date has been patchy. There are enough reasons to believe that Botswana will face significant problems in achieving high rates of manufacturing growth of the order of those seen in, for instance, Mauritius. Factors such as high utilities costs, shortages of serviced land, high labour costs and low productivity, distance from ports, and a lack of local raw materials, all mitigate against Botswana establishing a large scale internationally competitive manufacturing sector, although there may well be niches where export manufacturing can become successful.

36. In view of this Botswana cannot afford to rely upon any one source of future economic growth, and the emphasis must be on wide diversification, including potential export service activities such as tourism, transport and a variety of financial services. The constraints to internationally competitive production noted above are quite serious, and Botswana therefore needs to exploit all possible advantages that it has. One of the most important is its current financial strength, and yet the maintenance of exchange controls does not enable the country to exploit this comparative advantage to the full. Indeed, maintaining exchange controls can be interpreted as adding to the country's disadvantages in attracting foreign investment, and there seems little point in artificially contributing further to the negative features already present, which will already be difficult to deal with.

CONCERNS ABOUT EXCHANGE CONTROL LIBERALISATION

37. A number of concerns about the likely effect of exchange control liberalisation have been expressed by both the government and some parts of the private sector. These primarily relate to the following possibilities: (i) that a substantial proportion of the foreign exchange reserves will

flow out of the country; (ii) that the monetary authorities will be unable to react quickly enough to changes in international financial conditions or to large gross capital flows; (iii) that the government will be less able to independently manage interest rates and exchange rates, two key macroeconomic policy variables, and that these will be forced to follow international levels rather than being set in accordance with Botswana's domestic economic priorities, and as a result that interest rates will rise, and that the exchange rate may be less stable in the future; (iv) that Botswana will suffer a loss of tax revenue; (v) that some particular industries (such as insurance) would be adversely affected; and (vi) that Botswana might be used as a conduit for capital flight from neighbouring states, or attract illegal "money laundering" transactions.

38. **Foreign exchange reserves.** At September 1993 Botswana's official foreign exchange reserves totalled P10191 million (US$4042 million). Of this, approximately 90 percent represented assets owned by the government, and only 10 percent assets held by the private sector (including Debswana and parastatals). If capital account controls were removed, the holders of the privately owned assets would be free to withdraw these deposits and place them directly overseas. But even if this applied to all of the private sector deposits, the official reserves would only fall by some 10 percent, which is small relative to the size of the economy and the country's needs. In practice it is unlikely that the reserves would fall by anything like this amount, given that the private sector deposits include those held by Debswana and the parastatals, which can be expected to manage their reserves in a manner which is not disruptive to the economy of Botswana. Should capital account controls be removed immediately, we conclude that the official reserves would fall by no more than 5 percent.

39. It is important to note that even if private savers invest directly overseas, this simply means that some of the foreign reserves move from official (government/BoB) to private control; the nation's total stock of foreign reserves are unchanged. Private foreign deposits will earn a (tax exempt) income which will most likely be repatriated to Botswana, in which case the country will continue to benefit from earnings on the reserves. In fact it is quite plausible that total earnings on the reserves will increase. The official reserves have been invested conservatively in predominantly low risk, short and medium term foreign assets, which tend to yield relatively low returns; if private savers were prepared to be more adventurous and invest in longer term, higher risk assets then expected earnings would increase.

40. Analysis of projected economic developments over the next ten years suggests that the value of the reserves (in constant pula terms) will continue to rise through to the year 2000, and will then begin to decline slowly. Although it is anticipated that the current account will move into deficit before this time, a continued capital account surplus is forecast to contribute to an overall balance of payments surplus until the end of the century. Of the total reserves, a declining proportion will represent government deposits over this period (down to around one third after ten years). Much of the balance representing private sector deposits will still be attributable to Debswana and the parastatals, however, so the arguments above continue to apply to a large extent. In such a situation we consider that a maximum of 20 percent of the privately held deposits would be likely to leave the country; although the official reserves would fall as a result they would still remain at adequate levels during the ten year forecast period. Only if there were attempts to keep domestic real interest rates significantly below international levels would private capital outflows be expected to be much larger, thus reflecting the obvious point that opening the capital account does effectively require that future real interest rates approximate those ruling internationally. It should

be noted, however, that this would not require higher domestic nominal interest rates; it is preferable that higher real interest rates are achieved through lower inflation.

41. We therefore conclude that the size of Botswana's foreign exchange reserves is more than adequate to support the opening of the capital account, and any resulting reduction in the official reserves would be insignificant. It is also apparent that, on the basis of the best available forecasts, this finding will continue to apply for the next ten years.

42. The above assumes that government spending will be contained within the limits imposed by slower growing government revenues over the next decade. If this does not apply, and there is continued rapid growth in spending, this would result in a large government budget deficit, which would have to be financed either by drawing down the government's own savings at the BoB, or by government borrowing (which runs the risk of "crowding out" the private sector from financial markets). Both outcomes would lead to a reduction in the reserves. Whilst this could perhaps be prevented for a short time if capital controls were in place, this would simply be addressing the symptom of the problem, not its cause, which would lie in excessive government spending and an unsustainable fiscal deficit. Regardless of whether exchange controls are in place, the level of government spending remains the single major macroeconomic policy issue over the next decade.

43. An open capital account would have the benefit of imposing an external discipline on government expenditure, which might assist the task of the Ministry of Finance and Development Planning (MFDP) in resisting calls from other ministries for unsustainable levels of spending in the future. Therefore removing exchange controls should contribute to greater macroeconomic stability in the future.

44. As a result of removing barriers to capital flows between Botswana and the international financial system, the size of such capital inflows and outflows will increase. Some of these could well represent short term, potentially volatile capital movements, and it will be necessary for the monetary authorities to be capable of responding much more quickly to such flows than they do at present. For instance, a large inflow of foreign currency, converted to pula, would need to be sterilised through the issue of BOBCs in order to prevent consequent movements in interest rates. Assuming that such sterilisation could be carried out expeditiously, the only impact would be an increase in the reserves. The opposite would apply to a capital outflow, which could be dealt with by the authorities buying back BOBCs from the public, and running down the reserves. In the long term, capital inflows and increasing reserves are clearly more sustainable than capital outflows and falling reserves. Ultimately, i.e. after at least ten years, if the reserves fell to an unsustainably low level this would require changes in interest rates and/or the exchange rate. However, the current level of the reserves, and forecast levels for ten years, are so high relative to any conceivable net capital outflow that the monetary authorities will retain some flexibility in interest rate and exchange rate management for several years to come. The crucial issue is not so much concern about any **net** outflow of capital and running down of the reserves, but whether the authorities can respond timeously to increased **gross** capital flows, both inward and outward, in a manner which will maintain monetary stability. This will require some changes in the method of operation of the Bank of Botswana (for instance in maintaining a much more active "tap" issue/stock of BOBCs) and enhanced monetary management skills. These should not pose major problems in the long term but their absence in the short term suggests caution in the pace of liberalisation.

45. **Interest Rates and the Exchange Rate.** The high level of the foreign exchange reserves forecast for the next decade should, assuming that the mechanisms are in place to absorb capital movements, enable the government to manage interest and exchange rates, within limits, in accordance with Botswana's domestic economic needs. On interest rates, these limits are that domestic rates could not deviate significantly from international rates (in real terms) for any prolonged period; very low interest rates (such as those experienced in the 1980s) might well lead to unsustainable capital outflows. However, it is now widely acknowledged that strongly negative real interest rates have adverse effects on the domestic economy (which is one reason why interest rates in Botswana have been raised recently, even with exchange controls still in place), and it seems unlikely that government would wish to pursue a policy of negative real interest rates in the future. Another constraint is that long term interest rates (e.g. on a 20 year bond) would have to rise relative to short term rates, again reflecting more typical international interest rate structures (yield curves), but this is a desirable move in order to encourage the growth of long term savings deposits and the eventual growth of a capital market. Even within these constraints, the government would retain some flexibility, given the size of the reserves, to move interest rates upwards or downwards in accordance with domestic economic priorities; for instance, during a recession it would still be possible to reduce interest rates somewhat in order to boost investment and consumer spending. However, this flexibility would be even more limited should Botswana attract large amounts of potentially volatile short term/portfolio investments in pula (as opposed to offshore types of investments), and in this case a much closer tracking of international interest rates could be necessary if large inflows and outflows were to be avoided.

46. Botswana's real interest rates are now only marginally below average international levels, and thus only a small increase would be necessary in order to achieve equivalence. This is likely to be achieved during 1994 as inflation falls, and as a result there is no reason to believe that nominal interest rates would need to rise if exchange controls were removed. Nominal interest rates are far more dependent upon the inflation rate than on whether there are exchange controls in place.

47. Similarly, there would be flexibility to manage the exchange rate, but not to the extent of maintaining the value of the pula at a level which was overvalued or undervalued with regard to long term economic fundamentals. But as the target of exchange rate management in Botswana has been (successfully) to stabilise the real exchange rate of the pula against the rand over a long period, the current policy could continue. As long as capital flows could be sterilised, there is unlikely to be any major impact on the exchange rate of the pula as a result of removing exchange controls. Relatively large fluctuations in the value of the pula would only come if Botswana moved to a floating exchange rate regime, but this is a separate policy decision (unlikely in the short to medium term) and certainly not a necessary consequence of EC liberalisation. In the context of Botswana's economy, given the large size of some transactions (e.g. diamond sales) relative to the rest of the market, and the more general and well-established dangers of "overshooting" in a floating exchange rate regime (where market-led exchange rate adjustments go too far and introduce excessive volatility), there would continue to be a strong case for exchange rate management for the foreseeable future. From a theoretical perspective, liberalising exchange controls mainly affects the exchange rates of those currencies which are overvalued; although this applies to many countries in Africa, it has not applied to Botswana.

48. **Taxation.** At present the government derives some income from taxation of interest earned on domestic savings. Should some of those savings be placed overseas, some tax income would be

lost under the present taxation regime, as foreign source income is not liable to Botswana taxation. One theoretically possible remedy is to move to a world-wide source basis for taxation, which would make such foreign earnings liable. However, this is extremely difficult to enforce and is considered to be unworkable in the Botswana context. The maximum tax loss is estimated to be some P40 million a year at current prices, which is a significant amount relative to gross collections by the income tax authority but small relative to total government revenues. There are various ways in which this loss could be made good, such as a small transactions tax on foreign exchange dealings, or a withholding tax for residents in respect of their Botswana source interest income. There would also be some savings in view of the reduced interest payable by the Bank of Botswana on BOBCs (as the export of savings would largely be financed by a reduction in the issue of BOBCs). In the longer term, this tax loss would be compensated by increased taxation derived from the additional investment and economic activity which would result from exchange control liberalisation, although the amount likely to be earned from this source is impossible to quantify at this stage. In conclusion, as the tax loss is relatively small in overall revenue terms, this should not delay EC liberalisation.

49. The Department of Customs and Excise confirms that it now has the mechanisms in place to collect **trade data** without the support of EC rules. As a result there should be no significant loss of revenue from SACU.

50. **The insurance industry**. Insurance is potentially the sector most directly affected by complete current account liberalisation, as this would remove the protection which the industry presently enjoys under the exchange control rules. Whether the industry deserves continued protection is, however, a separate issue for the government to consider, and should such protection be thought necessary, it could easily be achieved by a minor amendment to the Insurance Act. As a result concern about the possible impact on the insurance industry should not constrain moves towards EC liberalisation.

51. Without exchange controls Botswana might be used as a conduit for capital flight from South Africa, whereby funds which have been legally acquired in South Africa are exported in a way which contravenes that country's own exchange control regulations. Indications are that in the past capital flight from South Africa has been substantial (although not through Botswana); future levels will depend closely on the success of the political and economic reform process there. Although such funds are quite legal in terms of Botswana law, their acceptance could undermine relations with South Africa. It is also possible that there might be attempts by outsiders to use a liberalised Botswana ECR to "launder" illegally acquired funds (such as from drug trafficking). The commercial banks already operate internal guidelines designed to exclude such transactions. Such guidelines may need to be reformed to deal with the new situation, but there is no reason why effective practice cannot be developed jointly by the commercial banks and the BoB, if necessary drawing upon the experience of other countries in similar situations.

OTHER COUNTRIES' EXPERIENCES OF EXCHANGE CONTROL LIBERALISATION

52. Over the past two decades a large number of developing countries have liberalised exchange controls, in many cases removing such controls completely. In some cases (especially in Africa) such reforms have been part of policy reform packages implemented as Stabilisation and Structural Adjustment Programmes under the auspices of the IMF and World Bank, but in others (notably in

south and east Asia) they have simply been a natural economic progression, opening up strong and growing economies to benefit from greater integration with the international economy. In addition many developed countries have abolished exchange controls in recent years as part of a trend towards international economic integration, but also reflecting the difficulties (if not futility) of trying to implement exchange controls in an increasingly integrated international financial environment.

53. Much of this experience is highly relevant to Botswana. Firstly, it reflects the fact that any country which does not liberalise will increasingly be left behind those that do, and runs the risk of being marginalised (or excluded) from international investment flows. A second lesson of other countries is the examples of successes and failures, thus providing evidence of preconditions for successful liberalisation and the appropriate sequencing of liberalisation measures.

54. A first point is that despite Botswana's relatively liberal exchange control regime, it is more currently restrictive than (a) other small open economies in a relatively less advantaged position (e.g. Mauritius and Zambia) and (b) other countries which in previous decades opened up their current and capital accounts when they too were, at that time, comparatively not as well off (e.g. Malaysia and Singapore). With regard to the adequate level of international reserves, most countries that have opened their capital account have done so with much lower levels of reserves than Botswana currently has, relative to the size of its import needs and of its domestic economy. On this basis of comparison, Botswana should already have liberalised much more extensively than it actually has.

55. Other important preconditions for successful capital account liberalisation include: maintaining a stable macroeconomy prior to and after liberalisation; reducing fiscal deficits to levels which can be financed in a non-inflationary manner; minimising levels of inflation; increasing the flexibility of market driven changes in wages, prices and interest rates; liberalising the domestic financial system and encouraging competition; reducing differences between domestic and external financial market conditions (such as real interest rates); strengthening prudential supervision of the financial system to international levels; and ensuring sufficient risk-management capability in the financial system. Botswana would appear to meet all of these conditions, except perhaps for some concern about a lack of wage flexibility in the labour market.

56. Those countries which liberalised in these conditions and maintained them thereafter generally experienced substantial increases in gross capital flows which resulted in rising net capital inflows and higher reserves (in contrast to the concern in Botswana of capital outflows). Exchange rate appreciation has often resulted from these net capital inflows.

57. Liberalisation did however impose greater demands on domestic macroeconomic management capability, and made it more difficult to control **both** interest rates **and** exchange rates in the context of an open capital account. However, this conflict would appear to be less severe in Botswana with its current and likely future high level of international reserves. These provide considerable flexibility with regard to interest rates and exchange rate targeting under Botswana's special circumstances.

58. A further important result is that liberalisation significantly improves the functioning of the domestic financial system, in terms of efficiency gains, productivity improvements, and

innovations in financial products and services, much of it under the influence of international competition. It also facilitates access to international financial markets, thus reducing borrowing costs for firms.

59. The experience of Mauritius is particularly instructive for Botswana, given certain similarities between the two economies. Current account restrictions have been completely removed and Mauritius is in the process of applying for IMF Article VIII status. The country has recently introduced a policy to develop its financial sector, following rapid manufacturing sector growth in the 1980s; as part of this it has also introduced capital account liberalisation measures but these are focused on an embryonic Offshore Banking Centre (analogous to the Export Processing Zone in manufacturing). It hopes to attract *inter alia* offshore banking, insurance and pension funds, international licensing and franchising, international data processing, international financial services, international consultancy and employment services, shipping and ship management, and aircraft financing and leasing. Since the rules for the Offshore Business Centre were promulgated in 1992 over 400 companies have been registered, over half of them from South Africa.

60. Varying approaches have been adopted towards the speed of capital account liberalisation. Several countries have dismantled controls quickly, including Argentina, Britain, Indonesia, Malaysia, New Zealand, Singapore, and Uruguay. Most countries have, however, followed the more gradual approach of first relaxing restraints on trade-related capital flows, followed by removal of restrictions on foreign direct investment; then by relaxation of restrictions on foreign portfolio investment; and finally removing constraints on other short-term financial flows. The evidence, however, suggests that success or failure with capital account liberalisation has not depended on whether liberalisation occurred quickly or slowly but on the credibility and consistency of other macroeconomic policies, especially anti-inflation policy.

IMPACT ON THE PRIVATE SECTOR

61. The main effects on the private sector of exchange controls abolition would be as follows:

- savings on time and costs, as well as fewer restrictions on organising business activities;
- the opening up of new investment opportunities, especially in international finance and service activities;
- access to international financial markets, possibly resulting in lower borrowing costs, and the opening up of currency hedging opportunities;
- no significant changes in domestic interest rates or the exchange rate in the short to medium term, other than those specifically planned by Botswana's monetary authorities;
- increased competition in the financial sector, leading to greater efficiency, higher productivity, and a wider range of products and services, thus contributing to financial deepening and broadening which is crucial to broader process of economic development in Botswana;
- the insurance sector need not be adversely affected as continued protection, if considered desirable, could be transferred to the Insurance Act;
- expansion of the Botswana Share Market through transactions in foreign securities and inflows of foreign portfolio investment;

- an improvement in the operation in the price mechanism, particularly in asset pricing, which will boost economic efficiency and raise the returns on investment;
- the ability of Residents to make outward investments from Botswana, which will lead to more investment opportunities, higher returns, and an increase in national income.

PROPOSALS FOR REFORM

62. The analysis of this study shows that the original justification for Botswana having exchange controls no longer applies, that ECs may already have led to lost opportunities for inward foreign investment, and that if maintained they are likely to harm the prospects for future economic growth and employment creation. The major concerns that have been raised in connection with removing exchange controls are either largely unfounded or can easily be dealt with. The conclusion, therefore, is that exchange controls should be removed. Furthermore, as ECs are doing more harm than good to the economy, they should be removed as soon as possible. Technically, exchange controls could be removed (suspended) almost at once. However, as certain preparatory measures have to be taken (for instance by the banks and many companies) this is effectively not an option. More importantly, removing ECs marks a fundamental change in the operation of the economy, and it is of crucial importance that EC liberalisation is handled in a manner which does not destabilise important macroeconomic relationships. The question is, therefore, how quickly can exchange controls be removed without causing instability which may in the longer term be counterproductive - for instance by requiring the reversal of reforms. In the case of Botswana, where there are relatively few current account controls, this question essentially refers to the speed of removing capital account controls. Related to this is the question of whether all remaining capital controls should be removed in one go - say within a few months of a decision to remove exchange controls being made - or spread over a longer, phased process.

63. It is important that Botswana removes its exchange controls quickly, in order to achieve the maximum benefit from the "window of opportunity" available before Zimbabwe and South Africa benefit from their own reform programmes. As noted in para. 54 above, Botswana should already have liberalised much more extensively than it actually has. However, removing exchange controls is a process consisting of a number of steps, and in the context of Botswana's economy there is a limit to how far this process can be prudently compressed. We consider that removing remaining ECs in one go is unnecessarily risky and not a realistic option, for the following reasons.

64. Firstly, following removal of capital controls, macro-economic managers will need to be able to respond quickly to sharp adjustments in international capital flows, to assert and tighten fiscal and monetary control, and to respond much more quickly to changes in the international economic and financial environment. Whilst it is to be hoped that this would be possible in Botswana, it would very much mark a movement into unknown territory where experience to date is limited. Although economic managers have responded well in the past, the existence of exchange controls has enabled decisions to be made more slowly. Opening the capital account will require a much faster response than Botswana is used to making, even though the present high level of reserves gives a breathing space of some six to eight years before the full impact of integration into the international financial system is felt. It will take time to put such mechanisms in place and develop the necessary skills, even if in the short term some skills are bought in and use is made of advice from international institutions such as the IMF. The uncertainty over the impact of removing capital controls is compounded by the fact that Botswana is moving into a new economic era of

reduced real mineral revenues, slower economic growth, and increased pressures on government spending. The ability to deal with this new situation in a non-inflationary manner has not yet been demonstrated.

65. A second risk is that if removal of capital controls leads to unexpected consequences which cannot be successfully dealt with, this might require some controls to be reimposed in order to stabilise the situation. This would be the worst possible course of action, and would cause a disastrous loss of credibility on the part of Botswana in international financial markets, which would be very difficult and time-consuming to recover from. It is very important from a credibility point of view - especially for a small and relatively unknown country such as Botswana - that any exchange control reforms be irreversible.

66. The institutional history of the MFDP is one of relative caution and conservatism in economic policymaking and changes thereof. In general this risk-averse approach has been successful and has served the country and the economy well (although the danger must also be acknowledged that this can lead to an over-conservative approach and perhaps a damaging resistance to change - and there is some argument that this is one reason why exchange control liberalisation is not as far advanced as it should be at this stage, given Botswana's economic strength). One of the important consequences is a consistency in economic policy which few (if any) other countries in Africa can match, and this in turn gives Botswana unrivalled international credibility in the economic sphere. Phased liberalisation of exchange controls fits more comfortably with MFDP's traditions of economic decision-making than the more risky strategy of removing ECs all at once.

67. On the basis of likely developments in Botswana and the applicable lessons from other countries, the balance of judgement must therefore weigh in favour of a progressive approach to capital account liberalisation rather than a rapid dismantling of capital controls. Prior to a full opening of the capital account, further progress must be made in (i) developing the financial system (including both the Bank of Botswana and private financial institutions) to introduce a higher degree of sophistication in handling enlarged volumes of gross capital flows in either direction with a wider range of financial assets and instruments; (ii) improving the capacity of the monetary authorities to rapidly sterilise large capital inflows and outflows; (iii) introducing more responsive mechanisms for managing interest and exchange rates; and (iv) exerting effective control over domestically-generated inflation. A phased approach enables the consequences of one step to be absorbed and considered before proceeding with the next, thus creating credibility and contributing to the irreversibility of reforms.

68. The need for a phasing of EC removal should not be seen as an excuse for prevarication or delay, as this runs the substantial risk of preventing Botswana from exploiting its current financial strength relative to other countries in the region, and missing out on potential inflows of foreign investment. Therefore, although a phased approach is desirable, there is some urgency given the need to substantially complete the process within a time period which would enable Botswana to compete, especially with Zimbabwe and South Africa for regional financial business. In the light of developments in these countries, and the fact that Mauritius already has a head start, and that Zambia has removed all exchange controls, this time period is very short. Therefore: **(i) Botswana must implement further EC liberalisation at a much faster speed than has been carried out in recent years; (ii) substantial liberalisation of capital account controls must start immediately;**

and (iii) complete removal of exchange controls must be completed as soon as possible, preferably within two and at most within three years.

69. Early steps in the liberalisation process should include the following (during 1994).

- a publicly stated commitment by government to the complete removal of exchange controls as fast as possible, and at most within two to three years;
- the complete removal of remaining current account restrictions and anomalies, and moving to IMF Article VIII status;
- permitting and encouraging domestic banks to operate foreign currency denominated accounts (FCDAs) for Residents and Temporary Residents. The operation of FCDAs would be an important step in developing a wider range of foreign currency denominated financial activities by the banks, providing the basis for offshore activities, as well as removing unnecessary costs for businesses with large volumes of foreign transactions;
- progressive liberalisation of restrictions on foreign currency holdings and transactions by Residents. This could involve giving all Residents a single annual foreign exchange allowance rather than the various allowances for specified purposes which exist at present. Residents would be able to use this allowance to accumulate foreign currency savings, but these would initially be restricted to deposits in FCDAs at domestic banks. In this way, private foreign currency savings would remain part of Botswana's reserves.
- permitting the Botswana Share Market to quote and sell selected foreign shares and bonds;
- permitting Residents to purchase property abroad up to a certain value;
- removing various anomalies and unnecessary elements from the existing exchange control regulations - such as the requirement for foreign currency purchases to be recorded in a person's passport, and the need for travellers to declare currency on entry to and exit from Botswana.

70. The advantage of the above steps is that they relate to enhancing the position of Residents, broadening the range of opportunities open to them, and reducing the costs facing the business sector. It would also remove most of the present imbalances between Resident individuals (citizens) and Temporary Residents (expatriates).

71. There would be no particular difficulty for banks in Botswana to operate foreign currency accounts, especially as they have ready access to the relevant expertise from their parent companies outside Botswana, and it would strengthen the banks' expertise in managing yet another category of international transactions. The operation of FCDAs would pose a number of technical issues - such as whether to initially require the commercial banks to make matching foreign currency deposits at the BoB - which would need to be discussed and resolved by the BoB and the commercial banks.

72. Some of the steps above (the trading of foreign stocks on the BSM, and allowing residents to buy property abroad) mark liberalisation of capital controls. These should be complemented by permitting *selected* Nonresidents to purchase BOBCs, and more generally encouraging foreign investors to use Botswana as a base for outward investment into the southern African region. For instance, overseas mutual funds interested in moving into the region could be encouraged to set up

a subsidiary in Botswana, leaving part of their portfolio in BOBCs and shares quoted on the BSM, and use Botswana as a base for investments elsewhere in the region (Johannesburg and Harare stock exchanges, privatisations in Zambia, Malawi etc.). Although this would entail a cost in terms of the interest paid on BOBCs, there would be enormous potential benefits in terms of Botswana's image as a centre for regional financial operations. There would also be income earned through payments for accounting, administrative, legal and financial services rendered in Botswana.

73. Subsequent liberalisation steps would include:

- to permit Residents to hold any type of foreign financial asset; perhaps up to a limit which would be progressively raised and then removed altogether; this would include holding foreign currency accounts overseas, direct purchase of shares on foreign stock markets etc., and taking out foreign currency life assurance and pension policies. This may require income earned from locally held FCDAs to be deemed to be foreign sourced (and therefore tax exempt) in order to give an incentive to retain FCDAs within Botswana rather than move to overseas accounts;
- gradually easing the restrictions on Nonresident holdings of BOBCs and quoted shares;
- a progressive easing of limits and restrictions on activities such as local borrowing by foreign controlled companies and other capital transactions.

Over time these moves would amount to a progressive opening up of the capital account and would culminate in a removal of all exchange controls before the end of 1996 at the very latest.

74. Other necessary moves related to exchange control liberalisation include:

- reform of tax regulations on a "follow-through" basis to prevent the application of withholding tax on remitted profits to the extent that the profits are derived from foreign (tax-exempt) sources. This would be necessary to attract administrative headquarters activities of international companies operating in southern Africa;
- transfer of protection of the insurance industry to the Insurance Act, if continued protection is considered to be desirable;
- consideration of ways to make up the for the tax lost when (currently taxable) domestic savings are transferred to foreign currencies;
- Making Nonresident earnings from Botswana-based financial assets non-taxable; such a move is essential if it is considered desirable to develop Botswana as a base for Nonresident (offshore) financial activities.
- A detailed review of the issues surrounding money laundering and the use of Botswana for capital flight from neighbouring countries. The existing commercial bank guidelines need to be reviewed and if necessary strengthened. The BoB may also wish to formalise a regulatory role in this area. Consideration of these issues may benefit from discussions with the South African and Zimbabwean governments regarding their concerns.
- arranging alternative sources of data for the BoB to compile Balance of Payments statistics and ensuring that the Department of Customs and Excise has the necessary procedures and skills to collect trade data at border posts and other entry points, and if necessary arranging further appropriate training programmes for Customs officers.

75. Some of these moves would require certain technical issues to be addressed. Many of them affect the commercial banks and could be dealt with by a joint Bank of Botswana/commercial bank working group. Others are tax-related and need to be dealt with by the Ministry of Finance.

76. Although it may be technically easier to remove exchange controls by suspending rather than abolishing the current legislation, it is central to the liberalisation programme that reversal of reforms should be avoided at all costs. The exchange control legislation should therefore be abolished as soon as is practicable; this will add greater credibility to the reforms.

CONCLUSIONS

75. The main conclusions of the study are as follows:

(i) The existing ECR, whilst it is amongst the most liberal in Africa and on the whole quite efficiently run, is increasingly restrictive to actual and potential business and investment in Botswana.

(ii) Botswana urgently needs to pursue all possible avenues of economic diversification. Whilst the existing ECR is not a major constraint on inward investment in the manufacturing sector, it is a constraint on service-related investment, and effectively precludes Botswana emerging as a base for regional administrative, technical and financial activities in the private sector. Removing exchange controls would make a positive contribution to boosting diversification, job creation and economic growth.

(iii) The existing ECR is probably perceived as more restrictive than it really is by potential investors who do not know Botswana well, if only because of "guilt by association" with other African countries. Botswana is failing to fully exploit its economic strength and stability in ways which might attract foreign investment.

(iv) Abolishing or substantially liberalising exchange controls is a policy increasingly being followed by other developing countries in Africa and elsewhere. Such a move would help Botswana to develop new sources of economic growth, and if Botswana does not make this move it risks being left behind as other countries reform.

(v) There would be some loss of tax revenue in the short term, although in the longer term this should be compensated by the taxation of increased investment and economic growth. There would be some constraints imposed on the government's ability to set interest rates and the exchange rate, but recent interest rate and exchange rate policy would appear to lie within these constraints, and thus effectively there would be no change. Removing exchange controls would make it more difficult to engage in unsustainably high levels of government spending in the future.

(vi) Although there should be no major movements in the exchange rate or interest rates as a result of removing ECs, management of the macroeconomy in the context of a liberalised relationship with the rest of the world requires new skills and institutional capacity in the MFDP, the BoB and the banks, which Botswana does not have at present.

(vii) Botswana should liberalise its exchange control regime as far and as fast as possible. However, the need for new and improved techniques of monetary and fiscal management mean that immediate abolition is not feasible. Therefore a phased programme, with the objective of complete removal of controls within two to three years, should be announced as

soon as possible. There is some sense of urgency because Botswana's window of opportunity to fully exploit its current financial strength and good economic record is unlikely to be very long, and the government should therefore treat the process of removing ECs as an urgent priority.

RECOMMENDATIONS

1. *Government should take the decision to completely remove all remaining exchange controls, preferably within two years and definitely within three, and to implement a phased programme of liberalisation within this period.*

2. *A working group, consisting of representatives from the Ministry of Finance and Development Planning, Bank of Botswana, the commercial banks and the non-bank private sector should be established to oversee the exchange control liberalisation process , and one of their key tasks should be to ensure that the timing of liberalisation remains on schedule.*

3. *All remaining current account controls should be removed as soon as possible and Botswana should apply to the IMF for Article VIII status. Negotiations should start with the IMF to clear any remaining obstacles.*

4. *The various foreign exchange allowances for Residents should be unified to provide a single annual allowance for any purpose. The limit for this allowance should be determined following more detailed consideration by the BoB & MFDP.*

5. *The Bank of Botswana should immediately address various anomalies in the existing exchange control system with a view to removing them as rapidly as possible.*

6. *The commercial banks should be permitted and encouraged to operate foreign currency denominated accounts (FCDAs), at the latest by mid-1994.*

7. *Resident individuals should be permitted to hold foreign currency within the limits of the annual allowance and to open FCDAs at Botswana banks.*

8. *Resident companies should be permitted to operate FCDAs for trade-related transactions.*

9. *A technical working group involving the BoB and commercial banks should be established to deal with issues such as the modus operandi of FCDAs, and the establishment of a forward market for the pula.*

10. *BoB and the commercial banks should review the existing guidelines regarding the acceptance of large cash deposits of foreign currency and other funds which may be of undesirable origin. Government should initiate contacts with the relevant authorities in South Africa and Zimbabwe so that their concerns in this area can be accommodated.*

11. *The Botswana Share Market should be permitted to trade in selected foreign securities; the final decision on which securities to sell to be made by the Interim Stock Exchange Committee.*

12. *Residents should be permitted to purchase one property outside of Botswana up to a limit to be determined by the BoB/MFDP.*

13. *Government/Bank of Botswana should commission a study to examine the costs, benefits and constraints regarding the future development of various regional and international financial services in Botswana, with a view to pursuing financial services as a key element of economic diversification.*

14. *Allow selected Nonresidents to purchase BOBCs with a view to attracting international portfolio managers and mutual funds operating in southern Africa to domicile in Botswana.*

15. *Allow reputable foreign companies to raise funds through a share issue in Botswana for investment elsewhere in the region.*

16. *Government should prepare to make the necessary legislative changes (to the Exchange Control Act, Income Tax Act etc.) to enable the liberalisation timetable to be met.*

17. *The BoB/MFDP should examine the required reforms to the financial sector which will enable the necessary responses to increased capital flows, with a view to introducing new instruments (such as longer term bonds), and to acquiring technical skills, by training of local personnel and if necessary by bringing in external advisors for a limited period.*

18. *As an interim measure transfer protection of the insurance industry from the EC regulations to the Insurance Act, and begin a review of whether continued protection of the insurance industry is in the national interest.*

19 *Arrange alternative sources of data for the BoB to compile Balance of Payments statistics . Ensure that the Department of Customs and Excise has the necessary procedures and skills to collect trade data at border posts and other entry points, and if necessary arrange further appropriate training programmes for customs officers.*

20. *During 1995 and 1996 there should be further liberalisation of exchange control limits and restrictions with the target of complete abolition not later than the end of 1996.*

21. *Taxation should remain on a local source basis but consideration should be given to means of replacing taxation lost through the export of domestic savings.*

22. *Tax reform should also address the need to attract foreign investment in services and finance. Suggested changes include (i) ensuring that Resident companies deriving tax-exempt foreign income from subsidiaries or associates within the region are not subject to withholding tax when these profits are remitted from Botswana (required if companies are to set up regional headquarters in Botswana), and (ii) ending the taxation of income from financial assets in Botswana paid to Nonresidents (required if Botswana is to attract offshore financial business).*

TIMETABLE FOR PROPOSED REFORMS

A.	*SHORT TERM (during 1994)*	
	Proposed measure	***Lead institutions***
1.	*Announce decision to abolish exchange controls within a fixed period (at most three years)*	*MFDP, BoB*
2.	*Removal of remaining current account restrictions*	*MFDP, BoB*
3.	*Application for Article VIII status; negotiations with IMF*	*MFDP, BoB, IMF*
4.	*Commercial banks to open FCDAs*	*BoB, Commercial Banks*
5.	*Reform of Residents' foreign exchange allowances*	*MFDP, BoB*
6.	*Permit local holding of foreign currency by Residents and opening of FCDAs at local banks*	*MFDP, BoB, Commercial banks*
7.	*Permit companies to operate FCDAs for trade-related transactions and for transactions in "invisibles"*	*MFDP, BoB, Commercial banks*
8.	*Permit BSM to quote and sell selected foreign shares and bonds*	*MFDP, BoB, Stockbrokers Botswana, Interim Stock Exchange Committee*
9.	*Permit Residents to purchase property abroad up to certain value*	*MFDP, BoB*
10.	*Removal of exchange control anomalies and minor restrictions*	*BoB*
11.	*Establish working group to oversee EC liberalisation process*	*MFDP/BoB/banks/BOCCIM*
12.	*Establish technical working groups (banking, taxation etc.)*	*MFDP, Tax Dept., BoB, banks*
13.	*Discussion of legislative implications (Exchange Control Act; Income Tax Act etc.)*	*MFDP, BoB, Attorney-General*
14.	*Move protection of insurance industry to Insurance Act*	*MFDP, Attorney-General.*
15.	*Examine alternative sources of data for balance of payments*	*BoB, Dept. of Customs & Excise*
16.	*Review measures to prevent use of Botswana for money laundering or other undesirable transactions*	*BoB, banks*
17.	*Allow selected Nonresident purchases of BOBCs*	*MFDP, BoB, Stockbrokers*
18.	*Encourage selected international investors to use Botswana as a base for regional investments*	*MFDP, BoB, Stockbrokers, local financial institutions*
19.	*Commission detailed study on Botswana's potential as a financial centre*	*BoB, MFDP, BOCCIM, local financial institutions*

B. MEDIUM TERM (preferably 1995; at the latest by 1996)

	Proposed measure	Lead institutions
1.	*Training of BoB/MFDP personnel*	*BoB, MFDP, IMF*
✓ 2.	*Upgrading of local banking structure*	*BoB, local financial institutions*
✓ 3.	*Upgrading local financial skills*	*local financial institutions*
4.	*Tabling of necessary legislation before parliament*	*MFDP, Attorney-General*
5.	*End restrictions on Resident holdings of foreign financial assets*	*MFDP, BoB*
6.	*End restrictions on Nonresident purchases of BOBCs*	*MFDP, BoB*
✓ 7.	*Further liberalisation of exchange control limits and restrictions until all exchange controls are removed*	*MFDP, BoB*
✓ 8.	*Reform of taxation: (i) nonresident earnings from Botswana financial assets; (ii) end withholding tax on remitted profits attributable to tax exempt sources*	*MFDP, BoB, Tax Dept., Attorney-General*
9.	*Introduction of longer term financial instruments*	*BoB, MFDP, Stockbrokers*

COST BENEFIT STUDY OF LIBERALIZING FOREIGN EXCHANGE CONTROL REGULATIONS IN BOTSWANA

MAIN REPORT

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ABBREVIATIONS

BDC	Botswana Development Corporation
BoB	Bank of Botswana
BOBCs	Bank of Botswana Certificates
BOCCIM	Botswana Confederation of Commerce, Industry and Manpower
BSM	Botswana Share Market
EC	Exchange Control
ECR	Exchange Control Regime
FCDA	Foreign Currency Denominated Account
FDI	Foreign Direct Investment
IMF	International Monetary Fund
MFDP	Ministry of Finance and Development Planning
RMA	Rand Monetary Area
SACU	Southern African Customs Union
SADC	Southern African Development Community
SSA	Sub-Saharan Africa
UAPTA	Unit of Account, Preferential Trade Area

1. *INTRODUCTION AND BACKGROUND*

INTRODUCTION

Background to the study

1.1. The idea for this study was born after the Francistown Conference, sponsored by the Botswana Confederation of Commerce, Industry and Manpower (BOCCIM) in September 1991; discussed the issue of exchange control liberalisation. This "Second National Private Sector Conference" included many suggestions from the private sector to the Botswana government, some of which concerned this particular topic. In addition the exchange control issue had for some time been under discussion by the Bank of Botswana, and to a lesser extent the Ministry of Finance and Development Planning (MFDP). More generally, exchange controls have been one of the more prominent issues on the public economic agenda in Botswana in recent years.

1.2. In 1993 BOCCIM and the Botswana Development Corporation (BDC) prepared detailed terms of reference for the study; and US-AID agreed to finance the study through USAID's contract with Deloitte and Touche for the "Botswana Private Enterprise Development project" (BPED). The USAID contract number for the BPED project is 623-0253-C-00-2014-00.

1.3. This report has been compiled for BOCCIM and BDC by Derek Hudson of Phaleng Consultancies, Gaborone; Charles Harvey of the Institute of Development Studies at the University of Sussex; Keith Jefferis of the University of Botswana; Bob Martin of Economic Resources Limited, Blantyre, Malawi; and Percy Mistry of Oxford International Associates, England. Mr. Martin was a member of the team of consultants under the auspices of the Crown Agents, London.

EXCHANGE CONTROLS IN BOTSWANA

Historical background

1.4. Before August 1976, Botswana operated the exchange control rules of the South African Reserve Bank, with regard to financial transactions with countries outside the Rand Monetary Area (RMA). There were no exchange controls of any kind between Botswana and the rest of the RMA, including South Africa. The very small amount of exchange control work, covering mainly capital transactions between Botswana and countries outside the RMA, was handled by one officer in the Ministry of Finance & Development Planning.

1.5. When Botswana left the RMA on 23 August 1976, Botswana designed its own exchange control system against the rest of the world, thus including controls against South Africa for the first time. The two main objects of the exchange control regime were to ensure that the Bank of Botswana was given a monopoly over the investment of Botswana's foreign exchange reserves, and to ensure that Botswana's savings were used for investment in Botswana. Subject to these two requirements, the object was to keep the exchange control rules as liberal as possible. This was interpreted to mean that there should, as far as possible, be no restrictions on current account transactions between Botswana and any other country.

1.6. A valuable by-product of the introduction of exchange controls against South Africa, was that the new rules helped to ensure that importers filled in their Customs entry forms, on which

they reported the value of the goods coming into Botswana. Previously, some importers had been rather casual about filling in the necessary entry forms. The new system helped considerably to ensure that Botswana received its correct share of the revenue from the Customs Union.

1.7. Now that it is apparent that foreign exchange is no longer a scarce resource (and is not likely to become one in the next ten years at least); now that it is obvious that Botswana has a surplus, and not a shortage of domestic liquidity; and now that the Department of Customs & Excise is running all the Customs entry points and has better trained staff at its disposal, the question arises as to whether Botswana needs exchange controls any more.

1.8. The consultants have examined the costs of maintaining the existing exchange control system, and find them to be substantial.

1.9. The consultants have found that the risks of a **large** capital outflow, if exchange controls were to be abolished, are at present negligible. See Appendix 1.

Existing exchange controls on current account transactions

1.10. It is commonly known that Botswana already has liberal exchange control rules for international current account transactions. A great deal of the exchange control work for such transactions has been delegated by the Bank of Botswana (BoB) to the Authorised Dealers, i.e. the licensed commercial banks. Most of the time, exchange control approval is quickly obtained for international current account transactions. Payment can then be speedily effected since there is no shortage of foreign exchange reserves.

1.11. A particularly important example is the ease with which payments can be made for imports of goods. Similarly, there are no delays in sending dividends out of the country to Nonresident shareholders of Botswana companies.

1.12. A special exception concerning the ease of paying for current account transactions arises in the case of insurance business. The present exchange control rules require Residents of Botswana to place nearly all their insurance business inside Botswana. However, this can be interpreted as a trade restriction rather than as an exchange control restriction *per se*. The primary object of the restriction is to protect the local insurance industry, not the balance of payments.

1.13. An exception to the general pattern of speedy approval for current account transactions, concerns the delays sometimes experienced by Residents in receiving Bank of Botswana approval for payments for imports of services (e.g. management contracts, professional subcontracts) received from abroad. The Bank of Botswana has not delegated payment for such categories of imported services to the Authorised Dealers. Even more burdensome is the need to have some of the **contracts** approved in advance by the Bank of Botswana, even before any invoices are presented for payment.

1.14. This can be particularly harmful for multinational corporations which frequently do business between their various subsidiaries in eastern and southern Africa. It does not help to encourage such companies to invest in Botswana, as it is known that a company in Botswana may have difficulty in getting permission to pay certain categories of its debts to its sister companies in the region. This is particularly the case whenever Bank of Botswana approval is required in advance, before the contract for foreign services can be signed. Cases exist where a local company has given up on obtaining BoB permission to make a payment for the importation of services, and

the actual payment has been settled offshore (whereby both the local importing company, and the South African exporting company, have set up offshore banking facilities, without the permission of their respective exchange control authorities). The payment offshore caused the local company to overstate its Botswana taxable profits.

1.15. Although the exchange control system generally works very well as far as current account transactions are concerned, problems are occasionally encountered. Appendix 12 reports on remaining current account constraints; Appendix 14 discusses present exchange control anomalies. A total of 50 EC rules need to be looked at, under the two headings of constraints and anomalies.

The existing system for international capital account transactions

1.16. A small number of capital account transactions have already been liberalised. These significant liberalisations are listed at Appendix 13.

1.17. Exchange control delays have been observed when complicated share transactions are being proposed, and one of the parties to the sale is a Nonresident. In some cases the Bank of Botswana is unable to pass final judgement on the proposed transaction if the seller of the shares has failed to comply with the rule that a clear description must be given as to how the valuation of the shares was arrived at. On other occasions it has become clear that the Bank of Botswana is "second guessing" what the parties to the share sale have agreed on, after a lengthy period of negotiations by the relevant parties. Such delay does not help Botswana maintain or develop a reputation of welcoming foreign investment.

1.18. Some foreign investors have experienced difficulties when they attempted to finance their investments in Botswana by means of (foreign) shareholders' loans.

1.19. Residents of Botswana are generally not allowed to make either direct or portfolio investments outside Botswana. See Appendix 18.

1.20. By and large, however, the present exchange control system is seen to be reasonably fair and fast as far as obtaining exchange control permission for most ordinary transactions is concerned. Problems mainly arise either with payments for imports of services or with capital account transactions which have not yet been liberalised.

1.21. It is also apparent that a great deal of time, effort and money is being spent by businesses on in-and-out foreign exchange transactions. Unless a Resident can arrange to make a foreign payment on the same day that foreign currency on account of an export is received, the currency received may not be used directly, as foreign exchange, to pay subsequent foreign invoices. The export receipts must first be sold for pula, and subsequently the pula may be sold for foreign exchange to pay an invoice. The resulting transaction costs can be significant. In addition, the BoB has to sell Bank of Botswana Certificates (BOBCs) to mop up the liquidity created by the (compulsory) sale of all incoming forex for pula.

STUDY OBJECTIVES

1.22. The main objective of this study has been to consider further possible relaxations of controls over those capital account transactions which have not yet been liberalised. What are the costs, risks and benefits of such further liberalisation? Can Botswana afford to get rid of exchange controls altogether? Is there any risk at all that Botswana would ever suffer the embarrassment of

having to re-introduce exchange controls, at a later stage? What would be the impact on the private sector in Botswana?

1.23. More specifically the issues considered include the following, as derived from the Terms of Reference:

a. Would there be an increase in private investment in Botswana if exchange controls were to be liberalised further?

b. Do any of the present exchange controls inhibit investment in Botswana?

c. What have been the experiences of other developing countries which have significantly liberalised their exchange control regimes?

d. Would there be an advantage to Botswana from changing its status at the International Monetary Fund (IMF) from Article XIV status to Article VIII status?

e. If further exchange control liberalisation were to be recommended, should this take the form of total abolition of exchange controls, or step-by-step liberalisation?

f. Should the latter be recommended, what should be the sequencing of liberalisation measures?

g. What would be the broader ("collateral") implications of exchange control liberalisation. Specifically, what would be the impact on:

- the conduct of macroeconomic policy by the Ministry of Finance & Development Planning and the Bank of Botswana.
- the collection of income tax.
- the local banking industry.
- the local insurance industry.
- relations with neighbouring states, including any problems with money laundering.

h. In general, what would be the costs, benefits and risks associated with the further liberalisation of exchange controls in Botswana?

1.24. Appendix 20 contains a set of cross references between the terms of reference and the contents of this report.

1.25. As an important aid to the study, a small number of forecasts was made of the level of foreign exchange reserves over the next ten years. The assumptions underlying the forecasts were changed slightly for each forecast. The forecasting exercise showed that there will be an abundance of forex reserves over the next ten years, even allowing for some possible capital flight. See Appendix 1.

1.26. Also of considerable interest is the experiences of other developing countries which have abolished exchange controls over capital account transactions; these are reviewed in chapter 2. On the whole, they have experienced net capital inflows after liberalisation, and the capital involved has stayed in the country as long as the government was seen to be pursuing reasonably sensible macro-economic policies. Conversely, any attempt by the government of a liberalised country to

subsequently run a large budget deficit, and to finance the deficit in a way which is considered likely to be inflationary, will scare capital away from the country. For example, the foreign exchange reserves of Columbia have fluctuated according to the successive views taken by investors (mainly Colombian) on how well the government is running the country.

1.27. Considerable care has been taken in this study to assess the impact of further exchange control liberalisation on those responsible for macro-economic management of the Botswana economy. Two of the key groups which shoulder this responsibility are the macro-economic section of the Ministry of Finance & Development Planning, and the Bank of Botswana. There would be little point in recommending changes which would be so burdensome on either the Ministry or the Bank, in the form of greater difficulty in managing the macro-economy, that they would be bound to conclude that the costs of such changes would outweigh the benefits.

1.28. Similarly, a great deal of care has been taken to examine potential losses of income tax if Residents of Botswana were to send their savings abroad under a liberalised regime. Under present taxation rules, any income earned by a Resident on foreign investments is not reportable in Botswana. See Appendix 6.

1.29. A careful analysis has been made of the impact of exchange control liberalisation on Botswana's insurance industry. Some continued protection of the insurance industry may be necessary, but this should be under the Insurance Act and not under the Exchange Control Act. See Appendix 7.

STUDY METHODOLOGY

Introduction

1.30. The study team approached the subject of the consultancy with a completely open mind. No preconceived notions were allowed to influence the results, especially as in any case different members of the team held varying views on the subject prior to the commencement of the study. The team was determined to let the evidence accumulated during the study speak for itself.

1.31. The IMF provided the team with advice on the points that would have to be negotiated between the Botswana authorities and the IMF, should Botswana apply to move to Article VIII status at the IMF. See Appendix 15.

1.32. A pair of simple but effective macro-economic models were used to answer some specific points. The first model looked at the proportion of exportable financial savings in Botswana that are not under Government control, and which could in theory leave the country, as capital flight, under a liberalised exchange control regime. See Appendix 1.

1.33. The second model was a forecast of Botswana's balance of payments over the next ten years. This second model helped us to estimate, among other things, the effect of future possible capital flight on income tax collections in Botswana. See Appendices 1 and 6.

1.34. The two models helped the team to evaluate the additional burden which would be placed on the Ministry of Finance & Development Planning (MFDP) and the Bank of Botswana, with respect to maintaining their *prima facie* excellent track record of high quality macro-economic management of the Botswana economy, if exchange controls were to be liberalised.

1.35. Interviews were held with a wide variety of people with relevant experience of exchange controls. These included accountants, bankers, civil servants and a wide variety of businesses and professional firms. A complete list of persons contacted is given at Appendix 19.

1.36. The Ministry of Finance & Development Planning and the Bank of Botswana were interviewed, to provide the basic data for the model referred to at paragraph 2.1.4 above, in which the balance of payments was forecast for the next ten years. As far as possible, assumptions made for the model were consistent with the assumptions underlying the long term forecasts in the government's National Development Plan VII. See Appendix 1.

1.37. A large number of experts on exchange control (EC) liberalisation in developing countries were interviewed at the IMF and at the World Bank in Washington, DC, in order to assist with the cross country analysis. In addition, a number of senior personnel were interviewed in Mauritius, as the basis for a more detailed report on that country.

Main components of the study

1.38. The components of the analysis in the report include:

- the impact of the existing exchange controls on the Botswana economy;
- the likely impact of EC liberalisation on the economy;
- analysis of the income tax issue;
- analysis of the impact on the insurance industry;
- cross country analysis, i.e. what has been the experiences of other developing countries that have liberalised EC over international capital account transactions.

THE BROAD INITIAL INVESTIGATIONS

The broad initial investigations - unsanctioned capital flows

1.39. Interviews provided evidence that the Botswana economy is sufficiently open to the rest of the world, and the permitted remittances for current account transactions are sufficiently generous, that there are already considerable international capital transactions taking place without the official sanction of the Exchange Control Department of the Bank of Botswana, including those which are already legal such as short term capital movements arising from leads and lags in the finance of international trade.

1.40. Loopholes in the capital account rules are exploited more by large financial "players" than by small businesses and individuals. To this extent the existing rules for Residents concerning capital account transactions are "regressive"; i.e. they apply more effectively to small businesses and less well off individuals, than they do to large businesses and wealthier Residents.

1.41. It follows that the financial and monetary authorities in Botswana, namely MFDP and the Bank of Botswana, are already to some extent managing the Botswana economy almost as if there were very few exchange controls on capital account transactions for large transactors.

1.42. It must be noted, however, that because the Botswana government presently either owns or controls between 85% and 90% of Botswana's exportable financial savings, very little capital flight

could take place if exchange controls were removed tomorrow. The possibility of capital flight, however, increases over time. See Appendix 1.

The broad initial investigations - likely new foreign investment

1.43. One of the key findings of this study is that because there are so few constraints on business due to exchange control rules, removal of these rules may not induce much new foreign investment to come to Botswana. The only clear cut exception that can be proven relates to multinational corporations that could well be induced to set up a regional headquarters in Botswana (see Chapter 4). However, this is not to say that other, presently unidentified, investment opportunities do not exist and that they would indeed be attracted to Botswana under a liberalised exchange control regime.

1.44. The possibility of setting up an international financial services centre in Botswana has been examined. Necessary conditions for such a new industry to be viable would need both a liberalised exchange control regime and an amendment to the Income Tax Act, to abolish withholding tax on interest earned on Nonresident bank accounts in Botswana. These would not, however, be sufficient; Botswana would also need to develop a much greater level of skills relevant to financial services than exist at present as well as broaden and deepen financial institutions and markets. In the short term, some additional expatriate skills will be required (see Chapter 4).

The broad initial investigations - the burden on the macro-economic managers

1.45. Another key finding is that the Ministry of Finance & Development Planning and the Bank of Botswana are right to be concerned about the future demand for high quality macro-economic decision makers in the Ministry and at the Bank. They are right to anticipate some possible financial and economic stress on the economy, and hence on senior civil servants and Bank staff, in some six to eight years time; **but the source of such financial stress will be the anticipated large government budget deficits and the resulting weakness of the current account of the balance of payments.** This is regardless of any exchange control liberalisation that might take place between now and then. In addition, there will be a continuation of the unauthorised capital flows that have been mentioned above (if controls have not been lifted by then). See Appendix 1. Exchange control liberalisation, to the extent that it is agreed by all concerned, will not be the **main** source of the future financial stress that the Ministry and the Bank will have to learn to deal with.

The broad initial investigations - the impact on the insurance industry

1.46. The local insurance industry is almost sufficiently strong to be able to stand up to competition from outside Botswana. If one wants to be doubly sure that the insurance industry would not be unduly damaged by exchange control liberalisation, then some residual protection could be provided to the industry under the Insurance Act. It is proposed that there would be enough time to amend the Act in the first nine months of 1994. See Appendix 7 for a detailed discussion.

LAYOUT OF THE STUDY

The main chapter headings

1.47. Chapter 2 discusses the experiences of a selection of developing countries which have liberalised exchange controls over capital account transactions. It also contains a detailed

bibliography. Mauritius was studied in some detail, even though it has not yet completely liberalised, because it appears to have many exchange control features in common with Botswana. Other countries in the sample whose various experiences are described include Argentina, the Bahamas, Bahrain, Brunei, the Channel Islands, Chile, Columbia, Hong Kong, Indonesia, Luxembourg, Malaysia, Mexico, the Philippines, Singapore, Thailand, Turkey, Venezuela and Vanuatu. Recent liberalising events in Zambia and Zimbabwe are commented on.

1.48. The vast majority of liberalising developing countries have experienced net capital inflows (more capital inflows than outflows) once controls were removed over capital account transactions. The only exceptions that have occurred, namely more outflows than inflows, have followed rapid increases in domestic spending fuelled by enormous government budget deficits, and a rapid increase in foreign indebtedness when a part of the deficit was financed by foreign borrowing.

1.49. It is interesting to note, however, that Botswana's situation differs in one major aspect from that of all the other liberalising countries amongst those studied. As a result of large foreign exchange reserves, Botswana will be able to postpone, e.g. for six to eight years, the inevitable impact of the rest of the world's financial trends on the Botswana economy. Whereas the other liberalising countries all have had to respond to interest rate changes in the developed world, and have also had to recognise pressures on their exchange rates due to capital flows in and out of their liberalised economies, Botswana will be at least partly immune from such pressures for a several years. See Appendix 3, plus remarks at para 4.44 and para 5.8.

1.50. Chapter 3 describes the rationale for exchange controls in Botswana, and their direct costs. One of the original reasons was that Britain introduced exchange controls in 1940 as a temporary war time measure to protect the British balance of payments. These British rules were then applied to the entire Sterling Area, including Botswana. The logic of this move has now been lost; many countries which previously copied Britain's example now continue to use exchange controls even though they have no such national military emergency. A common reason for maintaining exchange controls is to protect an over-valued currency. It follows that some overseas investors mistakenly expect to find that the currency is overvalued in Botswana, simply because Botswana has an exchange control system in place. American investors, in particular, think that there must automatically be a higher risk in investing in any country that has an exchange control regime in place.

1.51. Chapter 4 discusses the impact of Botswana's remaining exchange controls on foreign investment inflows. Although the removal of ECs would undoubtedly have a positive impact on such inflows, the magnitude is impossible to quantify at this stage, and it must be noted that besides ECs there are other, more severe, constraints to such investment.

1.52. Chapter 5 is an attempt to envisage the kind of macro-economic management that would be required to manage the Botswana economy, if there were no exchange controls at all. In the very long term, there could, for example, be some impact on the level of interest rates in Botswana if our interest rates were seen to be somewhat lower than those in the rest of the world in real terms. Short term effects are expected to be minimal. See Appendix 3.

1.53. Chapter 6 measures the immediate risk of capital outflows if there were to be an abolition of exchange controls tomorrow, and finds them to be rather small.

1.54. Chapter 7 summarises the conclusions of the report and makes a series of recommendations for the reform of the EC system in Botswana. We conclude that the benefits of complete removal clearly outweigh the costs, and that the risks of large unwanted capital flows originating with Nonresidents can be contained; and that the loss of income tax is manageable. We recommend that the Government commit itself to complete removal of exchange controls but that this be phased over a period of up to three years. Other recommendations cover the necessary accompanying actions.

The appendices

1.55. The appendices A1 through A18 contain large amounts of detailed discussion over a wide variety of topics related to exchange control liberalisation. There are cross references in the main body of the text to the various appendices.

1.56. Appendix 1 contains two forecasts of the level of the foreign exchange reserves ten years ahead, one without capital flight and one with capital flight. The forecasts indicate that the reserves will remain high, for the immediate future, under a variety of circumstances.

1.57. Appendix 2 looks at exchange rate policy. In the very long term, management of the pula's exchange rate will gradually become slightly more difficult.

1.58. Appendix 3 examines the likely impacts of exchange control liberalisation on the private sector. These are thought to be small.

1.59. Appendix 4 discusses the mechanics of foreign currency banking at banks in Botswana.

1.60. Appendix 5 briefly discusses some areas of Botswana law that would be affected by the liberalisation of exchange controls.

1.61. Appendix 6 discusses the taxation issue in more detail. An estimate is given of the net loss to the fiscus after accounting for tax lost on earnings from Residents' savings outside Botswana, less the savings from having to issue fewer BOBCs inside Botswana.

1.62. Appendix 7 covers the local insurance industry. Under current EC rules, insurance companies in Botswana are protected from foreign competition in that foreign currency is not normally available to Residents for the payment of insurance premiums outside Botswana. This would, however, appear to be primarily a trade restriction rather than a balance of payments restriction. It would therefore not affect Botswana's application to the IMF for Article VIII status.

1.63. Nevertheless, abolition of exchange control would remove the protection that the local industry currently enjoys. The issue of protection for the industry is discussed in detail in Appendix 7, but should be subject to further detailed consideration by Government before any decision is taken to move significantly from the present situation.

1.64. Should any continued protection of the insurance industry be found to be desirable, this could easily be achieved through the Insurance Act rather than through exchange controls. It is estimated that government could make any necessary amendment to the Insurance Act within a space of nine months of a decision to do so.

1.65. Appendix 8 comments on the fact that, under the existing EC rules, Non-resident controlled companies have to have their accounts audited, if they want to send a dividend to a shareholder outside Botswana. This rule would fall away if ECs were abolished.

1.66. Appendix 9 contains some key statistical indicators for selected liberalising countries. The sample of five countries all show rapid real growth rates, steady growth of their foreign exchange reserves, and a stable exchange rate for their currencies after liberalising their exchange control systems.

1.67. Appendix 10 examines a recent IMF working paper, in which the two authors suggest a series of tests that a country may apply, to see whether it is ready for abolition of exchange controls over international capital account transactions. Botswana meets the suggested tests.

1.68. Appendix 11 discusses an important logistical matter. At present, the Balance of Payments (BoP) section of the Research department of the Bank of Botswana obtains a great deal of data from exchange control forms, which arrive at the Bank in large numbers from the Authorised Dealers. A considerable effort will be required to find alternative sources of BoP data, if there are no exchange control requirements to fill in forms which explain why foreign currency is being either bought or sold.

1.69. Appendix 12 discusses the remaining current account constraints in the system, and Appendix 14 looks at known EC anomalies. The number of issues that would need to be looked at, during any interim period while one is waiting for exchange controls to be liberalised, is very large.

1.70. Appendix 13 lists those international capital account transactions which **are** permitted, under the existing rules.

1.71. Appendix 15 discusses both the principle and the detailed steps that would be necessary for Botswana to change from Article XIV status at the IMF to Article VIII status. In the view of the consultants, the change is overdue.

1.72. Appendix 16 discusses relations with South Africa. The burden of maintaining good relations will continue to rest with the commercial banks in Botswana, whether exchange controls are lifted in Botswana or not.

1.73. Appendix 17 describes some forms that can be modernised.

1.74. Appendix 18 discusses direct and portfolio investment abroad by Residents.

1.75. Appendix 19 lists the persons contacted during the study.

1.76. Appendix 20 provides a cross reference between the original terms of reference and the material of the present report, for ease of reference. The original terms of reference are also included.

2. *EXCHANGE CONTROL LIBERALISATION IN OTHER DEVELOPING COUNTRIES*

INTRODUCTION

2.1. The object of this chapter is to consider the experiences of other developing countries that have liberalised exchange controls over capital account transactions. A few initial thoughts are appropriate.

2.2. In a climate of post-debt crisis structural adjustment, deregulation and liberalisation throughout the developing world, the hitherto orthodox views of development economists and policy-makers about the need for exchange controls, and about the advisability of full or partial currency convertibility, are now changing -- albeit in Africa perhaps more slowly than elsewhere.

2.3. Developing country governments are beginning to realise that global financial markets now function in a more integrated fashion and in an entirely different technological and market environment to that which existed before. In small open economies (like Botswana), when the current account is almost fully liberalised, capital controls are rendered much less effective. This is especially the case when (unlike Botswana) the domestic economic environment, and the quality of domestic economic management, are such as to accentuate the natural propensity for Residents (whether corporate or personal) to acquire foreign assets for portfolio risk diversification purposes, to protect net worth.

2.4. Even in economies that attempt to be closed, parallel markets emerge which make exchange controls increasingly irrelevant to transactions in the real economy. In such economies all that exchange controls achieve is to shrink the size of the official or recorded economy, relative to that of the parallel economy. This has been the case with some of Botswana's SADC neighbours. However, recent actions taken by Uganda, Zambia and Zimbabwe in changing their exchange control regimes (ECRs) have now made their regimes more liberal than before, and perhaps even more liberal than Botswana's for small transactions on the capital account.

2.5. Between 1945-80, it was almost axiomatic that developing countries would restrict the use of a scarce resource (i.e. foreign exchange) with rules which governed all types of foreign transactions, whether on current or capital account. It was the normal, unquestioned presumption that exchange controls were an integral and necessary component of any developing country's economic management infrastructure; with the burden of proof being on proponents of "openness" to establish beyond doubt that such controls were not needed.

2.6. In the emerging new orthodoxy -- which is based on market-oriented ideology as well as (not so extensive) empirical analysis of cross-country experience and performance between 1984-93, and some limited attempts at partial econometric analysis -- the presumption now is that ECRs in developing economies should be open and unrestricted; **with the burden of proof being placed on opponents of openness**, who may be asked to "prove" that particular restrictions on ECRs would result in greater efficiency and welfare gains to a particular economy.

2.7. Comparative experience from different countries on these issues is discussed in some detail below although enough information is not available to dwell on all at equal length. The experience

of Mauritius is reported on more fully. Although Mauritius still has some exchange controls remaining, its situation is similar to Botswana's in many ways.

ADEQUACY OF RESERVES PRIOR TO LIBERALISATION

2.8. The issue of attaining a degree of 'reserves adequacy' prior to liberalising or removing exchange controls has been an important consideration in all countries which have removed exchange controls in the last decade. But generally, liberalising countries have had lower reserves than Botswana now has relative to their "buffer needs" at the time when they liberalised.

2.9. When Singapore removed exchange controls its reserves were about US $1.5 billion (or about 7 weeks of total imports).

2.10. In Indonesia capital controls were removed in 1971 (reserves were about US $1.2 billion) but current account restrictions remained. Interestingly enough, in Indonesia, policy-makers felt that subjecting the domestic economy to the forced discipline of an open capital account would prevent government from indulging in domestic fiscal and monetary excesses, with movements in the rupiah interest and exchange rates (caused by capital movements) establishing the parameters for government expenditure and the extent of tolerable fiscal deficit monetisation.

2.11. Ensuring an adequate build-up of reserves was important for Mauritius with progressive ECR liberalisation being loosely linked to higher degrees of reserves accumulation though no direct linkage or correlation has ever been explicitly established.

2.12. Though portfolio investment has not yet become a source of major flows largely because of the relative absence of varied financial assets and the existence of strictures on the purchase of land and real property by non-citizens, Mauritius' experience with liberalisation so far has been a significant net inward flow of foreign direct investment but probably for reasons which may not apply with equal force to Botswana (e.g. linkages with the overseas Chinese community, literacy levels and tactility of the labour force, real productivity-adjusted wage rates which, though rising rapidly, are more competitive than in Botswana etc.). In other countries which have liberalised their ECRs since the mid-1980s, gross reserves have accumulated very rapidly (particularly in Chile, Mexico and Thailand) as a result of large inflows of portfolio capital.

2.13. Against the experience of almost every other country which has liberalised its ECR since the debt-shock of the 1980s, the present level of Botswana's reserves (US $4.5 billion) relative to the size of its import needs and of its domestic economy would point to liberalising or even removing all capital and current account controls.

2.14. Many countries which have undergone major structural reform since the mid-1980s and have liberalised their ECRs, are now contemplating liberalising or removing capital controls with relative reserves-to-GNP and reserves-to-imports ratios which are far lower than Botswana's. Hence the inadequacy of reserves is no longer a valid argument for forestalling the further liberalisation and relatively early removal of capital controls in Botswana.

CAPITAL FLIGHT COMPARED WITH TIGHTNESS OF CAPITAL CONTROLS

2.15. The coincidence between countries with the tightest capital controls suffering the largest losses in terms of capital flight is instructive; especially when such controls have been erected to

shield sustained domestic macroeconomic mismanagement. These include most countries in Africa prior to embarking on their reform programmes, as well as in South Asia and in Latin America (where capital controls which had been removed in the mid-1970s were reimposed after the debt shock of 1982). Countries with looser or no exchange controls, whose environments are perceived as being politically and economically stable, which no longer have a major external debt overhang, and whose domestic policies offer attractive real rates of return on investment, whether of the direct or portfolio (i.e. on readily negotiable and transferable financial or real estate assets) kind, have usually benefited from the opposite effect -- i.e. large and sustained inflows of capital which have sometimes had the unintended effects of exerting upward (appreciation) pressure on their exchange rates, threatening to vitiate the benefits of their trade liberalising reforms.

INFLOWS OF CAPITAL INTO LIBERALISING COUNTRIES

2.16. Countries which have recently benefited from large capital inflows on partially or fully opening their capital accounts include, for example, Argentina, Chile, Colombia, Mexico, Indonesia, Malaysia, the Philippines, Thailand, Turkey and Venezuela. Other small, open economies which have been remarkably successful with their open capital accounts are of course Hong Kong, Singapore, Taiwan and many "haven islands" in the English Channel, the Caribbean and the Pacific. Mauritius with its offshore banking approach (effectively a quarantined open capital account) has launched an experiment which seems likely to succeed and eventually embrace the domestic economy as a whole.

2.17. Clearly there are factors which differentiate these economies from Botswana; some quite sharply. But the similarities and differences need to be seen in perspective with a balanced viewpoint being taken of possible private capital outflows -- which will inevitably occur with liberalisation and eventual full opening of the capital account -- from domestic sources being offset, possibly by a significant margin, by private capital inflows from neighbouring and other foreign sources which might be equally anxious to acquire assets in Botswana providing the environment for encouraging such inflows is right.

INTERNAL CONVERTIBILITY

2.18. Internal convertibility is defined as the legal right of Residents to acquire and maintain domestic holdings of assets denominated in foreign currency. Many developing countries now permit internal convertibility; some permit it for individuals but not for enterprises (e.g. Poland) while others permit the opposite even when they maintain extensive exchange controls on both the current and capital account (Sierra Leone and Liberia). Internal convertibility makes it very difficult to maintain effective restrictions on capital outflows which can be much harder to detect and prevent than outflows through a restricted current account.

EFFECTS OF RETAINING EXCHANGE CONTROLS IN BOTSWANA

2.19. There is some anecdotal evidence to suggest that Botswana's capital control regime (coupled with its concern about the social and political implications of an influx of high-level professional expatriates) may have prevented it from parlaying its "regional safe haven" characteristics into material domestic economic benefits -- in terms of high-value added service jobs, revenues from regional entrepot trade, and financial transactions etc. It may have done so by preventing

Botswana from taking other proactive measures to develop Gaborone -- during the course of the sanctions regime applying to South Africa-- as an attractive centre for major multinationals and other regional corporations from establishing regional headquarters in the mining, trade, finance, tourism, construction, surface/air transportation, and professional services (accounting, consulting, legal, engineering) industries. Singapore and Hong Kong had managed to do that in much the same way in their respective regions, and Mauritius is now attempting to do the same in the Indian Ocean.

2.20. Rapid and unrestricted capital convertibility is a *sine qua non* for encouraging such operations to locate in any jurisdiction. Whether that window of opportunity is now closing in Botswana remains to be seen, depending on the shape of the macroeconomic policy regime which emerges in South Africa and in other neighbouring countries (particularly Zimbabwe whose physical, institutional and human infrastructure may provide a competitive edge over Botswana when the location of such "co-ordinating management centres for regional operations" is being considered).

THE RISK OF CAPITAL OUTFLOWS

2.21. The general lesson that appears to emerge (with some noteworthy exceptions) from the experience of other liberalising countries in the 1980s is that concerns about the risk of destabilising capital outflows, when exchange controls are relaxed, may perhaps be misplaced for two reasons. First, in the current international financial system, capital outflows will occur irrespective of whether or not exchange controls are applied, if domestic macroeconomic management is viewed by the domestic and external community as untenable. Second, if the current account is kept fully or partially open (as indeed is now increasingly the case across the world), control over the capital account becomes increasingly difficult to enforce.

THE QUALITY OF MACRO-ECONOMIC MANAGEMENT

2.22. Learning from the experiences of diverse developing countries, the key lesson from the city-states of Hong Kong and Singapore to those as large as Indonesia and Mexico seems to be one of maintaining confidence on the part of the domestic and external community that, in the face of an open capital account with its immediate transmission of external shocks and pressures to the domestic economy, the quality of short and long-term domestic macroeconomic management will be such as to offer attractive real returns on investment whether direct or portfolio, and whether domestic or foreign. That is not to say that even countries with sound macroeconomic management do not temporarily suffer capital outflows that threaten to be destabilising -- as indeed Indonesia, Malaysia and Singapore have experienced from time to time and as Hong Kong experienced in 1983, after which it fixed its exchange rate against the US dollar. But when that happens, the openness of the capital account, coupled with realisation on the part of global markets that domestic policy is indeed tenable, results in those situations (which generally reflect some form of temporary market failure) being quickly reversed.

2.23. The experience of the Southern cone countries (Argentina, Chile and Uruguay) in this regard is useful to review since many observers have casually (and erroneously) linked the removal of capital controls in these countries in the 1970s to the emergence of their debt problems and to the accompanying phenomenon of capital flight. The several studies which have been done on these

countries suggest that capital controls *per se* probably had little or no influence on either increasing their vulnerability to excessive external borrowings or on capital flight. Instead these studies showed clearer correlations between uncorrected distortions in domestic economic policies and these two outcomes. The most critical domestic policy distortions which explained both the build-up of excess debt and capital flight were: unsustainably large fiscal deficits, excessive monetisation of these deficits, high inflation, high spreads between domestic and external interest rates which encouraged external borrowing, excessive government borrowing to finance domestic deficits, and the maintenance of overvalued exchange rates for prolonged periods.

2.24. Removal of capital controls in these countries by itself appears to have contributed relatively little to the debt problem or the capital flight problem since: (a) except for Chile, most of the external borrowing was done by governments and parastatals, and not by the private sector; and (b) the bulk of capital flight occurred from these countries after capital controls were reintroduced. Moreover, other countries which retained capital controls did not manage to prevent a debt crisis from emerging, nor did the same controls prevent capital flight.

2.25. As a corollary, it is also instructive to note that those countries in East Asia which liberalised their exchange and capital controls did not suffer either a debt problem or a capital flight problem; again because their domestic macroeconomic policies were viewed by domestic as well as external agents as being more tenable and sustainable. Indonesia, which had an open capital account and a heavy external debt burden decided to maintain its openness and yet escaped both a debt crisis or the phenomenon of sustained large net outward flows of capital.

2.26. What all these experiences point to is the conclusion that: (i) **the quality and credibility of domestic economic policy plays a far more important role than exchange controls in determining the vulnerability of a country to excessive external debt and to the direction of capital movements; and (ii) there is an important connection between liberalisation of the domestic financial sector (and its rate of integration with the international financial system) and success in removing capital controls.** This second point involves critical issues related to sequencing which are addressed later.

INITIAL CONDITIONS AND THE PROCESS OF EXCHANGE CONTROL LIBERALISATION

2.27. In considering the further relaxation or removal of exchange controls it is important for developing country governments to be clear about the *raison d'être* for doing so and to appreciate differences in the initial conditions in which different countries have found themselves before embarking on changes in their ECRs. The experience of different **developing** countries falls into the following categories:

2.28. Small open market-based economies which have removed exchange controls in order to develop manufacturing and service-based entrepot economies, with some having gone on to develop a successful, internationally integrated financial services sector. Bahrain, Djibouti, Hong Kong, Macao, Panama and Singapore are good examples of such countries while Mauritius is now in the process of attempting to emulate their success. Other economies have removed controls to develop their offshore financial services but have remained tourist economies rather than entrepots (e.g. the Bahamas, Cayman Islands, the Channel Islands, Netherlands Antilles, Vanuatu). These economies had virtually no natural resource endowments, except for their geographical locations,

and limited financial reserves when they first embarked on "openness". Initially they had open policies on the inward migration of people which have become progressively more restrictive with rising levels of development and income. Guatemala is an interesting case of a small Central American country, not very richly endowed, with an open ECR and no capital controls which does not quite fit into the above category or any of the others listed below.

2.29. Oil-producing economies whose export earnings from a mono-resource far exceed their import needs. Their openness is based on the comfort derived from large foreign reserves, coupled with a drive to modernise their economies through vertical integration based on their oil resources. These include mainly the oil-exporting countries in the Persian Gulf and Brunei. Some of these economies are also attempting to develop into manufacturing, trading and transport entrepots as well as financial service centres with some notable successes (such as the Emirates). Botswana is comparable more to some of these countries than to many others. Their initial conditions are defined as being less constrained by financial resources than by manpower and absorptive capacity limitations, with different economies having adopted different approaches to relieving these constraints.

2.30. Medium-sized industrial developing countries which have succeeded in developing a large, diversified base of manufacturing exports (occasionally alongside commodity exports) originally with stringent capital controls which have been gradually relaxed. Some of these economies have opened or reopened their capital accounts in the 1980s as part of an externally driven process of adjustment and liberalisation following a debt crisis (as in Latin America) while others have opened up as a result of domestically driven demands for greater integration with the world trading and financial system (as in East Asia). These countries include for example Argentina, Chile, Uruguay and Venezuela in Latin America and Malaysia, the Philippines, Taiwan, and Thailand in East Asia.

2.31. Larger, diversified economies with a well-developed manufacturing and service industry base as well as relatively sophisticated domestic financial sectors which have been progressively liberalised and are becoming increasingly integrated with the international financial system. Their primary objective is to offer an attractive environment for international direct and portfolio investment in order to reduce their dependence on external debt and to assure potential investors of the soundness of domestic economic policy. These include countries such as Indonesia, Mexico and Turkey. Other large countries which have recently executed a U-turn on exchange controls having completely freed their current accounts and intent on moving progressively towards greater ECR liberalisation coupled with the liberalisation of their domestic financial systems include India and Pakistan.

THE IMPACT OF LIBERALISING EXCHANGE CONTROLS

Capital Flows, Exchange Rates and Asset Prices

2.32. Earlier sections have already alluded *en passant* to some of the risks of capital flows likely to be induced by opening up the capital account in Botswana, pointing to the conclusion that the risks do not appear to be particularly high. This section deals with comparative experience in more detail and attempts to bring relevant experience to bear on the Botswana case.

2.33. Virtually all of the developing countries that established full convertibility on the capital account during the 1980s experienced significant increases in <u>gross</u> capital flows in both directions

but with overall net increases in capital *inflows* which were quite large relative to the size of their domestic financial systems. The reason was that when domestic financial systems in these countries were liberalised, in conjunction with capital account convertibility, high ex post real domestic interest rates (and equivalent returns on other securities) materialised. In many instances there was a high positive (exchange-risk adjusted) spread between the *ex post* (and *ex ante*) domestic interest rate and comparable international interest rate. **In almost all of these cases there was an appreciation of the real exchange rate.** This appreciation occurred notwithstanding differences among countries in: (a) their exchange rate arrangements; (b) the speed with which they had liberalised capital controls; (c) the ultimate sustainability of their ECR liberalisation; or (d) whether there was a net capital inflow or outflow resulting from the combined effect of financial sector and exchange control liberalisation.

2.34. In some instances the absence of capital controls led to the emergence of periodic asset price bubbles for securities, or real property (as in Hong Kong, Indonesia, Macao, Malaysia and Singapore) which eventually burst with a few disruptive short-term consequences whose effects did not endure. In Mauritius, land purchases by non-citizens were prohibited a few years ago when the absence of such prohibitions led to a dramatic rise in land prices fuelled by foreign purchases, leading to a situation in which few Mauritians could afford to purchase any land.

2.35. The experience of developing and industrial countries suggests that these effects of opening the capital account on capital flows, exchange rates, and asset prices can, to an extent, be moderated (if anticipated in advance) and the ECR liberalisation sustained by taking certain measures prior to opening the capital account and maintaining them thereafter. Such policy, institutional and regulatory measures would include:

- Maintaining a stable macroeconomy prior to and after ECR liberalisation.
- Reducing fiscal deficits to levels which can be financed in a non-inflationary manner.
- Minimising levels of inflation and reducing the effect of the "inflation-tax".
- Increasing flexibility for market-driven changes in wages, prices and interest rates.
- Limiting the domestic taxation of financial income, wealth and transactions.
- Liberalising the domestic financial system away from directed credit and administered rates.
- Reducing differences between domestic and external financial market conditions.
- Encouraging competition in the domestic market between domestic and foreign banks.
- Limiting the size of the "deposit insurance" safety net provided to the financial system (Botswana does not have any such system).
- Strengthening prudential supervision of the financial system to international levels.
- Ensuring sufficient risk-management capability in the financial system.
- Introducing instruments and capability in the financial system for hedging forward risks.
- Phasing ECR liberalisation at a pace commensurate with taking these other measures.

2.36. But, in the quarters where concern is expressed about "rich Batswana moving their money out" if capital controls were relaxed, insufficient attention is being paid to the equal and opposite prospect of Non-residents moving their money into Botswana. The southern African region, though moving through difficult transitions (hopefully in the right direction), remains in a state of economic and political flux. In such a neighbourhood, Botswana's safe haven characteristics should not be underestimated if its financial system were sufficiently liberalised, sufficiently efficient and sufficiently integrated with the international financial system, to offer the appropriate services for the protection of capital.

2.37. Capital flight has occurred from South Africa (despite stringent exchange controls and the dual exchange rate) over the last decade, and will continue to occur for the foreseeable future, although little of that capital appears to have touched Botswana. Equally, similar amounts of flight capital from SADC countries has also occurred, again without much of it apparently touching Botswana. Under a different domestic financial regime, it is entirely conceivable that Botswana could become a centre for regional (if not international) capital flows, although the size and extent of its potential in that regard remains a matter of open argument.

2.38. From experience elsewhere, the evidence suggests that opening the capital account after making the necessary changes in the domestic financial system (and therefore an increase in the interest rate structure) could result in a short-run **appreciation** of the exchange rate which Botswana would, for a variety of reasons (not the least being wage competitiveness), prefer to avoid. It is likely that any appreciation would not be as large as in other liberalising economies where expectations of a turnaround due to changed policies were transformed. On the other hand, if interest rates in Botswana remain at current levels, through the judicious use of Bank of Botswana Certificates, there would be no reason for the pula to appreciate. Pressure could also be taken off the pula's exchange rate if foreign currency bank accounts were available to Residents and if such bank accounts offered positive real rates of interest.

2.39. In the absence of wage flexibility, an exchange rate appreciation would make Botswana's productivity-adjusted wage rates even less competitive than they are now. The impact of an open capital account on exchange rates, domestic interest rates, and domestic inflation would introduce more complexity into the domestic policy-mix and make greater demands on the economy's managers.

2.40. In looking for possible solutions, the experience of East Asian countries in managing their exchange rates (to avoid sustained appreciation) with open or quasi-open capital accounts and floating exchange rate regimes is instructive. Under the exchange rate regimes of the 1980s, East Asian policy makers attempted to influence rates at the margin (through open market operations) generally to move in parallel to the US dollar (which represented the currency of their main export market), maintaining a stable if at times slightly undervalued exchange rate. Most importantly, the ability of East Asian economies to keep their macro-fundamentals in line by adjusting immediately to externally transmitted shocks, enabled them to avoid sharp swings in real exchange rates even under duress.

2.41. In contrast, countries in Latin America and Africa did not depreciate their exchange rates quickly or sharply enough in the face of high inflation. Some Latin American countries attempted to use the exchange rate as a nominal anchor against high inflation but failed because of their

inability to keep their other macro fundamentals in equilibrium, leading to the collapse of the real exchange rate and sharp real devaluations.

2.42. The prospect of an open capital account leading to asset price bubbles in Botswana is relatively limited. It is difficult (though not impossible) to see the prices of Botswana's limited number of securities being bid up rapidly as a result of large speculative external capital inflows or prices of land shooting up because of speculative buying by foreign purchasers (as happened in Mauritius).

Domestic Macro-economic Management

2.43. In East Asia, with the general relaxation of capital controls, there has been a shift from fixed to flexible (but managed) exchange rates. With financial liberalisation during the 1980s, there has been a general shift on the part of Asian monetary authorities to targeting interest rates or money supply aggregates away from directly controlling credit. In Indonesia, capital flows responding to differentials between domestic and international interest rates and to exchange rate expectations became a major source of monetary disturbances in the early 1980s. Domestic interest rates were particularly sensitive to exchange rate expectations because of the openness of the capital account. Indonesia adopted interest rate targeting following its financial reforms of 1983, because of concerns that targeting monetary aggregates in the wake of major financial sector changes and large asset portfolio shifts would result in undue instability in the level of interest rates with potentially adverse effects on output.

2.44. In mid-1987, when the Indonesian rupiah came under speculative pressure, policy shifted to protecting international reserves with greater flexibility in interest rates being tolerated. Other Asian countries (Korea, the Philippines, Thailand and Malaysia) have targeted monetary aggregates.

2.45. Singapore does not rely on either credit or monetary targets. Because of the high degree of capital mobility (and almost perfect substitutability between domestic and foreign financial assets), monetary aggregates are essentially demand determined. Any disequilibrium is resolved almost immediately through external capital flows. This results in domestic and international interest rates moving in tandem. Instead Singapore relies on targeting its exchange rate to influence domestic wages and prices through its effect on tradable goods prices.

2.46. Corresponding to changes in targets of monetary policy with more liberal capital accounts and flexible exchange rates, Asian countries also changed their chosen instruments for implementing policy, moving away from direct controls toward greater reliance on market-based instruments. That shift entailed greater reliance on open market operations, less dependence on reserve requirements, and a change from selective to generalised rediscounting. Initially, open market operations were limited by the absence of government debt instruments and the thinness of private money markets. The shift towards open-market operations was therefore accompanied by the issuance of central banks' own debt instruments (as in Botswana), the use of private money market securities and measures to develop inter bank markets, and secondary markets in short and long-term government securities.

2.47. These measures necessitated bringing yields on government securities in line with market yields and discontinuing forced absorption of below-market government securities by commercial and central banks. With open market operations influencing the absorption and injection of bank

reserves, the reliance on high reserve requirements was reduced, reflecting the changing view of Asian monetary authorities that reserve requirements were relatively blunt instruments -- i.e. small changes in reserve requirements usually precipitated large and occasionally disruptive shifts in commercial bank assets.

2.48. Fiscal policy can become more effective with an open capital account because (theoretically) there is less crowding out. By the same token, an open capital account enforces a measure of external discipline on assuring fiscal responsibility on the part of government, the absence of which results immediately in the imposition of penalties through adverse movements in interest and exchange rates. With an open capital account, fiscal policy can thus become a more effective alternative instrument to monetary policy for controlling short-run fluctuations in aggregate demand. The cost of more complexity (and decreased effectiveness) of monetary policy with an open capital account, must be weighed against the benefit of enhanced discipline over, and enhanced effectiveness of, fiscal policy.

2.49. An open capital account, by placing limits on the ability of governments to pursue counterproductive policies for too long without the imposition of penalties, can reduce the scope for arbitrary government excesses, resulting in an improvement in the credibility of policy and restoration of lost reputation.

Domestic Financial System and Capital Markets

2.50. Whereas in most Latin American countries the relaxation of exchange and capital controls in the 1980s appears to have occurred in the context of externally induced trade and exchange regime liberalisation, in East Asia it has occurred more as part and parcel of overall financial system liberalisation which increased the degree of integration between domestic and international financial markets. In both cases, ECR liberalisation, and especially the removal or relaxation of capital controls, has had a significant impact on the structure and functioning of the domestic financial system. Conversely, where ECR liberalisation has run into difficulty it has invariably been because prior policy and institutional reforms to liberalise, widen and deepen the financial system were not made in the right sequence.

2.51. The experience of other countries suggests strongly that domestic financial deregulation and liberalisation is a key precondition to liberalising the ECR, thus permitting access on the part of Residents to acquiring foreign assets (usually through the international financial system). If Residents are to be given easy access to international financial markets through foreign banks, then the domestic banking system must face essentially the same regulations and controls on interest rates and portfolio composition as foreign banks in their home market to remain competitive. Moreover, the domestic banks must have sound portfolios.

2.52. What is said about banks applies with equal force to other types of financial institutions (especially long-term lending institutions such as development banks) and capital market institutions, including stock exchanges.

2.53. The removal of capital controls may provide a spur and encourage the development of a more vibrant banking and financial services sector, perhaps made more competitive with the more aggressive entry of banks and financial institutions from South Africa, and possibly even from elsewhere in Africa, which enter Botswana to offer new products and services which the opening of the capital account will permit.

2.54. The question that arises, however, is whether Gaborone can develop as a genuine regional financial services centre when the most sophisticated financial centre on the African continent -- i.e. Johannesburg -- is a mere fifty minutes away by air and only four hours away by road. That window of opportunity may have been open in the 1980s and could have led Gaborone to develop the necessary financial and physical infrastructure during the sanctions regime, had that been a policy objective pursued by the authorities.

2.55. For these possibilities to materialise, opening the capital account may be a necessary but, by itself, not a sufficient condition. Capabilities for providing such services will need to be proactively developed and marketed throughout the region by financial as well as 'support service' institutions.

2.56. The development of such activity will require the further development of a strong regulatory framework for financial services as well as the creation and expansion of efficient machinery for effective supervision and enforcement which adheres to internationally accepted standards and norms. It will also require establishment of a clear notion of the extent of the "safety net" which the government is willing to underwrite to safeguard the assets of Residents and Non-residents which are "booked" in Botswana.

Domestic Savings, Investment, Growth and Wages

2.57. Among the issues that concerns policy-makers considering liberalising the capital account is the relationship, if any, between domestic savings and investment and international savings and investment. In countries (developed and developing) with completely open capital accounts, foreign savings rarely finance more than 10-15% of total domestic investment (except in the heavily concessional aid-dependent low-income African countries), so that levels of domestic investment remain heavily influenced by levels of domestic savings in most developed and developing countries.

2.58. In East Asia, inflows of foreign investment (direct and portfolio) have increased substantially with progressive capital account liberalisation and are generally observed to occur in countries which also have high domestic savings rates. Thus domestic investment, driven largely by domestic savings, is augmented at the margin by foreign savings which find rates of return in these countries attractive -- both on short-term portfolio investment as well as on long-term capital investment. Recent large capital inflows into Latin American countries such as Argentina, Chile, and Mexico also appear to be associated with high domestic savings rates. In these countries, foreign savings have perhaps played a larger role in reviving domestic investment between 1989-93 because a fairly large proportion of Latin American domestic savings (which have remained relatively stable as a proportion of GNP) has been devoted to making relatively large repayments on foreign debt.

2.59. By comparison, a relatively closed capital account has not yielded the same benefits to India which has a high domestic savings rate but a relatively low rate of foreign direct or portfolio investment (although foreign savings do play a role through inflows of fairly large official and commercial borrowings).

2.60. In the case of Botswana it is difficult to make the argument that opening the capital account would necessarily lead to an increase at the margin in the level of domestic investment given the limited range of investment opportunities available.

2.61. As a matter of economic policy, opening the capital account would require government to address more frontally the question of what strategies to adopt to correct the artificially high productivity-adjusted wage rate in Botswana.

The effect of liberalisation on neighbouring countries

2.62. A more liberal ECR in one country relative to neighbouring countries will influence the direction of capital flows. This has been the quintessential experience of "safe havens", some of the characteristics of which Botswana has in its own region. It has been particularly true of Switzerland which has been a magnet for capital flows from Europe in general (particularly from neighbouring countries such as France, Italy and Germany) and the rest of the world (in particular the Middle East and Africa). To a lesser extent it has also been true for Luxembourg and Liechtenstein. Similar financial service centres exist in other regions of the world. Havens such as the Caribbean islands and Panama service clientele from the western hemisphere; while centres such as Hong Kong and Singapore cater to the clientele of East, South and North Asia, as well as Australia and New Zealand. The financial services industry in all of these centres has become a leading generator of growth, jobs and economic diversification with significant spillover effects for growth in the real sector.

2.63. In Eastern Africa, the liberalisation of exchange regimes (but not yet of capital controls) has resulted in major changes in Tanzania and Uganda through the operations of foreign exchange bureaux, which have not been matched by Kenya in quite the same way. There is some anecdotal evidence of consequential cross-border capital movement within the trading communities which still tenuously link these three economies, though none of it has as yet been confirmed by hard empirical analysis. In Southern Africa too, significant ECR liberalisation measures have been taken by Zambia and Zimbabwe which, if continued, must be taken into account in the formulation of Botswana's own policies. Mozambique allows its citizens to maintain US $ bank accounts at the local banks, if they have a natural source of earnings.

2.64. There can be little question, based on experience elsewhere, that Botswana's opening its capital account, with the attendant changes that will need to take place in its interest and exchange rate regimes, will impinge on net capital flows to/from its neighbours. The largest source of capital flows to Botswana will almost certainly be South Africa, and perhaps to a lesser extent Zimbabwe, depending on the degree to which (and the speed with which) Zimbabwe's adjustment programme succeeds in liberalising the economy and turning its fortunes around.

2.65. However, given the continuing high degree of political violence in South Africa and uncertainty about the course and direction of the interim South African government's new economic policies and taxation regime, capital flight from South Africa (from the wealthier segments of all racial communities with transferable or mortgageable wealth) is expected to continue and probably increase considerably over the next 2-3 years.

SEQUENCING ECR LIBERALISATION

Theory & Orthodoxy

2.66. As noted earlier in this part of the study, the issue concerning further ECR liberalisation is not whether Botswana should liberalise, but how and how quickly ? What does the experience of other countries have to suggest in this regard ? Traditionally, certain preconditions have been

specified for currency convertibility which include: (1) an appropriate equilibrium exchange rate; (2) an adequate level of reserves; (3) the absence of any monetary overhang; (4) a distortion-free market-environment in which price signals are transmitted effectively and to which economic agents can respond flexibly; and (5) macroeconomy stability with the pursuit of credible long-run policies promoting growth of output and employment.

2.67. From the perspective of pure theory, it can be argued that, in the absence of price or exchange rate rigidities or market imperfections, both the current and capital accounts should be liberalised simultaneously without too much concern about phasing.

2.68. The more orthodox view that current account opening should precede liberalisation of the capital account is justified using the following rationale. Current account liberalisation usually requires a *depreciation* of the real exchange rate to counteract the effects of reductions in average levels of tariff protection on the balance-of-payments. But capital account liberalisation tends to produce an initial *appreciation* of the real exchange rate (for reasons discussed earlier). [In the case of South Africa, the combination of high customs duties to protect local manufacturers and assemblers, plus subsidies to uncompetitive exporters, all suggest that the rand may be overvalued at present].

Latin American Experience

2.69. The experience of the Southern Cone countries in the mid-1970s has also generated considerable argument about proper sequencing of ECR liberalisation. Chile first liberalised its current account with trade reforms which began in 1973 and were substantially completed by mid-1979. Capital controls on long-term capital movements were first lifted in mid-1979 and largely removed by 1981 although significant controls on short-term capital movements remained till 1982 when capital controls had to be reintroduced. This sequencing contrasted with the approach taken by Argentina and Uruguay which liberalised their capital accounts before their trade reforms were in place and their current accounts were fully opened. All three countries liberalised their domestic financial sectors at about the same time. Other aspects of domestic macroeconomic management were, of course, different in each of these three countries with the extent of fiscal reform in particular differing considerably. But, despite their different approaches, these liberalisations failed in all three countries leading to a debt crisis in all of them and to considerable continuing argument about the importance (or relevance) of sequencing relative to the play of other factors and influences.

2.70. Unlike Botswana, all three countries were characterised by a high degree of macroeconomic instability which was not entirely exogenously induced. Instability in these countries was partly heightened by the liberalisation strategy pursued, in particular by the effect of opening the capital account on the real exchange rate. The main endogenous problem in Argentina and (to a much lesser extent) Uruguay was the failure to control the fiscal deficit. Moreover, all three countries deregulated interest rates in the face of pronounced macroeconomic instability in financial markets which were imperfect and oligopolistic. Real interest rates therefore rose to very high levels discouraging investment, slowing down growth, leading to large scale insolvency of enterprises and precipitating a crisis in the financial system thus amplifying systemic instability. Removal of capital controls at the same time put further upward pressure on interest rates to compensate for expectations of currency devaluation. When the domestic currency was not permitted to depreciate at a rate which reflected the differential between domestic and foreign interest rates, all three

countries experienced large-scale short-term capital inflows. This undermined monetary control and added to inflation. Perversely, these capital inflows also contributed to upward pressure on the exchange rate at a time when the exchange rate needed to depreciate.

2.71. In Chile, the problems of a real exchange rate appreciation were aggravated by a system of wage indexation which was based on previous rather than current rates of inflation, resulting in a sharp rise in real wages which quickly contributed to uncompetitiveness, a deterioration in Chile's current account and reduced output. In Uruguay the exchange rate appreciation was accompanied by a growing fiscal deficit which was financed by an unsustainable level of foreign borrowing. In all three cases these different problems led to a perception that macroeconomic policy was non-credible and unsustainable, eventually triggering large-scale capital flight, a balance-of-payments crisis and abandonment of stabilisation efforts in 1982. Though the lessons of Argentina's and Uruguay's experience are still being debated and appear less conclusive, the Chilean case seems to suggest that, in those or similar circumstances, it was prudent to liberalise the current account first because of the relationship between macroeconomic stability, capital flows, the real exchange rate, and the credibility of policy.

2.72. In Chile's case experience also suggests that the capital account might have actually been opened more slowly than it was, after the full impact of trade reforms had been absorbed and appropriate measures had been taken to avoid an overshooting of the real exchange rate. Informed observers felt that the pace of capital account liberalisation in Chile could (and should) have been graduated through means such as: varying taxes on short-term capital inflows which threatened to be destabilising from a high level of initial taxation to a progressively lower level in later stages; varying differential reserve requirements on the use of foreign capital by banks; and varying the other limitations placed on the use of foreign capital by banks and other financial intermediaries. The importance of limiting the use of foreign capital by financial institutions was seen as necessary because of the multiplier effects that this particular use of foreign capital has in the domestic system.

2.73. In Mexico, ECR liberalisation occurred in the late 1980s after the debt crisis hit (whereas in the Southern cone it occurred before and may have exacerbated its effects). In contrast to the Southern cone countries which liberalised their financial systems quite early in the overall reform process, Mexico deregulated its financial system only in mid-1989 and, perhaps learning from Chilean experience, liberalised its capital account slowly. Though several exchange controls were dropped or loosened earlier, restrictions on inward foreign direct investment were relaxed late in 1989 while other capital controls (especially on short-term capital flows) were retained. Fiscal reforms between 1983-87 eventually resulted in a fiscal surplus in the primary balance (excluding interest payments) of 3% of GDP in 1987, though total (domestic and external) interest payments accounted for nearly 18% of GDP, resulting in an overall deficit of 15% of GDP and a still high (though declining) inflation rate of over 50%.

2.74. Following a large devaluation, a new stabilisation programme announced at the end of 1987 aimed at breaking inflation through a wage-price-exchange rate freeze agreed under a social pact with business and labour. The new programme reduced inflation but resulted in a real exchange rate appreciation with a sharp increase in the peso-dollar interest spread favouring peso assets and large net capital inflows in the form of repatriated capital. When interest rates were liberalised in 1989 domestic real interest rates rose again, widening the peso-dollar spread. Reacting differently to the Southern cone countries, the Mexican authorities announced a fixed rate of depreciation of

the exchange rate (at one peso per day between January 1989 and May 1990) and intensified domestic fiscal adjustment. The combination of these two measures, along with Mexico's Brady Plan debt accord in 1989, resulted in real interest rates declining, the rate of exchange rate depreciation slowing, and enhanced policy credibility with continuing net capital inflows. Mexico thus managed the transition to lower interest rates, reduced inflation and an appropriate real exchange rate without having to reintroduce capital controls as was the case in Argentina, Chile and Uruguay.

East Asian Experience

2.75. The experience of the East Asian countries was quite different. Except for the Philippines (which was more like a Latin American case) their liberalising adjustments were not made under the pressures of macroeconomic instability or in exiting from a debt crisis. Instead, with their continuing export-driven economic success, these countries all liberalised their financial systems during the 1980s not under duress but as a matter of natural economic progression. Overall, the process of financial and ECR liberalisation has been a gradual, phased and continuing process rather than occurring spasmodically (as in Latin America) through discrete episodes of radical liberalisation followed by corrective reversals.

2.76. Prior to the 1980s, however, these economies contradicted the view that free and open financial markets are most conducive to growth by employing tightly administered capital controls to encourage domestic accumulation when domestic savings were rising. Capital controls were imposed to retain domestic savings, insulate domestic interest rates and monetary conditions from foreign influences, and to support fixed exchange rates. They succeeded for a limited period of time and for two reasons. First, in the 1970s and before, international financial markets were not as globally integrated, fluid and versatile as they are now. Had these countries attempted to retain domestic savings mainly through capital controls (as India attempted to do unsuccessfully) in the 1980s it is highly likely that they would have experienced a greater degree of porosity and leakage than they actually did in the 1960s and 1970s.

2.77. Second, and perhaps even more important, these economies provided domestic savers and investors with real (devaluation-risk adjusted) returns on financial assets which encouraged the retention of capital even without restrictions in environments which were macroeconomically stable yet fast-growing. Contrary to conditions in most other developing countries, domestic conditions in the East Asian economies were not inimical to domestic savings or investment. Also, because of social cohesion, East Asian governments were unusually successful in convincing their wealthy industrialists and exporters, who were the most able to move their capital abroad, to invest their capital domestically instead.

2.78. The observations made by a recent World Bank report on capital controls in the East Asian economies are sufficiently noteworthy to bear repeating here especially as they contain hints of advice which seems particularly relevant for Botswana to heed: "...for certain periods in ...(Japan, Korea and Taiwan) ....restrictions on outward capital flows may have contributed marginally to domestic accumulation, if only by raising the risk and therefore the cost of sending capital abroad. If so, such restrictions, which have the potential disadvantage of driving otherwise legitimate economic activity underground, or even provoking capital flight, would rank among the comparatively risky interventions that are likely to prove successful only in economies that have able bureaucracies and have already established the fundamentals of growth. Moreover as the

trend towards capital account liberalisation in Japan, Korea and Taiwan suggests, restrictions are probably useful only for a limited time: as economies grow, becoming more sophisticated and more closely linked to international markets, restrictions on capital exports inhibit efficiency and must be dismantled. ....

2.79. In any event, the success of the more open (East Asian) economies undermines any suggestion that capital flow restrictions are somehow necessary for savings and growth. Hong Kong, Malaysia and Singapore have all achieved high and rising savings rates while permitting and -- in the case of the regional financial hubs, Hong Kong and Singapore -- even encouraging free flows of capital. Indonesia attempted to control its capital account from independence until the early 1970s but due to the very open nature of its capital market chose to (liberalise it thereafter). Finally, Thailand has retained formal restrictions on capital movements, but the economy in practice exhibits a high degree of openness. ....".

2.80. What East Asia's ECR liberalisation experience has to offer Botswana may be in understanding how to remove capital controls and to avoid reimposing them once they are removed. To begin with, the Asian economies followed very different timetables for accepting the obligations of Article VIII. Hong Kong moved to Article VIII status at the same time as the UK in 1961. Singapore followed in 1968. Taiwan had not accepted Article VIII status up to 1980 when it ceased being a member of the IMF when mainland China replaced it.

2.81. Japan did not accept Article VIII status until 1988, when it was relatively quite developed. Most of the Asian countries that accepted Article VIII status continued to retain major restrictions on their capital accounts for a long time; e.g. Japan eliminated all its capital account restrictions only in the mid-1980s although Singapore and Malaysia had done so by 1978.

2.82. Japan and Taiwan liberalised their capital accounts gradually in the 1970s and 1980s, adjusting the pace of relaxation as required to maintain macroeconomic stability and to minimise interest and exchange rate volatility. Indonesia lifted capital controls altogether in 1971 in the wake of political uncertainty which had triggered large-scale capital flight even though its financial system remained tightly regulated at the time.

2.83. Unlike the Southern cone countries, Indonesia's capital account has remained open through several difficult periods of subsequent domestic adjustment (with the oil booms of the 1970s, the collapse in oil prices in the 1980s, and a financial crisis in 1989) thus maintaining the confidence of investors and preventing any large scale capital flight. Indonesia began to liberalise its financial system in the 1980s through reforms which exposed its economy to shocks from sudden drops in foreign reserves, and to bouts of speculation caused by expectations of devaluation. Since then Indonesia has experienced a number of vicissitudes in its financial system requiring periodic adjustment; but in all instances the capital account has remained open actually facilitating the process of adjustment rather than complicating it.

2.84. The general view of all students of the successful East Asian economies is that financial and accompanying ECR liberalisation has proved to be a timely success which has enabled all the "high-performing" Asian countries to cope much better with externally induced shocks. It has also promoted financial deepening and contributed to improved resource allocation, improved mobilisation of global (and not simply domestic) financial savings for Asian development, and has improved the efficiency of investment as well.

RECENT EXPERIENCE IN THE TRANSFORMING ECONOMIES OF EASTERN EUROPE

2.85. The much more recent experience of five Eastern European countries (Bulgaria, the former Czechoslovakia, Hungary, Poland and Romania) in developing their financial systems and liberalising their ECRs between 1990-92 are also worth noting and instructive, although not perhaps of as much direct relevance to Botswana as the experience of the East Asian economies. In Eastern Europe, financial and ECR liberalisation is occurring in an environment in which the market economy ethos is not yet fully in place, the financial system is nascent and problem-ridden, and there is an urgent need for macroeconomic stabilisation and radical structural reform in the face of dramatically falling output.

2.86. Successful interest rate liberalisation is being inhibited by highly imperfect financial market structures, macroeconomic instability, a serious portfolio quality problem in the balance sheets of banks, and an unstable money demand function which is fluctuating in response to kaleidoscopic shifts in income, wealth and interest rates.

2.87. At the same time fiscal policy is in the process of being transformed with a sharp drop in revenue collections as the state attempts to replace its former net receipts from state enterprises to collections from a wider tax base. As a result, large fiscal deficits (as well as burgeoning state enterprise deficits) are being monetised through bank financing adding to inflation. Under these extremely difficult macroeconomic circumstances, all East European countries have moved quickly toward current account convertibility as a key step to integrating their economies with the international economic system, exposing their enterprises to external competition and providing an anchor for domestic prices.

2.88. In Eastern Europe the capital account remains highly restricted. Restrictions include: (a) unavailability of foreign exchange in the official market for Residents to acquire foreign assets; (b) surrender requirements for exporters; and (c) restrictions on holding foreign assets by enterprises. Contrary to the experience of significant capital flow leakages taking place through parallel markets in Russia, there is little evidence that restrictions on capital outflows are actually binding in the Eastern European countries. Premiums for black market foreign exchange are small and diminishing, suggesting that no significant amount of unofficial demand exists for acquiring foreign exchange to transfer assets abroad.

2.89. Second, the view of Eastern European authorities and the IMF is that since current account convertibility already allows repatriation of earnings from foreign investment, there is already some inducement provided to inward flows of foreign direct investment. However, there is a question as to whether either current or capital account convertibility would necessarily encourage large inflows of foreign direct investment immediately, in the absence of adequate legal systems, investment codes and company laws, inadequate communications infrastructure, imperfectly formed regulatory frameworks, and an as yet incomplete process of economic and political transformation. Third, adequate returns on domestic assets, credible exchange rate policies, increasing domestic investment opportunities created by privatisations, the shrinking size of the real value of private asset stocks and the expanded availability of imported goods through open trade channels all appear to have dampened tendencies encouraging capital outflows from Eastern Europe.

THE EXPERIENCE OF MAURITIUS

2.90. Particular attention was paid in undertaking this study to the experience of Mauritius with ECR liberalisation; and extensive discussions were held with Mauritian officials to understand the decision-making process behind its reforms. Economically it is clear that Mauritius, at the beginning of the 1990s, confronts some of the same issues which faced many of the high-performing Asian economies in the late 1970s and early 1980s before the process of financial liberalisation, and accompanying ECR liberalisation began. Mauritius faces the disadvantage of having a much thinner and narrower financial sector than most East Asian countries at similar stages of development, with an overdeveloped banking sector (relative to the commercial banking needs of the economy) and undeveloped capital markets.

2.91. Over-regulation of the financial system until 1992-93 has led to lack of competition; this is despite a large number of banks, excess liquidity, wide spreads for lending to non-priority borrowers, directed credit, a limited range of financial facilities for corporate borrowers, a structure of virtually negative interest rates and some degree of disintermediation.

2.92. Mauritius' approach to developing a more sophisticated financial services sector without fully opening its capital account has been to create an "offshore banking system" which provides a virtually open capital account to Non-Residents for offshore transactions but restricts the movement of Resident domestic capital and of foreign **portfolio** capital coming onshore. Some crossover is permitted with offshore banks being permitted to lend to export processing zone enterprises.

2.93. The Mauritian authorities and polity have decided clearly however that, in keeping with their democratic and inclusive political traditions, these changes will occur (as they did in East Asia) at a gradual, "absorbable", pace which will accommodate the needs of both macroeconomic as well as socio-political stability and will blend economic growth with more equitable income distribution before subjecting the economy to the full benefits and corresponding demands of complete openness. As in East Asia, growth-with-distribution objectives have already been achieved in larger measure than for many developing countries, through full employment and a trebling of per capita incomes over the last two decades.

2.94. In some senses, Mauritius may have been too successful too quickly in achieving that objective, because it is now faced with having to import labour (with its attendant social consequences) at all skill levels in order to avoid growth being sacrificed because of labour scarcity and uncompetitiveness (resulting from too large a rise in real wage rates for extremely price-sensitive export production, before skill and capital investment levels rise sufficiently to match growing wage growth with even higher rates of productivity growth).

2.95. Unlike the East Asian economies, however, which generated increased savings with growth in incomes, domestic savings in Mauritius have been declining as a proportion of GDP from a high of 29% of GDP in 1986 to 21% in 1990. They urgently need to be resuscitated if the large investment needs required for continued transformation (investment as a share of GDP has risen from 17% in 1984 to 30% in 1990 creating a widening resource gap) are to be met without unsettling the balance-of-payments, incurring unduly large debt burdens or giving up too large a share of control over domestic factors to foreign ownership.

2.96. Liberalisation of Mauritius' Current Account: Prior to 1988, Bank of Mauritius (BOM) permission was required for all import payments. In 1988 banks were authorised to approve payments of up to Rs 200,000 for imports without referral to BOM and this limit was removed in 1989. The World Bank observed in 1991 that, although under declared policy all current account transactions were theoretically free, the reality in practice was different. Commercial banks were only permitted to keep very small foreign deposits with correspondent banks and required to sell daily to the BOM any foreign exchange surplus to their immediate needs, with virtually the entire foreign reserves of Mauritius still being held and managed by BOM.

2.97. Official policy also calls for exporters to retain their foreign earnings to pay for their imports and other foreign expenses. In practice, exporters were still required (until mid-1993) to convert their proceeds in Mauritian rupees and reconvert them when paying for imports thus incurring two-way transaction costs unnecessarily. Direct conversion between foreign currencies (e.g. from DM into US dollars) was prohibited. However, the June 1993 Budget Speech of the Finance Minister categorically declared again that all current account transactions would now be made completely free from exchange controls, with Mauritius seeking Article VIII status in the IMF.

2.98. Mauritius' Capital Account: Though the capital account remains restricted there has been progressive liberalisation of allowable limits for various types of transactions. With the complete liberalisation of the current account, considerable scope exists for leakage from "grey area" transactions such as personal and business travel allowances. The table below shows the extent of liberalisation that has occurred between 1986-93 for different transactions. Mauritius' foreign reserves in mid-1993 stood at US $ 800 million, or about one-sixth of the reserves that Botswana has accumulated.

2.99. Inward capital transfers for foreign direct investment, especially in export oriented industries are openly welcomed except for purchases of land which are prohibited except for Resident citizens. Foreign portfolio investment in Mauritius remains restricted except for registered funds and for Non-Resident Mauritians who are permitted to invest up to MRs 500,000 in securities listed on the stock exchange. Dividend and capital repatriation approvals are readily provided to Non-Residents for capital transfers and rules and taxes on transfers of capital gains have been relaxed considerably. But approvals for capital repatriation are given only for the Mauritian rupee equivalent amounts at the time the investment was made, and not the dollar amounts that were brought in, so that the investor takes the full foreign exchange risk on the investment.

2.100. The very high taxes that previously applied on outward capital transfers by Residents (which were always subject to exchange control approval) effectively amounted to a harsh dual exchange rate regime. Now such transfers by Resident businesses are permitted tax-free providing they finance investments in other Indian Ocean islands under the IOC investment protocol. Approval for such investments is readily given (and no limits have been set) provided the investor can demonstrate to the authorities some benefit accruing to Mauritius from the investment. Pre-April 5, 1966 blocked accounts are not permitted to be repatriated.

2.101. BOM provides a six-month forward exchange cover facility for EPZ companies and for foreign borrowings undertaken by banks to finance the sugar industry. Exporters and importers may also arrange forward cover through their banks subject to certain restrictions. These

restrictions are felt to be unnecessarily onerous by banks which believe that conditions already exist in Mauritius for a sound inter bank market to emerge in spot and forward forex transactions.

2.102. In connection with financial system and further ECR liberalisation the Mauritian National Development Plan for 1992-94 observes that: "...... The previous plan period witnessed favourable developments with respect to the capital account. From a low net inflow of Rs 713 million in 1987, the capital account recorded a surplus balance of Rs 2,060 million in 1990, mainly as a result of higher direct foreign investment. ..... and is estimated to improve .... to Rs 2,650 million in 1994. .... During this plan period **further liberalisation of foreign exchange transactions will occur** .... (and) emphasis will be placed on the consolidation of the financial sector...... The policies proposed ... will ensure that the country will have a well-diversified and competitive financial sector where banks will be engaged in traditional banking activities and international transactions **with virtually no restrictions** ...... The **removal of exchange controls will enable the free movement of capital** by investors .....(and)... promote overseas investment by the Mauritian business community, particularly in the Indian Ocean region. .... With **the liberalisation of foreign exchange transactions, in particular capital transactions,** and the internationalisation of the capital market, action has been initiated to boost foreign investment which is forecast to grow in line with GDP during the period 1992-94. .... ".

2.103. The approach of the Mauritian authorities has been gradual and cautious in liberalising exchange controls on the current and capital accounts. The private sector would argue that it was too cautious and reactive rather than proactive. Government would respond with the assertion that it involves all segments of society (including business and labour) in annual discussions to reach consensus on what liberalisation measures should be taken next to accommodate pressures. The view of the government and BOM is that moving with "deliberate speed" -- taking each step after the implications and repercussions of the previous one have been fully absorbed and its effects seen -- is essential to create credibility and to guarantee the irreversibility of reforms.

The Speed of Capital Account Liberalisation

2.104. The final issue related to sequencing exchange control liberalisation, and particularly to liberalisation of the capital account concerns the question of whether capital controls should be dismantled quickly or whether they should be gradually phased out and in what sequence. The overall conclusion from the experiences discussed above would strongly suggest that gradualism is to be preferred to radical, swift dismantling. But things are not quite as clear-cut as that. Several countries have removed capital controls quickly (e.g. Argentina, Britain, Indonesia, Malaysia, New Zealand, Singapore and Uruguay). Most countries have, however, followed the more gradual approach of first relaxing restraints on trade-related capital flows, followed by removal of restrictions on foreign direct investment; then by relaxation of restrictions on foreign portfolio investment; and finally removing constraints on short-term financial flows. The evidence suggests that success or failure with capital account liberalisation has not depended on whether liberalisation occurred quickly or slowly but that the credibility and consistency of other macroeconomic policies (and particularly the credibility of anti-inflation policy) have played a key role in the sustainability of keeping the capital account open.

The Success of Mauritius' Offshore Business Centre

2.105. Mauritius has no exchange controls at all for the Offshore Business Centre. Some of the activities that can be conducted under offshore rules include the following: are: Offshore banking;

International licensing & franchising; Offshore insurance; International data processing; Offshore funds management; Other information technology services; International financial services; Offshore pension funds; Operational headquarters; International trading; International consultancy services; International assets management; Shipping and ship management; International employment services; Aircraft financing and leasing; Trust funds of various kinds

2.106. Apart from the complete freedom from exchange control, there are a number of incentives for recognised Offshore entities:

- zero income tax
- double tax agreements with about ten countries
- expatriate staff pay personal income tax at half the normal personal rate
- no sales tax on imported office equipment
- exemption from stamp duty
- generous concessions on customs duties on cars and household equipment
- No withholding tax on interest payable on Nonresidents' deposits or on dividends payable to Nonresidents; no estate duty or inheritance tax on the inheritance of shares in an Offshore entity.
- No capital gains tax.

2.107. Over 400 companies have been registered since the rules for the Offshore Business Centre were promulgated in 1992. Several of the newly registered companies are in effect offshore representatives of large South African companies. The implications for Botswana are very positive. It would appear to be more convenient for a South African company to set up a Representative Office in Botswana, once all the tax and customs duty concessions have been put in place here. Any customs concessions would of course have to be consistent with the rules of the Southern African Customs Union. It is also noteworthy that in Mauritius, a number of Onshore companies have been licensed to provide services to Offshore companies.

CONCLUSION

2.108 The now widespread experience of developing countries which have liberalised exchange controls, with particular attention paid to those which have liberalised capital account transactions, indicates that if the appropriate set of accompanying economic polices and characteristics are in place, then there is a net benefit from such liberalisation. These requirements are for macroeconomic stability (low inflation and no excessive deficit financing of the government budget), an exchange rate which is not overvalued, and real interest rates which are comparable with international levels. Where these conditions have applied, liberalising countries have tended to experienced capital inflows (thus boosting official reserves and assisting the balance of payments) and in some cases currency appreciation. In many countries there have also been increases in foreign investment inflows, although the fact that EC liberalisation has often accompanied much broader economic reform and adjustment programmes makes it difficult to evaluate the exact contribution of changes in ECs. Although some countries have removed all exchange controls at once, it is more common to adopt a gradual, phased approach. This is the strategy being adopted by Mauritius, a country with certain similarities with Botswana, the

objective being to avoid any possible destabilising moves which might undermine the credibility of the reforms and lead to damaging policy reversals. Liberalisation to date in Mauritius has led to a substantial number of new company registrations in a relatively short period.

MAURITIUS
LIBERALISATION OF EXCHANGE CONTROLS 1986-93

Type of Transaction	Allowable Limits for Transaction		
	Up to 1986	**Between 1986-92**	**Now (1993)**
Personal Travel :	UK£1,200 per person every 2 calendar years	MRs 200,000 (UK£10,000) per person every 2 calendar years	No Limit
Business Travel :	UK £120 per day pp.	Limits removed in July 1991	No Limit
Emigration :	MRs 100,000	MRs 200,000 in 1988 MRs 500,000 in 1990	MRs 500,000
Compassionate Remittances:	MRs 800 per month per person up to August 1993		No Limit
Cash Gifts:	MRs 500	MRs 1,000 in 1988 MRs 5,000 in 1990	MRs 5,000
Import of MRs	None	MRs 700 per traveller	M Rs 700
Export of MRs	None	MRs 350 per traveller	M Rs 350
Borrowings by Non-Residents:	None	MRs 10,000 (1988)	M Rs 10,000
Subscriptions	Approval Needed	Up to MRs 1,500 w/out approval (1988)	No Limit
Advertising Expenses:	Approval Needed	Up to MRs 10,000 (1988)	No Limit
Education: Fees:	As necessary based on certification provided		
Maintenance:	Variable based on Country of Study from UK£300 p.m. to Ind Rs1,100 p.m.		
Dividends:	Up to 03.93 exchange control permission required for dividend payments by Non-Resident controlled companies		No Permission Required
Capital Transfers:			
Original Capital:		Permitted but Approval Required	Same
Capital Gains:	Taxed at 35%	No Tax as of 07.92 providing original investment made from foreign funds and PMO approval obtained under Non-Citizens Property Act.	Same as 07.92
Resident Transfers:	Taxed at 45% when permitted	Taxed at 15% as of July 1989	
		Taxed at 5% as of Aug. 1992	Taxed at 5%

3. *DEVELOPMENT OF THE EC SYSTEM IN BOTSWANA AND ITS IMPACT*

THE MAIN OBJECTIVES OF EXCHANGE CONTROLS

3.1. The main objectives of African governments in having exchange controls have been **(a) to prevent capital flight, (b) to keep the nation's savings inside the country for domestic investment, and avoid excessive use of foreign borrowing, and (c) to allocate scarce foreign exchange to priority uses.** There was always an underlying assumption that foreign exchange reserves were a scarce national resource.

3.2. It has also been common **(d) to use exchange control rules to limit the local borrowing of non-resident controlled companies.** The objective was to reserve local credit for locally owned businesses, and to encourage foreign companies to bring in more capital than they would have done if allowed to borrow locally without limit. The underlying assumption was that local finance was a scarce resort that had to be carefully rationed.

3.3. In some instances, African governments have in effect used exchange controls **(e) to protect an overvalued exchange rate,** but this has never been the case in Botswana. Some governments with overvalued currencies created elaborate systems of subsidies to exporters and heavy customs duties against importers, as a substitute for a devaluation of the national currency. The IMF has generally put pressure on such governments to simultaneously devalue the currency, remove the export subsidies and make large reductions in protective customs duties.

3.4. In Botswana's case, there was also **(f) concern about the potential loss of the capital base on which to tax revenues from savings and investments,** because tax is only levied on locally generated income, and **(g) the need to develop a sound statistical base on trade transactions,** in order to capture the maximum benefits from the SACU Agreement.

3.5. A few observers of the Botswana scene believe that Botswana may have used exchange controls to protect an undervalued exchange rate, but this is somewhat speculative. In any case, a higher exchange rate could cause problems to those manufacturers in Botswana who are already finding it difficult to compete with similar goods manufactured in South Africa or Zimbabwe. See Appendix 3.

EARLY HISTORY OF EXCHANGE CONTROLS IN BOTSWANA

3.6. Britain introduced exchange controls in 1940 as an emergency war time measure. The entire Sterling Area followed suit, including Botswana. When Britain eventually suspended its entire exchange control regime, most of the former Sterling Area countries kept theirs in one form or another, for a variety of reasons.

3.7. Before the pula was introduced in August 1976, Botswana had no exchange controls with the rest of the then Rand Monetary Area (RMA) (consisting of Lesotho, Namibia, South Africa and Swaziland, and now called the Common Monetary Area); at the same time, Botswana applied South African exchange controls to its transactions with the rest of the world. Any exchange

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control request which could not be dealt with by the two Authorised Dealers, the then two commercial banks, was dealt with by an official in the Ministry of Finance & Development Planning. There was no possibility of Botswana using exchange controls to pursue any objectives different from those of the South African government.

3.8. At the time, the rules of the RMA required Botswana to keep most of its foreign exchange reserves in rand. This effectively meant that what South Africa quoted as its gross foreign exchange reserves, effectively included Botswana's reserves as well as their own.

3.9. From August 1976, Botswana applied its own exchange controls to all foreign countries equally. The resulting new exchange controls were applied against South Africa, as well as against Lesotho, Namibia and Swaziland. This represented a *de facto* introduction of exchange controls against those countries. Botswana's foreign exchange reserves were separated from South Africa's, except for any portion of Botswana's reserves which was kept in rand on a voluntary basis.

3.10. The Botswana government shared the general concern to keep locally generated savings inside the country. As in many other African countries, a large proportion of domestic assets was foreign-owned. It was feared that if many of those foreign owners wanted to move their capital out of the country over a short period of time, the foreign exchange reserves would all be dissipated and there would be a shortage of local savings with which to finance local investment. Capital outflows were controlled, and Residents were in general not allowed to maintain foreign bank accounts, or own any other kind of foreign financial asset. There was a strong belief that there must at all times be a guarantee that there would be sufficient local savings to finance local investment. Residents with money to invest, were required to invest all their funds within Botswana. This tended to drive down domestic interest rates.

3.11. Botswana, however, set generous limits on the local borrowing of non-resident controlled companies, based on the amount of capital they had brought into the country, once it became clear that the foreign exchange reserves were strong enough to make it unnecessary to force foreign investors to bring in all the required capital from abroad.

3.12. Botswana did not use the exchange control rules to determine which imports would be allowed and which would not. In fact, the rules on current account transactions were always fairly liberal: virtually all imports were allowed. There were relatively generous limits on the transmission abroad of local savings by Temporary Residents and on such other service payments as travel, foreign school fees, and payments for foreign medical services. There were almost no effective constraints on dividend payments abroad and none on the payment of interest on approved foreign loans. The current minor limitation on the payment of dividends by a bank, has been imposed under the Financial Institutions Act, not under EC, and applies equally to Resident and Nonresident shareholders.

3.13. In 1982 and 1983, when Botswana experienced the beginnings of a balance of payments crisis (because of the temporary stoppage of diamond exports, followed by a slowdown of diamond exports), a number of macro-economic measures were taken to slow down the economy and thereby reduce the demand for imports. There was no attempt to tighten exchange controls on current account transactions. The system started to move back into macro-economic balance quite quickly.

THE OVERALL EFFECT OF THE SYSTEM INTRODUCED IN 1976

3.14. The overall effect was that current account transactions were little affected in practice by the new exchange controls, while in general permission had to be sought for capital outflows other than the repayment of approved foreign debt (for which exchange control permission was required when it was brought into Botswana, and the repayment schedule for a foreign loan was agreed at that same time). The requirement on Residents, including especially Debswana, to keep all their savings inside Botswana and in pula, gradually led to the creation of surplus liquidity.

3.15. The 1976 process of shifting to exchange controls on transactions with South Africa for the first time, was undertaken without any significant loss of confidence in the Botswana economy. There was probably some (quite legal) movement of funds to South Africa just before the changeover. Large numbers of Botswana residents already had bank and building society accounts in South Africa. Strictly speaking, these should all have been converted to pula at once, after Pula Day on 23 August 1976.

3.16. What in fact happened in 1976 was that many businesses and individuals used their rand balances to pay for imports, and other foreign payments to South Africa (such as travel), in the last few months of the year. This is known because there was very little demand for rand from the Bank of Botswana during that period, even though the great majority of imports were then, as now, paid for in rand.

3.17. As a result, export receipts were added to the foreign exchange reserves, which built up steadily from a low initial level; at the same time, the stock of rand then in South Africa was gradually run down as importers used that stock to pay for their imports. The surprisingly rapid build-up of the foreign exchange reserves after Pula Day was in fact partly statistical in nature, but was nonetheless seen as an important expression of confidence in the new monetary system in Botswana.

3.18. In addition, there was no apparent slowdown in foreign investment inflows and tourism from South Africa, although of course it is not possible to be certain that inflows would not have been even larger if the old system of a common currency with South Africa had been maintained.

3.19. Most large corporations in Botswana, the banks and the mining companies in particular, sold their rand bank balances in South Africa to the Botswana banking system and obtained pula bank balances in Botswana. These transactions, together with the exchange of rand bank notes and coin for pula inside Botswana, allowed the Bank of Botswana to build up the country's foreign exchange reserves quite rapidly after Pula Day. For a short period, the reserves were built up by Residents running down their rand balances in the way described; in the longer run, the reserves rose to their present high level mainly because of the large receipts from diamond exports which were not all immediately spent.

THE SUBSEQUENT TREND IN THE EXCHANGE CONTROL SYSTEM

3.20. The general trend since 1976 has been for the exchange control rules to be gradually liberalised. Allowances for the various service payments (e.g. dividends being remitted to foreign shareholders, without prior Bank of Botswana approval), have been made increasingly generous. The same applies to the rules concerning the amount that a Non-resident controlled company may borrow locally in relation to the equity finance it has brought into Botswana from abroad.

Application of many of the detailed exchange control rules has been delegated by the Bank of Botswana to the Authorised Dealers, that is, the commercial banks. This has speeded up the application process considerably. Temporary Residents have been generously treated with regard to remittances sent out of Botswana.

3.21. Controls have remained, however, on the currency of savings of Residents, with only minor exceptions. Large importers in Botswana are allowed to maintain modest working balances at banks outside Botswana. They typically write rand cheques on a South African bank account, to avoid having to apply for foreign exchange for each and every import payment. They then make one large rand purchase once a month to top up their rand retained accounts, with exchange control permission, up to approximate limits.

3.22. Pension funds and the life funds of insurance companies have been allowed to invest abroad up to 50 per cent of their assets (see Appendix A13). Rules governing inward portfolio investment by foreigners have been progressively relaxed.

3.23. Recent liberalisation of current transactions include allowing permanent residents to use foreign credit cards within Botswana, to purchase foreign timeshare units, and to purchase air tickets directly from foreign travel agents. Limits for delegated authority by Authorised Dealers on certain transactions have also been increased (although this may simply reflect inflation and not be an increase in real terms), and remittance procedures for self-employed temporary residents have been simplified.

COSTS OF EXCHANGE CONTROLS

3.24. The impact of ECs is quite wide ranging, even in an economy which is generally well run and economically successful such as Botswana's. The existing ECR is very liberal by developing country standards, with regard to exchange controls over current international transactions. On the whole, it is efficiently run. The practice of delegating authority over many categories of applications to the commercial banks, has speeded up the processing of routine exchange control applications considerably. Nevertheless there are a number of direct costs of operating the system (such as the salaries of those administering the system employed in the banks), as well as a range of indirect costs. These are discussed in more detail below. The broader impact of ECs - on foreign investment and macroeconomic management and discussed in chapters 4 and 5 respectively.

Direct employment and time costs

3.25. Exchange controls have significant direct employment costs. The Bank of Botswana currently employs some 36 people in the Exchange Control Department, which has an establishment of 44. The commercial banks, which act as the agents of the Bank of Botswana in implementing exchange controls, employ approximately a further 75.

3.26. On occasions senior management of the Bank of Botswana and of the commercial banks become involved when complex exchange control cases are being adjudicated. The Bank of Botswana may refer difficult cases, especially those involving matters of principle, to the Ministry of Finance & Development Planning for final adjudication. This includes the settlement of exchange control appeals from the commercial banks on behalf of their customers.

3.27. The private sector incurs costs from having to fill in forms and queue at the banks. Customers have to spend time preparing the necessary information and documentation when applying to the Bank of Botswana in the more complicated cases which cannot be dealt with by the commercial banks.

3.28. In a few extreme cases, customers with very complicated transactions have had to hire merchant banks or outside accountants to prepare their exchange control applications and negotiate with the Bank of Botswana on their behalf. One customer (a subsidiary in Botswana of a multinational group) claims to have spent in excess of P100 000 in fees paid to its professional exchange control advisor in Botswana, in order to get all its exchange control affairs in order (this was after one of their initial foreign exchange transactions in Botswana was incorrectly handled). These particular negotiations took place over a two year period.

3.29. The documentation referred to above is often sufficiently complicated that the Bank of Botswana has to refer the applications back to the customer, for more detailed information, via his or her bank. The customer then has to resubmit the application. This delays the processing of the application even further, especially if the customer is not based in Gaborone. In a few extreme cases, a final exchange control decision has been made six months after the original application was submitted.

3.30. The private sector obviously incurs costs from having to wait for decisions from the Exchange Control Department of the Bank of Botswana. This cost is unknown and extremely difficult to estimate directly. It is presumably as large as or larger than the cost incurred by the commercial banks and the Bank of Botswana, on the grounds that for each bank employee spending time on dealing with applications there is probably a private sector employee or self-employed person spending as much or more time making the application. Delays caused by EC adjudication can cause increased interest costs and reduced profits.

3.31. Another hidden cost to business occurs when the Bank of Botswana (occasionally) tells a local business person that a proposed way of conducting an international transaction is not on the menu of permitted methods at the Bank of Botswana. There are a few examples where a proposed structuring of a complex business deal did not correspond with the Bank's ideas as to how the international aspects of the deal should be structured. The customer then either had to spend time and money trying to persuade the Bank to accept the customer's proposal; or, the customer had to re-arrange the proposed deal to comply with the Bank of Botswana's wishes. One customer claims that he received opposite advice from the Bank with respect to the proposed equity and debt structuring of two similar deals.

3.32. Considerable delays are sometimes experienced when complicated capital account transactions which involve Nonresidents are submitted to the Bank of Botswana for approval. Even when the basic type of capital transaction is permitted, the BoB may exercise its right to go through the proposed contract and debate the prices involved in the contract (e.g. the prices of shares that are for sale to a Nonresident, the rates of interest on a loan in which either the borrower or the lender is a Nonresident, etc.). This can cause considerable delays. This has given rise to some unhappiness in the private sector. The business community feels that the BoB may be getting out of its depth when it "second guesses" what the contracting parties have agreed to. The suggestion was made to the consultants that certain types of foreign investors are being discouraged from coming to Botswana, if their kind of business would likely involve them in the kinds of

international transactions that would require BoB approval. The BoB feels that it should not be criticised for taking its responsibilities seriously. In any case, companies that are envisaging complex deals involving Nonresidents are encouraged to bring their draft proposals to the BoB early on, so that the exchange control aspects can be discussed in good time. (One week is now the norm in Korea, etc.). The BoB has an accommodating attitude towards allowing accountants, bankers, company secretaries and lawyers to discuss proposed deals with the Exchange Control Department. The BoB says that a few customers are bound to be disappointed if they forget that exchange control permission is required when Nonresidents are involved, and then expect the BoB merely to rubber stamp a contract after it has been agreed by the contracting parties; for instance, we were told of one very large contract with a Nonresident was not only signed but even announced in the press, before the Resident party to the contract had thought to apply for exchange control permission from the BoB. The consultants did not feel that it was their job to try to adjudicate who is in the right and who is in the wrong, as far as delays are concerned. We have simply noted that there are significant costs to all the participants due to the fact that exchange control approval is required from the BoB itself, for complex capital account transactions which involve Nonresidents. These costs would disappear if there were no exchange controls in Botswana.

3.33. One company in the tourism business in Botswana has found itself in the following difficult situation. Because of the unusual nature of its international transactions, e.g. international leasing of equipment, hiring international contract staff, paying commissions to foreign marketing agents, etc., many of its exchange control applications may not be dealt with by the commercial banks but have to be referred to the Bank of Botswana for exchange control permission. The company claims that it engages in about 25 types of international transaction that require Bank of Botswana approval. The continuing need to process exchange control applications is a noticeable part of their operating cost structure.

3.34. Virtually all of the people involved in this process are skilled managers, so that the exchange control system employs in wholly unproductive activity a significant amount of the country's scarcest resource, namely skilled manpower. In addition, the whole process causes delays in the implementation of business decisions, which must at times add to costs.

Criminalisation of otherwise legitimate transactions

3.35. It is also possible, indeed probable, that some peoples' foreign transactions break the law in the process of avoiding exchange control rules. This makes criminals of people simply trying to spend or transfer their own money from one country to another. Moreover, it drives some transactions underground which might otherwise have been legal and therefore subject to taxation.

3.36. This factor is less serious in Botswana than in other African countries because Botswana's exchange controls constrain relatively few transactions, but it cannot be ruled out altogether. An obvious example is that a Resident cannot conveniently bring profits or dividends back into Botswana from a successful foreign investment, if the foreign investment was not legally made in the first instance.

Excess Liquidity and Interest Rates

3.37. With the exceptions noted above, Residents must hold their savings in Botswana and in pula. This has restricted Residents from (a) diversifying their assets physically outside Botswana

(e.g. by buying property in South Africa), and (b) diversifying their financial assets, in terms of currency, liquidity and risk characteristics. Such activities would be regarded as normal risk diversification strategies in developed countries (see Appendix 19 for a discussion on outward investment by Residents). This has three effects, relating to excess liquidity in the financial system, the level of interest rates, and a financial penalty for Residents.

3.38. One result has been that the private sector has probably held more pula-denominated financial assets than would have been the case without exchange control. Given an unrestricted choice, there would have been some exchange of pula assets by Residents (e.g. money held in savings accounts) at the BoB for foreign exchange to be invested in foreign currency denominated financial assets (e.g. the purchase of shares overseas). As a result there has been a "bottling up" of pula within the commercial banking system (although some holders of pula, such as Debswana, have been permitted to deposit these at the BoB), and this has been a major contributor to the problem of excess liquidity which characterised the banking system throughout the 1980s. Without exchange controls, the excess liquidity problem would have been much smaller or non-existent.

3.39. Excess liquidity has in turn contributed to the low levels of real interest rates in Botswana during the 1980s. Between 1986 and 1989 the BoB responded to the build up of excess liquidity by attempting to stimulate the demand for loanable funds through reductions in interest rates. Without ECs there would have been no such pressure and real interest rates would have been comparable with international levels.

3.41. Savers in particular have experienced strongly negative real interest rates for many years, much lower than that obtainable in US dollars and other major foreign currencies. In addition, the pula has declined in value against non-regional currencies because of the weakness of the rand and a perceived need in Botswana to prevent movements against the rand being too large. Thus ECs effectively imposed a tax on savers. This was a particular problem for those with large liquid balances in Botswana, notably Debswana.

3.42. The long period of negative real returns on financial savings must have resulted in some illegal outflow of domestic savings, made easier by liberal rules on current account transactions and by the openness of the Botswana economy. The amount involved is not known.

3.43. The low interest rate syndrome changed slightly in 1991, with the issue of Bank of Botswana Certificates (BOBCs) at rates of interest somewhat higher than the previous option for large savers, namely Bank of Botswana call accounts. Interest on the latter rose from 3.5 per cent in 1988 to 11.5 per cent in March 1991, before they were replaced later in 1991 by BOBCs. These currently have an annual compound interest yield of about 14 per cent.

3.44. The amount of BOBCs outstanding was P1.1 billion at mid-1993. The yield on BOBCs is currently very slightly above the rate of inflation, giving a positive real rate of return for those holders, such as pension funds, which are not liable for income tax. The return is still negative in real terms for those holders liable to tax on their income from BOBCs.

The effect of exchange controls on prices

3.45. There is a theoretical advantage in abolishing exchange controls, namely that abolition would remove an artificial barrier between relative prices in Botswana and those in the global economy. This should result in more efficient allocation of resources, lower costs to the Botswana consumer, and more rapid growth in real income. However, this is not a strong point in the

Botswana context. The price distorting effects of Botswana's membership of the Southern African Customs Union are likely to be more important, i.e. Botswana consumers buy expensive goods manufactured or assembled in South Africa, because these goods are protected by the external tariff of the Customs Union.

3.46. As mentioned elsewhere in this report, the economic cost of having surplus liquidity drive up asset prices has been mitigated by the issue of BOBCs. It has also helped that pension and life assurance funds are allowed to have up to 50% of their assets outside Botswana. This has removed some of the artificial upward pressure on local asset prices.

Possible gains and losses in economic management

3.47. The removal of the barrier that exchange controls create between the Botswana economy and that of the rest of the world, would make economic management in Botswana more difficult. It could sometimes force the authorities to follow policies which could be slightly different from those which they would have chosen in Botswana's own interests if the economy had remained insulated from the rest of the world's financial community. For example, the free flow of capital into and out of the country, under a liberalised regime, might eventually force the country to have interest rates and an exchange rate, among other policy instruments, slightly different from those that would otherwise have been chosen. The cost of running the present exchange control system has to be seen in this light. See chapter 5.

3.48. The cost to a saver of being required to keep spare cash in Botswana has thus been reduced; indeed the nominal return from interest on Bank of Botswana Certificates is now higher then that on equivalent investments in major foreign currencies; the relative yield in total depends, however, on how the pula moves in value against any foreign currency regarded as a possible alternative investment. The real returns on pula financial assets are still below the real returns on many foreign currency assets.

3.49. Residents of Botswana are still, however, prevented from diversifying their risks by investing abroad (except via their pension and life assurance funds); in particular, they are prevented from hedging against a possible fall in the rand, which would probably be followed (at least in part) by some weakness of the pula, as in the past.

3.50. The question arises therefore as to whether Residents should be allowed to buy foreign currencies for investment purposes, as well as for current payments. Such a change could arise either from complete abolition of exchange controls, or be part of a further relaxation of the exchange control rules and regulations, with limits set on amounts that a Resident might be allowed to invest abroad each year. This is discussed further in Appendix 18.

Additional material

3.51. Some additional material is given at Appendix 3, which deals with the impact of exchange control liberalisation on the private sector.

4. THE IMPACT OF EXCHANGE CONTROLS ON FOREIGN INVESTMENT INFLOWS

INTRODUCTION

4.1. The need to diversify the economy away from its current dependence upon diamonds, provides the basis of current economic development initiatives. It is central to the Seventh National Development Plan (NDP7) which runs from 1991 to 1997. Particular emphasis is placed upon development of manufacturing industry, although a role is also envisaged for service activities such as tourism. More recently, there has been discussion of the potential for Botswana to develop as a regional or international centre for the provision of banking and/or other financial services. There are many factors influencing the potential for Botswana to diversify along these lines, and these will be discussed below, although the emphasis will be on the extent to which Exchange Controls have an impact on the potential for economic diversification.

4.2. It is worth noting a number of important points regarding diversification and the development of new economic activities to meet job creation needs, and to replace diamonds as the central source of economic growth. Firstly, any economic activity which is to lead the economy must be export-oriented; being a small and relatively open economy, Botswana is always going to be dependent upon imports for a large proportion of its consumption and investment goods, and therefore needs to be able to generate foreign exchange to pay for these imports. For the manufacturing sector in particular, export production is crucial because the domestic market is very small in relation to available economies of scale, and hence the minimum scale of production required in order to achieve competitive standards of cost efficiency. Secondly, new economic activities will be to a large extent dependent upon foreign investment inflows. This is not solely because of financial needs - unlike most developing countries, Botswana does not have a "savings gap" and has had a surplus of domestic saving over investment for many years. This situation is gradually changing as government moves from surplus to deficit, but the substantial foreign reserves which have been accumulated in recent years will provide a financial cushion for future investment needs.

4.3. Inward foreign investment is perhaps more important because of the other benefits which it brings: technology; technical, managerial and entrepreneurial expertise; and access to markets. Thirdly, although Botswana does have a number of advantages over many developing economies, especially those in sub-Saharan Africa (SSA), it also has a number of characteristics which mitigate against diversification away from minerals, and as a result the country must pursue a wide range of new economic activities; relying on any one new activity (such as labour-intensive manufacturing) to replace minerals would be unwise, and the country cannot afford to neglect any of potential avenues for diversification.

4.4. The above discussion relates to a particular kind of inward investment, termed **foreign direct investment,** (FDI) whereby a foreign (Nonresident) individual or company takes a share in a Botswana company. Typically this is a majority share holding, but may involve a joint venture with one or more local investors (such as BDC) in which the Nonresident has either a majority (which BDC prefers) or a minority stake. Although the primary motivation of the external investor is to

make a profit on the investment, the involvement usually goes beyond a purely financial one in that the investor is likely to be involved in the management of the Botswana subsidiary and may well have other business links (such as marketing its products overseas) with it. FDI may be financed by equity capital, or shareholders' loans in the local company, or local bank loans, or all three. FDI is generally made on a long term, semi-permanent basis.

4.5. Inflows of financial capital may take a variety of other forms besides FDI. Increasing attention has recently been devoted to **portfolio investment**, whereby a Nonresident purchases a Botswana financial instrument such as a share or a bond. Portfolio investment is purely a financial transaction and involves only minority stakes in companies. It does not entail any role in their management. It is generally short to medium term. Portfolio funds can be quite volatile, being moved rapidly from one location to another in search of maximum returns.

4.6. Finally, capital inflows may also result from money laundering or incoming capital flight. The former relates to money of legally doubtful origin brought into Botswana to be "laundered", i.e. converted into untainted money by the Botswana banking system. The latter category relates to money which was originally legally acquired in its home country but which has been exported from that country illegally in terms of the other country's exchange control regulations; there is nothing illegal about it in terms of Botswana law, but prudence and the maintenance of good relations with other countries may require that such inflows are discouraged.

FOREIGN DIRECT INVESTMENT: MANUFACTURING

4.7. One of the arguments made for abolishing exchange controls is that it would greatly improve the investment climate in Botswana, and thereby induce an increase in FDI inflows. Such an argument is necessarily speculative and surrounded by uncertainty, being about future events. However, some conclusions can be drawn by examining (i) past inflows of FDI, and (ii) the importance of other factors, relative to ECs, in influencing the investment climate.

4.8. In recent years net inflows of foreign investment into Botswana have nearly always been large and positive (see table 7.1). Most of these inflows represent investment in the mining industry, which during the 1980s have been dominated by the establishment of the Jwaneng diamond mine, improvements at the Orapa diamond mine, and towards the end of the decade, the establishment of Soda Ash Botswana at Sua Pan. The main exception to this trend was 1987, when the stockpile of diamonds which had been accumulated in earlier years (when production exceeded exports) was sold. Part of the proceeds of the sale were used by Debswana to purchase a share holding in De Beers. This involved a large outward portfolio investment by Debswana. This more than offset that year's capital inflows. This resulted in an exceptional net capital outflow in 1987.

TABLE 1

NET PRIVATE FOREIGN INVESTMENT IN BOTSWANA 1980 TO 1991

(P million, current prices)

1980	+97	1987	-142
1981	+94	1988	+87
1982	+64	1989	+369
1983	+58	1990	+512
1984	+129	1991	+428
1985	+200	1992	+242
1986	+187		

Source: Bank of Botswana annual reports

4.9. The continuous net inflow of foreign private investment shown in Table 1 does not prove of course that inflows of foreign investment would not have been even larger if exchange controls had been more liberal or had been abolished. However, in most recent years the capacity of the economy to absorb more investment was extremely limited: there were shortages of serviced land, executive housing, skilled labour, places in schools and other necessary resources. This argument is strongly supported by the observed effects of rapid increases in the Government's development spending from 1987 to 1990. Inflation of construction costs accelerated rapidly, there were acute shortages of housing and skilled labour; there were even reports of shortages of semi-skilled and unskilled labour, among many other symptoms of excess demand. This shows it would not have been possible for significant additional foreign investment to have taken place; the absorptive capacity of the economy has generally been fully used in recent years, except possibly during the current slowdown.

4.10. Furthermore there is little evidence that inward FDI has been inhibited by the existing system of ECs. During the course of this study a number of interviews were carried out with bankers, accountants and other professionals, with a wide knowledge through their clients of investments in Botswana; these revealed only two examples of inward investments which had been discouraged by the existing system of ECs. Of course, there may be others which are not known about, and it is possible that some potential investors have been discouraged by the very existence of ECs, and not bothered to investigate Botswana further.

4.11. Some concern was expressed to the team that Botswana suffers from "guilt by association" with other African countries maintaining strict EC systems, which - in combination with over-valued exchange rates - have undoubtedly discouraged FDI in the past. According to this view, the image which Botswana presents to potential investors would be much improved if ECs were suspended or abolished, enabling Botswana to maximise the benefits of its relatively strong economic position in comparison with other counties in SSA. Whilst there may be some merit in this view, particularly in the future when Botswana will face greater need to attract FDI as part of the diversification drive, we consider that ECs have not been a major constraint to inward FDI in the past, and indeed the economy did not have the capacity to absorb much more FDI than it attracted anyway.

4.12. Past inflows may not be a reliable guide to the future. Investment in mining is quite different to other forms of FDI. Mineral deposits are fixed in one place, and in most cases potential investors do not have the option of producing the same product elsewhere if other aspects of the overall investment climate are more favourable - De Beers could not have moved Jwaneng if it had not been happy with the investment climate in Botswana. Diversification into manufacturing is likely to concentrate upon attracting FDI in labour intensive "footloose" industries such as textiles and clothing, where different factors apply. Firstly, such industries are highly mobile, and involve shifting capital equipment around the world in search of low labour costs and easy access to raw materials and markets; manufacturers have a wide choice of countries in which to locate. Secondly, these industries are highly competitive, and small variations in cost structures and the investment climate have a major impact on profitability and the location decision.

4.13. With regard to the manufacturing sector, Botswana's present ECs are quite liberal and are unlikely to provide a *major* deterrent to inward investment, although they may well provide frequent minor irritation. The main EC concerns are the ability to freely import raw materials, components and spare parts, and to receive the full value of the foreign currency proceeds of export sales, if applicable. In addition, a foreign investor will require to be able to repatriate after-tax profits overseas if so desired. There is evidence of problems sometimes caused by bureaucratic delays in EC matters, but in general the system with regard to trade in goods and profit remittances operates effectively without restriction. In addition, a large proportion of expatriate salaries is remittable, and gratuities for expatriate workers are free of exchange control.

4.14. There would be no EC problem in taking the whole investment out of Botswana if the foreign shareholder should ever decide to sell the investment to a Resident and take the proceeds out of the country. In combination with a strong more-or-less convertible currency, the current EC regime provides a relatively favourable environment for manufacturers.

4.15. The prospects for attracting inward FDI in manufacturing are far more dependent upon other factors which outweigh EC issues. In its recent report on the prospects of industrialisation in Botswana, the World Bank did not even mention ECs as a factor relevant to the attraction of FDI in manufacturing. A decision by a foreign investor to locate in a particular country is influenced by a number of factors, including access to markets, competitively priced natural resources, and the existence of a low cost production base for export. Political and economic stability are also important in influencing perceptions of risk and the ease of doing business. While Botswana scores well on these latter considerations - clearly its political and economic stability are almost without parallel in sub-Saharan Africa, it does badly on most of the former, especially with regard to its own very small domestic market. Botswana does have good access to markets under its membership of the SACU Agreement, the trade agreement with Zimbabwe, and the Lome Convention. This advantage is partly offset by distance from the sea and high transport costs, at least for exports to international markets.

4.16. There are other reasons why Botswana is a high cost place to produce manufactured goods for export. These include:

- high labour costs due to a combination of high wages by regional standards and low productivity, coupled with a structure of labour legislation and practice which makes it difficult to reward productive workers and penalise inefficiency;

- a shortage of technical and managerial skills which requires reliance upon (expensive) expatriate labour;
- high utilities costs (water, electricity and international telecommunications);
- a lack of raw materials, particularly due to the low potential of agriculture to provide materials on which to base agro-processing activities;
- shortages of serviced land and factory buildings, with the constraints resulting from rapid economic growth exacerbated by bureaucratic inefficiencies in government land allocation and a refusal to allow private sector developers to provide serviced industrial buildings for rent;
- a shortage of long term finance for the private sector and a generally underdeveloped financial sector;
- a regulatory environment, which although improved in recent years is still a significant constraint on industrial and commercial activity;
- a shortage of housing, and of good quality schooling and health facilities - which all tend to be expensive as a result.

4.17. Our overall conclusion is that these factors are far more important than ECs in determining inflows of FDI in manufacturing, which does not seem to be significantly deterred by the present EC system. Therefore, liberalising or abolishing ECs is unlikely to make much difference to inward FDI in manufacturing. However, reforming ECs would certainly not do any harm, and there is a strong argument that Botswana should not add to its natural disadvantages (distance from ports, lack of raw materials etc.) by creating any other impediments to investment, however small. Although further liberalisation of ECs should have a beneficial impact on inward attraction of manufacturing FDI, we would caution against expectations that this will by itself lead to any significant inflows; attention to other constraints is far more important and potentially far more effective.

FOREIGN DIRECT INVESTMENT: SERVICES

4.18. The same conclusions cannot be drawn for investment in service industries. A firm involved in the international trading of services will face far more problems in its EC dealings than one involved in merchandise trade. Firstly, the Bank of Botswana has not delegated authority for service transactions to the commercial banks as Authorised Dealers, and so approval has to be obtained from the BoB itself - which can often be subject to lengthy delays and require responding to time-consuming further enquiries from the BoB.

4.19. Secondly, a key area where a Botswana firm could be involved in international services transactions is when that firm is using Botswana as a regional base for activities in other parts of southern Africa; indeed, this is precisely one type of inward investment which the government should be keen to attract. Both of the specific examples of potential investments which had been discouraged by the present EC regime fall into this category.

4.20. The consultants were told of multinational firms considering establishing regional headquarters in Botswana, to cover their interests in southern Africa, meaning both the SADC region and South Africa. Two of these firms eventually did not set up their regional headquarters

here because the (additional) investment into Botswana would have had to be as a Resident of Botswana for exchange control purposes; and it was anticipated by the investor that the regional company would not have been given permission by BoB to maintain a foreign currency bank account, either in Botswana or abroad.

4.21. The regional headquarters company would have had to sell its initial injection of foreign funds (e.g. pounds sterling) for pula; it would then have required permission from the Bank of Botswana for the purchase of pounds (say) with pula, for later payment to, or investment of some of that money in, regional associate businesses. This would remain true even if it was in effect spending its own money. Even more onerous would have been the requirement to obtain *prior* approval from the Bank of Botswana, before entering into certain specific kinds of service agreements with sister companies. For the particular type of business concerned, international professional consultancy, these rules were thought to be too burdensome, especially as the exchange control authorities have sometimes been slow to approve payments for invisible transactions and have generally been unwilling to permit outward investment by Resident companies.

4.22. The second example was of a company operating road transport services out of South Africa throughout southern, central and eastern Africa. Partly as a result of political and economic difficulties involved in operating out of SA, including that country's EC regulations, the company was considering using Botswana as an administrative and financial base for its regional operations. Most of the transactions relating to these operations were denominated in US dollars, and for Botswana to be attractive as a regional base it would have required to be able to use a US dollar bank account in Gaborone. As a Resident company, however, all receipts would have had to be converted into pula, and all outward payments applied for through the usual channels. Without the convenience of being able to operate a dollar account, Botswana was not attractive enough to serve as a regional base, and the idea was shelved. In this context it is worth noting that many other countries in the region, including Zimbabwe, Uganda, Tanzania and Kenya, all permit the operation of Foreign Currency Denominated Accounts (FCDAs) either without restriction or for various specified purposes.

4.23. These two examples are particularly disturbing because, as noted above, there are a number of reasons to believe that Botswana will not find it easy to develop an internationally competitive manufacturing sector. Services, however, are less likely to be adversely affected by factors such as a lack of raw materials, high transport and utilities costs and low labour productivity, and more likely to be helped by some of Botswana's positive factors such as an efficient (if expensive) telecommunications system, availability of modern office accommodation etc. It would also seem that Botswana's education system is far more geared up to producing white collar workers than manual workers; whereas the system is weak in the area of technical and artisan type skills and the encouragement of manual dexterity which are required for the development of manufacturing, it does seem to be producing clerks and administrators, and could produce a highly computer literate workforce with further investment (which could easily be afforded) in computer education at school level.

4.24. We therefore conclude that the present EC system **does** act to deter inward investment in services, particularly those with a regional (or international) orientation. Reform of the EC regime could therefore be expected to lead to a greater flow of inward service-related investment. Following political reform in South Africa, many African countries will be seeking trading and

investment links with South Africa companies, and those companies will also be keen to develop markets in the region, and possibly make investments there also. However, the South African economy is likely to remain weak for some time, with fairly strict exchange controls in place, especially on capital movements.

4.25. As a result South African companies may well have an interest in routing trade and investment in the region through an external centre, enabling them to take their profits and accumulate capital outside of the South African exchange control net. Alternatively, Botswana-based companies may also be in a position to exploit the opportunities offered by regional operations. Of potential regional locations for such activity, Botswana's strong economy, nearly convertible currency, and relatively developed transport and communications infrastructure, must make it a front-runner to attract such investment. However, this is unlikely to happen under the present EC regime; as an absolute minimum, such firms will require to be able to operate FCDAs, and would probably want to operate without any ECs at all. If the present regime is not reformed, Botswana could be deterring one of the potentially important sources of economic diversification, where the country does otherwise appear to have some comparative advantage.

FOREIGN DIRECT INVESTMENT: BANKING & FINANCIAL SERVICES

4.26. It has been suggested that Botswana could have considerable potential in developing as a centre for regional or international financial services, possibly including but not limited to offshore banking activities. Whilst there are a range of different types of activity which could fall under the "financial centre" heading, they are all based upon the idea that one of Botswana's key sources of comparative advantage is its financial strength - its ownership of financial resources in the form of substantial foreign exchange reserves. Associated with this is the convertibility and stability of the currency, but these are less of distinctive features. Other countries of the region are undertaking reforms which have led or are leading to currency convertibility and stability, but they do not possess financial resources to the degree that Botswana does.

4.27. As with any type of inward investment, there are a number of factors which determine the relative attraction of different potential locations. Key factors with regard to the development of a financial centre include breadth and depth of the domestic financial structure, maturity of central bank and regulatory authorities, telecommunications costs and quality, state of development of financial markets. In addition broader factors such as political stability, taxation policy, macroeconomic stability, currency strength, convertibility of currency and impact of exchange controls, level of inflation, physical location, labour costs and availability of skilled labour are also important. On some of these Botswana does well - such as political and economic stability and strength of the currency, but on others - such as the state of development of domestic financial institutions and markets, availability of skilled labour, it does less well in comparison with other countries of the region, notably Zimbabwe and South Africa.

4.28. The experience of Mauritius may however be an instructive example for Botswana. Following the highly successful development of an export-oriented manufacturing sector during the 1970s and 1980s, based primarily on its Export Processing Zone, Mauritius has more recently implemented a second stage of its economic diversification strategy by encouraging the development of offshore banking and related financial, administrative and legal service activities (for more details refer to chapter 2). Although this is at an early stage, reports indicate that there has already been a large number of companies established in Mauritius to take advantage of this

liberalised environment for offshore activities, and that the single largest source of these companies has been South Africa. This does not necessarily indicate that Botswana would be as successful if it followed the same course of action - the problems experienced by Botswana in attempting to emulate Mauritius' move into export-oriented manufacturing indicate that caution is in order - but it does undoubtedly reflect a substantial demand from South Africa for offshore financial and related business services. In some respects, most obviously physical location, Botswana is better placed than Mauritius to serve South Africa in this regard.

4.29. For Botswana to have any prospect of emulating the experience of Mauritius there needs to be rapid and substantive development of the financial environment in order to provide the basis for international operations. Many of the issues involved in establishing Botswana as an international financial centre have been examined in detail in a recent paper by the Deputy Governor of the Bank of Botswana ("Botswana as a Prospective Financial Centre" by Dr Laurence C. Clarke, presented to the Botswana Society Symposium on Botswana in the Twenty-First Century, October 1993). This paper takes a positive and optimistic view on Botswana's potential in this sphere of future economic activity, and presents a detailed agenda of actions required to move towards this objective. The key actions required in the short term and medium term are as follows:

- Creation of foreign currency facilities in domestic markets
- Total abolition of Exchange Controls
- Upgrading of local financial skills
- Reshaping local taxation policy
- Intensification of regional financial co-operation
- Placement of Botswana international bond or equity market issues
- Movement to IMF Article VIII status
- Upgrading of the local banking structure
- Creation of a Capital Market Regulatory Authority
- Preparation and implementation of legal framework for offshore activity
- Marketing (regionally and internationally) of new financial activities and facilities
- Cross-listings on local stock exchange

4.30. We fully endorse this programme, and indeed many of the proposed actions are in line with the specific recommendations of this report (see chapter 7).

4.31. Nevertheless, two important points need to be made with regard to Botswana's potential in this area. Firstly, such a programme would need to be implemented rapidly. Botswana's financial system is underdeveloped in comparison with those of South Africa and Zimbabwe; its advantages lie in its financial strength (access to financial rescues), and the stability of the more general economic and political environment. Both of these countries are undergoing fundamental change at present (predominantly political change in South Africa and economic reform in Zimbabwe) which if successful will undermine if not eliminate Botswana's comparative advantage in these areas. Therefore Botswana's "window of opportunity" is almost certainly very short - probably in the range of three to five years. Secondly, any strategy to develop Botswana as a regional or international financial centre would entail heavy reliance upon expatriate labour and the devotion of substantial resources to servicing and supporting such an influx; both would be politically sensitive and possibly unpopular in the light of frequently expressed concerns regarding foreign domination of the economy.

4.32. The above points have tended to be neglected in some of the more optimistic analyses of Botswana's potential in this area - such as that made by the World Bank in its recent overview of opportunities for industrial development in Botswana. To date only preliminary assessments have been made and what is now required is an in-depth appraisal of the costs and benefits of various possibilities - offshore banking, regional banking services, other types of financial services such as pension fund management, leasing and reinsurance - before the issue can progress further. However, what is clear is that further extensive reform of the current financial and taxation system would be required before there was any prospect of developing along these lines. Minimum requirements would be the removal of exchange controls, reforms to withholding tax regulations, and allowing individuals and corporations to hold, and local banks to provide, FCDAs. With regard to the focus of the present study, whilst it would be premature to conclude that removal of ECs would necessarily lead to a rapid expansion of the financial sector and Botswana's emergence as a regional or international financial centre, there is virtually no possibility of developing financial services in Botswana along these lines if the present EC system remains. In other words, removal of ECs is a necessary, but not sufficient condition for Botswana to attract FDI in the financial sector. Furthermore, there is sufficient potential for Botswana to develop in this area to justify government (primarily MFDP and the Bank of Botswana) embarking upon the in-depth analysis and implementing a programme of action immediately.

4.33. Whilst it may seem contradictory to recommend implementation before a more detailed appraisal has been carried out, it is important to note that many of the actions listed - in terms of developing the breadth, depth and expertise of both institutions and markets - are in any case required to serve the increasingly sophisticated domestic needs of the economy. These should therefore be adopted as soon as possible, leaving those aspects which are more specific to international financial activity - such as the legal and taxation framework - until the results of a more detailed consideration of the areas upon which Botswana should concentrate. Such a review should consider as wide a range as possible of financial and related services and not concentrate on the narrow field of offshore banking.

4.34. One example of a relatively modest way in which Botswana could develop on the basis of its financial resources, and which ties in with promotion of the country as both a regional financial and administration centre for international companies is through the use of the Botswana Share Market as a means for companies to raise capital for expansion of their activities in the region. As noted above, many South African companies view the southern African region as ripe for expansion, but under present South African EC rules, they cannot export capital from South Africa to establish foreign operations; such capital has to be raised externally. One route would be for such a company to raise capital through a share issue on the Botswana Share Market, and then use this money to finance the establishment of an operation in, for instance, Zimbabwe or Zambia. Botswana would benefit in a number of ways. Firstly, it would receive dividend payments form the profits made on the foreign operation, and these would provide a source of (invisible) export earnings - in the same way as Debswana currently earns dividends on its shares in De Beers. Secondly, Botswana financial institutions would benefit from commissions and fees earned on such deals, and also gain expertise in organising international financial transactions. Thirdly, it would help to develop the Botswana Share Market, providing breadth and liquidity to the market, and provide an investment opportunity for institutional investors which would otherwise tend to invest funds offshore. Fourthly, using Botswana as a base for such financial transactions would

naturally encourage its use as a base for wider administrative and service transactions for companies operating regionally.

4.35. There may be some objections to an arrangement of this type on the basis that Botswana's financial resources are not being used for productive investment inside Botswana; however, this is an empty argument if the alternative is that the financial resources remain as part of the BoB's reserves in banks in London or New York etc., or invested by the institutions as part of their offshore portfolios. In fact there is an attractive logic to such an arrangement, in addition to the points made above. Botswana has financial resources, but limited opportunities for productive investment. Neighbouring countries have increasing opportunities for productive investment as reform programmes take place, but have a shortage of financial resources. Combining Botswana's financial resources with other countries' opportunities for productive investment would leave everybody better off, and also provide real substance to rhetoric regarding regional integration.

PORTFOLIO INVESTMENT

4.36. Private portfolio investment has become an increasingly important flow of finance to developing countries in recent years. These flows, which averaged under US$6 billion a year in the period between 1982-88, were estimated at US$34 billion in 1992, in a range of financial instruments including stocks, bonds, country funds, certificates of deposit etc. Portfolio investments are made by institutional investors in developed countries - pension funds, life assurance companies, mutual funds etc. - and the increased flows reflect the recognition by fund managers that developing countries offer high risk-adjusted returns. One particular attraction is that returns in developing country markets show a very low level of correlation with returns in developed country markets, and so there are substantial portfolio diversification gains to be made. As the proportion of developing country securities in these investment funds is at present relatively low (less than 1 percent, compared to an estimated optimum share of 20 percent), it is generally anticipated that the flow of portfolio investment into emerging markets will continue to increase rapidly over the next decade. Whilst most portfolio flows have been directed towards Latin America and the Far East, there are indications that flows to African markets which meet the necessary requirements are also set to increase.

4.37. Inflows of portfolio equity investment into a country are determined by a number of factors besides the expected financial returns on shares; these include the creditworthiness of the country concerned, regulatory impediments such as restrictions on who can purchase shares and the standards of investor protection laws, and other factors such as withholding taxes and exchange control regulations. Like many developing countries, Botswana imposes restrictions on the way that a Nonresident may buy shares and bonds. These include:

(i) A Nonresident may not beneficially own more than 5% of the issued share capital of any company that is listed on the Botswana share market, without EC approval;

(ii) As a group, Nonresidents may not in total own more than 49% of the "free" share capital in a listed company (where the "free" shares are those not in the hands of controlling parent companies) without EC approval;

(iii) Nonresidents are not permitted to be the beneficial owner of Bank of Botswana Certificates.

4.38. There are no restrictions on repatriation of capital introduced under (i) and (ii) above.

4.39. To date the Botswana Share Market (BSM) has only benefited from relatively small inflows of portfolio investment, but interest in the market by outside investors has been increasing steadily in 1993; indeed, much of the recovery in the market index since mid-1993 is attributed to purchases of share by foreigners. Until now the restrictions noted in (i) and (ii) above have not been binding *vis a vis* portfolio investors. However, indications are that they may become binding in the near future, and so could unduly impede. Although any relaxation of the above regulations would not be expected to make any immediate significant impact on the inflow of portfolio investment, inflows could be impeded in the future without such liberalisation.

4.40. We consider that the potential for inward portfolio flows are likely to increase in the future, for a number of reasons. Firstly, the general global trend towards increased portfolio flows, as noted above; Botswana meets many of the requirements of international portfolio investors and is therefore likely to benefit from these increased flows. Secondly, the fact that it takes time for any country to become established in investors' perceptions as a potential outlet for investment funds. This is especially the case for a small, relatively unknown country like Botswana, and therefore the attraction of portfolio inflows would be a cumulative process as Botswana does become better known. This process is likely to be accelerated by the abolition of exchange controls, as Botswana would become even more attractive as an investment location. Although the present EC regime has not been a constraint on inward portfolio investment, it is possible that the existence of ECs has contributed towards a more general adverse perception of the country as being typical of other African economies.

4.41. It is worth pointing out that although the limits on inward portfolio investment have recently been liberalised, they are less generous than, for example, those which have recently been implemented in Zimbabwe.

4.42. Portfolio investment inflows are generally considered to be beneficial. Amongst the effects which are frequently cited in other developing countries are that they provide access to a further source of foreign capital, and enable domestic companies to tap these sources, which can be important in the face of restricted availability of domestic savings. Secondly, they may increase market liquidity. Thirdly, by increasing the demand for shares and hence their price, foreign investors reduce the cost of capital for domestic firms. On the negative side, the short term nature of portfolio investment can lead to substantial and rapid inward and outward flows, which may cause instability in both the share market and the currency market.

4.43. However, not all of these effects may be applicable to Botswana, due to some of the unusual characteristic of the economy. In the past there has been an excess of domestic savings over investment, which, combined with fairly strict ECs on capital exports by Residents, has led to a certain amount of capital being bottled up inside the country without adequate investment opportunities. It has been argued that as a result domestic asset values have been bid up and are artificially inflated. If this is the case, then the returns to capital are already relatively low; while such returns may be attractive to domestic savers with few other outlets for funds, they may not be sufficient to attract foreign inflows from sources with a wider choice of investment opportunities; this may be part of the explanation as to why portfolio investment to date has been limited.

4.44. One of the effects of abolishing ECs would be to remove the restriction on capital export by Residents; if the outflow was significant, then this could contribute to a decline in asset values and hence an increase in the cost of capital, which might induce a greater inflow of portfolio

investment. However, as argued elsewhere in the report, we do not consider that capital export by Residents will be very high. This is partly because the institutions, which are the largest non-government savers, have already had the freedom to invest overseas to a much greater extent than they have actually used. Therefore liberalisation of ECs would not lead to further outflows from that source. Whilst there may be some offshore investment by wealthier citizens, the gross outflows are unlikely to be significant in overall economic terms.

4.45. The gradual increase in the inflow of foreign portfolio investment suggests that Botswana may be gradually reaping the benefits of increased international awareness of the existence of the BSM. However, in the medium term inflows are likely to be constrained by the small size of the market and lack of a wide range of shares. In such a situation continued inflows of foreign investment could indeed push up prices and p/e ratios, making further inward investment unattractive. It is partly due to the limited range of shares that portfolio investors are beginning to approach the current EC limits. Over the longer term inflows of portfolio investment can only be sustained if the market is broadened by ensuring more listings; it is this rather than ECs, which is likely to be the constraining factor.

4.46. It is possible that Nonresidents would want to buy more BoB Certificates, if exchange controls were liberalised. On the face of it this would involve the Bank of Botswana in unnecessary expense, as the rate of interest paid on BOBCs is relatively high, and yet the funds are not actually required for any productive purpose by the Government or the BoB; selling BOBCs is purely a liquidity absorption measure rather than a means of raising money to cover a government budget deficit, as is more usual. However, selling BOBCs to foreigners would involve an inflow of foreign currency into the BoB which would then be exchanged for pula. In the meantime the BoB can invest the foreign currency overseas, and it will make a profit on this as long as BOBC rates are below the expected (pula) return on, for instance, short term US dollar deposits which at present they are. Nonresident investment in BOBCs would be particularly valuable if it came from international portfolio investors as it would mark a significant vote of confidence in Botswana on the part of the international financial community, and in the longer term could therefore bring substantial benefits.

4.47 It has been argued that Botswana does not need portfolio investment, on the grounds that such capital only has a short term presence in the country, does not contribute to productive capacity, and at a time when the reserves are already very high it simply worsens the problem of excess liquidity. However, this would appear to ignore the benefits which portfolio investment can bring in terms of developing Botswana's potential to act as a financial centre to the region. For instance, much of the recent rapid growth in mutual funds in the US and other industrialised countries has been oriented towards investment in emerging markets, including those in southern Africa. Botswana could aim to act as a channel for these investments into the region; part of the funds remain in Botswana (e.g. in BOBCs or shares) whilst the remainder flows outward to neighbouring countries (e.g. the Zimbabwe and Johannesburg stock exchanges). Botswana would benefit from a net inflow of funds and an increase in international reserves. There would be a cost in that the BoB would have to pay interest on the extra BOBCs issued, although this would be (wholly or partially) offset by the earnings on the additional international reserves. However, Botswana would be carrying out a financial service function to the region, and furthermore it would create a demand for supporting accounting, administrative, financial and other professional functions on which further development of financial services depends.

BOTSWANA SHARE MARKET

4.48. Reference has been made at several points above to the Botswana Share Market. Although it remains small, it plays a significant role in the financial sector and can potentially play a much more important role. Most aspects of its operation would be directly affected by abolition of ECs. Earlier in this chapter it was suggested that it could play a role in the raising of capital by South African or Botswana firms to finance the establishment or expansion of regional operations. It may also be in a position to attract inflows of foreign portfolio investment.

4.49. The BSM is also constrained by EC regulations when there are transactions involving controlling interests in firms. Restrictions on inward investment by Non-resident controlling interests may affect, for instance, the sale of shares by a Resident controlling interest to a Non-resident (such as the takeover of BGI by Engen), or the flotation of a Non-resident controlled company (e.g. Pep). In both cases, approval of the proposed share deal **was** granted by the Bank of Botswana, but reportedly only at the last minute and after long delays that jeopardised the whole transaction. It also appears that as these were relatively new types of transactions for Botswana, part of the reason for the delays was a lack of expertise within the BoB in implementing its own regulations. This experience suggests that the BoB should make efforts to improve its internal procedures for dealing with such applications, if necessary by bringing in the outside expertise necessary for dealing with unfamiliar practices.

4.50. One possibility for further developing the BSM would be to allow dual-listings of foreign shares. This would effectively open up foreign portfolio investments to Residents and thus allow greater diversification of their portfolio of assets. This might be an interim measure that could easily be adopted by a relaxation of current ECs prior to total liberalisation. In this interim period sales to Residents could be confined to pula transactions if the authorities are unwilling to see foreign exchange holdings by Residents.

4.51 The recent opening up the Zimbabwe stock exchange to foreign investors led to a substantial inflow of funds and an increase in share prices. This is unlikely to happen in Botswana to anything like the same extent as current regulations provide much less binding constraints to foreign investors than did Zimbabwe's prior to liberalisation, and any overhang of unsatisfied demand for Botswana shares is likely to be small.

MONEY LAUNDERING

4.52. Botswana is in the fortunate position that the existing licensed banks set very high standards of behaviour for themselves with regard to all kinds of unethical practices, including money laundering. All the banks have in-house guidelines about the kind of customer who may open an account with them, and the kinds of transactions they can operate over these accounts. These guidelines will continue to be operational whether exchange controls are liberalised or not. Some of the local banks have benefited from having sight of advisory circulars issued by a foreign central bank.

4.53. Botswana is also in a fortunate position with regard to the high professional standing of the Bank Supervision Department of the Bank of Botswana. It is anticipated that any incipient money laundering problem in Botswana will be nipped in the bud by this Department. In addition, the Bank of Botswana has in the past had reason to discuss large offers of anonymous dollars with MFDP. These discussions have resulted in polite rejections of the money on offer.

4.54. It is of course necessary that both the local banks and the Bank of Botswana will need to be especially vigilant about a possible inflow of tainted money, if exchange controls are abolished in Botswana. The consultants are confident that there is a sufficiently close degree of co-operation between the banks and the Bank of Botswana to enable the problem of money laundering to be kept under control.

SUMMARY AND CONCLUSIONS

4.55. Our overall conclusion with regard to inflows of foreign investment is that the existing EC regime is not a major constraint on inward investment in manufacturing. However, it is a constraint on service-related investment, and more or less precludes Botswana emerging as a base for regional administrative, technical and financial activities in the private sector. If ECs are abolished, suspended or 'greatly liberalised from their present position, then no major inflows of manufacturing investment would be anticipated, as there are other more serious constraints on this kind of investment.

4.56. It is more likely that there would be inflows of service-related investment, including bases for regional operations, where the particular constraints which inhibit manufacturing are less of a problem. The ending of ECs is also a necessary condition for the development of any regionally or internationally oriented financial services, although it is not a sufficient condition. Part of the gains would come from removing a constraint on particular forms of business activities, but in addition Botswana would gain from a more general improvement in the perception and international image of the country as a location for investment. A major further liberalisation of EC would place Botswana in a unique position with regard to all sub-Saharan African (SSA) countries apart from the francophone CFA countries (which have virtually no exchange controls either with each other or with France) and Mauritius (which currently engaged in a liberalisation process).

4.57. Although several countries have liberalised their EC regulations, for instance through the establishment of Bureaux de Change, these countries still do not offer the same freedom of action, or promise of continuity, as countries that have abolished or greatly simplified the regulations on dealings through official channels, and which are perceived as having guaranteed availability of foreign exchange reserves to meet all contingencies. Furthermore Botswana can demonstrate the key ingredient of political stability that is demanded by international investors. Although the inflows of investment into Botswana as a result of abolishing ECs might not be very large, at least in the short term, it is essential that every possible avenue of potential economic diversification away from minerals is explored, and the country cannot afford to maintain (outdated) restrictions on doing business which might have the effect of discouraging some of that potential investment and growth.

5. *MACROECONOMIC MANAGEMENT WITHOUT EXCHANGE CONTROLS*

INTRODUCTION

5.1. It has gradually become apparent during the course of this study, that a higher level of skill is going to be required in future, to manage the Botswana economy. This is primarily because our forecasts point in the direction of an ever increasing government budget deficit. This in turn is likely to give rise to a deficit on the current account of the balance of payments (the model at Appendix 1 assumes that this will in fact be the case). It is thought likely that eventually, after some eight to ten years, the current account deficit could be larger than the net inflow of capital into Botswana, so that there will be an overall balance of payments deficit, not just a deficit on the current account.

5.2. Our forecast is that the level of the foreign exchange reserves will continue to rise for the next eight to ten years, in nominal terms. Thereafter, there is a risk that the reserves will start to fall, and at a greater rate than they were built up. See Appendix 1.

5.3. The task facing the Ministry of Finance & Development Planning and the Bank of Botswana is to train their senior staff in adjustment techniques, which in this case especially includes keeping the budget deficit down to a manageable size. The second key management technique will be for the managers of the economy to find the least inflationary way of financing the budget deficit, without harming the private sector by depriving it of working capital. It will also be necessary to minimise the impact of the budget deficit on the current account of the balance of payments, which is possible but difficult to do.

5.4. Appendix 2 deals with exchange rate policy. To begin with, it will be possible for the monetary authorities to maintain a firm grip on exchange rate policy, because of the high level of foreign exchange reserves. In addition, the ability of the Bank of Botswana to issue BOBCs means that it is possible (though a bit expensive) for the Bank to issue enough BOBCs to absorb incoming capital. This is in contrast to the experiences of other liberalising countries, as indicated in chapter 2, where some countries found that they could not resist upward pressure on their exchange rate after liberalisation. In some liberalised countries, the official process of dealing with large inflows and outflows of capital becomes a major part of their "open market operations", i.e. the sale and purchase of treasury bills with the aim of controlling the domestic money supply at the level considered appropriate by the authorities. In the case of small liberalised economies with large foreign currency deposits from Nonresidents, e.g. Vanuatu and its US dollar deposits from Japanese investors, the impact of capital inflows which are not converted into the local currency, is that large proportions of Vanuatu's foreign exchange reserves must be kept in US treasury bills and other short term instruments].

5.5. The increased burden of managerial responsibility will fall on the main managers of the economy, whether exchange controls are liberalised or not. The remainder of this chapter examines the extent of any additional burden that could be imposed on these managers, if exchange controls are liberalised. The general view of the consultants is that this additional burden of responsibility is

relatively small. In our view, exchange control liberalisation is not the biggest issue that the managers will have to handle.

EXCHANGE CONTROLS AS A RESTRAINT ON CAPITAL FLOWS

5.6. Exchange controls impose a barrier between Botswana and the rest of the world as far as financial flows are concerned. This barrier is however only partial or temporary. There is overwhelming evidence from the rest of the world that, over time, Residents find ways around exchange control rules if there is sufficient incentive to hold foreign assets in preference to domestic assets. Similarly, Nonresidents find ways around the rules if they are very keen to invest illegally inside a country.

5.7. Nevertheless, exchange controls do reduce the impact of exogenous shocks to the economy, by postponing and slowing down the impact of inflows and outflows of capital.

EXCHANGE CONTROLS AND INTEREST RATES

5.8. An apparent example of the insulating effect of exchange controls is that Botswana has a "flat yield curve"; that is, the interest rate on 20 year Public Debt Service Fund (PDSF) loans is the same as the interest rate on three-month BOBCs[1]. In major foreign currencies there is typically a three or four percentage point spread between long and short term rates of interest. However, even if exchange controls were to be abolished, Botswana would not necessarily have to adjust interest rates to the same structure as the rest of the world in present circumstances, because the present high level of foreign exchange reserves would allow the monetary authorities in Botswana to take their time in responding to outside pressures.

5.9. At present, Government does not need to borrow to finance a deficit, and has enough funds to finance the PDSF. There is currently not really a "market" in long term finance, therefore. At some point in the future, the Government will have to borrow to finance part of its spending; and the parastatal and private sectors will have to borrow long term on the open market, possibly by selling corporate bonds. [A technical problem facing the Botswana Stock Market is that there would initially be only a very low turnover in long dated bonds, i.e. the bonds would be somewhat illiquid]. At that point, the structure of interest rates in Botswana will probably have to move more into line with the structure in other countries, including a comparable spread between short and long term rates. But this is some way off in the future.

5.10. The 1993 Budget Speech announced that government funding of the PDSF would be somewhat less in future, because of the gradual change from a government budget surplus to a deficit. If this policy is implemented, the demand for long term finance will have to be supplied more from market forces than in the past, and this will force up long term interest rates. If exchange controls are abolished, banks in Botswana will have to offer a comparable higher interest rate to attract long term funds, which could otherwise be placed abroad. There would be some impact on corporations, who would be pressed to find profitable ways of using the more expensive

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1 *PDSF loans are available to parastatals, institutions in which the government has a major share such as the Botswana Building Society, and subsidiaries of parastatals, e.g. Financial Services Company.*

financing. However, this should not be a major concern as the key issue with regard to long term finance in Botswana is not its cost but its availability.

5.11 Botswana's benchmark interest rates (the commercial banks' prime lending rate, or the BOBC money market rate) have recently become marginally positive in real terms (without taking into account the effect of taxation). Nominal interest rates have been relatively stable over the past 12 months, but falling inflation (down from 17% in January 1993 to 13% in November) has resulted in significant increases in real rates. As Table 2 shows, Botswana's real interest rate on 3-month money market instruments is not excessively out of line with Japanese and US rates, although lower than those in Europe.

TABLE 2

INTERNATIONAL INTEREST RATE COMPARISONS

	Inflation (%) (consumer prices, Nov. 1993)	3-month money market rates (%)	
		nominal	real
Botswana	13.1	13.9	0.8
USA	2.7	3.3	0.6
UK	1.4	5.4	4.0
Germany	3.7	6.2	2.5
France	2.2	6.5	4.3
Japan	1.3	2.0	0.7

Sources: The Economist, Bank of Botswana, Central Statistics Office

5.12 This suggests that should capital controls be removed such that Botswana became integrated with international capital markets, Botswana's real interest rates would not have to rise substantially. Whilst there was a major gap between real interest rates in Botswana and international levels in the mid-to late 1980s, this has now largely disappeared as a result of the Bank of Botswana's policy of raising interest rates. Furthermore, with inflation falling, it is likely that any desired increases in real interest rates can be achieved in the short to medium term through lower inflation rather than increases in nominal interest rates.

THE EFFECT OF "LEADS AND LAGS" WITH RESPECT TO TRADE PAYMENTS

5.11. If exchange controls were to be abolished, foreign capital would be able to flow freely into and out of Botswana. Care would need to be exercised over possible asset price bubbles. Mauritius, for instance, has had to control the price of land by prohibiting foreigners from buying any more land.

5.12. It is important to note, though, that some short term capital flows already occur legally, via the financing of trade. For example, if an importer decides to change to paying cash for imports instead of only paying after utilising the available three months' credit, that amounts to an outflow of short term capital. The foreign exchange reserves would be lower by the amount of the earlier payment.

5.13. The discount for immediate payment is the equivalent of the foreign interest rate. The importer may in fact borrow from a bank in Botswana in order to make the earlier payment. In such a case, the importer compares the cost of borrowing and expected changes in exchange rates,

with the cash discount, to see which is more advantageous. If the importer does not need to borrow, the relevant interest rate for comparison is the deposit rate.

5.14. Similarly, an importer who decides to repay local borrowing, and only pay for imports after three months, is effectively borrowing from the foreign supplier. This causes an inflow of short term capital. This form of foreign borrowing, from a foreign supplier (who may in turn borrow from a foreign bank) can be just as much an inflow of capital into Botswana as other more obvious forms of foreign borrowing, such as drawing down a World Bank loan.

5.15. Exactly analogous capital flows occur through changes in the timing and source of borrowing to finance exports.

5.16. In many countries, short term capital movements of this type (known as "leads and lags" because they derive from changes in the timing of payments for imports and exports) can be larger than the country's foreign exchange reserves. This is not the case at present in Botswana. Foreign trade is a high proportion of Gross Domestic Product (GDP), but the foreign exchange reserves are very much larger than any possible capital flows deriving from leads and lags. So this is not a major worry at present, nor will it be for the next ten years.

5.17. The foreign exchange reserves were equivalent to about 20 months imports of goods and services at the end of 1992. If finance for imports and exports is for a maximum of three months, which is generous because South African suppliers are so near, then 20 months covers the maximum of leads and lags in export and import finance with a large margin to spare (for a forecast of changes in import coverage to 2003, see Table A1.1).

5.18. There would be some additional possibilities for short and long term capital movements if exchange controls were to be abolished. In particular, Residents would be free to convert pula bank balances into foreign assets. These movements would take place principally in response to relative interest rates and expectations as to future changes in exchange rates. Capital flows would also respond to other expectations, for example as to political changes or risk of expropriation, in either Botswana or in neighbouring countries. For example, money might flow into Botswana because of a worsening of political and economic expectations in South Africa. If there are no exchange controls on Residents' movements of capital, interest rates in Botswana will gradually start to be influenced by the financial behaviour of the big "players" in Botswana.

THE IMPACT OF LARGE CAPITAL INFLOWS

The effect of on the demand for BoB Certificates (BOBCs)

5.19. At present, capital inflows from abroad that are accepted by the local banks would result in new pula deposits in the banks, because all incoming forex must be sold for pula. This would at first be matched by additional commercial bank deposits at the Bank of Botswana. In order to sterilise the effects of this increase in the money supply, the Bank of Botswana would then have to issue additional BOBCs.

5.20. This would be costly to the Government and to a much lesser extent to the Bank of Botswana. The Bank of Botswana would have to pay the going rate of interest on the additional BOBCs, at present about 13 to 14 per cent when compounded, while earning less than that on the additional foreign exchange reserves. [If the pula were to depreciate against the sold foreign

currency by more than the interest rate differential, the Bank of Botswana's overall profits would increase rather than decrease.]

5.21. The Government gets 95 per cent of the Bank of Botswana's operating profits, so 95 per cent of any loss of profit would be reflected in a loss of government revenue. The remaining 5 per cent of losses would reduce that share of the Bank of Botswana operating profits which is transferred to the Bank's General Reserve Account.

Large capital inflows and the effect on interest rates

5.22. If the Bank of Botswana did not issue additional BOBCs, their price would be bid up, causing a fall in their rate of return, that is a fall in interest rates. Alternatively, the exchange rate would rise; if such a rise were small, the lowering of import prices would lower inflation and might subsequently cause lower wage rises, without damaging exporters' competitiveness. If such a rise in the exchange rate were larger than could be accommodated in lower wages rises, it would damage the economy.

5.23. The above process, with a rising exchange rate and lower inflation, occurred at times during the 1980s, when the pula's nominal exchange rate rose gradually against the rand. This was incorporated, via slower inflation of import costs in Botswana, into a lower rate of inflation in Botswana than in South Africa. The real bilateral exchange rate between the pula and the rand stayed roughly constant.

5.24. If the nominal exchange rate were to rise faster than could be accommodated in lower inflation and lower wage rises, causing a rise in the real exchange rate, this would make producers in Botswana less competitive in competing with imports and in trying to sell non-traditional exports; exporters of primary commodities (diamonds, copper-nickel and beef) would obtain lower pula receipts.

5.25. There is a small risk, therefore, that a very large and unexpected inflow of capital from abroad would either lower interest rates or raise the exchange rate beyond what the Botswana authorities would have wanted. The authorities at present have only one instrument, BOBCs, available to sterilise these inflows; this might prove insufficiently flexible to cope with very large and sudden inflows. At present, BOBCs are only issued at infrequent intervals; there is no "tap" issue, that is a stock of Certificates held by the Bank of Botswana which could be available to be sold on a daily basis in the event of additional demand becoming apparent after a large capital inflow. However, this could be easily rectified.

5.26. At present interest rates, this sterilisation process would be expensive in government revenue from Bank of Botswana profits foregone, unless there were an offsetting capital gain for the Bank of Botswana due to the fall in value of the pula against the currencies in which the foreign exchange reserves are invested. The result might therefore be a partial loss of control over domestic interest rate policy or exchange rate policy, or both. Any new BOBCs issued would also add to commercial bank liquid assets, making possible additional commercial bank lending. Nonresidents' BOBCs would not increase the banks' lending base, and could be made ineligible for discounting if so required.

Capital inflows and additional commercial bank lending

5.27. At present, as for many years past, the commercial banks have had more liquid assets than required by the regulations. Additional liquid assets would not therefore make any substantive difference. In future, though, additional liquid assets might remove a constraint on commercial bank lending. This could be prevented by the Bank of Botswana by raising the liquid asset requirement, and would be limited at some point by the capital and reserve ratios required by law. Again, though, large and rapid inflows might make it difficult for the Bank of Botswana to react quickly enough to prevent unwanted surges in commercial bank lending.

Why change all the incoming forex into pula?

5.28. One might well ask why the Botswana authorities should insist on large inflows of foreign funds being sold for pula, if the pula created by such a rule are unwanted and simply add to the existing surplus of pula inside the country. The important question of Residents holding assets in foreign exchange e.g. at foreign currency bank accounts in Botswana, which do not have to be sold for pula, has already been mentioned and is examined further later on.

Present and future effects of a large outflow of capital

5.29. An outflow of capital from Botswana would have the reverse effects. Commercial bank deposits would fall, leading to commercial bank sales of BOBCs (Non-residents are at present not allowed to hold BOBCs). The Bank of Botswana would either be obliged to repurchase the BOBCs, or would issue fewer new BOBCs on the roll-over dates, and the foreign exchange reserves would fall. Alternatively, if the Bank of Botswana were not to repurchase the BOBCs offered for sale, their price would fall and interest rates would rise; or the rate of exchange would fall, causing higher import prices and higher inflation.

5.30. Past experience is that depreciation of the pula would not result in a fall in the real exchange rate and an improved competitive position for producers competing with imports, or for non-traditional exporters, unless subsequent wage increases could be held below the rate of inflation. Unfortunately, it is unlikely that this would happen because wage increases have been so strongly linked to inflation in recent years. Thus the result of a nominal devaluation would most probably be an increase in inflation without any real gains for the economy.

5.31. At present, as is established below, the foreign exchange reserves are very much larger than any possible outflow of capital from Botswana. Such factors as a loss of confidence, or a rise in interest rates abroad, or a widespread belief that the pula is likely to fall in value, (which could be caused by a fall in value of the rand), or any combination of these factors, could cause some selling of pula for foreign exchange. The amounts involved would, as at now, be so small that the foreign exchange reserves would not be in any danger of falling to zero.

5.32. In the future, however, if the foreign exchange reserves fall in relation to GDP and the domestic money supply, it is possible that the reserves would not be large enough to absorb an outflow of capital easily. In such circumstances, the Bank of Botswana would not be able to accommodate capital outflows, and interest rates would have to rise, or the exchange rate would have to be devalued, or both. According to the forecasts in Appendix 1, this cannot happen for at least ten years.

5.33. According to the forecasts presented in Table A1.1, domestic savings would be adequate for the finance of investment during the next ten years, using the assumptions about diamond revenues and government spending on which the table is based. If savings were to be less than investment, then by definition the foreign exchange reserves would fall. The Table shows that the reserves only start to fall, by relatively small amounts, in the last three years of the forecast period; and should this begin to create a shortage of domestic savings, the government would have various policy options for alleviating that constraint.

INCREASED ACTIVITY BY THE BANK OF BOTSWANA

5.34. In sum, the complete opening of the economy to inflows and outflows of capital would require the Bank of Botswana to be very active in buying and selling BOBCs. It is quite possible that the flows would be too rapid or too large, in which case interest rates or the exchange rate or both would have to change in response to these flows, possibly in ways that would not suit the objectives of domestic economic policy.

AN ADDITIONAL FORM OF FISCAL DISCIPLINE

5.35. It is also possible to argue that the opening of the capital account to international flows would provide a valuable corrective discipline to fiscal policy. If the government were to overspend, or plan to overspend, in the eyes of the those active in the market, there would be an outflow of capital. This would provide an instant signal to which the government would have to respond quickly if the outflow were larger than could be conveniently accommodated.

5.36. In order for this additional form of fiscal discipline to work, it is going to be necessary for the senior officials in the Ministry of Finance & Development Planning to be able to react faster to changing domestic and international circumstances. This may imply that the Ministry will have to train its senior staff to a higher level of managerial competence than has been the case in the past, when official decisions could be taken more slowly. The Minister of Finance will have to advise his Cabinet colleagues on the additional need for the Botswana government's finances to be kept under control.

5.37. Both the Ministry and the Bank of Botswana will have to be more aware of the differences between real interest rates in Botswana and those in the rest of the world. This in turn will make Botswana's monetary authorities more aware of possible real changes in exchange rates.

5.38. It may be noted that the majority of developing countries that have liberalised their exchange controls, have subsequently experienced capital inflows. This has in turn caused their exchange rates to appreciate. The Botswana situation is, however, somewhat different. See Appendices 2 and 3.

6 THE IMMEDIATE RISK OF CAPITAL OUTFLOWS

INTRODUCTION

6.1. Although considerable emphasis has to be placed on the long term risk of large capital outflows from Botswana, it is instructive to see what the risk of capital outflows would be if exchange controls were abolished tomorrow. The answer is that the short term risks are negligible.

Possible capital outflows at present

6.2. At the end of September 1993, the foreign exchange reserves were worth P10.2 billion. From the Bank of Botswana's end year balance sheets, it can be seen that the domestic equivalent of most (about 90 per cent) of the reserves was either owned or controlled by the government (see Table 3 below). Almost exactly the same conclusion would hold from an analysis of the "Monetary Survey", that is, an analysis of the combined balance sheets of the Bank of Botswana and the commercial banks.

6.3. As can be seen from the notes to Table 3, the percentage of the foreign exchange reserves controlled in recent years by the Botswana government is if anything understated. Parastatals and Debswana can be regarded either as independent in their financial decisions, and therefore as being able to move their liquid assets abroad if that seems optimal; or they can be regarded as under government control, in which case they would retain their liquid assets in Botswana if asked to do so by the Government, even if it seemed to their management that it would be financially optimal to move them abroad.

THE IMPORTANCE OF DEBSWANA

6.4. The above analysis has assumed that Debswana and Dicorbot (independently owned) are outside government control and that they sell all of their US dollar export receipts for pula, as they are required to do under the present exchange control rules. The situation would be slightly different, in the short run, but more significantly different in the long run, if one were to vary these assumptions.

6.5. The largest private holdings of pula deposits by far are those of Debswana, partly held against future quarterly tax liabilities. A great deal of the argument depends on whether Debswana would continue to keep those liquid assets in pula, if the exchange control rules were changed so as to allow them to be held in foreign currency denominated assets. For example, one could imagine Debswana having a US $ denominated bank account at a bank in Botswana, if exchange controls were to be liberalised. Debswana's diamond export earnings could then be held in dollars until such time as Debswana needed to sell some of its dollars for pula, to cover income tax payments and any other local expenses.

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TABLE 3

GOVERNMENT AND PRIVATE CONTROL OF BOTSWANA'S FOREIGN EXCHANGE RESERVES

(end-years, 1988-92, P million)

	1989	1990	1991	1992
Foreign exchange reserves	5248	6234	7708	8563
Government owned or controlled:				
Government deposits	3013	3966	4377	5210
Bank of Botswana reserves	503	855	1451	1351
Other BoB liabilities (a)	402	624	818	894
Required liquid assets	220	270	326	367
Sub-total	4138	5715	6972	7822
Govt as a % of foreign exchange reserves	**79%**	**92%**	**90%**	**91%**
Privately owned and controlled:				
Notes and coin	148	189	222	233
Excess liquid assets (b)	202	77	161	165
Other deposits at BoB (c)	833	362	59	33
BoB Certificates, other (d)	-	-	432	572
Sub-total	1183	628	874	1003
Private as % of foreign exchange reserves (e)	**22%**	**10%**	**11%**	**12%**

Notes:

(a) *Mostly accrued profits owing to the government, also including IMF Reserve Tranche and SDR allocation.*

(b) *Excess liquid assets less balances held abroad, because balances held abroad have already left the country.*

(c) *Other deposits include parastatal and Debswana deposits, which could alternatively be regarded as being under government control.*

(d) *Other holders of Bank of Botswana Certificates; other that is than commercial bank holders, include Debswana and parastatals, which could be regarded as being under government control. It is assumed here that their management of their financial assets is independent of Government.*

(e) *Government plus private percentages add to slightly more than 100% of reserves, because of the presence of a small quantity of domestic assets on the assets side of the balance sheet of the Bank of Botswana.*

6.6. Debswana has tended to act independently in managing its financial affairs, but is not unmindful of any major government concerns. It would not want to embarrass the government by making huge switches every few days between pula and dollar deposits, with the attendant large changes in the domestic money supply (in pula). But the analysis shows that it would be necessary for the managers of the Botswana economy to come to an understanding with Debswana about the

timing of Debswana's sales of dollars for pula, if Debswana were allowed to maintain a US dollar account.

6.7. There would be advantages to the Botswana authorities from such a scheme. If Debswana held some of its export earnings in dollars, there would be less of a monetary surplus (in pula) for the Bank of Botswana to have to mop up by the sale of BoB Certificates. And if Debswana promised not to suddenly sell large amounts of pula back into dollars, one of the major theoretical risks of capital outflows would be eliminated.

THE DAMPENING EFFECT OF CURRENCY IN CIRCULATION

6.8. It is doubtful that very much of the pula note circulation in Botswana would be exchanged for foreign assets, if exchange controls were abolished. Most of the notes and coin in circulation are used for everyday transactions, and would not be exchanged for foreign currency unless confidence in the pula fell so low that people preferred to use some other currency. [This has happened to some extent in other countries, for example so-called dollarisation in the former Soviet Union and in Latin America, and to some extent in Mozambique, but the possibility seems remote in Botswana].

6.9. Some part of the currency in circulation is held not as transaction balances but as savings. In 1976, the savings proportion was estimated as some two thirds, held mainly by older people in areas remote from bank branches and still suspicious of entrusting their savings to banks. The proportion of the note issue held as savings may be similar now, but it seems probable that the groups most likely to hold their savings in notes would be slower than average to convert their savings into foreign assets.

THE WORST CASE SCENARIO

6.10. Even if all the private sector liquid assets shown in Table 2 were to be exchanged for foreign assets, the numbers show that in recent years (and at present) the foreign exchange reserves are very much larger than any possible outflow. In 1992, for example, the entire privately held portion of the foreign exchange reserves which could leave the country (without the Bank of Botswana acting as a lender of last resort to the commercial banks) was only 9 per cent of the foreign exchange reserves.

6.11. The private sector also holds real assets such as houses, farms, businesses and other forms of property. In order to convert these physical assets into foreign exchange they would either have to be sold for pula, which would reduce someone else's liquid assets; or they would have to be sold for foreign exchange, in which case the net effect on the foreign exchange reserves would be zero (except in the unlikely event that the seller then sold his forex for pula).

6.12. A final possibility is that those with physical assets could first borrow pula from the commercial banks against the security of their assets, and then buy foreign exchange with the money borrowed. This would be additional to the potential for capital flight from money balances held by the private sector. There is a limit to such credit creation, set by the excess liquid assets of the commercial banks, and the level of shareholders' capital and reserves that they have to maintain as a proportion of their loans. The commercial banks' unused lending capacity is quite small in relation to the foreign exchange reserves, as can be seen from Table 2 above. Moreover, the

Bank of Botswana has various powers for limiting commercial bank lending, including the power to increase the liquid asset requirement.

6.13. It is a remote possibility that the private sector might wish to withdraw more of their bank balances than the available spare liquidity, or even than the total liquid assets of the banking system. This is the situation in which the central bank is supposed to act as a lender of last resort. In such a case, if the Bank of Botswana really did lend to the commercial banks, and if the deposits were all used to buy foreign exchange, more of the foreign exchange reserves would be needed than shown as the proportion controlled by the private sector in Table 3. At present, even if all private sector deposits in the commercial banks, including those of parastatals, were to be sold for foreign exchange, it would only use up about 15 per cent of the foreign exchange reserves, using end-1992 statistics. In the future, however, if there is a large government budget deficit, if imports rise faster than exports, and if capital inflows are less than the current account deficit, the maximum possible capital flight would rise as a proportion of the foreign exchange reserves. But at present, there is nothing to worry about.

6.14. In these very unlikely circumstances, given that it would mean people selling all their deposits, both savings and transactions balances, for foreign exchange, the Bank of Botswana might have to take action. The most obvious short term measure would be to raise overnight domestic interest rates quite sharply, in order to make it more attractive at the margin to hold pula assets overnight compared to foreign assets; but if there were a crisis of political or exchange rate expectations, it would be necessary to do something to change those expectations in the medium and long term if one wanted to stabilise the domestic financial scene. [A public relations exercise would be needed, to reassure members of the public that an overnight marginal interest rate of (say) 100% per annum, maintained for a few days on new bank borrowings while there is a crisis, would not translate into significantly higher borrowing costs for regular borrowers].

6.15. In conclusion, even the worst case scenario would produce a manageable outflow of reserves. In practice the amount in of capital outflow would be much less than this. Therefore capital flight cannot be a concern in the near future.

7. CONCLUSIONS AND PROPOSALS FOR REFORM OF BOTSWANA'S EXCHANGE CONTROL REGIME

CONCLUSIONS

This study has considered the operation of exchange controls in Botswana. Its main conclusions are as follows.

7.1. Although there were sound reasons for introducing a comprehensive regime of exchange controls when the pula was established in 1976, those reasons no longer hold - due to Botswana's successful economic record since that time and in particular the build up of a very high level of foreign exchange reserves - and do not provide justification for maintaining such a system of controls.

Costs of existing ECR

7.2. The existing EC regime is quite liberal and in general efficiently administered. Nevertheless, exchange controls impact on the economy in a variety of ways, many of which involve costs to private sector businesses and to individuals. There are significant direct costs, including cost of employing skilled personnel in administering ECs in the Bank of Botswana and the commercial banks, the time which firms have to devote to dealing with EC matters, and in some cases the costs to firms of employing outside professionals (lawyers, accountants etc.). There are also the costs (in terms of bank charges and commissions) of extra foreign exchange transactions, for instance when firms engaged in foreign trade have to convert export receipts to pula and then back to foreign currency to pay for imports.

7.3. There have also been a number of restrictions on the ways in which firms can conduct their business, for instance preventing some kinds of contracts, restricting the amount of local borrowing by foreign-controlled firms, and discouraging foreign firms from bringing in capital in the form of shareholders' loans..

7.4. In the past there has also been a significant financial penalty on savers (both individuals and firms) as a result of low real interest rates in Botswana and EC restrictions on investing abroad through the acquisition of foreign currency financial assets, which generally offered higher real rates of return than those denominated in pula.

7.5. Exchange controls have also acted as a constraint on inward foreign investment in Botswana. Whilst this has probably not been significant in the manufacturing sector, it has been in services. This has inhibited Botswana's development both as a regional administrative centre for international companies operating in southern Africa and as a potential financial "safe haven" in the region. These represent lost opportunities during the politically and economically turbulent 1980s, and ECs will continue to deter foreign investment - something which Botswana cannot afford.

7.6 Exchange controls have contributed to excess liquidity and, through the bottling up of funds within the economy, have themselves been a cause of low real interest rates and the mis-pricing of some assets, such as property.

7.7. Most of the present controls are on capital account transactions; those on current account transactions are relatively few. Given this, and the openness of Botswana's economy, the existing capital account transactions are relatively "leaky" and therefore not particularly effective. Furthermore they are regressive in that the largest economic agents (both companies and individuals) can find ways around the controls (and thus avoid being penalised), whilst smaller and less wealthy agents cannot.

Benefits of existing ECR

7.8. There have also been some benefits of the EC regime, most of which accrue to the government. Firstly, it has increased tax revenue, by enabling the taxation of interest on local financial assets, whereas some of this would have been lost if the acquisition of foreign financial assets had been permitted (earnings from outside of Botswana are not taxable).

7.9. Secondly, the official foreign exchange reserves (held by the Bank of Botswana) have been higher (although not significantly so) than they would have been without ECs.

7.10. Thirdly, the Bank of Botswana and the Government have benefited from their monopoly control of such foreign financial assets, given that the real returns paid to holders of pula savings have been much lower than those earned by the BoB on the reserves, for most of the period since 1976.

7.11. Fourthly, it has enabled greater independent control over interest and exchange rates by Botswana's monetary authorities.

Likely benefits of EC liberalisation

7.12. The study has also considered the likely effects of significantly liberalising or completely removing exchange controls. There would be a number of important **benefits**. Firstly, financial and time savings to the private sector, and more generally to the economy as a whole. The private sector would also benefit from greater freedom in its business affairs.

7.13. Secondly, an improvement in Botswana's investment climate and therefore in increase in inward foreign investment, especially in the services and financial spheres. This opens up the possibility of establishing Botswana as a regional administrative headquarters for international companies and also as a financial services centre - something which is effectively precluded whilst ECs remain. However, such inward investment would also need to be encouraged by certain other measures accompanying the removal of ECs, such as tax changes and institutional reform in the financial sector. One important area that would be opened up, with significant future potential, would be for local, regional and international companies to use Botswana's substantial financial resources for investments elsewhere in the region, enabling Botswana to use its financial strength to benefit from the wide range of investment opportunities available in the region but which at present cannot be exploited because of shortage of finance in those countries. The ability to make outward investments from Botswana would also help to attract regionally-oriented portfolio investment funds from overseas; besides leading to net capital inflows for Botswana this would

also lead to spin-offs in terms of demands for professional services and contribute to the development of Botswana as a regional financial hub.

7.14. There would be a positive net effect on job creation, given that inward investment would create some jobs (although the impact is impossible to quantify, the number would probably not be large). Some posts would disappear in the banking system, but given the general shortage of skilled personnel all of the individuals involved should be redeployed elsewhere.

7.15. Cost savings and increased inward investment would have a positive impact on economic growth, although the magnitude is impossible to quantify.

Concerns about EC liberalisation

7.16. In terms of the main concerns which have been expressed by both Government and the private sector about EC liberalisation or removal, we find these to be largely unfounded. Analysis shows that over a ten year period any outflow of official foreign reserves will be small, and the reserves will remain high enough to meet foreseeable needs.

7.17 The main macro-economic issue in the medium term (ten to fifteen years) will be the level of government spending, and this will need to be addressed in much the same way with or without ECs in place. Indeed, not having ECs will probably increase the chances of addressing this issue in an economically sustainable manner, given that the risk of capital outflows would constrain the use of inflationary deficit financing of government spending.

7.18 The continued high level of reserves means that government will retain flexibility in its policies with regard to management of interest and exchange rates over the next decade, although broad limits will be imposed by international economic conditions. The exchange rate will continue to be managed (there is no necessary connection between removing ECs and moving to a floating rate system) and the objectives of exchange rate management - those of maintaining export competitiveness through a stable real exchange rate combined with a low inflation rate - will remain unchanged. Interest rates will approximate international levels in real terms, and although this implies a small increase from present levels of real interest rates, this will most likely be achieved as a result of lower inflation. We do not consider that nominal interest rates will rise above present levels, and indeed are more likely to fall, unless inflation starts to rise again. Any rise in real interest rates is likely to be greater for long term than for short term rates, in order to bring the shape of Botswana's yield curve more in line with that of international rates. Similarly, the return on equities should rise. Increasing yields on long term financial instruments should encourage long term savings.

7.19 Net capital inflows may increase as a result of liberalisation but of more concern is higher levels of gross capital flows (both inflows and outflows). This would require prompt action by the monetary authorities in order to sterilise such flows, in order to ensure that the main impact is on the reserves rather than on interest rates. This would require new skills on the part of monetary managers, as well as developments of financial markets (such as a tap issue of BOBCs) and financial instruments (bills and bonds with a range of maturities). All of this would take time to put in place. It would also require (i) greater awareness, and (ii) much faster responsiveness of the decision-making process in the Bank of Botswana, but particularly in the MFDP; it would not be sufficient to respond to events with a long time lag. It will be necessary for the government's economic managers to engage in "real-time" monitoring of economic events, i.e. be aware of events

as they happen rather than after they have happened. This especially applies to those economic relationships linking Botswana to the international financial system.

7.20 There would be some loss of taxation income as interest on savings placed overseas would be non-taxable under present regulations. Although this loss would be significant in relation to current tax revenues, it is small in relation to total government revenues. The cost to the Government would in any case be partially offset by savings of interest payable on BOBCs as the amount outstanding would drop by an equivalent amount to the export of savings. There are also other possible tax reforms which could be used to make up this loss. One potential theoretical response to this tax loss would be to move to a worldwide source basis for taxation (as opposed to the present system of taxing domestic income only). However, this is neither desirable - because of the disincentive effect it would have - nor practical to implement. Any inflows of investment resulting form EC removal would also raise additional tax income.

7.21 There would be some loss of import data if exchange control forms were no longer required. However, the Department of Customs and Excise are confident that they have the systems and personnel in place to be able to collect the necessary trade data in order to ensure that Botswana does not lose out on its share of revenue under the SACU Agreement.

7.22 Protection for the insurance industry can, if necessary, be transferred to the Insurance Act.

7.23 The BoB and the commercial banks can further develop existing guidelines so as to ensure that Botswana without exchange controls will not be used as a conduit for funds of undesirable origin.

Other countries' experiences

7.24 The now widespread experience of developing countries which have liberalised exchange controls, with particular attention paid to those which have liberalised capital account transactions, indicates that if the appropriate set of accompanying economic polices and characteristics are in place, then there is a net benefit from such liberalisation. These requirements are for macroeconomic stability (low inflation and no excessive deficit financing of the government budget), an exchange rate which is not overvalued, and real interest rates which are comparable with international levels. Where these conditions have applied, liberalising countries have tended to experienced capital inflows (thus boosting official reserves and assisting the balance of payments) and in some cases currency appreciation. In many countries there have also been increases in foreign investment inflows, although the fact that EC liberalisation has often accompanied much broader economic reform and adjustment programmes makes it difficult to evaluate the exact contribution of changes in ECs. Although some countries have removed all exchange controls at once, it is more common to adopt a gradual, phased approach. This is the strategy being adopted by Mauritius, a country with certain similarities with Botswana, the objective being to avoid any possible destabilising moves which might undermine the credibility of the reforms and lead to damaging policy reversals. Liberalisation to date in Mauritius has led to a substantial number of new company registrations in a relatively short period.

7.25. Sub-Saharan Africa has followed this international trend towards EC liberalisation, albeit rather slowly. However it is worth noting that even during the period over which the present study has been conducted, several countries in the region have undertaken significant liberalisation. Most notable amongst these is Zimbabwe - one of Botswana's main competitors for

inward investment into the region - which has moved far from its earlier system of rigid controls, and in some respects is now more liberalised than Botswana. Zimbabwe and other countries in the region are moving in the direction of complete removal of ECs, and although there are other aspects of the overall investment climate in which Botswana has an advantage, there is a danger that Botswana will be left behind in the crucial area of exchange controls.

Impact on the private sector

7.26 The main effects on the private sector of exchange controls abolition would be as follows:

- savings on time and costs, as well as fewer restrictions on organising business activities;
- the opening up of new investment opportunities, especially in international finance and service activities;
- access to international financial markets, possibly resulting in lower borrowing costs, and the opening up of currency hedging opportunities;
- no significant changes in domestic interest rates or the exchange rate in the short to medium term, other than those specifically planned by Botswana's monetary authorities;
- increased competition in the financial sector, leading to greater efficiency, higher productivity, and a wider range of products and services, thus contributing to financial deepening and broadening which is crucial to broader process of economic development in Botswana;
- the insurance sector need not be adversely affected as continued protection, if considered desirable, could be transferred to the Insurance Act;
- expansion of the Botswana Share Market through transactions in foreign securities and inflows of foreign portfolio investment;
- an improvement in the operation in the price mechanism, particularly in asset pricing, which will boost economic efficiency and raise the returns on investment;
- the ability of Residents to make outward investments from Botswana, which will lead to more investment opportunities, higher returns, and an increase in national income.

RECOMMENDATIONS FOR REFORM

7.27 As a result of the above analysis we conclude that the costs of Exchange Controls as they presently operate in Botswana significantly outweigh the benefits, and therefore that there is an unassailable case for substantial reform and liberalisation of Botswana's present EC regime.

7.28 However, there are a number of issues that still need to be addressed within this broad conclusion, including:

(i) How far should such liberalisation and reform go? Specifically, should it extend to complete removal of Exchange Controls?

(ii) Over what time frame should reform take place? Should it be immediate or more gradual?

(iii) If complete removal is adopted, should the existing legislation be suspended, amended or completely abolished?

(iv) What should be the sequencing of reform?

(v) What accompanying measures are required to ensure that any potential adverse effects of liberalisation (such as on the insurance industry) are minimised?

IMF Article VIII Status

7.29. In respect of point (i), we can first of all consider current account restrictions. These are already minimal, and remaining restrictions should be abolished as soon as possible. This would enable Botswana to apply to the IMF for Article VIII status - indeed, there is a strong argument that Botswana should long ago have applied for Article VIII status. Whilst such a move would require Botswana to pledge to the IMF (and to itself) that ECs over current account transactions would never be reintroduced in the event of a balance of payments crisis, this should not be a major concern; it gives the Government and the Bank of Botswana an added incentive to manage the economy in such a way that controls over current account transactions would never be required. Furthermore, the re-introduction of controls over capital account transactions would be permitted, if there ever were a balance of payments crisis, under Article VIII rules.

7.30. A number of detailed negotiating points would have to be agreed with the IMF, before Botswana could be achieve Article VIII status. These are not matters of principle and are therefore not major obstacles. The IMF has clarified the position regarding the use of exchange controls to protect Botswana's insurance industry. The IMF regards Rule 16 (about buying insurance inside Botswana) in the Balance of Payments Manual as a trade restriction, not as a restriction designed to protect the foreign exchange reserves. These rules are therefore not an obstacle to moving to Article VIII status. Appendix 15 contains a detailed discussion of the implications of moving to Article VIII status.

7.31. There are no reasons why Botswana should not move to Article VIII straight away. The advantages are valuable but somewhat intangible - along the lines of international goodwill (from the point of view of outside investors), and along the lines of promised good fiscal behaviour (from everyone's point of view).

Recommendation ***The Government of Botswana should immediately announce its intention to apply for IMF Article VIII status and remove all exchange controls over current account transactions, and should open discussions with the IMF in respect of clearing any remaining obstacles to this move.***

7.32 Removing the remaining current account restrictions is, however, only a minor issue as there are so few such restrictions anyway. The real issue is that of liberalising capital account transactions, as the restrictions here are much more extensive, more binding and more extensive in terms of their impact on the economy. Two other important points need to be made. Firstly, *de jure* removal of current account restrictions may not result in a *de facto* removal if capital account restrictions remain, as current transactions would still need to be checked in order to ensure that they are not capital transactions in disguise. Most EC form-filling and bureaucracy would therefore remain, and potential benefits be correspondingly reduced. Secondly, part of the benefit of EC liberalisation for Botswana is the impact that this can have, if handled properly, on the attitude of international investors towards the country. The public relations benefits of removing current

account restrictions are fairly small - especially when there are in any case few such restrictions - and do not compare with the potential PR impact of complete removal.

7.33 The options with regard to capital account restrictions are progressive liberalisation - perhaps at a faster rate than has taken place in the past - and complete removal in the short to medium term. Progressive liberalisation could include moves to permit the acquisition of limited foreign assets by Residents (such as the purchase of one property, or financial assets up to a specified value), the trading of foreign shares on the Botswana Share Market, and encouraging external investors to use Botswana as a base for outward investment into the southern African region. Whilst these moves would be in the right direction, we consider that they should be viewed only as a preliminary step towards complete removal of ECs, as it is only with complete removal that the maximum benefits - in terms of cost savings and the attracting of foreign investment - can be obtained. Partial liberalisation would, for instance, require the maintenance of most if not all of the EC bureaucracy in the BoB and the commercial banks. As technology develops and the international financial and trading system becomes more integrated, any remaining controls will in any case become more difficult to enforce. Of the potential costs or disadvantages of complete liberalisation, some can be dealt with by legislative or other changes, whilst others are not significant enough to stand in the way of such a move. Most importantly, complete liberalisation would put the maximum distance between Botswana and other countries of sub-Saharan Africa, and thus enable Botswana to achieve maximum benefits of its economic and political strength and stability. However, we would stress that whilst complete removal of ECs is a desirable and indeed necessary objective for Botswana, this should implemented in a way which is compatible with both the institutional structure of Botswana's economic management capacity and with minimising the risks involved in such a move.

7.34 In other countries the sequencing of exchange control liberalisation has been a crucial issue (see chapter 2 above and appendix 10). However, it appears that Botswana has already implemented many of the required prior conditions: the macroeconomy is stable, real interest rates are no longer negative, the currency is stable and not overvalued, and there is a high level of foreign exchange reserves. However, some of the preconditions are not fully satisfied: wages are "sticky" and not fully responsive to market forces, and although the government budget is currently in reasonable shape there is significant uncertainty as to whether in future government spending will be accommodated without leading to inflationary deficit financing. So although Botswana is in a reasonably strong position with regard to the macroeconomic preconditions for EC liberalisation, some caution and further reform is required.

7.35. The analysis of this study shows that the original justification for Botswana having exchange controls no longer applies, that ECs may already have led to lost opportunities for inward foreign investment, and that if maintained they are likely to harm the prospects for future economic growth and employment creation. The major concerns that have been raised in connection with removing exchange controls are either largely unfounded or can easily be dealt with. The conclusion, therefore, is that exchange controls should be removed. Furthermore, as ECs are doing more harm than good to the economy, they should be removed as soon as possible. Technically, exchange controls could be removed (suspended) almost at once. However, as certain preparatory measures have to be taken (for instance by the banks and many companies) this is effectively not an option. More importantly, removing ECs marks a fundamental change in the operation the economy, and it is of crucial importance that EC liberalisation is handled in a manner which does

not destabilise important macroeconomic relationships. The question is, therefore, how quickly can exchange controls be removed without causing instability which may in the longer term be counterproductive - for instance by requiring the reversal of reforms. In the case of Botswana, where there are relatively few current account controls, this question essentially refers to the speed of removing capital account controls. Related to this is the question of whether all remaining capital controls should be removed in one go - say within a few months of a decision to remove exchange controls being made - or spread over a longer, phased process.

7.36. It is important that Botswana removes its exchange controls quickly, in order to achieve the maximum benefit from the "window of opportunity" available before Zimbabwe and South Africa benefit from their own reform programmes. As noted in para. 54 above, Botswana should already have liberalised much more extensively than it actually has. However, removing exchange controls is a process consisting of a number of steps, and in the context of Botswana's economy there is a limit to how far this process can be prudently compressed. We consider that removing remaining ECs in one go is unnecessarily risky and not a realistic option, for the following reasons.

7.37. Firstly, following removal of capital controls, macro-economic managers will need to be able to respond quickly to sharp adjustments in international capital flows, to assert and tighten fiscal and monetary control, and to respond much more quickly to changes in the international economic and financial environment. Whilst it is to be hoped that this would be possible in Botswana, it would very much mark a movement into unknown territory where experience to date is limited. Although economic managers have responded well in the past, the existence of exchange controls has enabled decisions to be made more slowly. Opening the capital account will require a much faster response than Botswana is used to making, even though the present high level of reserves gives a breathing space of some six to eight years before the full impact of integration into the international financial system is felt. It will take time to put such mechanisms in place and develop the necessary skills, even if in the short term some skills are bought in and use is made of advice from international institutions such as the IMF. The uncertainty over the impact of removing capital controls is compounded by the fact that Botswana is moving into a new economic era of reduced real mineral revenues, slower economic growth, and increased pressures on government spending. The ability to deal with this new situation in a non-inflationary manner has not yet been demonstrated.

7.38. A second risk is that if removal of capital controls leads to unexpected consequences which cannot be successfully dealt with, this might require some controls to be reimposed in order to stabilise the situation. This would be the worst possible course of action, and would cause a disastrous loss of credibility on the part of Botswana in international financial markets, which would be very difficult and time-consuming to recover from. It is very important from a credibility point of view - especially for a small and relatively unknown country such as Botswana - that any exchange control reforms be irreversible.

7.39. The institutional history of the MFDP is one of relative caution and conservatism in economic policymaking and changes thereof. In general this risk-averse approach has been successful and has served the country and the economy well (although the danger must also be acknowledged that this can lead to an over-conservative approach and perhaps a damaging resistance to change - and there is some argument that this is one reason why exchange control liberalisation is not as far advanced as it should be at this stage, given Botswana's economic strength). One of the important consequences is a consistency in economic policy which few (if any) other countries in

Africa can match, and this in turn gives Botswana unrivalled international credibility in the economic sphere. Phased liberalisation of exchange controls fits more comfortably with MFDP's traditions of economic decision-making than the more risky strategy of removing ECs all at once.

7.40. On the basis of likely developments in Botswana and the applicable lessons from other countries, the balance of judgement must therefore weigh in favour of a progressive approach to capital account liberalisation rather than a rapid dismantling of capital controls. Prior to a full opening of the capital account, further progress must be made in (i) developing the financial system (including both the Bank of Botswana and private financial institutions) to introduce a higher degree of sophistication in handling enlarged volumes of gross capital flows in either direction with a wider range of financial assets and instruments; (ii) improving the capacity of the monetary authorities to rapidly sterilise large capital inflows and outflows; (iii) introducing more responsive mechanisms for managing interest and exchange rates; and (iv) exerting effective control over domestically-generated inflation. A phased approach enables the consequences of one step to be absorbed and considered before proceeding with the next, thus creating credibility and contributing to the irreversibility of reforms.

7.41. The need for a phasing of EC removal should not be seen as an excuse for prevarication or delay, as this runs the substantial risk of preventing Botswana from exploiting its current financial strength relative to other countries in the region, and missing out on potential inflows of foreign investment. Therefore, although a phased approach is desirable, there is some urgency given the need to substantially complete the process within a time period which would enable Botswana to compete, especially with Zimbabwe and South Africa for regional financial business. In the light of developments in these countries, and the fact that Mauritius already has a head start, and that Zambia has removed all exchange controls, this time period is very short. Therefore: **(i) Botswana must implement further EC liberalisation at a much faster speed than has been carried out in recent years; (ii) substantial liberalisation of capital account controls must start immediately; and (iii) complete removal of exchange controls must be completed as soon as possible, preferably within two and at most within three years.**

<u>*Recommendation*</u> *Government should take the decision to completely remove all remaining exchange controls, preferably within two year and at most within three, and to implement a phased programme of liberalisation within this period.*

<u>*Recommendation*</u> *A working group, consisting of representatives from the Ministry of Finance and Development Planning, Bank of Botswana, the commercial banks and the non-bank private sector should be established to oversee the exchange control liberalisation process , and one of their key tasks should be to ensure that the timing of liberalisation remains on schedule*

7.42 The initial stages of liberalisation should aim to open up opportunities for Residents which they are currently denied (thus ending imbalances between Residents (citizens) and Nonresidents (expatriates)), and to enable the private sector to benefit from cost savings and efficiency gains. Furthermore, attempts should be made to broaden and deepen the financial sector, in particular to promote market-driven efficiency gains and to develop foreign currency denominated banking activities. This leads to the following recommendations:

<u>*Recommendation*</u> *The various foreign exchange allowances for Residents should be unified to provide a single annual allowance for any purpose. The limit for this*

allowance should be determined following more detailed consideration by the BoB & MFDP

Recommendation — *The Bank of Botswana should immediately address various anomalies in the existing exchange control system with a view to removing them as rapidly as possible.*

Recommendation — *The commercial banks should be permitted and encouraged to operate foreign currency denominated accounts (FCDAs), at the latest by mid-1994.*

Recommendation — *Resident individuals should be permitted to hold foreign currency within the limits of the annual allowance and to open FCDAs at Botswana banks*

Recommendation — *Resident companies should be permitted to operate FCDAs for trade-related transactions*

Recommendation — *The Botswana Share Market should be permitted to trade in selected foreign securities; the final decision on which securities to sell to be made by the Interim Stock Exchange Committee*

Recommendation — *Residents should be permitted to purchase one property outside of Botswana up to a limit to be determined by the BoB/MFDP.*

7.43 These changes will give rise to a number of technical issues, such those relating to the operation of FCDAs - which can be dealt with by the Bank of Botswana and the commercial banks. Due to the enhanced dangers of money laundering and other undesirable capital flows in a liberalised system, the existing guidelines operated by the commercial banks need to be reviewed, with the possibility of strengthening the BoB's formal regulatory and supervisory role in this area.

Recommendation — *A technical working group involving the BoB and commercial banks should be established to deal with issues such as the modus operandi of FCDAs and the establishment of a forward market for the pula.*

Recommendation — *BoB and the commercial banks should review the existing guidelines regarding the acceptance of large cash deposits of foreign currency and other funds which may be of undesirable origin. Government should initiate contacts with the relevant authorities in South Africa and Zimbabwe so that their concerns in this area can be accommodated.*

7.44 The longer term objectives of exchange control liberalisation are to enhance Botswana's potential to act as a regional financial services centre. This involves a wide range of issues beyond exchange control which need thorough investigation

Recommendation — *Government/Bank of Botswana should commission a study to examine the costs, benefits and constraints regarding the future development of various regional and international financial services in Botswana, with a view to pursuing financial services as a key element of economic diversification.*

7.45 As part of this process Botswana needs to attract inflows of external funds, particularly those which are regionally oriented and which can use Botswana as a base. The southern African region is increasingly of interest to fund mangers in the industrialised countries (as demonstrated by

substantial portfolio investments in South African shares towards the end of 1993), and it would be ideal if regional funds could be domiciled in Botswana. Part of their portfolio could be left in BOBCs whilst Botswana would be used as a base for investing the remainder in investments elsewhere in the region (Johannesburg and Harare stock exchanges, privatisations in Zambia, Malawi etc.). As this would involve a cost to the Botswana government (through the interest paid on BOBCs) such investments should be gradual and selective in the early stages, although subject to progressive extension and liberalisation. In the longer term, the cost should be offset by the enormous potential benefits in terms of Botswana's image as a regional centre for financial operations. There would also be earnings from the administrative, legal and financial services which could be provided in Botswana in support of such transactions.

<u>*Recommendation*</u> *Allow selected Nonresidents to purchase BOBCs with a view to attracting and encouraging international portfolio managers and mutual funds operating in southern Africa to domicile in Botswana.*

<u>*Recommendation*</u> *Allow reputable foreign companies to raise funds through a share issue in Botswana for investment elsewhere in the region.*

7.46 All of the above recommendations should be implemented in 1994. The subsequent programme should work towards the target of complete removal of exchange controls, at the latest by the end of 1996.

<u>*Recommendation*</u> *Arrange alternative sources of data for the BoB to compile Balance of Payments statistics . Ensure that the Department of Customs and Excise has the necessary procedures and skills to collect trade data at border posts and other entry points, and if necessary arrange further appropriate training programmes for customs officers.*

7.47 Finally, there are a number of actions which must accompany the above recommendations for reform. These relate to legislative changes, to training and capacity building, and to institutional development.

<u>*Recommendation*</u> *Government should prepare to make the necessary legislative changes (to the Exchange Control Act, Income tax Act etc.) to enable the liberalisation timetable to be met.*

<u>*Recommendation*</u> *The BoB/MFDP should examine the required reforms to the financial sector which will enable the necessary responses to increased capital flows, with a view to introducing new instruments (such as longer term bonds), and to acquiring technical skills, by training of local personnel and if necessary by bringing in external advisors for a limited period.*

<u>*Recommendation*</u> *As an interim measure transfer protection of the insurance industry from the EC regulations to the Insurance Act, and begin a review of whether continued protection of the insurance industry is in the national interest.*

<u>*Recommendation*</u> *Arrange alternative sources of data for the BoB to compile Balance of Payments statistics . Ensure that the Department of Customs and Excise has the necessary procedures and skills to collect trade data at border posts*

and other entry points, and if necessary arrange an appropriate training programme for customs officers.

Recommendation — *Taxation should remain on a local source basis but consideration should be given to means of replacing taxation lost through the export of domestic savings.*

Recommendation — *Tax reform should also address the need to attract foreign investment in services and finance. Suggested changes include (i) ensuring that Resident companies deriving tax-exempt foreign income from subsidiaries or associates within the region are not subject to withholding tax when these profits are remitted from Botswana (required if companies are to set up regional headquarters in Botswana), and (ii) ending the taxation of income from financial assets in Botswana paid to Nonresidents (required if Botswana is to attract offshore financial business).*

Appendix 1

IMPACT OF SHORT TERM CAPITAL OUTFLOWS: FORECAST TO 2003

A1.1 Introduction

A1.1.1 The main objects of this appendix are to study (a) the proportion of exportable financial savings in Botswana that are privately owned, and how this proportion will change with time; and (b) what the effect of a capital outflow (financed by these private savings) would be on Government revenue, if exchange controls over capital account transactions were to be liberalised. The time scale is from 1993 to 2003. All the assumptions inherent in the forecasts of the study are carefully specified.

A1.1.2 The main findings of the study are that (a) the proportion of the savings that are Government controlled starts at a very high figure but then falls steadily over the period; (b) any capital outflow would have such a small effect on Government revenue as to be almost negligible.

A1.1.3 An additional finding is that the level of the foreign exchange reserves is likely to continue to rise for a number of years, but that once the peak has been passed, the reserves could start to fall faster than they were built up. The timing of this switch, from a slow build-up to a rapid decline, is not known exactly but could be around 2000.

A1.2 The starting point

A1.2.1 The present high level of the foreign exchange reserves, and the high proportion of them owned or controlled by the Government, makes the potential size of any capital outflow that might occur today, if exchange controls were to be abolished completely, so small as to be of very little concern. It is important, however, to examine whether the potential for capital outflow is likely to increase in the future, how large the potential outflow is likely to be, and what the impact could be on Government revenue.

A1.2.2 The forecast set out in detail in Table A1.1 is used to see how the foreign exchange reserves are likely to increase or decrease in the next ten years; and how much the proportion of liquid assets controlled by the Government is likely to decline, from its present level of around 90 per cent.

A1.2.3 There are of course an infinite number of forecasts that could be made, by varying the underlying assumptions. The forecast presented here is a very simple one, with a minimum of complicated relationships. This has the advantage that the consequences can be very easily recalculated using different assumptions. As far as possible, the assumptions used are those in the current National Development Plan. These have been amended where possible by more recent estimates in use in MFDP. A few very simple new assumptions have been made where official ones are not available, basically that most components of the forecast will continue to change as in the past or in line with estimates of GDP.

A1.2.4 Botswana's main exports are not expected to increase in real terms; but Government spending is expected to continue to increase, although more slowly than in recent years. As a result, Government's cash balances accumulated in surplus years are expected to be used in the next ten years to finance increasing budget deficits. The forecast depends most crucially on the assumptions made about mining output, because this provides the bulk of exports and tax revenue; and about Government's spending, because this is the largest single determinant of growth in GDP, and therefore of imports. The forecast of the foreign exchange reserves assumes that exports (and therefore Government revenue) grow slowly, but that there is a steady inflow of foreign investment to provide a partial compensation.

A1.2.5 Detailed assumptions about mining

Mining output: this is taken from the forecasts provided to MFDP by the mining companies, as revised for the Mid-Term Review of NDP7. The forecasts of annual percentage rates of growth are as follows:

	Assumptions about mining growth	
	NDP7	First half NDP8
	(annual percentage real rate of growth)	
Diamonds	1.58	0.27
Copper-Nickel	0.00	0.00
Soda ash	12.58 (a)	6.27

Note: *Second half of NDP7; note that the increases are from a lower level than had been hoped and anticipated originally.*

A1.2.6 Detailed assumptions about government spending

Government spending: **development spending is assumed to remain flat in nominal terms** and thus to decline at 10 per cent a year in real terms, given the forecasting assumption of 10 per cent a year inflation. Net PDSF/RSF lending is assumed to decline more slowly than development spending, by slightly more than 3 per cent a year in real terms. Forecasts of Government's recurrent spending derive in part from these assumptions about development spending (see below).

A1.3 The anticipated current account deficit

A1.3.1 As can be seen in Table A1.1, these assumptions generate a current account deficit on the balance of payments from 1996 onwards. The impact of this on the foreign exchange reserves depends on capital inflows. The Table assumes that private long term capital investment grows at 5 per cent a year. The starting point is 1993, when it is assumed to be P300 million (at 1992 prices), higher than the preliminary figure for 1992 (P243 million) but lower than the average for the three previous years (P434 million) which was high because of the large investment in Sua Pan. Government borrowing abroad is assumed, as in MFDP forecasts, to increase by 10 per cent a year in real terms. Both these assumptions have implications for the current account, because dividends and interest must subsequently be paid to foreigners as their return on previous foreign capital inflows. Using these assumptions, the foreign exchange reserves continue to increase in real terms until 2000, but decrease thereafter, at an accelerating speed.

A1.3.2 In other words, if these assumptions hold, and there are no large new mineral discoveries before 2003, further adjustment or additional foreign capital inflows will be necessary to prevent the foreign exchange reserves from starting to fall in about seven or eight years time, at an ever increasing rate. As the reserves fall, income earned from them will also fall, while increasing dependence on foreign borrowing will increase the payment of interest abroad. Moreover, the proportion of foreign finance obtainable on concessionary terms is likely to decline. Botswana will thus enter a vicious financial circle, replacing the virtuous circle of the 1980's when increasing reserves yielded increasing income from abroad. A similar point can be made about the government budget: when the accumulated balances are all spent (in 2004 in this forecast, but of course sooner if the assumptions prove too optimistic, or later if exogenous events are favourable), rapidly increasing domestic borrowing will require increased payments of interest out of the government budget.

A1.4 Other detailed assumptions on the balance of payments

A1.4.1 Imports increase at the same rate as non-mining GDP.

A1.4.2 Exports of services:

- Shipment expenses increases pro rata with exports.
- Other transport and travel increase at 4.85 per cent a year in NDP7 and at 5.02 per cent a year in NDP8.
- Receipt of dividends from abroad increases at 5 per cent a year.
- Receipt of interest from abroad is assumed to increase over the previous year by 7.5 per cent of the increase in the foreign exchange reserves, as this approximates the average rate of return on the foreign exchange reserves from interest alone, plus some allowance for the real increase in foreign purchasing power which accrues from depreciation of the Pula because of higher inflation than in the industrialised countries.
- Migrant remittances from abroad fall at 5 per cent a year, as the number of migrant mine workers in South Africa continues to fall.
- "Other" assumed constant.

A1.4.3 Imports of services:

- Shipment, other transport and travel increase pro rata with imports.
- Dividends paid abroad increase pro rata with diamond export receipts plus 10 per cent of private capital inflows.
- Retained earnings and migrants' outward remittances (both very small) are assumed constant.
- Inward transfers to the government and outward other transfers are assumed to grow at 5 per cent a year.
- Private long term capital inflows are assumed to grow at 5 per cent a year in real terms, from a base of P300 million in 1993, which is more than the figure for 1992, but substantially less than the average for the three previous years (see paragraph A1.2 above).

- Valuation adjustment is the gain (or loss) in pula terms on the foreign exchange reserves resulting from depreciation (or appreciation) of pula against the SDR; a small allowance for a real positive contribution is included in interest from abroad (see above).

A1.5 Government's cash balances

A1.5.1 Forecasts of the government's cash balance derive from MFDP forecasts provided to the study, and derive closely from the forecasts in NDP7. The actual level of government spending in the early years of NDP7 is so far broadly consistent with the Plan forecasts. The key underlying assumptions include 10 per cent inflation; a constant nominal level of development spending; recurrent spending, with a factor of 26 per cent for the recurrent implications of past development spending, yielding a real rate of growth which declines steadily from 14.7 per cent in 1993 to 2.7 per cent in 2003. As a result, the forecast government cash balance falls at an increasing rate from a peak in 1993, and would be wiped out altogether in 2004, when domestic borrowing becomes necessary (unless foreign borrowing is higher than assumed).

A1.6 Government control of the forex reserves

A1.6.1 In order to forecast how much of the foreign exchange reserves remain under the control of the Government over the next ten years, it was also necessary to try and forecast the various items in Table 3 of the main text:

- Liquid assets requirement for the commercial banks assumed to grow at the same rate as non-mining GDP plus 2.5 per cent a year in real terms as the economy monetises and urbanises further. Liquid asset requirements increased faster than non-mining GDP by an average of 4.5 percentage points from 1982 to 1992; the excess is assumed to be less in the next ten years.

- Bank of Botswana "other liabilities": this item consists mostly of retained profits accumulated before paying them over to the Government (which receives by statute 95 % of the Bank's operating profits); a small amount consists of balances related to the IMF reserve tranche and SDR holdings. It is assumed therefore that this item increases or decreases pro rata with the foreign exchange reserves.

- Bank of Botswana's own capital and reserves: the Bank of Botswana transfers 5 per cent of operating profits to its general reserve, and all of the revaluation gains to the revaluation reserve; 10 per cent of the accumulated balance on the revaluation reserve is transferred to the government each year; this item is assumed to change in line with the foreign exchange reserves.

- The total of Government-controlled liquid assets is taken as the sum of Government cash balances, Bank of Botswana "other liabilities", commercial bank liquid asset requirements and Bank of Botswana reserves.

- For forecasting purposes, it would in theory be possible to include a portion (say a third) of the currency in circulation as being transactions balances and not savings, and thus not likely to be converted to foreign exchange; the amount is small. It would only increase the proportion of the foreign exchange reserves controlled by government (that is, not likely to be part of capital flight) from 34 per cent to 35 per cent in 2003.

- No allowance has been made for liquid assets of Debswana and parastatals, on the assumption that they have financial independence, and that they will continue to have it in the years to 2003. (This is of course quite a conservative assumption; in practice, Government would be expected to influence the behaviour of these bodies, concerning the currency of their savings).

A1.7 The results of the forecast

A1.7.1 The proportion of the foreign exchange reserves owned or controlled by the Government, using the definition in the previous paragraph, and the assumptions set out in earlier paragraphs, declines steadily from 91 per cent in 1992 to 36 per cent in 2003. If the assumptions used were to be extrapolated into the years after 2003, the ratio would continue to decline. It would be higher throughout if it is assumed that Debswana and the parastatals would not choose to hold their liquid assets in foreign currencies even if it were allowed.

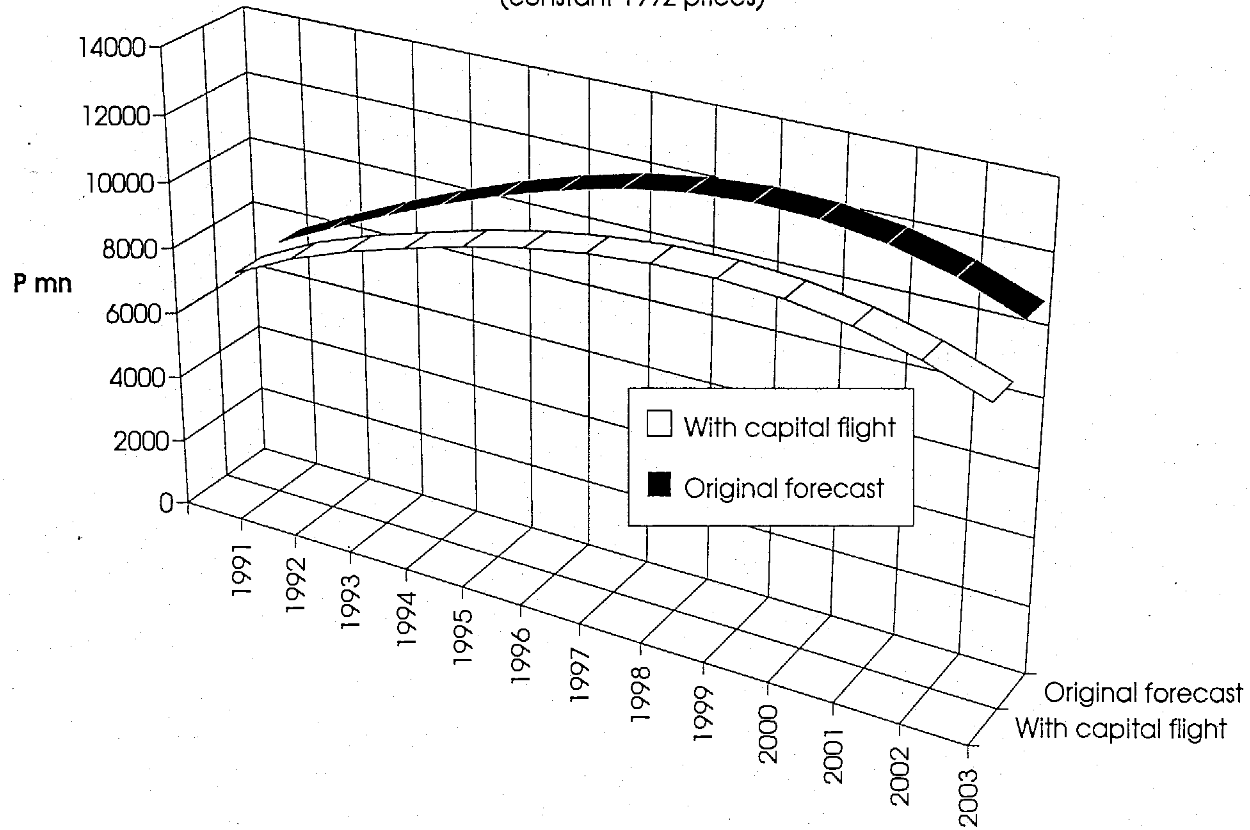
A1.7.2 The attached spreadsheet at Table A1.1 first summarises all the assumptions that went into the base forecast, without any capital flight by private sector Residents and with only a modest 5% increase (in constant 1992 prices) of incoming investment per year. The line "Actual reserves" on the spreadsheet is shown on the chart under the subheading "Without capital flight".

A1.7.3 It is then assumed that 20% of the available private sector savings leave Botswana each year and are not replaced by larger incoming capital flows. The second (lower) curve on the chart shows the forecast of the level of the foreign exchange reserves, under these assumptions. It is entitled "With capital flight". It is interesting to see that there are only relatively small changes in the shape of the curve, with the peak year occurring one or two years earlier than before.

A1.7.4 The second table analyses the relative loss of government revenue, due to the capital flight, and finds it to be very small.

Forecast of Forex Reserves

(constant 1992 prices)



BALANCE OF PAYMENTS FORECAST 1992 TO 2003 (1992 prices): CAPITAL FLIGHT/LOSS OF REVENUE								
	1991	1992	1993	1994	1995	1996	1997	1998
EXPORTS	3690	3696	3862	3950	4042	4137	4236	4298
diamonds	2941	2899	2945	2991	3039	3087	3135	3144
copper-n	251	216	295	295	295	295	295	295
beef	149	197	201	206	210	215	220	224
soda-ash	14	50	58	67	75	83	92	100
other	289	335	362	391	423	457	495	535
adjustment	46	-1						
IMPORTS	3490	3400	3581	3771	3972	4183	4406	4640
SERVICES exports	1246	1434	1511	1566	1618	1668	1715	1758
shipment	56	56	59	60	61	63	64	65
other tpt	12	15	16	16	17	18	19	20
travel	215	258	271	284	298	312	327	343
dividends	43	51	54	56	59	62	65	68
interest	744	883	947	987	1025	1058	1088	1113
ret'd earnings	0	0	0	0	0	0	0	0
migrants	85	80	76	72	69	65	62	59
other	90	90	90	90	90	90	90	90
SERVICES imports	1760	1860	1873	1930	1991	2055	2122	2184
shipment	224	223	230	242	255	269	283	298
other tpt	89	102	91	96	101	107	112	118
travel	137	157	153	161	169	179	188	198
dividends	672	686	700	711	722	734	746	748
interest	335	386	402	417	433	451	470	492
ret'd earnings	30	35	35	35	35	35	35	35
migrants	16	10	12	12	12	12	12	12
other	257	261	250	256	263	269	276	283
TRANSFERS	345	505	337	354	372	390	410	430
govt	481	660	500	525	551	579	608	638
other	-136	-155	-163	-171	-179	-188	-198	-208
CURRENT ACCOUNT	31	375	257	169	70	-42	-167	-338
CAPITAL ACCOUNT	676	401	448	470	494	519	545	572
pte long term	428	243	300	315	331	347	365	383
pte short term	144	0	0	0	0	0	0	0
govt	126	158	148	163	179	197	217	238
cbs	-22	0	0	0	0	0	0	0
RRORS & OMISSIONS	58	84	100	105	110	116	122	128
VERALL BALANCE	765	860	805	744	674	592	499	362
ALUATION ADJ	709	-5	0	0	0	0	0	0
HANGE IN RESERVES	1474	855	805	744	674	592	499	362
CTUAL RESERVES	7708	8563	9368	10112	10786	11378	11878	12240
IPORT COVER(mths)	18	20	21	21	22	22	22	22
HANGE IN G BAL		833	246	-142	40	-69	-439	-371
OVT BAL (curr p)	4377	5210	5456	5314	5354	5285	4846	4475
IDEX		100	110	121	133	146	161	177
OVT BAL (1993 p)	4377	5210	4960	4392	4023	3610	3009	2526
IQUID ASSETS REQ	326	367	395	424	456	490	527	566
oB OTHER LIAB	818	894	978	1056	1126	1188	1240	1278
urrency x .33	74	78	85	94	103	114	125	138
oB RESERVES	1451	1351	1383	1418	1456	1497	1539	1584
OVTOWNED	6972	7822	7716	7290	7061	6784	6315	5954
-OWNED/FOREX RES	90	91	82	72	65	60	53	49

	1999	2000	2001	2002	2003	
EXPORTS	4357	4420	4488	4560	4638	
diamonds	3152	3161	3169	3178	3187	NDP7 1.58%; ndp8 0.27%
copper-n	295	295	295	295	295	0.0%
beef	224	224	224	224	224	NDP7 2.2%; NDP8 0.0%
soda-ash	106	113	120	128	136	NDP7 +8.3 p.a.; NDP8 +6.27% p.a.
other	579	627	679	735	796	NDP7 +8.1%; NDP8 +8.3%
adjustment						
IMPORTS	4871	5114	5369	5636	5917	With GDP, NDP forecasts
SERVICES exports	1796	1828	1853	1871	1882	
shipment	66	67	68	69	70	Pro rata exports
other tpt	21	22	23	24	26	NDP7 +4.85%: NDP8 5.2%
travel	360	378	397	417	438	NDP7 4.85%; NDP8 5%
dividends	72	75	79	83	87	+5% p.a.
interest	1131	1142	1145	1140	1125	Prev yr plus 5% of ch in reserves
ret'd earnings	0	0	0	0	0	
migrants	56	53	50	48	46	Falling 5% a year
other	90	90	90	90	90	Constant
SERVICES imports	2248	2315	2388	2465	2547	
shipment	313	328	345	362	380	Pro rata imports
other tpt	124	130	137	144	151	Pro rata imports
travel	208	218	229	240	252	Pro rata imports
dividends	750	752	754	757	759	diamonds + 10% of pte capital inflow
interest	516	542	571	603	638	Previous year plus 10% of new debt
ret'd earnings	35	35	35	35	35	Constant
migrants	12	12	12	12	12	Constant
other	290	297	305	312	320	Constant
TRANSFERS	452	475	498	523	549	
govt	670	704	739	776	814	5% growth
other	-218	-229	-240	-252	-265	5% growth
CURRENT ACCOUNT	-514	-707	-917	-1146	-1394	
CAPITAL ACCOUNT	600	630	662	695	730	
pte long term	402	422	443	465	489	5% growth
pte short term	0	0	0	0	0	
govt	262	288	317	349	384	10% growth
cbs	0	0	0	0	0	
ERRORS & OMISSIONS	134	141	148	155	163	5% growth
OVERALL BALANCE	220	64	-107	-296	-502	
VALUATION ADJ	0	0	0	0	0	Assumed zero
CHANGE IN RESERVES	220	64	-107	-296	-502	
ACTUAL RESERVES	12460	12524	12417	12121	11620	
IMPORT COVER(mths)	21	20	19	18	16	
CHANGE IN G BAL	-535	-697	-853	-994	-1112	
GOVT BAL (curr p)	3940	3243	2390	1396	284	From MFDP forecast
INDEX	195	214	236	259	285	MFDP assumed 10% inflation
GOVT BAL (1993 p)	2022	1513	1014	538	100	In 1992 prices
LIQUID ASSETS REQ	609	655	704	756	813	GDP growth plus 2.5%
BoB OTHER LIAB	1301	1308	1296	1265	1213	Pro rata reserves
Currency x .33	151	166	183	201	222	10% growth
BoB RESERVES	1630	1676	1723	1770	1815	5% of 7.5% of reserves
GOVT OWNED	5561	5151	4737	4330	3941	Gov bal+liq asset req+BoB other liab
G-OWNED/FOREX RES	45	41	38	36	34	Gov % of res [+BoB reserves

TABLE A1.2

EFFECT ON GOVT REVENUE IF 20% OF ELIGIBLE BALANCES LEAVE BOTSWANA

	1991	1992	1993	1994	1995	1996
PRIVATE OWNED	736	741	1652	2822	3725	4594
20% PTE OWNED	147	148	330	564	745	919
LOSS OF REVENUE	14	14	31	54	71	87
TOT REV (curr p))	4000	4527	4649	4835	5600	6251
TOT REV (1992 p)		4527	4226	3996	4207	4270
SAVING OF REV		13	29	49	65	80
NET LOSS OF REV		1	3	5	6	7
NET LOSS (%)		0,03	0,06	0,09	0,11	0,12
	1997	1998	1999	2000	2001	
PRIVATE OWNED	5563	6285	6899	7373	7680	
20% PTE OWNED	1113	1257	1380	1475	1536	
LOSS OF REVENUE	106	119	131	140	146	
TOT REV (curr p))	6747	7719	8547	9471	10506	
TOT REV (1992 p)	4189	4357	4386	4418	4456	
SAVING OF REV	97	109	120	128	134	
NET LOSS OF REV	9	10	11	12	12	
NET LOSS (%)	0,13	0,13	0,13	0,12	0,12	
	2002	2003				
PRIVATE OWNED	7791	7678	Liquid assets owned privately			
20% PTE OWNED	1558	1536	Assumed 20% capital flight			
LOSS OF REVENUE	148	146	95% of 10% of capital flight			
TOT REV (curr p))	11668	12977	Total govt revenue (current p)			
TOT REV (1992 p)	4499	4548	Total govt revenue (1992 p)			
SAVING OF REV	136	134	14.5% of 40% (tax) of capital flight			
NET LOSS OF REV	12	12	Loss minus saving			
NET LOSS (%)	0,11	0,09	Net loss as % of total revenue			

Appendix 2

EXCHANGE CONTROLS AND EXCHANGE RATE POLICY

A2.1 A review of Botswana's exchange rate history

A2.1.1 Many countries use exchange controls to hold total imports below what would be demanded otherwise, because of shortages of foreign exchange. In other words, exchange controls are used as an alternative to other macro-economic policies, such as devaluation of the domestic currency, or reduced domestic demand.

A2.1.2 The main reason for preferring exchange controls to other policies is that the latter are more unpopular in the short run. Devaluation increases the cost of imports and needs to be accompanied by other unpopular changes, such as low wage increases, tax increases, higher interest rates, and cuts in government spending, if the intended benefits of devaluation are not to be offset by increased inflation.

A2.1.3 An additional effect of exchange controls is to increase domestic inflation, because imports are reduced and this reduces aggregate supply. The effect of exchange controls is therefore that the real exchange rate rises: inflation increases faster than in the country's trading partners while the nominal exchange rate is fixed. This makes imports appear cheap in relation to locally produced goods, and at the same time reduces the profits of exporters. Over time, therefore, exchange controls worsen the shortage of foreign exchange.

A2.1.4 None of these arguments apply to the case of Botswana. There have been almost no constraints on the use of foreign exchange for imports, and relatively few on payments abroad for services. The few controls that do exist on current account payments are mainly necessary in order to prevent capital outflows occurring disguised as current account payments.

A2.1.5 Botswana's exchange rate policy has in fact developed more independently of exchange control rules than that of most other African countries. The exchange rate is protected from pressures to change, to some limited extent, by exchange controls on capital movements, but this factor is not the dominant one.

A2.1.6 When Botswana used the rand as its currency, before August 1976, the exchange rate against other currencies was simply determined by their rates against the rand, and therefore by policy in South Africa.

A2.1.7 After August 1976, the rate for the pula was pegged at parity with the rand for 100 days. Thereafter, it was pegged to the US dollar, as was the rand, so that the one-to-one rate against the rand was maintained on a de facto basis.

A2.1.8 Since that time, exchange rate policy has been used on the one hand to try and reduce inflation in Botswana, and on the other hand to avoid as far as possible making domestic production uncompetitive in foreign markets. There have therefore been both revaluations and devaluations.

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A2.1.9 The choice of foreign currency baskets against which to peg the pula has also varied, in an attempt to achieve the chosen policy objectives with a minimum of discrete changes in the nominal peg.

A2.1.10 The overall effect has been that the pula has risen in nominal terms against the rand, from P1 = R1 in 1976 to P1 = R1.35 (approximately) at present. Because the rand has fallen against non-regional currencies, however, the pula's rate against the US dollar has fallen from $1.15 in 1976 to $0.53 at the end of 1992 and to $0.39 at the time of writing this report.

A2.1.11 When the rand fell rapidly against non-regional currencies, especially in the early 1980s, the pula had to follow most of the way. If the pula had been pegged to the dollar, imports from SA (which supplies some 80 to 85 per cent of imports) would have become much cheaper. This would have reduced inflation, but it is unlikely that inflation would have fallen by enough to offset the change in the nominal exchange rate. As a result, production of tradable goods and services in Botswana would have become uncompetitive internationally.

A2.1.12 This consideration had to take priority over what was happening to the exchange rate against non-regional currencies. If currencies important to Botswana move against each other, as happened when the rand fell against the dollar, it is impossible for the pula to keep constant exchange rates against all currencies. The sharp fall of the pula against the dollar was thus inevitable, even though it caused a number of unwanted side effects.

A2.1.13 Later in the 1980s, the pula's nominal exchange rate against the rand rose more slowly. This reduced import prices and inflation, and the lower rate of inflation was incorporated in lower wage rises. The overall result was that the real exchange rate did not rise, that is the costs of producers in Botswana rose more slowly than cost in SA. The ability to compete with imports was not eroded by the rising nominal value of the pula.

A2.1.14 More recently, Botswana reacted to the very rapid fall of the Zimbabwe dollar (especially in 1991) by devaluing the pula. A high proportion of non-traditional exports, especially textile manufactures, went to Zimbabwe, and were threatened by the changed bilateral exchange rate. Unfortunately, the devaluations (two, each of 5 per cent) were not nearly large enough to restore the competitive position of Botswana exporters to Zimbabwe; but they did push up the Botswana rate of inflation. Annual inflation was 16 per cent in 1992, up from 12 per cent a year earlier, and higher than in South Africa for the first time for some years.

A2.1.15 Again, this illustrated the extremely difficult problem of managing exchange rate policy when trading partners' exchange rates move in different directions. It is possible to try and keep a trade-weighted exchange rate index constant; but this is only a form of average. Averages conceal as much as they inform when the components of the average move in radically different ways.

A2.2 Exchange rate policy in the absence of exchange controls

A2.2.1 The abolition of exchange controls would make exchange rate policy marginally more difficult. As discussed in the chapter on macroeconomic policy, it could be difficult to insulate the rest of the economy from large movements of capital into and out of Botswana. If the Bank of Botswana cannot change the number of BOBCs quickly enough, either interest rates or exchange rates could be forced to change in response to market pressures. However, a managed exchange rate policy is still practical.

A2.2.2 However, as has also been explained, large capital movements are already possible, both legally via leads and lags in trade payments, and illegally by avoiding exchange controls on the capital account. The authorities have been coping with such movements for a long time without too much difficulty. A part of the explanation for this is the large size of the foreign exchange reserves and the existence of excess liquidity in the commercial banks. So long as these conditions hold, capital movements merely change the amount of reserves and of excess liquidity, without forcing the authorities to change their policies. Abolition of exchange controls would increase the scope for capital movements and make them easier by making them legal. Abolition would not create a new problem, therefore; it would merely make an existing problem slightly larger.

A2.2.3 In the future, the reserves are expected to become smaller in relation to foreign trade. Using the assumptions underlying Table A1.1, the reserves are expected to fall from 22 months import cover in 1998 to 16 months in 2003, with further falls thereafter. If the assumptions prove to be too optimistic, this could happen sooner. At some point, the reserves will become a constraint, and the authorities may have to react more rapidly than at present to an outflow of capital, for example by raising domestic interest rates, by devaluing the currency, or by changing some other policy which is causing a loss of confidence in the pula.

A2.2.4 Similarly, if a capital outflow leaves the commercial banks short of liquidity, they will have to raise their interest rates to make it more attractive for people to keep their money in Botswana, or they will have to reduce their lending.

A2.2.5 Inflows of capital are less of a problem, because it is always possible for the Bank of Botswana to hold more reserves, and for the commercial banks to hold additional excess liquidity. However, if the pula equivalent of an inflow is not sterilised, as explained in the chapter on macroeconomic policy, interest rates may fall, the exchange rate may rise, or both.

A2.2.6 There is some evidence that capital flows respond to interest rate changes in Botswana, although it is rather limited because interest rates have not been used much for this purpose. In 1982, for example, when diamond export sales fell sharply, an increase in interest rates had an immediate and large positive effect on the foreign exchange reserves.

A2.2.7 It is possible that the long period of negative real interest rates in Botswana caused outflows of capital, both legal and illegal. However, this would not necessarily show up in the balance of payments statistics if the movements were concealed in the current account. Moreover, they would not have caused concern because of the overall strength of the balance of payments, which was reflected in rising reserves. Statistics of capital flows for the period since the recent large increase in interest rates are not yet available.

A2.2.8 It appears from the above that interest rates have been adequate as an instrument for influencing short term capital flows. The question arises, though, as to whether they would be adequate in all future circumstances, or whether exchange controls would be needed as well.

A2.2.9 Short term capital flows, as has already been noted, depend on expectations about future changes in exchange rates as well as on interest rate differentials. In extreme circumstances, exchange rate expectations can completely overwhelm interest rate differentials, so that even very large changes in interest rates do not have the intended effect.

A2.2.10 This was seen several times earlier this year in the currencies which are or were members of the European Exchange Rate Mechanism. Once those operating in the market decided that the pound, or some other currency, was likely to be devalued, they sold that currency despite large increases in interest rates. Indeed, large upward movements in interest rates were at times a signal to the market that devaluation was inevitable and therefore had the opposite effect to that intended. In the end, sales were so large that the expectations became self-fulfilling, and devaluation occurred.

A2.3 Possible speculation against the pula

A2.3.1 There could be similar expectations about the pula at the present time, not because of anything that is happening in Botswana, but because of uncertainties about the rand and the expectation that the pula would maintain its present rate against the rand if the rand depreciated against non-regional currencies. This is by no means certain, because the rand might benefit from an increase in confidence , for example if political events are favourable, or if the World Bank and the IMF reach agreement to lend to South Africa.

A2.3.2 However, even if there was a widespread expectation that the pula would depreciate against non-regional currencies, the foreign exchange reserves are at present very much larger than any possible sales of pula for foreign currency. The scenario in which expectations overwhelm interest rate differentials cannot occur in Botswana today.

A2.3.3 This may not always be the case in the future, if the reserves decline in relation to liquid pula assets available for capital flight. However, exchange controls would be of relatively little use in such circumstances. As explained above, entirely legal leads and lags in the finance of trade (visible and invisible) can make large scale capital flight possible even if strict exchange controls exist. Moreover, it is not possible to eliminate illegal capital flows by means of exchange controls. Speculation against other currencies with exchange controls, for example the British pound, was very large under exchange control regimes, and forced devaluations on a number of occasions.

A2.3.4 Speculative outflows will eventually eliminate the reserves unless they are larger than any possible sales of the domestic currency (as in Botswana at present). Countries may try to borrow foreign exchange if the reserves are not enough, to defend the exchange rate, but borrowing is also limited. It appears that even if the world's major central banks decide to defend a particular exchange rate or set of exchange rates, their resources are currently inadequate to offset the resources available in the market.

A2.3.5 Exchange controls can slow down some of the capital movements that make it hard to maintain a particular exchange rate. The evidence is, however, that they do not succeed in the end. Meanwhile, the attempt to defend an overvalued currency can be very expensive, in two ways.

A2.3.6 Firstly, the central bank is forced to sell its foreign exchange reserves cheaply. When the devaluation eventually occurs, those who bought the foreign exchange cheaply make large profits at the expense of the central bank.

A2.3.7 Secondly, exchange controls often enable a government to delay a necessary change in the exchange rate, at high cost to the economy. The value of using exchange controls to delay a devaluation depends therefore on whether it is the markets or the government who are right, as to what the exchange rate ought to be.

A2.4 Speculative capital inflows

A2.4.1 The argument concerning capital inflows in the expectation of an upward revaluation of the currency is not entirely symmetrical. There is a limit to how low interest rates can go; and foreign exchange can always be added to the reserves, if speculators sell foreign exchange for pula in an attempt to cause the pula to be revealed.

A2.4.2 There are cases where speculative inflows have apparently forced a revaluation in a currency. Nevertheless, it is possible to resist upward pressure on a currency for much longer than to resist downward pressure, and it may be possible to resist upward pressure indefinitely.

A2.5 Managing the exchange rate without exchange controls

A2.5.1 These arguments seem somewhat remote from the concerns of Botswana at present. Even if foreign exchange reserves are less of a cushion in the future, it seems that interest rates are likely to be adequate to influence capital flows, and the market is just as likely to be correct about the exchange rate as the Government. For example, if the market perceives that the budget deficit is too large and cannot be sustained, it is probably better for the Government to be forced quickly into corrective action by market forces, than for it to be able to postpone a change of policy behind the temporary protection of exchange controls.

A2.5.2 Overall, the argument of this appendix is that the abolition of exchange controls would add to the potential for inflows and outflows of capital. This might add to the already difficult task of managing the exchange rate in Botswana.

A2.5.3 However, the greatest difficulty in exchange rate policy arises from changes in the cross exchange rates of trading partners; some capital movements already occur (without official sanction) and seem to have been managed without difficulty; and there is some limited evidence that large capital movements are reasonably sensitive to changes in interest rates.

A2.5.4 It would seem, therefore, that exchange rate policy can continue to be used for the maintenance of competitiveness and (sometimes) the reduction of inflation, even if exchange controls are completely abolished.

A2.5.5 Speculative outflows will eventually eliminate the reserves unless they are larger than any possible sales of the domestic currency (as in Botswana at present). Countries may try to borrow foreign exchange if the reserves are not enough to defend the exchange rate, but borrowing is also limited. It appears that even if the world's major central banks decide to defend a particular exchange rate or set of exchange rates, their resources are currently inadequate to offset the resources available in the market.

A2.6 Conclusion

A2.6.1 Management of the pula's exchange rate will in the future gradually become slightly more difficult, as the ratio of private savings in Botswana increases relative to the level of the foreign exchange reserves; and as the level of the reserves falls relative to the volume of imports. Greater skill will be required by the managers in Botswana of this key "price", i.e. the international value of the pula. A **managed** exchange rate is implicit in all of the consultants' proposals.

A2.6.2 In the absence of exchange controls, this management problem will be slightly more difficult than it would otherwise have been. However, the potential hidden costs of using exchange controls to hang onto an incorrect exchange rate could be much higher. An overvalued exchange rate will simply encourage capital flight, whether or not there are exchange controls, at tremendous eventual cost to the central bank.

A2.6.3 The so-called "speculators" who turned out to have made the correct assessment of the situation, will make large capital gains when the currency is eventually devalued, at the expense of the central bank. It is wiser to bite the bullet and meet the market forces head on, without exchange controls, than to try to use exchange controls to maintain what the market regards as an incorrect exchange rate for the pula.

A2.6.4 This will require an increased level of skill among the managers of the macro-economy. Fortunately, there is enough time (about six to eight years) in which to develop the skills that will be required. In the very long run, it may be necessary to change from a managed exchange rate to a free float. Any so called " free float" will however have to be accompanied by central bank intervention on the foreign exchange market. This will require yet another higher level of skill. But that is definitely a problem for the next century.

Appendix 3

THE IMPACT OF EXCHANGE CONTROL LIBERALISATION ON THE PRIVATE SECTOR

A3.1 Introduction - the macro-economic arguments

A3.1.1 Botswana is an unusual position, compared to other countries that have contemplated abolition of exchange controls, for two reasons.

A3.1.1.1 Firstly, Botswana's high level of foreign exchange reserves, and the willingness of the Bank of Botswana (BoB) to issue more Bank of Botswana Certificates (BOBCs) if necessary, protect the local financial scene from disturbances due to foreign capital movements to a very substantial extent. In the short run, any movements of "hot money" in and out of Botswana should have minimal effects on local interest rates and the exchange rate for the pula.

A3.1.1.2 Secondly, there is only a relatively small amount of local money that can move back and forth across Botswana's borders.

A3.1.2 If there is a large inflow of funds from abroad, the BoB can issue more BOBCs in order to prevent interest rates from falling. The foreign exchange that is sold for pula can simply be added to the BoB's gross foreign exchange reserves. This should not put any upward pressure on the exchange rate that cannot be coped with.

A3.1.3 If any of this money suddenly wants to leave Botswana, the BoB will have ample foreign exchange reserves with which to finance the purchase of foreign exchange by footloose holders of pula. The resulting drop in the money supply need not cause any increase in interest rates in Botswana. All that would be required would be a suitable reduction in the value of BOBCs issued by the BoB. The foreign exchange reserves will be large enough to make it unnecessary for the pula to be devalued on account of the capital outflow.

A3.1.4 Thus, notwithstanding the textbook arguments that (a) large scale capital inflows generate falling interest rates and a rising exchange rate, and (b) large scale capital outflows generate rising interest rates and a fall in the exchange rate, this is most unlikely to happen in the short run in Botswana. It is far more likely that Botswana will have a breathing space of six to eight years in which to prepare for these kinds of eventualities. During this initial period of six to eight years, the Botswana monetary authorities will be able to set interest rates and the exchange rate exactly where they want them, without having to worry about pressures from large capital flows. It is accordingly most unlikely that EC liberalisation will have a significant effect, in the short run, on interest and exchange rates.

A3.1.5 To some extent, the BoB will save some of its expenses if there is either a net outflow of funds from Botswana, or if Residents choose to keep foreign exchange bank accounts inside Botswana. The BoB will then not suffer the expense associated with mopping up surplus liquidity, if the holders of the surplus liquidity choose to hold it in foreign currencies. [The system works well in Swaziland, which has no exchange controls over capital account transactions with South Africa. Any surplus Swazi money goes to South Africa, but can be recalled to Swaziland in case of need. The Central Bank of

Swaziland does not incur any costs related to the mopping up of surplus liquidity, because by their definition there is practically none].

A3.1.6 At a much later stage, when several years of Botswana government budget deficits have weakened the authorities' grip over monetary policy, capital flows could start to have an influence over domestic interest rates and the exchange rate. This could start to happen next century.

A3.2 The impact on transaction costs

A3.2.1 Conversely, the impact on foreign exchange transaction costs will be immediate. Those businesses in Botswana with large in-and-out foreign transactions will be able to maintain foreign currency receipts in foreign exchange, and not have to sell them immediately for pula. They will therefore not incur double transaction costs when they subsequently need to make foreign currency payments.

A3.2.2 A further possible saving in expense could arise if pula cheques could be accepted outside Botswana. It would be up to the banks in Botswana and in other countries, to make the necessary clearing and settlement arrangements.

A3.2.3.1 Many large importers in Botswana already have retained accounts in those countries from which they import a great deal. At present, these retained accounts are subject to the exchange control rules of both Botswana and the country of domicile of the account.

A3.2.3.2 In particular, rand retained accounts are subject to both Botswana's and South African EC rules. If Botswana lifts its EC restrictions, the South African rules will remain in place. It may however be possible to negotiate with the South African Reserve Bank that South African importers of Botswana goods may be allowed to pay for their imports from Botswana, by simply crediting the Botswana exporter's rand retained account. This would put Botswana's exporters on an even footing with exporters to South Africa in Lesotho, Namibia and Swaziland.

A3.2.4 In some parts of the Common Monetary Area (CMA) (consisting of Lesotho, Namibia, South Africa and Swaziland), it is customary for exporters to add something to the f.o.b. price of their exports to Botswana, to cover "the Botswana factor". This relates to the unethical behaviour of some Botswana importers who tell their CMA trading partners that they cannot pay their accounts on time "because of Botswana's exchange controls". There is a worry among some consumers in Botswana that this "Botswana factor" may be part of the explanation as to why South African goods cost so much more in Botswana than they do in parts of the CMA which are equally distant from the South African supplier. With EC liberalisation in Botswana, importers here will no longer have an excuse to delay payments to South Africa and the rest of the CMA. It will be interesting to see if Botswana's importers can negotiate better prices from their CMA suppliers, as a result.

A3.3 The impact on asset prices

A3.3.1 In the late 1970's and early 1980's, surplus liquidity that was bottled up inside Botswana because of the EC regulations, caused interest rates to fall way below the rate of inflation. Anyone holding assets at a bank, such as savings and call accounts, was severely penalised. Conversely, borrowers could borrow easily and cheaply. In particular, households took advantage of the low interest rates to obtain a great deal of consumer credit.

A3.3.2 Some other investors took advantage of the government's scheme to assist house purchases by means of a partial government guarantee to the Botswana Building Society and other home mortgage lenders. These investors bought houses under this scheme and hoped that the rent from tenant occupants would cover their monthly mortgage payments to the lender. As a result of the demand for this type of investment, housing tended to be over priced.

A3.3.3 In general, there was a mis-pricing of domestic capital assets due to the enforced retention of surplus funds in Botswana, which Residents were forbidden to invest outside Botswana. This led to price distortions in the economy which in turn inhibited the price mechanism from working efficiently in allocating economic resources.

A3.3.3 The recent Bank of Botswana policy of pushing up interest rates has contributed to a general correction of asset values, including reductions in property and share prices.

A3.3.4 If exchange controls are abolished, the Bank of Botswana will still be in control of the situation but will have to be able to react quickly to any large movements of capital in or out of Botswana. The volume of BOBCs in circulation will need to be increased or decreased so as to meet the demand, if interest rates are to be maintained at the level thought to be desirable by the Bank.

A3.3.5 In general, however, once Residents are allowed to decide where to place their assets, there will be a trend towards more appropriate pricing of assets inside Botswana, but large price changes are not expected.

A3.4 The impact on the investment climate

A3.4.1 This has been extensively dealt with in Chapter 7. What remains to be said here is that any net **portfolio** investment inflow after EC liberalisation in Botswana, could make it slightly easier for a Resident business to sell shares or float a bond on the Botswana stock exchange. Any net **direct** investment inflow could be directed more towards financial service type industries. [Manufacturing is seen to be risky because it is so tradable and so competitive]. The local banks, merchant banks, BDC, lawyers, the services affiliates of chartered accountants, etc., should all be on the lookout for opportunities to go into partnership with foreign investors who would find that a major stumbling block has been removed in Botswana. There will be a challenge to the local banks to raise their performance standards to the level expected internationally, and to broaden the range of services offered in Botswana. The banks would also have to factor any loss of commission on forex dealing, into their business plans.

A3.5 Asset diversification

A3.5.1 Residents of Botswana with sufficient liquid funds will need to think of asset diversification possibilities.

A3.5.2 Given that there are strong links between the pula and the rand (e.g. a nearly constant real bilateral exchange rate), one would expect an investor to look for quite high real rates of return from investments in Botswana, to compensate for the exchange rate risk. This risk relates to the possibility of a real devaluation of the rand, i.e. the rand might fall by more than the inflation rate differential with the developed world. Given that it may not be wise to put all one's eggs in one basket in Botswana, some asset diversification (far away from South Africa) may be in order for those Residents of Botswana who have until now had all their assets in pula.

A3.5.3 Conversely, those Residents of Botswana who have sufficient confidence in the rand may wish to buy a house or apartment in South Africa.

A3.5.4 The managers of Botswana pension and life assurance funds will be faced with an interesting problem. [Their needs are different from those of other investors because of the long term nature of their investments]. If at the time of EC liberalisation, they are up against the limit of having 50% of their assets outside Botswana, they may wish to decide whether a further diversification in favour of foreign assets is justified.

A3.6 Possibilities of investment and job creation

A3.6.1 In the short term, job creation will be slow. In the long term, one may look to other liberalising developing countries for guidance. Exchange control liberalisation incontrovertibly created jobs in Hong Kong, Panama, Singapore and Malaysia; arguably in Indonesia (which as a consequence has a much more sophisticated financial sector than the domestic economy actually needs); and certainly in the tax haven islands, e.g. the Channel Islands, the Cayman Islands, the Bahamas, the Netherlands Antilles, and Vanuatu; and in Mauritius' offshore banking industry. In all these countries, the financial sector would not have developed at all without EC liberalisation; and the number of jobs and the size of investment in finance are now second only to the tourism sector. In Chile, after the 1987 liberalisation, jobs in the financial services industry expanded dramatically.

A3.6.2 If South Africa retains exchange controls and Botswana abolishes them, then South African firms will be looking for financial services partners in Botswana. The South Africans will be looking for much greater operating flexibility with their Botswana affiliate than they can get in South Africa itself. This will apply especially to corporate treasury functions when they want to organise facilities for their subsidiaries, e.g. if a South African head office wants to make a loan from its Botswana affiliate to a Malawian, Zambian or Zimbabwean subsidiary.

A3.7 Currency risks facing the private sector

A3.7.1 There is obviously a risk of a real rand devaluation in the next few years. ("Real" means that the rand may fall against the SDR by more than inflation differentials would indicate). This will immediately affect the pula. Corporate treasurers in Botswana's private sector will have the freedom, after EC liberalisation, to decide just how much hedging they want to do and how they want to diversify their assets and liabilities so as to minimise their exposure to currency movements.

A3.8 Conclusion

A3.8.1 Residents of Botswana, including Botswana businesses, have very little to fear, and much to hope for, from EC liberalisation. All sorts of new business opportunities are likely to appear; and it will become much easier to control normal operating risks due to currency fluctuations against the SDR. There is very little risk of large movements in interest rates, and only a small risk of a small movement in the exchange rate against the rand.

Appendix 4

MECHANICS OF FOREIGN CURRENCY BANKING AND OUTWARD PORTFOLIO MANAGEMENT

A4.1 Introduction to foreign currency accounts

A4.1.1 Discussions held on these topics, primarily with commercial bankers, have been informal and the views received do not represent definitive positions, and have not been cleared with senior management or holding companies outside.

A4.1.2 No particular difficulties are seen in conducting foreign currency banking in Botswana provided commercial banks are given adequate notice, are permitted to handle their own foreign currency reserves and make their own clearing arrangements. There is implicit agreement that foreign currency liabilities should be matched by assets in the same currencies and with similar maturities. Any speculative positions should be the responsibility of the foreign correspondent or holding corporation, and not of the bank's Botswana operations.

A4.1.3 Even if "Offshore Banking Units" on the Mauritius model are developed, most transactions will be initiated by wire transfer or written instruction and could be executed immediately. Cheque transactions would be likely to be moderate in number, and would therefore most probably be cleared following physical transmission to London, involving a delay of two weeks or so (as applies in most Offshore Banking Units). Cheque transfers between accounts within Botswana would go through the same procedure, but it would be a commercial decision for individual managers whether to provide credit to the beneficiary immediately, based on the name and standing of the drawer. This is in line with current procedures where foreign currency cheques are deposited to pula bank accounts.

A4.1.4 Any request by a customer to write a cash cheque and draw his foreign currency in foreign currency bank notes, would be subject to prior agreement with the local bank involved. There are heavy carrying costs for any bank that keeps a supply of foreign currency bank notes in its vaults.

A4.1.5 Training courses and procedure manuals are available from correspondents, etc., abroad to provide guidance in the area of preventing abuse through money-laundering deposits. These are based partly on procedures accepted by the regulatory authorities in the United States, the trend setter in what is acceptable and not acceptable in this function. No particular difficulty is foreseen in complying with any specific instructions emanating from the Bank of Botswana as regards limits on acceptance for notes and coin from Common Monetary Area countries.

A4.1.6 Transmission costs for foreign notes are significant and if an imbalance calling for physical transmission of a particular currency in one direction or the other arose across the banking system, the transaction costs for notes of the currency concerned may have to reflect that.

A4.2 Clearing of pula cheques deposited outside Botswana

A4.2.1 Acceptance of pula cheques drawn on bank accounts in Botswana and sent back to Botswana for collection from abroad would not present a problem. It is a practice that previously prevailed within the sterling area and the rand area, respectively, while Botswana was part of these systems.

However, settlement would probably be in foreign currency through London or Johannesburg clearing for the foreseeable future. That would be expensive.

A4.3 An "Afro - pula" currency

A4.3.1 Emergence of an "Afro - pula" medium of exchange does not seem likely and would lift the whole central and commercial banking system on to a totally new level of complexity, sophistication and risk exposure. Meantime, there would be nothing to prevent the pula being used as a reference currency on a regional basis should people choose to do so, but settlement would be effected through a major convertible currency, or the UAPTA, as appropriate.

A4.4 Forward cover

A4.4.1 Greater freedom in foreign forward cover transactions would be acceptable, but on a swap basis through London or elsewhere and not on a speculative basis. Contractual evidence to support requests for cover in either direction would be required and continued restriction in dealings to pula would be acceptable.

A4.5 Offshore banking

A4.5.1 A small number of specialist expatriate personnel would be required to administer an Offshore Banking Unit, or anything resembling one.

A4.6 The effect on the exchange rate

A4.6.1 Central bank determined exchange rates for the pula are not incompatible with maintaining foreign currency deposit accounts and even overdrafts. Restrictions on conversion into pula could be administered on a basis similar to monitoring for money laundering, but probably not within precise or fluctuating monetary limits.

A4.7 Outward portfolio investment by Residents

A4.7.1 Outward portfolio placement and management services would require a small amount of imported expertise to establish the business (as the creation of Stockbrokers Botswana has done for internal portfolio investment). Creation of such a facility and monitoring the activities permitted and the generation of reporting data is feasible if appropriate legislation classing the operation as a special category of financial institution is put into place. Such legislation could provide for all documentation of title to be held by the licensee or other approved custodian. This would not be a unique approach. Indeed there is considerable regional experience in it in the comparable fields of blocked emigrant assets and the foreign investment pool that operated in Zimbabwe until 1984. However, it would seem to be rather a large effort if total abolition of exchange control is agreed as the preferred option.

Appendix 5

LEGAL ISSUES

A5.1 Introduction

A5.1.1 In a number of Chapters and appendices to this report, suggestions have been made, or are implicit, as to areas where legislative action may be worthy of consideration, including legislation in the field of taxation. This Appendix attempts to pull these suggestions together. The listing is neither comprehensive nor intended to be in any way prescriptive. It is clearly for the authorities in Botswana, and nobody else, to determine what legislation, if any, is presented to the National Assembly or to Ministers with delegated authority.

A5.2 In the field of banking and financial services:

A5.2.1 More categories of definition of non-bank financial institutions may be required, specifically including financial intermediaries, unit trust administrators and portfolio investment operations. Capital and ratio requirements for them can perhaps be relegated to secondary legislation, but they should be subjected to inspection and prudential supervision. In the main Act, licensed banks should be prohibited from adopting uncovered foreign currency positions except with the general or specific authority of Bank of Botswana. Reporting requirements to the Department of Taxes could be increased.

A5.2.2 If exchange controls are not abolished, the Exchange Control Act could be restricted to empower the Minister, in consultation with Bank of Botswana, to introduce by secondary legislation restrictions on inflows and outflows of capital and all transactions with specified countries or of a specified nature, as required to maintain the stability of the pula or in the national interest as the case may be from time to time and for any length of time. Initial secondary legislation could cover money laundering operations, money related to drug trafficking, etc., and residual controls on capital movements generally that are decided upon.

A.5.3 In the field of insurance:

A5.3.1 Supervision of all insurers, brokers and agents licensed to carry on insurance business in Botswana might have to be strengthened, and it could be made clear that transactions with or through unregistered enterprises are not in any way protected by such inspection or supervision.

A5.4 In the field of company law:

A5.4.1 A requirement for compulsory independent audit by a registered practitioner either generally, or for all companies with any Non-resident shareholders or nominees therefor.

A5.5 Investment incentives

A5.5.1 In the field of investment incentives, consideration should be given to measures that might be desirable. Much wider considerations than the scope of this Report require to be taken into account

in such a review, but exchange control liberalisation will not achieve its fullest potential as regards direct investment inflows unless all categories, apart from a negative list, are given substantially equal treatment.

A5.6 In the fields of Customs & Excise and Sales Tax:

A5.6.1 Relief (to the extent permissible under the SACU Agreement) is desirable for transit transactions and local manufacturing, storage, service, processing or assembly for export; also for repair facilities for goods from abroad.

A5.7 Other taxes

A5.7.1 In the field of direct taxation, capital taxation and taxation of foreign exchange transactions, many possibilities have been cited. Some are probably to be regarded as medium term goals rather than as essential at the inception of an exchange control liberalisation exercise. The listing here indicates what are seen as the most important items:

A5.7.2 To compensate for loss of tax revenues on interest earned on funds that might be moved abroad, it may be appropriate to extend the definition of income deemed to accrue in Botswana to cover income from investments made from funds originating from Botswana. The collection onus could lie partly with licensed investment intermediaries and a presumptive option could be offered where such intermediaries are not used.

A5.7.3 Allied to the above compensation for lost revenue could be a transaction tax, activated when necessary by secondary legislation, of up to 0.25% on purchases or sales of foreign exchange, or both. However, such a transaction tax would discourage the setting up of an international financial services centre in Botswana. It could even drive business offshore.

A5.7.4 Concessional abolition of taxes that inhibit inflow of foreign funds for portfolio investment, including withholding tax on interest, taxation of exchange gains accruing to non-residents and of capital gains accruing to them generally, as well as Capital Transfer Tax; possible relief for management costs of a Botswana-based portfolio equity investment fund.

A5.7.5 Abolition or relaxation of withholding taxes on service payments to non-residents; relaxation could take the form of an option to submit a return supporting a repayment claim; abolition could be accompanied by non-deductibility by residents of some proportion of relevant payments.

A5.7.6 Re-introduction of Estate Duty for domiciliaries, or linking of Capital Transfer Tax declarations on death to validity of grants of probate in Botswana for re-seal elsewhere.

A5.7.7 Extension of relief for foreign-source direct investment to all forms of investment not on a negative list.

A5.8 The Exchange Control Manual

A5.8.1 In the event of partial exchange control liberalisation only, the Bank of Botswana Exchange Control Manual will require extensive redrafting in the areas highlighted at Appendices 12 and 14 below.

Appendix 6

TAXATION

A6.1 Introduction

A6.1.1 The fiscal consequences of a significant liberalisation of exchange control are both relatively complex and difficult to quantify.

A6.1.2 The principal legislation involved is the Income Tax Act (Chapter 52:01) which imposes taxation on all income arising from a source in Botswana or a source deemed to be in Botswana, and also certain forms of capital gain, including gains on sale of most property including unlisted shares, and foreign exchange gains. Deductions may be claimed for expenditure wholly, exclusively and necessarily incurred in the production of taxable income, regardless of where that expenditure has been incurred. In principle, the place of residence of the recipient of Botswana source income is irrelevant.

A6.2 Modification of general principles

A6.2.1 Certain income is exempt, regardless of who receives it. Examples include interest from the Botswana Savings Bank and dividends on Botswana Building Society shares; also (by paragraph xiii of the Second Schedule) other loan interest if the Minister is satisfied that exemption is in the public interest.

A6.2.2 Certain exemptions and allowances are available to residents only. Relevant examples include an exemption for the first P1 000 of taxable interest, and the availability of zero and the lowest reduced rate relief bands.

A6.2.3 Certain income is taxed on a presumptive and final basis at fixed rates with no expense deductions or reduced rate bands allowable. This mainly applies to Botswana source income accruing to Non-residents in the form of interest, commercial royalties, management, service, technical and consultancy fees of many kinds; however it also extends to dividends payable to Residents and Non-residents alike. This is achieved by the Withholding Tax mechanism, which is an extremely efficient way of collecting tax revenue.

A6.2.4 Under Section 55, various exemptions and rebates are granted to development companies in specified industries and regions. These can extend to exemption from the application of withholding taxes.

A6.2.5 Under Sections 134 to 136, the taxable income of any holder of more than 5% of the shares in a company, or a lender to it, can have his or its income arbitrarily increased on the basis of non arms'-length transactions, with no corresponding deduction for the company concerned.

A6.2.6 There are Double Taxation Agreements with Britain, South Africa and Sweden, which vary the taxation otherwise payable to some extent. However, these are modern, well-designed Treaties and their main application of relevance is to exempt management fees, etc. accruing to taxpaying Residents of these countries from Botswana sources from withholding tax or assessment in Botswana.

A6.3 The effect of exchange control liberalisation on tax collection

A6.3.1 The most obvious and immediate impact on income tax collections of a significant liberalisation of exchange control would be to divert some savings and hence interest on those sourced and taxable in Botswana, to destinations outside Botswana, where the interest arising would not be subject to tax in Botswana (there would also be other impacts - positive and negative - which are dealt with below).

A6.3.1 The loss of tax on interest on funds moved abroad would be a gross loss, with little corresponding compensating reduction in deductions claimable. No data is available on the gross amount of interest subject to taxation in Botswana, although the amount payable to Non-residents is known as a final withholding tax applies to such interest and the amount collected through it is recorded separately. A model has therefore been constructed, using what data are available from the Statistical Annex to Bank of Botswana's 1992 Annual Report as a primary source. The first step is to estimate the quantum of savings that might go (pula millions), and the lost income arising therefrom.

Interest on Bank of Botswana Certificates	**126**
less: estimated payable to exempt pension funds, local authorities and parastatals - say, 15%	-19
covered by Non-resident withholding tax (BoB Certificates are available only to Residents)	(-)
undeclared - estimated at	(-)
covered by P1 000 exemption - estimated at	(-)
	107
Interest on commercial bank call, time and savings accounts, assuming an average rate of 12.5% thereon	**158**
less: covered by P1 000 exemption, assuming 3 000 claimants	-3
covered by Non-resident withholding tax, based on total foreign liabilities of commercial banks	-6
undeclared by recipients - say same as above	-6
estimated payable to exempt pension funds, etc. (who will be primarily invested in BoB Certificates)	- 6
	137
Interest on deposits with leasing companies, assuming an average rate of 14%	**19**
less covered by P1 000 exemption	m -
pension funds, etc. and undeclared	m -
	19
Dividend on Botswana Building Society shares, assuming an average rate of 10%	**15**
less: statutorily exempt	-15
	NIL
Interest on Botswana Building Society savings and term deposit accounts, assuming an average rate of 5%	less:
covered by P1 000 exemption and non-declaration	-1
	NIL
Interest on Botswana Savings Bank deposits, assuming average rate of 7%	**2**
less: statutorily exempted	-2

NIL

Gross taxable interest from financial institutions	**263**
[Gross taxable interest from corporate sector and personal borrowings from sources other than financial institutions has been ignored as the borrowing requirements will continue in one form or another]	
Taxation thereon at 30%	79
less: effect of personal reduced rate reliefs thereon (minimised as interest income taken as top slice of total income for this purpose) - say	-4
Maximum potential loss of revenues	75
Reduced to reflect maximum amount likely to be transferred out of Botswana before interest rates have to move sharply upwards and contain the flow as a result of elimination of excess liquidity within the economy - say interest attributable to Bank of Botswana Certificates @ 30%	38
Add: inflation in 1993 - say 15%	
	= **45 million**

A6.4 The size of the amount lost

A6.4.1 P45 million (in 1993 prices) is a substantial amount of lost revenue. It amounts to almost 5% of gross collections by the income tax authority. Ignoring all other effects - positive and negative - of exchange control liberalisation, consideration has to be given to the various ways in which a loss of this magnitude could be made good. The possibilities that follow are reasonably wide ranging, but cannot be comprehensive:

A6.5 Possible amendments to the Act

A6.5.1 The source law for citizens and permanent residents could be amended from Botswana income to world-wide income on an across-the-board basis. This approach is adopted by most OECD countries, and by an increasing number of developing countries. It is nonetheless difficult to recommend for Botswana:

A6.5.2 It greatly increases the complexity of income tax legislation and the resources required to implement it. Given the manpower and equipment constraints currently faced by the Department of Taxes, these requirements are probably incapable of achievement in the short term.

A6.5.3 It inevitably increases the propensity for non-compliance. The risks of detection resulting following non-declaration of foreign income are relatively low. Such increased propensity would result in inequity and a risk of reduced success in the current attempts to improve reporting compliance for local source income.

A6.5.4 An "on-account" withholding tax for residents could be introduced (very simply) in respect of their Botswana source interest income. Our calculations indicate that prima facie this should pull in some P5 million from undeclared income. More significantly, however, it would accelerate the collection of the whole P75 million cited above, by an average of up to nine months, which should be worth some further P4 million at least to government directly or indirectly.

A6.5.5 To maintain equity between remitters and non-remitters, amounts sent abroad other than against specific consumption documentation could be deemed to produce income taxable in Botswana. Fortunately, Botswana's existing Tax Treaties make allowance for this possibility. If the annual "round sum" approach for individuals' remittances were adopted, this would be relatively easy for banks to calculate and report. Should investments be placed through an authorised intermediary in Botswana as suggested elsewhere in this Report, calculation and reporting would be particularly straightforward. However, it has to be accepted that in a totally open regime, where transfers do not require to go through banks or intermediaries, the concept would break down and a switch to world-wide sourcing would become almost inevitable.

A6.5.6 In a partially liberalised regime (annual allowances or use of local intermediaries), the basis of extended-source taxation could be kept very simple for those who so opt. As an alternative to submission of a detailed return of relevant foreign income and assets, individuals could be permitted to agree to a presumptive taxation approach. Under such an approach income tax could be levied on the basis that exported capital is earning a return of, say, 10% on the cumulative pula amount remitted. The rate applied could be concessional to allow for the probability of an element of foreign taxation, management costs and personal expenditure - 25% could be appropriate (2.5% of gross). Applied to the capital sum whereby the conclusion in paragraph 4 above is derived, the amount collected would be up to P25 million.

A6.5.7 The articles of the IMF do not preclude the imposition of a moderate transaction tax on purchases and/or sales of foreign exchange. In 1991 (the most recent year for which full data are available) inflows through the banks totalled P4 718 million, and outflows totalled P4 452 million. A tax at 0.25% on these amounts would have produced P23 million, subject to exemptions (that would no doubt be inevitable). Taxation of this nature could be switched between inflows and outflows as a policy tool, and would be extremely simple to collect from licensed dealers in foreign exchange.

A6.5.8 While internal interest rates continue to maintain a profile that results in a net loss to Bank of Botswana or government on its Certificates or other similar instruments issued to neutralise excess liquidity, there would be a saving to the fiscus of the amount of that turn. Based on the 1992 amount in issue, this saving would have amounted to some P27 million, based on the average return earned by the Bank on its foreign reserves if an amount equal to the whole of excess liquidity had been moved offshore by residents.

A6.5.9 From the above, it seems clear that direct revenue losses resulting from exchange control liberalisation could be compensated for quite simply and without imposing any heavy administrative burden.

A6.6 Other considerations

A6.6.1 However, loss of income tax on local interest revenues is by no means the only impact certain to occur following exchange control liberalisation. Other obvious effects are incapable of even rough

quantification, but some do require consideration of points of principle (and hence potential legislative action). These include:

A6.6.2 The broadening of the tax base that will occur from productive use of new inflows of direct investment attracted to an open economy.

A6.6.3 The Botswana-source interest and dividends that will arise as a result of inward portfolio investment. This raises major points of principle:

A6.6.4 At present, there is no mechanism for allowing relief for the expenses of management of an equity based portfolio invested in Botswana; if such investment is to be sought actively, under the Botswana system of taxing dividends a specific repayment claim approach as a direct cost to the fiscus will probably be required, as applied in Britain for many years, and as applied in a rudimentary form in South Africa where fund investments earn a mixture of dividends and interest.

A6.6.5 The possibility of exempting from withholding tax the interest earnings of foreign portfolio investment; countries that actively encourage foreign inflows frequently take this approach, including Britain. The obvious objection that in many cases this amounts to giving to some other fiscus what is rightly due to Botswana is considered to be outweighed by the lower interest rates that suffice to attract and retain investment and by the fact that a high proportion of the investors in this category are wholly exempt from taxation in respect of the funds in question anyhow. These considerations apply with especial force if any international financial centre is developed and incoming funds are not converted, or only partially converted to pula. A competitive return cannot be offered if taxation is applied in these circumstances.

A6.6.6 If an international financial centre is to be developed, then the basis of taxation of companies incorporated in Botswana but not earning income sourced there (other than through the money market) requires consideration. Generally, a flat annual tax or registration fee is imposed in the range of $500 to £500, and this can build up to become a useful source of revenue. In some centres, such companies can opt for full local taxation (often at concessional rates) as this exempts them from taxation at higher rates on unremitted income in their home countries and produces windfall additional tax collections for the host country. It does require significant legislative change and the creation of a specialised taxation unit for the companies who exercise the option.

A6.6.7 In any economy with exchange controls, some element of prejudicial transfer pricing occurs. This means that imports of goods and services are overvalued, and exports of goods and services are undervalued, as a device to transfer and accumulate cash abroad. Elimination of the motivation for such abuses results in increased taxable profits being declared locally and enhanced corporate tax collections. In some countries in Africa prejudicial transfer pricing is estimated as high as 25% of private sector import and export transactions. It is unlikely to be anywhere near these levels in Botswana but, provided tax rates are held down to levels prevailing in the region generally, a useful accretion to the fiscus from direct taxation should result from exchange control liberalisation due to this feature.

A6.6.8 If Botswana develops as a regional services centre (i.e. establishment of regional holding company, group treasury and headquarters functions), additional tax collections will arise:

- through PAYE on the jobs created
- through the profits generated.

For companies of this nature, a minimum tax formula related to expenditure usually has to be evolved, since otherwise they will tend to declare a break-even situation even though an economic service of value to the group is being carried on.

A6.6.9 The potential applicability of deemed income accruing to Nonresident controlled close companies may have to be restricted, or relief given by allowing a corresponding deduction to the investee company.

A6.7 The impact of ECL on other kinds of tax

A6.7.1 The taxation implications of exchange control liberalisation would not be confined to direct taxation of incomes and potential taxation of foreign exchange flows. There would also be impacts, and probable need for legislative amendment in other areas of taxation also. Some of these include:

A6.7.2 Sales Tax is building up into an important source of revenue for Botswana. Much of it is collected on imports based on value declarations. Where there is exchange control, frontier value declarations tend to be inflated on balance for reasons set out in detail at paragraph 6.6.7 above. Sales tax on the excess is accepted by some as part of the premium that has to be paid to move capital irregularly (and in at least some cases is a premium that can be recovered from the ultimate purchaser of the goods in question). In a liberalised regime where money can be sent out freely without production of Customs endorsed entry documentation, the balance of the equation changes, and under-declaration of value at frontier becomes a prevalent practice. This, of course, applies to duties on direct imports to Botswana from non-SACU countries, and direct consignments through to inland ports that may be established inside the country, as well as to Sales Tax. To some extent, the loss of revenue resulting will be offset against higher direct tax collections on enhanced profits when the goods are sold, but full compensation in this manner is unlikely. Institutional strengthening of a Customs Administration is in fact the only real response, and this does take time to achieve (Preshipment Inspection Schemes are usually designed primarily to detect overpricing not under pricing). In the medium term, a loss of perhaps 5% of frontier Sales Tax collections is a near-probability, and a small loss of revenue into and therefore out of the SACU pool. This puts the total exposure in the range up to P10 million annually.

A6.7.3 Foreign exchange gains arising in Botswana are taxable, and on a schedular basis. Inward investment funds beneficially owned by Non-residents will have to be exempted from this impost as it will be impossible to calculate without their co-operation and in any event would be a negative inducement for such flows.

A6.7.4 Capital gains arising in Botswana are taxed as being in the nature of income and apply to Nonresidents as well as to Residents. Many countries nowadays tax capital gains, but the principle is not yet fully enough established for open economies to extend it to Nonresidents who are also non-domiciled as regards portfolio investment. To some extent this has already been accepted in Botswana by an interim exemption for foreign investors on the Botswana Stock Exchange. For similar reasoning as at 6.6.5 above, this exemption will probably have to be formalised and extended to all moveable property (even shares in property companies that are not close companies).

A6.7.5 The Capital Transfer Tax has a low marginal rate for individuals (7%), but not for local or foreign companies (35%). For the same fundamental reasoning as set out immediately above, it is

customary to exempt non-domiciliaries from this kind of taxation. Problems of assessment and collection are particularly intractable in this area.

A6.7.6 The historic collections from taxes on capital are not identifiable except in the case of Capital Transfer Tax where they have been a minimal 0.2% of total tax collections. However, it is considered a sound assumption that very little capital taxation indeed will have been collected from Nonresidents, and hence that no significant loss to the fiscus would result from restricting its applicability on a domiciliary basis except on disposals of real property.

A6.8 Estate duty

A6.8.1 In order to go some way at least towards catching up on tax evasion by individuals following relaxation of exchange controls, it may be worth considering reintroduction of a "classic" system of Estate Duty Taxation requiring disclosure and capital taxation of world-wide net assets of an individual on death. Such a system is not perfect. Inter-vivos dispositions and joint ownership of foreign assets can evade it, but they evade Capital Transfer Tax in many instances in any event. An alternative to the classic approach may be identifiable. The important feature sought is a mechanism whereby probate cannot be obtained to a domiciliary's foreign assets without tax clearance from Botswana. To achieve this, grant of probate locally (required for re-seal to establish title abroad) should relate to specifically listed assets in respect of which satisfactory arrangements have been made for security for payment of Estate Duty (or equivalent) and any back-taxes on undeclared taxable income. This issue requires separate, expert, study but should not be especially complex.

A6.9 Incremental collection due to new direct investment

A6.9.1 The additional tax revenues that could flow from new direct inward investment following liberalisation of exchange control cannot be quantified and should appropriately be looked upon as a bonus that might arise but is not certain to. The incidence of such investment and revenues will be heavily influenced by policy initiatives outside the direct purview of exchange control. These policy initiatives could include tax incentives, but the scope for dramatic attractions in this area is possibly limited by the conditions of the SACU agreement. Nonetheless, it may be worthwhile to examine the scope for "in-bond" manufacturing or a simple system for duty drawback, and also for incentives such as Zimbabwe has adopted involving exclusion of certain export revenues from taxable income. The motivation may be different but the effects could be positive.

A6.10 A "follow through" system of tax exemption

A6.10.1 We have already recommended that there should be no Botswana income tax on interest earned by Nonresidents on their deposits at local banks. A further amendment will be necessary to bring Botswana into line with other "offshore" centres.

A6.10.2 If a Nonresident sets up a regional headquarters company in Botswana, then (as with any other company in Botswana) the income that the company receives from subsidiaries, associated companies and sister companies outside Botswana is not taxable in the hands of the Botswana company. A problem will arise, however, if the local company pays a dividend to the Nonresident shareholders. As the law currently stands, that dividend will be subject to a 15% withholding tax, as a tax on the Nonresident shareholder, even if the company's income is tax exempt.

A6.10.3 To avoid this anomaly, it would be necessary to amend the Income Tax Act so as to cancel the taxation of a dividend payable to a Nonresident if the dividend itself is derived from tax free income.

A6.10.4 It might be necessary for the local company to keep two sets of books, one dealing with local taxable income and the other dealing with tax free foreign income. Alternatively, it might be better for the Nonresident to set up two regional headquarters companies in Botswana, with one of them dealing exclusively with the foreign companies.

A6.11 Tax incentives concerning income earned by Residents on foreign assets

A6.11.1 A subject of great practical interest, but which would need a careful study before it could be implemented, concerns income tax incentives for Residents who have obtained the right, after EC liberalisation, to choose where to invest their savings. The ideas below follow closely on steps that have been implemented in India and Sri Lanka.

A6.11.2 Recommendations above, about exempting interest on local foreign currency accounts of Nonresidents, could be extended to Residents. This would "level the playing field" as regards tax status, as to whether a Resident kept a foreign currency account inside or outside Botswana.

A6.11.3 Alternatively, if a Resident has placed funds abroad, there could be a tax credit in Botswana if the income earned abroad is brought back to Botswana and invested in an approved long term asset.

A6.11.4 Ideas in this general area, as suggested above, would all help to protect the level of Botswana's foreign exchange reserves, and are seen as long term ideas for the future.

Appendix 7

THE BOTSWANA INSURANCE INDUSTRY

A7.1 Introduction

A7.1.1 The insurance industry is deserving of particular attention in this study because it is specifically protected under the current EC regulations. The impact of liberalising ECs may therefore have an impact on insurance which may be quite different to that on other economic activities. After a brief review of the structure and development of the industry, we therefore consider the likely results and implications of EC liberalisation for the insurance industry, as well as any wider economic implications.

A7.1.2 The insurance sector consists of two quite distinct activities:

(a) short term - including personal and property insurance against risks such as fire, theft, accident, etc.

(b) long term - life assurance and pensions.

The operation of these two sub-sectors is quite distinct and each has different relationships with the rest of the economy. Furthermore there are some differences in the way in which they are affected by the operation of EC regulations. Therefore the two will largely be dealt with separately below.

A7.2. Overview of the Insurance Industry

A7.2.1. The Botswana insurance industry consists of three private companies and one government-run insurance fund[1]:

A7.2.1.1 **IGI Botswana Holdings Ltd. (IGI)**, established in 1974, is currently the second largest of the three private companies, with net group income of P6.0mn and assets of P112 million in 1992. Its subsidiaries deal in both short and long term business. IGI is a public company quoted on the Botswana Share Market (BSM); the majority of the shares were previously beneficially owned by the South African insurance company IGI. Following the collapse of IGI South Africa in early October 1993, its shares in IGI Botswana were put up for sale. The Botswana company was sold in November 1993 to Botswana Insurance Holdings Ltd (BIHL). IGI Botswana will continue to operate as a separate company, but there could be some restructuring and rationalisation to take advantage of economies of scale between IGI Botswana and BIHL.

A7.2.1.2 **Botswana Insurance Holdings Ltd. (BIHL)**, established in 1975, under the sponsorship of the Botswana Development Corporation (BDC), is currently the country's largest insurance company. Group net income in 1992 was P5.2 mn and assets P140mn. BDC has since divested some of its original majority share holding and the company is quoted on the BSM. Current shareholders include:

1 *Whilst this report was being written, the structure of the industry was materially changed with the takeover of IGI by Botswana Insurance.*

BDC/Sechaba Investment Trust - 34%; St. Paul (UK) Ltd. - 31%; Southern Life Association (South Africa - part of the Anglo American group) - 10%; Botswana public and institutions - 25%.

A7.2.1.3 The combined BIHL/IGI group - with total assets of some P250 million, has secured a near monopoly position and will dominate the local insurance market. The new group will account for approximately 80 percent of short term premium income. In the life assurance sector, BIHL/IGI will be the sole operator and will also dominate pension activity.

A7.2.1.4 **Botswana Eagle Insurance Company (Pty) Ltd. (BEIC),** established in 1975 as a wholly owned subsidiary of South Africa's Eagle Insurance, which is in turn majority owned by Eagle Star of the UK. In common with its parent, BEIC undertakes all classes of short term insurance but is not involved in life or pensions business.

A7.2.1.5 **Motor Vehicle Insurance (MVI) Fund.** In 1986 the government relieved the private sector of responsibility for providing compulsory Third Party motor insurance, and established the MVI Fund to meet uninsured Third Party claims. The Fund is financed by a fuel levy, and administered from within the Ministry of Finance and Development Planning. Although it is a short term insurer, the MVI Fund is a large mobiliser of capital, given the delay in settling major claims.

A7.2.2.1 The insurance industry has grown rapidly in recent years; total assets of the private sector companies increased from P7 million in 1980 to over P250 mn in 1992. In addition the MVI Fund had assets of P30mn. Most of the increase in assets was accounted for by the rapid growth of life and pensions business. However, gross premium income, mostly for short term business, has also increased rapidly, from P6.8 million in 1982/3 to an estimatedP120mn in 1991/92.

A7.2.2.2 Part of the industry's expansion has come from the rapid growth of the Botswana economy during the 1980s, although it has grown faster than the economy as a whole. The industry now forms an important component of Botswana's financial services sector, providing significant employment and skills development opportunities. Through its life and pensions business the industry is responsible for a major part of Botswana's long term savings, and hence plays a potentially important role in capital market development and the mobilisation of long term investible funds. Employment in the industry currently totals around 400.

A7.2.3 Short term insurance

On the short term side a small number of large clients account for a major share of overall business. These include the large mining companies - Debswana, BCL and Soda Ash Botswana - and parastatals such as Air Botswana, BDC, Water Utilities and the Botswana Power Corporation. Some of the risks insured are very large relative to the underwriting capacity of the local industry, and as a result reinsurance outside Botswana is essential. Premiums paid to reinsurers (mostly in South Africa) typically amount to one half of gross premium income. Although the net risk burden underwritten by local companies is often quite small, they do earn commission of reinsurance business which partially accounts for the high profits earned.

A7.2.4 Life and Pensions

IGI and BIHL both offer life assurance policies. They also operate a recognised pension scheme to which the public can subscribe, with limited income tax benefits. [Currently, an individual may con-

tribute up to P9 000 per year to a recognised pension scheme, on a tax deductible basis]. In addition they operate private pension schemes on behalf of a number of companies.

A7.2.5 Brokers

The bulk of insurance business is conducted through brokers; approximately twelve are registered in Botswana. Two firms - Associated Insurance Brokers and Sedgwick Forbes, both part of international groups - dominate with 90 percent of the market.

A7.2.6.1 Regulation/Insurance Acts

The Insurance Act 1987 governs the operation of all insurance operations in Botswana, which must register with the Registrar of Insurance. Major changes introduced in the 1987 Act include prohibiting any one insurance company from conducting both life and general insurance business, and from owning insurance broking operations. The Act also covers the general activities of insurance companies with regard to capital adequacy, solvency margins, and the maintenance of sound insurance principles.

A7.2.6.2 The Act stipulates that any insurance placed offshore by Botswana residents must be placed through Botswana brokers. As a result of ECs (see below) the amount of such insurance is currently very small. However, if ECs were liberalised in a way which affected the insurance industry, this part of the Act could become more significant.

A7.3. Exchange Controls and the Insurance Industry

A7.3.1 The industry is currently protected in terms of Notice E.C.16, which states that "where insurance cover is available . . . from Botswana based insurers, that cover must normally be taken in preference to cover offered by non-resident insurers". The one exception is where "the premiums quoted by Botswana insurers are excessive in relation to those quoted by foreign insurers for the same risks" although nowhere does the Notice define "excessive". The intention is therefore that permanent residents of Botswana, and businesses resident in Botswana, should obtain their insurance cover inside Botswana if such cover is available, notwithstanding differences in premium rates, unless these are "excessive". With this exception, Botswana insurers therefore receive absolute protection and the market is closed to other insurers. In recent years only very small amounts of insurance have been placed offshore under this exception.

A7.3.2 Two main justifications have been given[2] for this protection

(i) that it would facilitate the growth of the local industry;

(ii) that such growth would lead to an increasing net retained risk within the country and a decrease in externally placed reinsurance, and would therefore lead to a net foreign exchange saving.

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2 *In a letter, dated 11th April 1984, from the Registrar of Insurance to all Botswana insurance companies and brokers.*

A7.3.3.1 The protection of the insurance industry is a common practice internationally. Six common arguments are put forward[3]:

(i) protection of policyholders

(ii) avoidance of wasteful and destructive competition

(iii) development of local insurance markets

(iv) protection for the balance of payments

(v) channelling funds to local capital markets

(vi) national security

A7.3.3.2 Besides points (i) and (vi), the above can be broadly classified as a standard "infant industry" argument, and this has clearly motivated the case for protection of the industry in Botswana. However Botswana is unusual in that the primary form of protection for the industry is through the EC system, rather than legislation enacted specifically for this purpose (although there is an Insurance Act it is not aimed at protecting the local industry). Point (v) refers primarily to life and pensions business and will be dealt with in para. 4.7.

A7.3.4.1 The case for continued infant industry protection of the Botswana insurance industry is weak. Effectively the industry has been protected for 17 years, and in that time it should have matured well beyond the infancy stage; certainly it is much larger now than it was then, both in absolute terms and in relation to the size of the economy. [The infant industry provision of the Southern African Customs Union (SACU) Agreement permits protection of locally manufactured goods for only eight years; there is general agreement in development economics that prolonged protection is undesirable, with a lack of competition leading to operating inefficiencies and opportunities for excess profits in protected industries which are typically monopolistic or oligopolistic].

A7.3.4.2 Although there is no general case for continued protection, and it could be removed quickly by reclassifying at least short term insurance premiums from capital to current account, it could be the case that removal of protection would be disruptive to the domestic industry. If so, a gradual reduction in protection might be less harmful than an immediate and total removal.

A7.4. The Effects of removing protection

A7.4.1 There are likely to be a number of effects of removing protection of short-term insurers. Prior to discussing the likely magnitude of these effects, we note that there appears to be a consensus within the insurance industry - both in Botswana and South Africa - on two important points. Firstly, that premium rates offered by Botswana insurers are competitive within the region. Secondly, that South African firms would not be particularly interested in selling policies into Botswana from a South African base given the exchange risk of covering pula liabilities with rand assets. Subject to the above, we can hypothesise the following effects of removing protection.

A7.4.2 Local brokers - who under existing legislation retain a collective monopoly over the placing of insurance offshore - would begin to offer foreign as well as domestic policies to clients. The avail-

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3 *Carter , R. & Dickinson, G. (1992)* Obstacles to the Liberalization of Trade in Insurance *(London: Harvester Wheatsheaf).*

ability of foreign policies to cover Botswana risks would depend upon the extent to which foreign insurers wish to penetrate the Botswana market. We consider that this is unlikely to happen on a major scale - especially as externally-based insurers would need to have assessors and agents on site in order to be able to offer an acceptable level of service. Furthermore, it seems unlikely that on the core individual business (household, motor, etc.) South African (or other) insurers could offer rates which are significantly lower than those offered by Botswana insurers, at least once they found out the different risk profile in Botswana. In addition the exchange risk issue would be a disincentive.

A7.4.3 Notwithstanding the requirement that all external insurances be placed through Botswana brokers, some individuals might place insurances directly offshore. Although technically illegal under the 1987 Insurance Act, enforcement in the case of private individuals would be virtually impossible without EC restrictions.

A7.4.4 The loss of large risks

A7.4.4.1 By far the most important impact of removing protection of short-term insurers is the possible loss of large risks placed by major clients - the mining companies, parastatals, and subsidiaries of foreign companies. Some companies may be able to obtain more favourable premium rates overseas, especially the local subsidiaries of foreign companies; for instance, it seems likely that Soda Ash Botswana could obtain insurance for Sua Pan more cheaply as part of an ICI's[4] world-wide policy than within Botswana - even if only because of the benefits of bulk purchasing discounts. Similar arguments could be made for the numerous direct and indirect subsidiaries of Anglo American operating in Botswana. Such a move is made more likely by the increasing tendency for multinational companies to place insurance with "captive" insurers - i.e. their own subsidiaries - rather than on the open market.

A7.4.4.2 Parastatals might find it cheaper to insure directly overseas, but on balance it seems unlikely that they could individually secure lower rates than can the Botswana insurance companies, who derive a certain amount of bargaining power given the large amounts of reinsurance business which they place offshore. It is also important to note that although Botswana's parastatals are large relative to the domestic economy, they are small companies in international terms and do not have ready access to insurance expertise.

A7.4.4.3 The main danger of a loss of business comes from those companies which are subsidiaries of South African firms (e.g. OK Bazaar, Metro), which would almost certainly place insurances through group policies. Although they would be taking on a certain amount of foreign exchange risk (policy benefits would be in SA rand), this is likely to be more than offset by savings on overheads. The Botswana insurance companies could therefore be exposed to a significant loss of business through this channel. Whilst net retained risk and hence net premium income would not be reduced to the same extent - as much of these risks are reinsured - the local companies would also lose reinsurance commission. The effect on profits could therefore be considerable.

A7.4.4.4 However, it should be noted that the largest clients are all partially or completely government-owned, and if government so decided it could continue to place insurance with local insurers, if this was considered to have wider benefits (externalities) - although this would contradict the more general Government policy of allowing parastatals to manage their own business affairs.

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4 *The British chemical multinational ICI is an indirect shareholder in SAB through South Africa's AECI.*

A7.4.5.1 In principle we would consider that protection should not be indefinite, and that if infant industry arguments for protection are used then it is essential that this be time-limited. Many of the objectives sought by the introduction of protection have been achieved, and at the same time local insurance companies would appear to be competitive. On economic efficiency grounds there are strong arguments for removing protection after 17 years.

A7.4.5.2 However, the major difficulty with this is that such an opening up would not necessarily expose Botswana insurance companies to a competitive international (or regional) market in insurance; whilst foreign companies would be free to trade in Botswana (subject to the provision of the Insurance Act), Botswana companies would not be free to trade in neighbouring countries, whose insurance markets largely remain closed. Competition should be a two-way street, and there would not appear to be much to gain from allowing foreign firms to compete with Botswana companies without reciprocal rights for Botswana companies in those firms' home markets.

A7.4.5.3 Whilst international trade in goods tends to be reasonably competitive, trade in services often is not, and insurance is no exception. We would therefore conclude that whilst in principle there should be a removal of protection and opening up of the insurance market to competition, this should be done on a co-ordinated regional basis (perhaps through SADC and/or SACU) rather than by Botswana alone.

A7.4.6.1 Beyond the infant industry argument, there may well be consumer-protection arguments in favour of some continued controls over the industry, in that product quality is not immediately obvious in insurance, and there is ample scope for fraud. Furthermore, purchasers of external (foreign) insurance policies would have no legal recourse under Botswana law in case of disputes, only under the law of the country of domicile of the insurer. [It might be possible, however, to sue the local insurance broker through whom the offshore insurance contract had been placed]. However, as the amount of insurance placed externally by small/medium clients is likely to be insignificant, this does not seem to be a matter of great concern, at least for short term insurance.

A7.4.6.2 Partial protection is provided by the existing Insurance Act legislation concerning the operations of insurance companies, brokers and agents in Botswana, and this could perhaps be reviewed if the Botswana market were opened to external insurers. The issue of consumer protection would not appear to be applicable to large clients who take a informed decision to insure externally. They may actually be better off; in the event of a dispute over a major claim, they would be able to take direct legal action against the insurer bearing a large proportion of the risk, rather than against a small Botswana insurer bearing an insignificant portion of the overall risk.

A7.4.7 Life and Pensions Business

Life assurance and pensions business is affected by ECs in two ways. Firstly, the same restrictions apply to the purchase of external policies as to short term insurances, i.e. it is normally prohibited. Secondly, restrictions apply to investment of the asset portfolio built up by long term assurers and pension managers. Specifically, the proportion of such portfolios invested outside of Botswana may not exceed 50 percent[5]. Both restrictions must be seen as part of Botswana's capital account controls,

5 *As well as the life assurance companies, these restrictions also apply to other institutions managing pension and similar assets, including Time Pensions Managers and Debswana Pension Fund.*

and the effect is to keep savings within the country which might otherwise be invested elsewhere. However, the second restriction is more liberal than the general regime of capital account controls, reflecting the need for portfolio managers to achieve a prudent diversification and avoid the risk which an excessive concentration on a limited range of assets would involve, given Botswana's underdeveloped capital market.

A7.4.8.1 The first restriction can be seen as applying primarily to wealthier citizens, who might otherwise wish to take out their own foreign-currency denominated pensions or life assurance policies, in addition to any contractual savings schemes that they might already have in Botswana. As such, a relatively small number of people are likely to be involved. The majority of pension holders are in occupational (company) pension schemes, which are operated locally. In this case the second restriction applies. However, this is a non-binding constraint at present. In 1992 the combined portfolio composition of BIHL, IGI and Debswana Pension Fund (the three largest institutional savers) was as follows:

Botswana	listed equities	32%
	unlisted equities	9%
	property	32%
	other	11%
Total Botswana		**84%**
Offshore financial assets		**16%**

Source: Information provided by fund managers

A7.4.8.2 Clearly the proportion of offshore assets is substantially below the 50 percent ceiling, reflecting the relative attraction of domestic investments; in recent years shares and property in particular have shown high returns. However, portfolio managers indicate that the proportion of offshore investments is likely to rise in the future, given an anticipated shortage of high quality local equities. Nevertheless, as long as other local assets (property, BoB Certificates etc.) continue to offer returns comparable with those obtainable offshore, it is unlikely that the ceiling will be reached within the next ten years; the constraint will therefore remain non-binding.

A7.4.9 Abolition of capital account controls would therefore have a limited impact on life and pensions business. The main impact would be felt by wealthier citizens, who might want to diversify their currency risk and who would therefore alter their savings portfolios through the inclusion of foreign currency pensions or life assurance policies.

A7.4.10 A final point concerns the wisdom of introducing consumer protection measures in respect of long term savings schemes. The buyer is purchasing a product today which will pay off at some time in the future; that future may be twenty years or more ahead. An inability by an insurance company to meet commitments at that future date could be disastrous for the policyholder.

A7.4.11 It is common in other countries to operate some form of registration or vetting of schemes, whether regulated by the state or the industry itself, for the purposes of consumer protection. While Botswana schemes are regulated, the same does not apply under Botswana law to offshore schemes, and this may give such schemes an (unfair) advantage over local schemes. Should capital account controls be liberalised so that Botswana residents can purchase offshore schemes, various moves are possible. Firstly, Botswana brokers could be restricted to marketing only local schemes. Secondly, tax incentives (such as tax deductibility of premiums) could be used to favour local over offshore schemes.

Thirdly, it may be prudent to ensure that any offshore schemes marketed by brokers in Botswana adhere to international standards (if available) or national standards in the countries in which those schemes are based; whilst this would offer greater consumer choice, it would probably offer less consumer protection, assuming that local schemes are more closely regulated than many offshore schemes. Finally, it would be difficult to enforce any standards or protection measures for offshore policies taken out directly by individuals.

A7.5 Conclusion

A7.5.1 We understand that Botswana's present restrictions on international trade in insurance under EC 16 are not considered by the IMF's Legal Department to constitute a restriction on current account transactions, but are instead classified as a trade restriction. A removal of such protection would not therefore be required for a move to Article VIII status.

A7.5.2 We note that there are some arguments for continued protection of the insurance industry, at least until there is greater liberalisation of trade in insurance within the southern African region. Before a final decision is taken by Government on the future of protection for the industry, a more in depth examination of these issues is required. However, there is no need for protection to be carried out through EC regulations, as it could easily be done through amendments to the Insurance Act. This would entail a change in the system of enforcement - at present ECs provide a convenient means to enforce protection, whereas in the absence of ECs reliance would have to be placed upon auditors to ensure that companies are not breaching applicable legislation regarding the placing of insurances. However, the need for continued protection of the insurance industry, should this be accepted by Government, does not constitute sufficient grounds for delaying liberalisation of ECs. We therefore recommend that:

(i) Any need for continued protection of the insurance industry should not be considered grounds for delaying any liberalisation of ECs.

(ii) Government should as a separate issue consider the case for continued protection of the industry, in the light of regional barriers to trade in insurance and other services.

(iii) The means of protecting the insurance industry should as soon as is practical be transferred to the Insurance Act away from EC regulations.

Addendum - impact of recent events

A7.5.3 Although the reduction in the effective number of insurers following the takeover of IGI by Botswana Insurance does not change the principle of the arguments above, it does change their practical impact. Any consideration of local protection must weigh the benefits of fostering the growth of domestic industry against the costs of monopoly power and potential exploitation of Botswana consumers. This could take place through high premium prices and reduced efficiency, due to the absence of effective competition.

A7.5.4 In our view, the balance has been substantially shifted and the dangers of monopoly are now very real; protecting an industry where there is effective domestic competition is very different from protecting a near monopoly. It may now be that competition in the Botswana insurance industry can only be assured by opening the market to outside firms; reform of the EC regulations provides an opportune moment for government to take a view on the costs and benefits of continued protection.

MAINTAINING ACCOUNTING STANDARDS AFTER LIBERALISING EXCHANGE CONTROLS

A8.1 Introduction

A8.1.1 The Botswana Institute of Accountants is a self-regulatory body which subscribes to international standards of auditing, accounting disclosure and acceptable ethical practices. There appears to be an adequate number of qualified and experienced practitioners in the country to meet current needs. At present, the Institute is not a member of the Eastern, Central and Southern Africa Federation of Accountants (ECSAFA), but as yet this is not a critical factor, given membership of the world-wide bodies IFAC and IASC.

A8.1.2 This situation can result in a false sense of security as regards quality of financial reporting. Apart from the ethical code, international standards largely apply only to cases where an audit is conducted in terms of legislation or submitted to voluntarily. Under companies' legislation in Botswana, independent audit is not required in the case of proprietary companies unless at least one shareholder in a company demands it. It is not a legal requirement for most unincorporated enterprises and the form of report called for in the case of some statutory bodies effectively rules out full compliance with international disclosure requirements (though it does not rule out compliance with international audit procedures).

A8.1.3 Where proprietary companies, partnerships or other forms of business or financial enterprise have any Non-resident ownership participation, the existing exchange control rules have required that they submit to full audit and disclosure requirements as a precondition for approval of remittance abroad of any dividends or other forms of profit-sharing. As a result, many entities not legally compelled to have full independent audit have voluntarily submitted to it. This has protected creditors from transfers of money or assets prejudicial to their interests out of Botswana. It has also protected the country's foreign exchange reserves. Most importantly, it has almost certainly reduced tax evasion on the part of enterprises with foreign ownership participation. The amount of tax evasion prevented by full audit is unquantifiable, but some unstructured but objective research in Nigeria is known to have indicated that in that jurisdiction the tax effects of independent audit by a reputable firm were very substantial, though they still fell far short of the anti-evasion propensity generated by a stock exchange listing where the directorship has extraordinary motivation to disclose optimum profits. (In other words, even the most reputable and dedicated auditor will only unearth a proportion less than 100% of what directors deliberately determine to conceal - a point reinforced by recent scandals, such as BCCI and the Maxwell Communications Group).

A8.2 After exchange control liberalisation

A8.2.1 Only the foreign participation sector of Botswana's cash economy is subjected to the partial comfort given by full independent audit at present. If exchange control is significantly relaxed it may be appropriate to consider the following steps:

A8.2.1.1 A legislative requirement that all companies, either with foreign ownership participation or generally, require independent audit (the approach taken in Malawi, probably alone in the region), and

A8.2.1.2 A legislative, or even administrative, requirement that all business enterprise accounts submitted in support of income tax returns, or all enterprises over a specified size or with a specified number of employees, be audited as though they were, as near as may be, companies incorporated in Botswana. A selective approach at the Commissioner's discretion is possible, but subject to complaint that the discretion has been exercised in a discriminatory manner resulting in inequitable additional cost for the enterprise concerned.

Appendix 9

KEY INDICATORS FOR SELECTED LIBERALISING COUNTRIES

A9.1 Introduction

A9.1.1 The object of this section is to show how well the economies have performed in some of the developing countries that have liberalised many or all exchange controls over capital account transactions. Botswana's key indicators are included for comparison.

A9.1.2 The base data years are not identical for all of the countries. They comprise the most recent years reported in the IMF's Statistical yearbooks and vary from 8 years ended 1989, through 7 years to 1990, to 8 years to 1991.

A9.1.3 The economies are not all at the same stage of development or levels of formal employment.

A9.1.4 They all have healthy growth rates, healthy balances of payments, strong foreign exchange reserve performance, and only modest changes (in both directions) in the exchange rate.

Singapore: The trade balance has been consistently negative; investment is strongly and increasingly positive; other services are strongly and increasingly positive.

Malaysia: The trade balance has been consistently positive; investment income is consistently negative; other services are consistently negative.

Thailand: The trade balance has been consistently strongly negative; travel (tourism) provides a strong net inflow; investment income is only modestly negative; other services net out close to zero.

Indonesia: The trade balance has been consistently positive; travel (tourism) provides a strong net inflow; investment income is only modestly negative; other services are strongly negative.

Mauritius: The trade balance has been consistently very strongly negative; travel (tourism) provides a strong net inflow; investment income has switched from negative to positive; other services net out close to zero.

Botswana: The trade balance has been consistently very strongly positive; investment income is still a net substantial negative; travel (tourism) is a modest positive; other services are a modest negative.

Rates of growth, government's proportion of GDP, balance of payments, level of foreign exchange reserves

	Singapore	Malaysia	Thailand	Indonesia	Mauritius	Botswana
GDP real growth rate	7.8%	5.8%	8.5%	5.2%	6.6%	10.7%
Proportions of GDP						
tax collections	16.4%	20.4%	15.6%	16.4%	21.9%	24.1%
total govt. spending	28.3%	32.2%	19.0%	21.1%	27.1%	35.3%
govt. saving (borrowing)	3.0%	(4.6%)	(1.6%)	(1.7%)	(2.3%)	10.3%
capital formation	4.1%	1.0%	3.0%	4.6%	2.9%	6.0%
BOP annual averages (US $ millions)						
Current account	1 183	(526)	(2 845)	(1 961)	(35)	203
Investment net flow	2 203	1 438	2 304	3 214	72	119
Short-term capital	(395)	(55)	2 237	367	(25)	(11)
Unrecorded	(678)	168	525	(501)	119	50
Annual cumulative percentages						
reserves growth	18.5%	8.1%	33.0%	18.0%	45.7%	34.3%
exchange rate movement	4.2%	(2.8%)	1.0%	(9.6%)	(1.8%)	(6.9%)

Appendix 10

IMF 1993 PAPER ON CAPITAL ACCOUNT CONVERTIBILITY: SUMMARY OF KEY POINTS

A10.1 Introduction

A10.1.1 The terms of reference for the present study require the consultants to conduct a literature survey. The bulk of the work in that regard is included in Chapter 5, which deals with the experiences of other developing countries which have liberalised exchange controls over capital account transactions. Some 39 references are covered in the bibliography at Appendix 21.

A10.1.2 It became apparent to the consultants, however, that one particular reference work stands out as being particularly relevant to the present study. This is *Liberalization of the capital account: experiences and issues*, by Donald Mathieson and Liliana Rojas-Suarez in the Research Department of the IMF (IMF Occasional Paper No. 103). A summary of the paper was given in "IMF Survey" magazine of April 5, 1993.

A10.2 Recent statistics about capital controls

A10.2.1 Recent statistics show only 9 industrial countries and 21 developing countries have achieved full capital account convertibility. The remaining 123 members of the IMF either restrict payments for capital transactions, or use separate exchange rates for some or all capital account transactions.

A10.3 Preconditions for establishing capital account convertibility (through macro-economic, financial and fiscal policies)

A10.3.1 The authors of the IMF paper suggest a set of preconditions for the liberalisation of exchange controls over capital account transactions to be a success. These are:

(a) Reduce differences between domestic and external financial market conditions; establish more flexible interest rates.

(b) Remove or reduce restrictions that inhibit the flexibility of wages and prices.

(c) Limit taxes on income, wealth and transactions.

(d) Strengthen safety and soundness of the domestic financial system; strengthen bank supervision.

(e) Reduce the government's fiscal deficit; finance the remaining fiscal deficit in a non inflationary way; avoid use of the "inflation tax".

(f) Restructure and recapitalise any weak domestic financial institutions.

A10.3.2 It is interesting to note that Botswana meets nearly all the above preconditions. The only clear difference with the above set of ideas is that there is quite a lot of "stickiness" with regard to wages in Botswana. Minimum wages are high relative to the shadow price for labour; while higher level wage earners have a strong belief that they have a right to an annual salary adjustment to cover the rate of inflation, regardless of any failure to increase productivity, and regardless of how difficult they make it for unemployed work seekers to get into formal sector employment.

A10.4 Advantages seen by the two authors of the IMF paper

A10.4.1 The authors see potential benefits to a country from the introduction of capital account convertibility. These are:

(a) It facilitates specialisation in the provision of financial services, thereby improving efficiency.

(b) It introduces competition from abroad in the financial services industry, thereby offering a wider choice to consumers.

(c) It stimulates innovation and improves local productivity.

(d) It helps small countries to gain better access to international financial markets.

(e) It can reduce borrowing costs.

(f) It improves the allocation of global savings to the most productive uses, thereby improving global welfare.

(g) It allows Residents to hold internationally diversified portfolios, thereby reducing the vulnerability of Residents to domestic shocks.

(h) It encourages domestic enterprises to diversify their activities abroad, and to adopt new technologies and managerial techniques.

A10.4.2 Botswana appears poised on the threshold to gain all of the above benefits.

A10.5 Further comments

A10.5.1 The authors concede that special efforts may be required to capture the income tax due on income earned on those savings of Residents which are held outside the country.

A10.5.2 They also note that a country that is undergoing a major structural adjustment program will need to make a series of adjustments in an orderly sequence, and that removing capital controls could come near the end of the sequence.

A10.5.3 An additional comment is that a credible anti-inflation policy is crucial if capital account convertibility is to be maintained. This of course is much more likely to be the case if one has a consistent set of macro-economic policies in place.

A10.6 Summary

A10.6.1 The IMF paper provides considerable encouragement for Botswana to liberalise exchange controls over capital account transactions. The only major stumbling block is the worry about the potential loss of income tax revenue for the Government. This important subject is dealt with at Appendix 6.

A10.6.2 A minor additional comment made by the authors relates to wage flexibility, i.e. the ability of wages to respond to market forces. Whereas Botswana does not perfectly satisfy this condition, this is not enough of a hindrance to nullify the main conclusion that Botswana is likely to benefit considerably from liberalisation of exchange controls over capital account transactions.

Appendix 11

BALANCE OF PAYMENTS STATISTICS IN THE ABSENCE OF EXCHANGE CONTROL STATISTICS

A11.1. The need for high quality balance of payments statistics

A11.1.1 It is not an exaggeration to state that availability - prompt availability - of reliable balance of payments statistics is a crucial macro-economic tool in a modern economy. It is therefore extremely important that a sound data-base for collection of such statistics is not lost without replacement in the course of any exchange control liberalisation exercise.

A11.1.2 Balance of payments statistics typically provide a somewhat spurious aura of precision, and much can be read into a modest current account surplus or deficit, for example, that is the arithmetical outcome of the addition and deduction of extremely large aggregates that themselves incorporate large estimates and many borderline transactions between capital account and current account. Not infrequently, the balancing figure in a presentation of BOP Statistics ("Errors and Omissions") is larger than the current account balance and many of the disclosed current account components. The latter has happened in Botswana in the past, even using exchange control data as an unusually large data source (due to the good running records maintained by relevant personnel). In recent years, however, Botswana's error and omissions have been fairly small.

A11.1.3.1 Perhaps due to the ready availability of data from exchange control sources, the scope and coverage of BOP questionnaires to parastatal and private sector enterprises other than financial institutions has been limited compared to at least some other regional countries, and the questionnaire forms used have not been noticeably "user-friendly". Nevertheless, the Research Department of the Bank of Botswana has made considerable use of this data source. Information from multinational corporations on investment income and direct investment is extracted from the BOP questionnaires.

A11.1.3.2 Improved coverage in this function and more thorough monitoring of frontier documentation could probably improve the accuracy of BOP statistics, and reduce the magnitude of revisions to initial "flash" estimates.

A11.1.3.3 Under the present system relatively little attention appears to be given to analysis of short-term capital movements or to the true breakdown between unrequited transfers (a current account item) and short and long term capital movements. Currency revaluation movements outside the banking system may also be a weak area. These are common difficulties, and extend to OECD countries - probably to a greater degree than in Botswana.

A11.1.4 A schedule to this Appendix details identified areas where BOP data come from exchange control sources, and suggests some substitute sources. It would take a considerable time to put these substitute sources into operation for timely reporting, and in some important areas they would be far from perfect. While this is a problem faced by all open economies, it does seem appropriate to retain forms similar to the present "Form A" and "Form S", plus individual cumulative transaction record cards to capture data for the foreseeable future. This was the approach taken in Germany and France. The forms are for information only, and are restyled accordingly.

A11.1.5 An issue not directly related to collection of BOP statistics in fact, but widely thought to be, is the declaration required not once, but twice, by incoming travellers of the foreign currency they are carrying (but not the pula, which it would be illegal for visitors to import). Not long ago, such declarations were widespread practice in Africa, but recently they have virtually disappeared. Zimbabwe retains them on a voluntary basis for those who may wish to re-export foreign exchange, but Mozambique, Malawi, Tanzania, Kenya, Zambia, Nigeria and Ghana are all known to have abolished them and to have dropped controls on foreign exchange physically imported and exported.

A11.1.6 It seems that the rationale in Botswana is that:

A11.1.6.1 The Immigration Authority requires reassurance that an entrant has adequate means to support himself while in Botswana and will not have to be repatriated at state expense. Elsewhere, this is achieved by requiring the production of an onward air ticket, or by specific enquiry at land frontiers on a discretionary basis. A few countries require physical presentation of fixed amounts of convertible currency cash or an apparently valid credit card.

A11.1.6.2 The Customs Authority, as agents in the exchange control regime require a written declaration to support any subsequent prosecution or forfeiture if there is an attempt to take out foreign exchange a traveller cannot demonstrate he has brought in. Such prosecutions and forfeitures are rare, and could fall away with liberalisation. Elsewhere, there seems to be consensus that the entry declaration form serves inadequate purpose to justify its retention. It undoubtedly irritates arriving passengers, most of whom know about the high foreign exchange reserves .

POSSIBLE ALTERNATIVE SOURCES FOR BALANCE OF PAYMENTS DATA CURRENTLY DERIVED FROM EXCHANGE CONTROL SOURCES

CURRENT ACCOUNT ITEM	POSSIBLE ALTERNATIVE SOURCE
Table III (Shipment freight and insurance)	
Road Freight receipts	Returns from trucking enterprises
Resident air charter receipts	Returns from Air charter enterprises
Transit trade receipts	Estimates from frontier documentation
Transit trade payments	Estimates from frontier documentation
"Other" freight/insurance payments	?
Clearing and forwarding storage charges	Returns from agents grossed up for consignments handled by principals
Table IV (Other Transportation)	
Passenger fare receipts - other	Returns from relevant bus companies, car hire and safari operators
Airport earnings	Returns from airport
Other aircraft charter receipts	Returns from air charter enterprises
Passenger fare purchased abroad	IATA returns + travel and tour agents
Passenger fare payments - other	As for receipts other + travel agents
Port disbursements	
- repairs (vehicles)	Returns from vehicle importers
- servicing	Returns from clearing agents and estimates
- other	Returns from clearing agents and estimates
Charter and hire payments	
- planes	Returns from charter enterprise, travel and tour agents
- trucks	Returns from truckers and clearing and forwarding agents and estimates
Table V (Foreign Travel)	
Business travel income	Surely existing "Tourism Statistics" cover this?
Student travel income	Returns from relevant educational establishments
Official sector travel income	Surely existing "Tourism Statistics" cover this?
Medical income	Returns from private hospitals and estimates
Car hire income	Car hire companies
Training income	Returns from relevant establishments and estimates

Personal foreign travel costs Business travel costs Student travel costs Medical expenses Car hire expenses Training costs	No entirely satisfactory sources though returns from major relevant enterprises could assist. Supplementation from random questionnaires at ports of entry and exit is adopted in many countries.

Table VI (International investment income)

Sundry direct investment income Other investment income	Improved coverage through, and targeted questions in existing BOP questionnaire. Returns by any licensed foreign investment intermediaries. No solution re direct or portfolio investment by individuals not using an agent
Same headings - payments	Same approach re income

Table VII (Govt. sundry transactions)

Local expenditure by diplomatic missions	Returns of total credits to their bank accounts
Local expenditure by TA personnel	Random questionnaire approach
Services provided under aid Programmes	Returns from Cash Flow Unit
Other (agents fees, etc.)	

Table VIII (Other services)

Insurance receipts and payments	Returns from insurers, brokers and agents plus expanded BOP survey
Income and local expenditure of hired labour	Estimates from a sample of relevant employers
Other service receipts	Expanded BOP survey where recipient is a business. Re individuals not registered as businesses, there seems no very satisfactory solution, especially where income not repatriated. Other countries ignore as not significant or use broad estimates.
Other service payments	Same approach as for other service income

Table IX (Private transfers)

Tax repayments and pensions from foreign governments, and foreign tax payments	consolidated data from foreign governments is unlikely to be available. There is no satisfactory solution as regards individuals and estimation plus intelligence is resorted to where residual informative reporting falls short (i.e.. where no repatriation occurs)

Institutional transfers	Reporting by relevant institutions
Other transfers	Except for personal effects (where Customs can assist), the situation is as for governmental taxes and pensions above
Table X (Government transfers)	**No problem**

A11.2 Capital Account

Source data have not been provided, but we are advised that data from "Debt Recording Management System" reports are utilised, and it is likely that:

- The Official sector provides comprehensive data.
- Business and other formalised enterprises can provide adequate data of short-term movements of significance through expanded BOP survey questionnaire usage;
- Data on individuals where repatriation occurs (in either direction) through banks or other recognised intermediaries can be captured if documentation similar to Form A and Form S is retained;
- Data on physical cash and instrument transfers can be extrapolated from random frontier questionnaires.
- Data re resident individuals who do not repatriate or use a recognised intermediary can only be estimated, as is the case at present (however the statistical significance of such transactions is questionable, since once assets are surrendered from official control they cease to form part of Botswana's reserves, and are instead attributable to the reserves of the new host country).

REMAINING CURRENT ACCOUNT CONSTRAINTS

A12.1 Introduction

A12.1.1 Current account constraints are of particular importance because they would stand in the way of Botswana's application to the IMF to change to Article VIII status. It is important that any such constraints be listed so that they can be negotiated where necessary with the officials concerned. See also Appendix 15.

A12.2 A "dual exchange rate" for the pula

A12.2.1 The scheme for a partial Government guarantee of the exchange rate applicable to some foreign debt service commitments of certain parastatals, constitutes a dual exchange rate regime. Such regimes are permitted under Article VIII status only if they are (a) temporary and (b) non-discriminatory. Given that no such guarantees have been given since 1990, a commitment not to resume the practice may be sufficient to establish that it was a temporary feature, but the point will require negotiation with the IMF. As the beneficiary parastatals are monopolies or near-monopolies, the non-discrimination criterion may also be prima facie satisfied, though the view could be expressed that the potential reduction in tariffs distorts the impact of market forces on consumers. If so, the cost of withdrawing the scheme and replacing it with limited subsidies should be containable, provided the concept is not applied to any future borrowings.

A12.3 Expatriate remittances

A12.3.1 While the permitted level of expatriate remittances is very high, the Fund appears to take the view that once an individual is classified as a Resident (in any sub-category, including a Temporary Resident), it is wrong in principle that there should be any form of restriction on remittances they can make in respect of current account transactions - which include the earnings of migrant labour. This objection could be accommodated by permitting expatriates access to local borrowing facilities and redefining their permitted remittance level on application to Bank of Botswana as gross earnings (including earnings from sources other than employment), less their personal taxation liabilities. The Authorised Dealer delegated authority limit could probably remain as at present.

A12.4 Insurance restriction

A12.4.1 The exchange control requirement that virtually all insurance should be purchased locally is seen by the Fund as being fundamentally a restraint on trade, and therefore presumably an issue ultimately for GATT, rather than the IMF. However, it is clearly an anomaly that protection of this kind should in this one area be extended through exchange control which the Fund points out should not be used as a surrogate for other legislation. It would not be a difficult matter to transfer any protection required for the industry or policy-holders to the legislation dealing with the licensing of insurers, brokers and agents - and in a manner that should obviate later objection from GATT once it deals with service transactions comprehensively.

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A12.5 Current transactions in general

A12.5.1 The Fund has drawn attention to a need to identify all laws impinging on freedom to make current account remittances, and not merely those enshrined in the Exchange Control Act, or Regulations and Rules made under it. Neither our Terms of Reference nor the time available to us has permitted a comprehensive review of legislation to identify such constraints, if any. It is suggested that these would emerge over a period after transition to Article VIII status and can be dealt with when that happens. It seems unlikely that they will prove to have a material potential impact on current account transactions.

A12.6 Barter trade

A12.6.1 The Bank's Exchange Control Manual EC3 requires all barter or countertrade contracts to be referred to the Bank of Botswana. This involves considerable delay for applicants outside Gaborone, and preventing a (hypothetical) wholesaler in Chobe District obtaining items in short supply locally in exchange for items in short supply in similarly remote districts of Zambia, Namibia, Angola or even Zimbabwe. Both a de minimus limit and a substantial Authorised Dealer approval amount would seem to warrant consideration.

A12.7 Lease and hire importations

A12.7.1 EC4 (para 1.5) imposes a tax clearance requirement for lease and hire importations. Given that no withholding tax requirement exists for such remittances, this would seem to be a case of surrogation for other legislation. This could conveniently be dropped.

A12.8 Extended credit for imports

A12.8.1 EC 4 (para 4.1(iv)) requires extended credit beyond six months for imports to be registered in advance. Notification of existence of a term obligation at the end of the six month period would seem adequate as a capital account safeguard in most circumstances. Often an importer will not be aware that he will require extended credit when he places a contract. Prior notification could be dropped.

A12.9 Preconditions for dividend remittances

A12.9.1 EC 6 (para 2) requires as a precondition for dividend remittances on every occasion, the production of the original authority to export the relevant share certificates and a detailed listing of all shareholders (not excluding details of Residents). These requirements seem unnecessary.

A12.10 Partnership remittances

A12.10.1 EC6 (para 3) restricts partnership profit remittances to a basis pro rata to Resident partners. The meaning of pro rata could be restricted to a headcount basis, regardless of capital contribution levels - a device resorted to from time to time elsewhere when reserves have been under pressure or a firm out of favour.

A12.11 Interest on foreign loans

A12.11.1 EC6 (para 5) restricts interest remittances to cases where prior Bank of Botswana approval for an underlying loan has been obtained, and does not delegate any authority to Authorised Dealers.

A12.12 Pension payments

A12.12.1 EC6 (para 7) implies that a shareholding in a paying company may influence approval for a pension payment.

A12.13 Foreign contributions to foreign business travel

A12.13.1 EC7 (para 10) requires that any money or money's worth made available to a business traveller from foreign sources must be deducted from his business travel allowance. The implication that such resources reduce the basic business travel cost may not always be logical. The requirement could now be dropped.

A12.14 Tight definition of eligible pula earnings for contract TR's

A12.14.1 EC8 (para 2) excludes from "eligible earnings" of Contract Temporary Residents profit-shares, interest, dividends and directors' fees. This is too narrow.

A12.15 Hiring or repairing trucks

A12.15.1 Under EC11, payments for truck hire and repairs require specific reference to Bank of Botswana. Doubtless this restriction arises from some earlier abuses, but the continued need for it warrants re-examination. It may be that Authorised Dealers can be provided with a short negative list of local hirers and foreign contractors for whom reference is required to the Bank of Botswana.

A12.16 Merchanting trade

A12.16.1 EC12 requires Bank of Botswana's approval for merchandise purchases where goods will only transit Botswana, or not come into the country at all. This will prevent the development of entrepôt trade from a Botswana base. There is certainly potential for abuse in such trade, but deeming the sale of such merchandise to be an export, and subject to normal repatriation requirements, should reduce the risk to the same extent as applies to all exports inherently.

A12.17 Outward leases

A12.17.1 EC15 (para 3.1) requires Bank of Botswana approval for outward lease contracts extending over a period greater than six months. This may inhibit the development of what has become a major feature of the business world, and a potentially lucrative source of invisible earnings for Botswana from impecunious regional countries anxious to spread payments for capital goods imports over the working life of the assets. It may be delegated to the Authorised Dealers.

A12.18 Return of defective goods

A12.18.1 EC15 also imposes what are now very low limits for certain unrequited transfer and capital remittances; but more importantly also for replacement of defective exports and return of defective imports. The limits could be raised.

A12.19 Insurance

A12.19.1 EC16 (para 2) restricts remittance of payments for insurance. This would seem to be an instance of surrogate legislation, and is dealt with elsewhere in this Report. Reinsurance contracts in excess of the very low level of P500 per month require Bank of Botswana approval. This level should be raised.

A12.20 Guarantees to abroad

A12.20.1 EC18 does not permit Authorised Dealer clearance for some forms of guarantee required in the normal course of trade, particularly in the service sectors. This could be a restraint of trade.

A12.21 Interest paid abroad

A12.21.1 EC20 (para 6) requires application to Bank of Botswana for most interest remittances. This seems unnecessary where the underlying debt instrument has already been approved or where the interest is in the normal course of practice for the transaction concerned. Could be more be delegated to the Authorised Dealers?

A12.22 Current accounts between businesses in two countries

A12.22.1 The maintenance of current accounts between businesses in Botswana and businesses outside is quite significantly restricted - in particular, the account of a Non-resident cannot be credited without Exchange control or delegated Authorised Dealer approval. A more appropriate restriction might be to require such accounts to be split between BOP Current Account transactions (excluding unrequited transfers) and other transactions, and exempting the BOP Current Account element from the full rigour of the approval process. For many businesses, running accounts of routine transactions are an extremely practical, cost-effective and efficient means of handling transactions with residents and foreigners alike. Quarterly summarised reporting may be appropriate with right of access to examine underlying documentation, and settlement or conversion into a registered, but informal, loan at annual intervals, or more frequently where the balance exceeds, say, the capital and reserves of an enterprise.

Appendix 13

PERMITTED CAPITAL ACCOUNT TRANSACTIONS

A13.1 Introduction

A13.1.1 Various transactions are permitted which are either overtly of a capital account nature or which fall into a grey area where a transaction may be either of current or capital type. The permitted transactions are listed here for convenience, so that one can see what the starting point would be if one were to think of liberalising the existing capital account rules.

A13.1.2 A point worth noting is that in practice the allowances stated below are considerably more generous than those obtaining in other countries in the region, especially where large sums of money are concerned.

A13.2 Capital transactions for pension and life assurance funds

A13.2.1 The above funds are allowed to hold up to 50% of their assets outside Botswana, subject however to the requirement that the Bank of Botswana may give 12 months' notice of the repatriation of such foreign assets to Botswana. This rules out long term contractual fund management abroad.

A13.3 Local borrowing by nonresident controlled local companies

A13.3.1 Nonresident controlled companies in Botswana may borrow (from all sources in Botswana) an initial tranche of local financial support up to P500 000. In addition, a second tranche may be borrowed up to four times the company's capital and reserves; an additional third tranche may be borrowed by Nonresident controlled manufacturing companies.

[A13.3.2 Commercial banks in Botswana which would like to take advantage of such generous EC permissions, must of course take the credit risk themselves. The banks' lending would be subject to lending limits under the Financial Institutions Act. This is supervised by the Bank Supervision Department of the Bank of Botswana. However, they are generally allowed to accept guarantees from first class overseas banks if the local company is unable to offer adequate local security to the local banks concerned].

A13.4 Emigration allowances for Residents who wish to leave Botswana

A13.4.1 Residents emigrating from Botswana (whether businesses or individuals) can normally transfer the entire value of their local assets when they leave Botswana. Although the Bank of Botswana reserves the right to phase transfers for family units in excess of P150 000 over three years, and business transfers in excess of P50 million, the Bank has very rarely availed itself of this right when emigrants have applied to take larger estates with them. In effect, the limits are not binding.

A13.5 Remittances from deceased estates

A13.5.1 Authorised Dealers may approve legacies from the deceased estate of a Botswana resident to a nonresident beneficiary up to P75 000.

A13.5.2 Authorised Dealers may approve legacies from the Botswana portion of the deceased estate of a nonresident to a nonresident beneficiary up to P2 000.

A13.5.3 Larger amounts must be submitted to the Bank of Botswana. These are generally approved.

A13.6 Special facilities granted to Residents

A13.6.1 Residents are allowed the use of up to two (foreign currency denominated) credit cards. Although these credit cards are intended primarily for travel purposes, they can also be used informally to pay for imports, a current account transaction. To the extent that the credit cards are ever used (illegally) for capital account transactions, it would in practice be very difficult for either the Bank of Botswana or the Authorised Dealers to detect such misuse of the cards.

A13.7 Special facilities granted to Temporary Residents

A13.7.1 A special set of capital transfers out of Botswana is available to Temporary Residents. These are primarily intended to facilitate the departure of a Temporary Resident from Botswana; but certain other capital transfers may be permitted in advance of such a departure if the source of the funds in Botswana is clearly defined as being with the Temporary Resident concerned. For example, consideration will be given to a request by a TR to sell a house in Botswana and remit the proceeds before the TR is ready to leave Botswana.

A13.8 Special facilities granted to students abroad

A13.8.1 Botswana students studying abroad are given blanket permission to open one foreign bank account while they are students. In practice, it is not possible to ensure that these foreign bank accounts are closed when the student returns to Botswana.

A13.9 Portfolio investment outside Botswana by Residents of Botswana

A13.9.1 This kind of asset diversification is generally not permitted to Residents. Exceptions have been made for foreign assets acquired outside Botswana before 23 August 1976, or to foreign assets acquired before the individual concerned became a Resident.

A13.9.2 An additional special exception applied to the purchase of shares in De Beers by Debswana Diamond Company (Pty) Ltd.

A13.9.3 Residents are generally not allowed to have bank accounts outside Botswana which are not trade related, nor are they allowed to have foreign currency bank accounts inside Botswana. Exceptionally, a Resident may be permitted to pay alimony from a foreign bank account or to comply with some other court order which requires a foreign bank account to be maintained.

A13.9.4 Residents who are the beneficiaries of inheritances outside Botswana, may apply for permission to retain the asset outside Botswana and only bring the income from the asset back into Botswana.

A13.9.5 Permission has been given to Residents to buy "time shares" in foreign holiday estates. This amounts to the prepayment of future vacations outside Botswana.

A13.10 Trade related foreign bank accounts

A13.10.1 Where a Resident business imports goods from a large number of suppliers in one country (e.g. South Africa), the Resident may apply for permission to open and maintain a "retained account" at a bank in the country concerned. The Resident business may then pay for its imports from that country merely by writing cheques on its bank account in that country. Monthly bank statements must be sent to the Bank of Botswana to ensure that the conditions applicable to the retained account have been strictly observed.

A13.10.2 In a small number of instances related to the tourist industry, permission has been granted for the holder of such foreign bank accounts to credit the account with (invisible) export earnings. There is a possibility that this facility may in future be extended to other small exporters.

A13.11 Direct Investment outside Botswana by Residents

A13.11.1 This kind of external investment is tightly controlled by the Bank of Botswana. Conditions for granting approval are tough and permission will not be granted merely because the proposed investment is a good one in the eyes of the Resident wishing to make the investment. There should be some "upstream" or "downstream" linkage to the domestic Botswana economy and dividends should be remitted from the foreign investment to Botswana every year. Only a small number of direct foreign investments have been approved over the last seventeen years. This rule seems to be unnecessarily restrictive, given the high level of Botswana's foreign exchange reserves.

A13.11.2 As a general rule, Resident individuals are not allowed to own a house or apartment outside Botswana. This also seems to be too restrictive.

A13.12 Offer by the Bank of Botswana to purchase returned pula currency

A13.12.1 The Bank of Botswana stands ready to buy pula with US dollars whenever a bank outside Botswana wishes to repatriate pula currency to Botswana. Whereas the bulk of such returned pula was probably used abroad to buy foreign goods and services, the possibility does exist that some of the returned pula may have been used for an unauthorised transfer of capital out of Botswana. The net amount that is returned to Botswana is around P6 to P7 million per month. It is not possible to split this amount between current and capital transaction amounts.

A13.12.2 There are very few other countries in southern Africa which accept their own currency back without hesitation, and pay for it with hard currency.

A13.13 Conclusion

A13.13.1 When one combines the liberal rules for current account transactions with the already permitted capital account transactions, it becomes clear that Botswana's exchange control system is already quite liberal.

A13.13.2 The two major place where the system are not liberal, are discrimination against Residents with respect to outward investment, either for outward portfolio investment or for outward direct investment; and the inability of Residents to hold foreign currency bank accounts, even at a bank inside Botswana.

Appendix 14

PRESENT EXCHANGE CONTROL ANOMALIES

A14.1 Introduction

A14.1.1 The following list of anomalies is helpful in the sense that they provide a checklist of items which could usefully be discussed (and amended as appropriate) if one is going to have a period of step by step liberalisations of exchange control, as opposed to outright abolition.

A14.2 Exchange rate guarantees for servicing a foreign loan

A14.2.1 Certain exchange rate guarantees from government have in the past been available to parastatal organisations on some of their foreign borrowings. Similar guarantees were never available to the private sector; and in that sector forward cover is not permitted for debt service until the closing period of a foreign loan commitment.

A14.3 Restrictions on share holdings in Botswana

A14.3.1Residents of any category are not permitted to have a registered foreign source stake in the equity of a Botswana company; and expatriates do not appear to be permitted, and are certainly not encouraged to invest in their employer. There seems no logical reason why even permanent Residents should not be allowed to introduce legitimately held foreign funds for local investment; or why contract and self-employed expatriates should be similarly restricted, and excluded from Employee Share Ownership Participation Schemes (ESOPS).

A14.3.2 Many countries in Africa with tight exchange control regimes and/or facing acute and recurrent foreign exchange shortages permit all of these practices (e.g. Malawi, Zambia, Tanzania, Nigeria) and some -notably Nigeria and Tanzania - actively encourage them as inducing a return of even illegal flight capital and reducing the propensity for future capital outflows. In Nigeria, the encouragement goes as far as special tax breaks specifically for such funds, and in Tanzania anonymity and hence amnesty from back-tax investigation is offered by permitting Bearer securities for such inflows. ESOPS can be powerful motivators for senior expatriate staff.

A14.4 Declarations for emigration

A14.4.1Declarations required of permanent Residents at time of emigration apparently extend to world-wide assets. It seems wrong in principle that there should be an implied threat that an individual with legitimate assets abroad could be penalised as regards remittability of his Botswana assets on that ground. A beneficial owner of illegally accumulated foreign assets that have hitherto escaped detection is extremely unlikely to disclose them at the time of emigration. In any event, Botswana has no easily foreseeable need to restrict individual emigration allowances.

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A14.5 Nonresidents' restriction concerning company memorandum

A14.5.1 Paragraph 10 of the Exchange Control Regulations of 22/8/76 renders subscription of the memorandum of a Botswana company invalid if made by a nonresident without approval. This seems pointless, as such subscription is merely an undertaking that does not override other laws including the requirement that no shares actually be issued to a non-resident without approval. Mere subscription confers no remittance rights. It is likely that a number of companies are operating ultra vires as a result of visiting promoters having subscribed a memorandum of association citing a temporary address in ignorance of this Regulation.

A14.6 Limitation on "Bearer" securities

A14.6.1 Under paragraph 15 of the same Regulations, issue of Bearer certificates and coupons need approval. Bearer certificates of ownership have their risks and should not be forced on anybody, and may be outlawed by companies legislation or stock exchange rules in some countries. However, the requirement for positive exchange control approval before issue of a bearer certificate or coupon of any kind is a very wide-ranging one. It could be more appropriate to provide that bearer title confers no better claim to remittability than registered title in accordance with Exchange Control regulations would do, and to confine that to evidence of inward remittance (or equivalent) at fair value for any security held in that manner.

A14.7 Repatriation of foreign receipts

A14.7.1 Regulation 25 imposes a duty on Residents to collect and repatriate foreign amounts due to them. This is an unusually wide ranging requirement in that it would appear to extend to inheritances and windfalls, (and perhaps even to foreign assets of expatriates). Even in a siege economy, this would be an unusual requirement, although not unknown. In Botswana's circumstances a restriction to amounts falling due as a result of transactions or funds initiating in or from Botswana might be more appropriate, and specifically excluding amounts exempted in terms of the Rules in force from time to time.

A14.8 Loans to Nonresident controlled companies

A14.8.1 Regulation 31 prohibits lending to a foreign controlled company without approval. At present, there are very liberal standing approvals for such lendings by Authorised Dealers, but not by others, not even affiliates or local shareholders. It is hard to see that this whole area is truly an Exchange Control matter. It is rather a distortion in the financial and commercial markets as a whole and, in theory, cuts off companies that happen to be foreign controlled from all but 30 day payment facilities on purchases. Often, credit must be extended unwittingly by parties who do not even know that the beneficiary is non-resident controlled.

A14.8.2 Other countries, such as Malawi, have studied the issue and concluded that even when the private sector is crowded out from credit generally, commercial judgement should be the sole determinant of who should be financed and who should not. Any other approach creates distortions that can become even more serious than the advantage gained by a sound multinational willing to guarantee local facilities unconditionally.

A14.8.3 From time to time, the EC rules have been liberalised with respect to the uses to which locally borrowed funds may be put, by a Nonresident controlled company. It is now a valid question as to whether any such rules are still needed at all.

A14.9 Approval of foreign contracts

A14.9.1 Regulation 34 makes it an implied condition of all foreign contracts that, unless there is an express condition to the contrary, they are invalid without exchange control approval. With disappearance of exchange restrictions from many countries, a surprisingly large number of sophisticated and even official sector individuals have quite forgotten this whole concept and overlook the need to check on this approval. Court proceedings for recovery would enable prejudicial exchange control irregularities to be exposed. It is suggested that a more reasonable approach (already adopted in several other countries) would be to make payment into a blocked account in the name of the beneficiary an adequate defence for a Botswana debtor threatened with legal proceedings and loss of credit rating in the event of remittance of payment due under a contract being refused.

A14.10 Definition of Nonresident control

A14.10.1 The First Schedule to the Regulations deems a company to be Non-resident controlled if half of its interest payable or preference dividends declared are due to Non-residents. This is clearly an anti-avoidance mechanism, doubtless originating from some specific abuse in the past. It is unusual, internationally speaking, and does not accord with the normal understanding of the concept of control. Even those aware of the provision may have no way of finding out whether a company passes the interest test in particular. The mechanism seems incompatible with a liberal exchange control regime.

A14.11 Limit for service remittances

A14.11.1 In terms of the Bank of Botswana's Exchange Control Manual, EC2 para b(ii) sets the de minimus limit for approval for service remittances at P500 (c. £125). This is a very low amount; it would require 2 000 such remittances to total P1 million, and 18 000 to total £1 million. The limit should be brought up to date.

A14.12 Capital transfers

A14.12. 1 Per EC5 (para 10) any capital transfers of Botswana assets or obligations between Non-residents require Bank of Botswana clearance. There does not appear to be a de minimus exemption, or a formalised exemption for stock exchange transactions. A de minimus exemption would be helpful.

A14.13 Purchase of air tickets

A14.13. 1 EC7 (para 15) permits anybody to purchase air tickets locally for pula, yet prohibits Residents from accepting reimbursement outside for tickets bought in Botswana.

A14.14 Emigration of Temporary residents

A14.14. 1 EC8 (para 6) permits remittance of 100% of proceeds of Temporary Residents' assets sold to a citizen on emigration, but only 65% of proceeds of sale to non-citizens or to Nonresident-controlled companies. This is an unnecessary restriction.

A14.15 Exchange control as a surrogate for tax collection

A14.15.1 Under EC8, and many other EC Rules also, tax clearance is required as a precondition for remittance approval. This could be construed as an instance of exchange control being used as a surrogate for other laws.

A14.16 Limits for sundry transactions

A14.16.1 EC9 sets limits for remittance approval by Authorised Dealers for many categories of sundry service payments, unrequited transfers (and even small capital transactions). For most residents, the hypothetical gross total permitted if all sub-heads were activated would be generous indeed. However, there are many cases where a particular company or individual will trigger the limit for a specific sub-heading, given that there are no distinctions based on company size or the income of an individual, and given also that indexation is applied only at irregular intervals and in arbitrary amounts to amounts fixed in a depreciating currency.

A14.16.2 Doubtless Bank of Botswana approves applications for excess amounts promptly, but the amount of paper generated and the man-hours taken up by this process must be substantial. there is room for a general increase in the limits.

A14.16.3 There is probably no ideal solution to this issue so long as even vestigial controls remain, but a pragmatic approach could be:

- for business remittances no limits where documentation is produced, except for a Bank of Botswana clearance requirement for a few items such as commission payments in excess of, say, 5% of the relevant gross transaction value;
- for adult individuals a gross annual maximum covering all sub-heads and without a documentation requirement at an amount subject to automatic and non-contentious inflationary adjustment, such as the published salary of a civil servant in a given grade. This approach could also tackle the issue of permanent resident individuals having an avenue available for the acquisition of holiday or retirement residences outside Botswana - in which case, in practical terms it would have to be linked with holding assets outside Botswana (a point dealt with at Appendix 18).

A14.17 Declaration of foreign assets held by Residents

A14.17.1 EC10 (para 2.4) requires all Residents (which include all companies, all branches operating in Botswana for over six months and nearly all individuals, other than residence permit holders, physically present for over a year) to declare all foreign assets. This is an unusual requirement, redolent of countries in extreme situations of war or extraordinary financial exigency, and is normally applied only as part of confidential immigration applications for citizenship or permanent residence to ensure that applicants do not become a financial burden on the state. For exchange control purposes, citizens do not generally have to account for foreign assets other than those that have arisen from local resources.

A14.18 An anti-competition practice

A14.18.1 In practice if not in theory, EC10 virtually restricts both Residents and Temporary Residents to one branch of one bank for their foreign exchange/foreign asset and liability dealings. The reasoning behind the restriction is logical, being a practical way of controlling abuses, but a side effect must be a general restraint on competition and a particular constraint in establishing business for a new Authorised Dealer. An alternative approach could be:

- for individuals to have just one endorsement in their passport(s) citing their foreign exchange banker of record, which bank is then obliged to maintain a personal record of his cumulative transactions and to give clearance promptly to other banks and financial institutions for transactions within any limits. (Tardy responders would soon lose customers);
- for companies and businesses to advise, and receive confirmation in writing from, Bank of Botswana and their selected foreign exchange banker of record in a similar manner.

A14.19 Foreign currency bank accounts at Botswana banks

A14.19.1 EC10 (para 8) virtually prohibits the opening of foreign currency bank accounts in Botswana, and specifically prohibits their use for export sale proceeds. Those who export goods or services with a significant import content are therefore exposed to currency fluctuation risks and foreign exchange forward cover and dealing costs unnecessarily. Even countries facing extreme balance of payments problems have mostly found ways around at least some of the aspects of this problem, particularly where their currency has been tending to depreciate. As dealt with in detail elsewhere in this report, the maintenance of foreign currency accounts need not expose any bank (including a central bank) to currency risk.

A14.19.2 It is also surprising that very few Non-resident pula accounts are approved. Provided credits to such accounts are controlled, they can reduce the administrative work involved for organisations with regular foreign dealings considerably. They also encourage the establishment of regional service centres and suchlike.

A14.20 Dealings in foreign currency, not by Authorised Dealers

A14.20.1 EC13 (para 2.2) restricts dealings in foreign currency to Bank of Botswana and Authorised Dealers, though tourist establishments are understood also to be specially authorised within certain limits, and as regards purchase of foreign currency only. Possibly unintentionally, the restriction appears to extend to offshore hedging switches of the currency in which a contracted transaction is originally designated.

A14.20.2 More problematically, experience elsewhere shows that requirements of this nature are widely ignored, and the foreign exchange in question is then driven "underground" into a parallel market or banked abroad. Probably a de minimus exception is required to avoid creating a propensity to break the law that can build up to significant proportions, and also to avoid considerable frustration and a negative impression of Botswana by visitors unable to change currency when they want to - particularly at the time of departure from the country.

A14.21 Overnight positions of Authorised Dealers

A14.21.1 EC13 (para 4) restricts the overnight foreign currency holdings of Authorised Dealers. It is difficult to see justification for this restriction provided positions are reported and records subject to inspection. While Bank of Botswana spot dealing costs are low, there is no obvious reason why profits and losses on foreign exchange positions should be restricted to a central bank.

A14.21.2 The restriction in para 10 to dealing with non-residents on a spot basis only may be diverting potentially profitable forward cover business to countries of origin, or even withdrawing the facility completely from traders in Botswana imports and exports in countries that have suspended forward cover schemes, thereby tending towards "dollarisation" of the economy.

A14.22 Authorised Dealers' forward positions

A14. 22.1 EC13 (para 9.2) restricts the forward position of Authorised Dealers. These forward positions are often fully covered. It could be more appropriate to reduce the restriction to uncovered foreign positions only, given the healthy state of the foreign exchange reserves.

A14.22.2 It is unclear why forward cover can be made available for loan and similar payments (including lease instalments) only after 75% of the original loan period has expired. A cover requirement for long-dated contracts could provide greater comfort to corporate borrowers and leasers.

A14.23 Export retentions

A14.23.1 Para 9.6 permits Bank of Botswana to authorise export retentions only against firm import contracts. This will often be an impossible or financially unsound requirement. A more liberal rule would be appropriate.

A14.24 Assigning insurance policies

A14.24.1 EC16 prohibits Non-residents from assigning insurance policies in favour of Residents. It is unclear why there should be such a restriction.

A14.25 Courier service for bank notes

A14.25.1 EC17 relating to physical import and export of bank notes, etc., does not appear to have been amended to cover the now common practice of using a courier service.

A14.26 Foreign investment by Residents

A14.26.1 EC19 relates to outward foreign investment, and is clearly predicated on the basis that government and its central bank knows better than a citizen or a resident enterprise what foreign investments are likely to be of benefit to the nation. Special approval is not restricted to initial investment, but is also required for any subsequent transfers or switches. Individual Residents are prohibited completely from making foreign investments and any foreign securities they may come to hold must be given into the possession of an Authorised Dealer (in Botswana).

A14.27 Prior approval to make a will with a Nonresident beneficiary

A14.27.1 Remarkably, the EC19 Rules impose a requirement for prior Bank of Botswana approval for a Resident's will to contain a bequest in favour of a Non-resident. Few will be aware of this provision, and others will forget it when a nominated beneficiary leaves the country. This is surely a matter for consideration on application by an executor or personal representative above the limit prescribed elsewhere in the Rules (currently a mere P10 000).

A14.28 Lodging Bearer certificates with an Authorised Dealer

A14.28.1 All pula denominated Bearer certificates must be lodged with an Authorised Dealer. As argued at A14.6 above, this is probably an unnecessary requirement, particularly as regards BoB certificates, which cannot be held by non-residents in any event.

A14.29 Investment abroad by pension and life assurance funds

A14.29.1 The permission for life assurance and pension funds to invest abroad is in fact circumscribed as all such investments must be realisable on twelve months' notice being given, and title must be in the name of an Authorised Depository (a condition quite possibly illegal in the investee country). Further, sale proceeds must be repatriated, rather than reinvested abroad. These conditionalities must hamper the objective of the relaxation, which is presumably to optimise returns to beneficiaries.

A14.30 Rules for incoming investments

A14.30.1 EC19 also requires that in cases of inward investment, the source of the money must be disclosed - a matter that is of no concern to Botswana in the absence of obvious indications that money-laundering is being attempted. Further, it requires that on sale, citizens must be given an opportunity to match the offer price intended to be accepted. This can contravene pre-emption rights and ignores the fact that many direct investments are sold for trade reasons to a particular party. Any legislation in such areas should not be buried in exchange control rules.

A14.31 Discouragement of foreign borrowing

A14.31.1 EC20 (para 2) discourages foreign borrowing by Residents very strongly; indeed places very comprehensive and non-transparent power in the hands of the Bank of Botswana in this respect. Yet Government is exempt from exchange control and directly or through parastatals, has accepted some one billion pula in foreign loans, while this facility is denied to the rest of the economy. The virtual prohibition extends even to unsecured shareholder loans and to local loans from Non-resident controlled companies and does not even exclude loans denominated in pula.

A14.31.2 There is no doubt that acceptance of loans in a foreign currency exposes a borrower to a particular, unique, risk and that foreclosure even on a pula loan from a foreign financier may be likely to follow rather quickly after default. There is also no doubt that foreign debt service obligations have no element of sensitivity to general economic conditions. However, it seems wrong in principle to insulate the local lending community from competition in the extreme manner that applies to the private sector under this Rule. There is a strong case for at least the gradual relaxation of this rule.

A14.32 Further discussion on local borrowing by Nonresident companies

A14.32.1 EC21 amplifies the restriction already highlighted on pula lending to Nonresident controlled companies and to Botswana branches of foreign companies, and specifically extends it to bill discounting facilities, leasing facilities and opening of uncovered letters of credit. It is understood that Authorised Dealers now have delegated authority up to P5 million in this area, and that local financing can now be used for purposes other than working capital.

A14.32.2 These are welcome concessions, but still leave the Nonresident controlled sector in a second-class citizen status and places an onerous burden on those doing business with the sector, as the onus is on the creditor not to extend facilities rather than the other way round. It is likely that in practice the Rule is almost totally ignored except by registered financial institutions.

A14.32.3 In another country (Malawi) when a similar restriction was examined, it was discovered that it had become almost completely ineffective. Those who had to, borrowed formally or informally through trade sources - often unfairly by taking vastly extended credit. Exemptions were freely granted to foreign controlled purchasers of agricultural produce. The restriction was abolished and no adverse impact occurred. Indeed the reverse applied as affected businesses paid their local creditors more promptly and felt altogether more comfortable. No crowding out of local businesses from access to credit was detectable.

A14.33 Nonresident controlled groups

A14.33.1 An important sub-issue is that EC21 provides no exemption for group treasury functions where a group is Nonresident controlled. This pushes up net group interest expenditure in two ways : first by application of the spread between borrowing and lending rates, and second by denying access to the finest rates for both borrowing and lending, applicable to large deposits and large, evenly secured borrowings. Neither local nor regional group treasury functions can develop with this restriction in place.

A14.33.2 An alternative control (still retained in Malawi) is to prohibit dividend and profit remittances to controlling non-residents when a local group company is in a net current liability position or has a qualified audit opinion that implies such a position could arise.

A14.34 Restrictions on outward direct investment

A14.34.1 EC22 regulates outward direct investment very strictly, imposes many pre-conditions and warns that conditionalities are likely to be attached if approval is given. In particular, it restricts applications to stakes large enough to ensure active participation in management, thereby ruling out many strategic trade investments. It also envisages full repatriation of foreign earnings, a requirement that is rarely compatible with successful direct investment. There are likely to be many cases where a business plan envisages reinvestment of at least some of the profits in the business. Such tight restrictions are probably only appropriate when national foreign exchange reserves are low. See also Appendix 18 below.

A14.35 Prohibition on foreign bank accounts

A14.35.1 The general restriction on Residents maintaining bank accounts abroad has probably only one redeeming feature: it creates simple grounds for the raising of legal procedures in the event of

abuses against the Rules generally. Going by the experience of other countries, and anecdotal indications as regards Botswana, there are most probably several hundred Batswana citizens, non citizen Residents and even companies with unauthorised foreign bank accounts.

A14.35.2 While a small number of cases of substantial abuses may be included, a vast majority will have been established primarily for convenience for petty transactions in South Africa, the United Kingdom and Zimbabwe. The very existence of a prohibition on such accounts will militate against repatriation of surplus funds from them, just as the very existence of exchange controls will create a parallel market premium for a currency, with detrimental effect on the balance of payments. (In Botswana this rate is said to lie at around P1 = R1). Consideration could be given to a de minimus exemption for foreign balances held by Residents. The legal sanctions could still be triggered where balances (or other assets) abroad are found to exceed this amount.

A14.36 Prejudice against expatriate wives married to citizens

A14.36.1 If a citizen woman marries a non citizen man, the non citizen husband retains his right to be classified as a Temporary Resident.

A14.36.2 If a non citizen woman marries a citizen man, the non citizen wife loses her right to be classified as a Temporary Resident. It would be fairer to classify wives, for exchange control purposes, without reference to their marital status.

Appendix 15

MOVING TO ARTICLE VIII STATUS AT THE IMF

A15.1 Introduction

A15.1.1 The Articles of Association of the International Monetary Fund allow a member country to choose a kind of junior status, namely membership under the rules of Article XIV, or a more senior status under the rules of Article VIII. The latter category of members pledge not to have exchange control restrictions over current account transactions, and not to have multiple currency practices.

A15.1.2 The argument has always been that some countries would only be able to join the IMF if they were allowed to have at least some exchange controls over current account transactions. These countries, including Botswana, have all joined the IMF under Article XIV status.

A15.1.3 A high proportion of the Article XIV status members of the IMF are in sub-Saharan Africa. This fits in with the rest of the world's perception that there are special risks associated with investing in Africa.

A15.1.4 However, the IMF has always had as one of its goals that all its members should think in terms of either having no exchange controls at all, or of only having exchange controls over capital account transactions. Such member countries have Article VIII status at the IMF.

A15.1.5 The IMF's philosophy has been that the IMF will allow its members to avail themselves of the special exemptions under Article XIV, which allow current account restrictions, as long as this is seen as a temporary measure. In principle, all the Article XIV countries at the IMF, which includes the majority of the African members, should be trying to get rid of exchange controls on current account transactions, so that they can move "up" to Article VIII status. Up until now, however, only Djibouti, Gabon, the Gambia, South Africa, Seychelles and Swaziland have moved to Article VIII, out of all the IMF's members in sub-Saharan Africa. [Mauritius has recently applied to the IMF to change to Article VIII].

A15.1.6 The IMF's argument is based on sound economic principles to do with maximising the world's economic growth rate. However, some Article XIV member countries have found it difficult to move in the direction that the IMF would like to see. In such cases, the IMF takes a fairly relaxed view and is prepared to wait for the economic conditions to be "right" before it suggests that an Article XIV member could be ready to change its status to Article VIII. As far as Botswana is concerned, the IMF first raised the question of Botswana moving to Article VIII status some years ago.

A15.2 Conditions attached to Article VIII status

A15.2.1 An Article VIII country has to make two pledges to the IMF:

(a) if the country experiences a balance of payments crisis, it will not try to solve the crisis by tightening or re-introducing exchange controls on current account transactions;

(b) the country will not engage in a "multiple currency practice", i.e. the country will not have two or more exchange rates for its domestic currency.

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A15.2.2 If an Article VIII country experiences a balance of payments crisis of such magnitude that it cannot keep its promises to the IMF, the country should discuss its problems with the IMF and get the IMF's approval before it breaks either of the above rules. This applies, for example, to South Africa's reintroduction of the Financial Rand dual rate of exchange for the rand, in 1985.

A15.2.3 In case a balance of payments crisis requires such urgent action that there isn't enough time to consult with the IMF before an Article VIII country places restrictions on current account transactions, the member must consult with the IMF immediately afterwards.

A15.2.4 If an Article VIII country does not comply with the above Article VIII rules, it risks being declared ineligible to borrow from the IMF. The country would then be worse off than if it had remained a member of the IMF under Article XIV.

A15.3 The appropriate strategy for an Article XIV country

A15.3.1 It follows that an Article XIV country should not apply to the IMF to change to Article VIII status unless it is confident that it can maintain an exchange control regime which is free of restrictions on current account transactions, at least for the foreseeable future.

A15.3.2 The idea is that a country should be able to make other macro-economic adjustments, such as changes in interest rates, changes in the exchange rate, credit ceilings at the commercial banks, a wage freeze among the employed labour force, a reduction in Government spending, etc., to be able to handle a balance of payments crisis, without having to resort to current account exchange control restrictions.

A15.3.3 At the very least, the country must accept that it would need to have prompt discussions with the IMF if it ever needed to introduce, or re-introduce, either current account restrictions or a dual exchange rate practice.

A15.4 Advantages to Botswana

A15.4.1 There would be two main advantages to Botswana from moving to Article VIII status. The first would be the leverage that it would give to the Ministry of Finance & Development Planning, to solve balance of payments crises in Botswana by using "correct" macro-economic tools. The second is the additional comfort it would give to foreign investors, since it would become one stage more difficult for the Botswana government to change its mind, for example, about allowing dividends to be sent out of Botswana to foreign shareholders or about applying exchange controls over imported inputs.

A15.5 Detailed negotiations with the IMF

A15.5.1 Unfortunately, quite a lot of "homework" would have to be done before Botswana could formally adopt the Article VIII obligations. This includes analysing the grey areas of exchange control where it may not be 100% clear as to whether a particular EC rule is a current account restriction or not. Some examples of "homework" exercises are given below.

A15.5.2 Preliminary indications are that the IMF would probably not regard the existing restriction (EC rule 16) about buying insurance locally, as a current account restriction. The IMF might argue that rule 16 envisages a trade restriction designed to protect the local insurance industry, and not a

mechanism for protecting the balance of payments. The IMF would argue that if anyone had ever been able to obtain exchange control permission to buy insurance abroad, the required purchase of foreign exchange would almost certainly have been readily forthcoming from the Bank of Botswana. If this argument wins general acceptance, then Botswana could apply to the IMF for Article VIII status without having to remove the restriction on the purchase of foreign insurance services.

A15.5.3 It follows that discussion about EC rule 16 and the local insurance industry should not be influenced by the debate about Botswana moving to Article VIII status at the IMF.

A15.5.4 The IMF would need to be satisfied that there are no undue delays in giving exchange control approval for current account transactions. Where the right to approve an EC application has been delegated to an Authorised Dealer, approval or disapproval is expected to be rapid. However, where the Bank of Botswana has reserved the right to examine a current account application itself, such as a payment for an invisible import, there can occasionally be substantial delays. This issue would have to be negotiated between the IMF and the Botswana authorities.

A15.5.5 The IMF would need to be satisfied that the system of remittances for Temporary Residents is working smoothly, and that all the current account foreign currency needs of expatriates working in Botswana are fully and speedily met.

A15.5.6 The IMF would be expected to go through the Exchange Control Manual with a fine tooth comb, to see if they could find any lacunae connected with current account transactions. For example, they would want to know the exchange control status of an expatriate who states on arrival in Botswana that he intends to stay in Botswana for more than six months but less than twelve months. (The Manual is silent on this issue).

A15.5.7 Similarly, the IMF would expect that any system of checking current account transactions in order to make sure that they are not capital account transactions in disguise, is not so onerous as to amount to an unreasonable burden on a person making a genuine current account transaction.

A15.5.8 There would have to be a negotiation between the IMF and the Botswana authorities on the best way to handle the Government's remaining outstanding obligations to parastatals in Botswana, concerning the exchange rate risk sharing scheme, with respect to parastatals' foreign loans which are not yet fully repaid.

A15.6 Conclusion

A15.6.1 There would still be some work to be done, by way of negotiations with the IMF on a few remaining technical issues, before Botswana could move to Article VIII status at the IMF.

A15.6.2 Having said that, the long term advantages to Botswana of moving to Article VIII status at the IMF would appear to outweigh the disadvantages. Botswana would be even more strongly committed to good macro-economic behaviour than it already is. If there ever were a balance of payments crisis, for example if the rest of the world stopped buying all of Botswana's diamonds, the Botswana authorities would be expected to strongly resist any pressure to reintroduce exchange controls over current account transactions. This concept will in turn make Botswana a more attractive country for foreign investment since it adds one more degree of comfort to foreign investors that they will always be able to get their profits out of Botswana, pay interest on foreign loans, not be prevented from paying for imported inputs, etc.

Appendix 16

RELATIONS WITH SOUTH AFRICA

A16.1 Introduction

A16.1.1 It is in Botswana's best interests to maintain good working relations between the banking systems of Botswana and South Africa. This is certainly the case at present.

A16.1.2 There is a strong natural demand for rand bank notes in Botswana. In fact, there have been times in the past when the local banks have had to apply for permission to import rand currency in bulk from South Africa, in order to meet the excess local demand for rand over the supply.

A16.2 A South African problem

A16.2.1 Recently, there has been significant capital flight from South Africa. A figure of between R5 and R6 billion per year has been mentioned. But it is thought that very little, of this capital flight uses Botswana as a conduit.

A16.3 Measures taken by Botswana banks

A16.3.1 The following small steps which have been taken by banks in Botswana indicate that Botswana is not unaware of the South African problem:

(a) Commercial bank managers in Botswana discourage their staff from buying rand bank notes (for pula) across the counter from anyone who attempts to sell more than R500 at a time, where the R500 limit is equal to the South African exchange control limit of R500 that may be taken out of South Africa by any one individual per trip; larger amounts should in principle either have been collected in R 500 units at a time (e.g. at a local hotel which has been authorised to buy foreign exchange from bona fide travellers), or they should be accompanied by a South African export form to prove that they left South Africa legally;

(b) The bank managers would normally not accept large amounts of rand from a third country in southern Africa;

(c) The banks discourage their staff from opening nonresident pula bank accounts for casual visitors to Botswana who have no known business activities in Botswana.

(d) In addition, the local banks have close contacts with their correspondents in South Africa and make it their business to keep up to date with South African thinking on money laundering and other undesirable practices.

A16.4 Could the problem increase in size in the future?

A16.4.1 If exchange controls in Botswana were completely liberalised, there is a risk that such a situation in Botswana could facilitate capital outflows from South Africa. Even if the total outflow (via all possible routes) from South Africa did not increase, any use of Botswana as a conduit for a

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proportion of the illegal capital outflows would attract the attention of the South African authorities. This could act as an irritant to the new government in South Africa.

A16.4.2 One would have to rely on the good sense of the banks in Botswana to continue to impose their own, in-house, restrictions on transactions which represent money which has been exported illegally from South Africa.

A16.4.3 The Bank of Botswana could use its moral suasion over the local banks if the position appeared to need some additional discipline.

A16.5 Conclusion

A16.5.1 It will remain in Botswana's best interests not to encourage the kind of capital flight from South Africa which is in breach of the South African exchange control rules.

A16.5.2 This can probably be achieved by the continued application of current banking practices, e.g. that large cash deposits of rand are not acceptable.

A16.5.3 There is, however, one weakness in the system. A number of hotels and safari operators in Botswana have been licensed to accept foreign exchange in payment for business and holiday accommodation granted to tourists. These businesses with authorised foreign currency tills can hide a single large rand cash payment in among the rand cash they have received from South Africans who are utilising not more than R500 cash per visit to Botswana. The Bank of Botswana needs to carry out some surprise inspections from time to time, to emphasis that foreign till holders should not encourage South Africans to break the (South African) law.

Appendix 17

MODERNISING THE FORMS

A17.1 Assumptions for this appendix

A17.1.1 This appendix only applies if exchange controls are not abolished altogether.

A17.2 Two kinds of forms to be considered

A17.2.1 There are two kinds of forms on which exchange control information is reported:

(a) Exchange Control forms;

(b) Forms used primarily for other purposes.

A17.3 Kinds of modernisation

A17.3.1 One may ask if:

(a) a particular method of asking for exchange control information is still required;

(b) if No, can the form be dropped or else modified so as to exclude the unwanted information;

(c) if Yes, is there any way that the process of form filling can be simplified or modernised.

A17.4 Suggested forms where exchange control information is no longer required (one belonging to Exchange Control, one not)

A17.4.1 At present, exchange control records are kept on a file at one's main bank branch concerning the accumulative purchase during a calendar year, of foreign currency facilities for Personal and Business Travel.

A17.4.2 In addition to the above official record on a file, a separate exchange control record of each transaction is kept either in the back page of one's passport, or on a loose leaf form PP/B- which is attached to the passport either with a staple or with a paper clip. These latter records are not passed on to a new passport if one hands in an old passport during the year and obtains a new one. Similarly, it is difficult to tell if anyone has removed a form PP/B- from the back of a passport.

A17.4.3 If a person returns from overseas with unused foreign currency facilities and sells them back for pula, the traveller's records should in principle be credited with the returned foreign exchange. This applies equally to the form PP/B- at the back of the passport, but this form is not always so marked.

A17.4.4 It is difficult to see that the second type of exchange control record is in fact capable of being used by anyone. It is therefore recommended that the second form of record keeping (on forms PP/B-) be now cancelled, unless there is any convincing reason for its retention.

A17.5 Immigration, and Customs & Excise

A17.5.1 In 1976, the Bank of Botswana made representations to both the Immigration and Customs & Excise Departments for their assistance in ensuring that the newly introduced exchange control rules would be diligently obeyed. One suspected source of unauthorised leakage of foreign exchange was that visitors to Botswana might try to take more foreign currency out of Botswana than they had brought in, as a means of assisting a Resident to make an illegal export of capital. In due course, both the Immigration and the Customs & Excise Departments incorporated the Bank of Botswana's recommended currency questions in their own forms for arriving and departing passengers.

A17.5.2 It so happened that the Immigration Department could use the currency questions asked of incoming passengers, for their own Immigration purposes. That is, the Immigration Department has the right to ask an incoming passenger what financial facilities the passenger has at his or her disposal with which to support himself or herself while inside Botswana. The written currency declaration on the Immigration form satisfied that particular need, as far as Immigration was concerned.

A17.5.3 The point has now been reached, however, where the Bank of Botswana is looking at some P9 billion worth of foreign exchange reserves and probably does not need to ask currency questions of passengers, for exchange control purposes. Indeed, there is an element of embarrassment whenever a visitor expresses surprise that Botswana is still asking currency questions on immigration and customs forms, when a large number of other countries have dropped the questions from the written forms, partly because they found them to be ineffective.

A17.5.4 There is a world-wide trend for Immigration Officers not to ask visitors for written currency declarations but rather to use their own judgement on whether or not to ask a visitor any of the routine currency questions that are necessary for Immigration purposes. In other words, an Immigration Officer would not lose his or her ability to satisfy himself or herself that an incoming passenger had enough funds for local support during the visitor's stay in Botswana, if the questions were no longer on a form. The same kind of argument applies to a Customs & Excise Officer who would retain the right to make currency enquiries if that was appropriate to any given situation.

A17.5.5 It would be worth asking the Immigration and Customs & Excise Departments if their forms for visitors and returning residents could be redesigned so as to eliminate the currency questions, without reducing the efficiency with which they carry out their respective functions.

A17.6 Forms that are still required but which could be modernised

A17.6.1 Whenever someone wishes to sell foreign currency to a bank for pula, a form S has to be filled in by the customer if the amount involved exceeds certain limits. These limits are P2 500 per transaction if the foreign funds are derived from visible exports, and P500 if the funds are derived from any other source. Apart from any other reason, these limits were originally chosen so as to provide information in sufficient detail to the Balance of Payments statisticians at the Bank of Botswana.

A17.6.2 The form contains a number of headings with which the customer can describe the kind of transaction that was involved. Experience has shown that there are a few additional categories of transactions which could usefully be added to the form, for descriptive purposes.

A17.7 Recommendations

(a) Form PP/B- appears to serve no useful purpose and should be scrapped, unless some convincing reason is found for its retention;

(b) The currency questions on the Immigration and Customs & Excise forms, originally requested by the Bank of Botswana, are no longer needed for exchange control purposes. The currency questions should be taken off the forms, unless some convincing other reason is found for their retention;

(c) Form S should be redesigned so as to include more categories of transactions;

(d) The two limits above which form S must be completed, should be increased in line with inflation since the limits were last set.

Appendix 18

DIRECT AND PORTFOLIO INVESTMENT ABROAD BY RESIDENTS OF BOTSWANA

A18.1 Introduction

A18.1.1 A small number of permissions have been given since 1976 for Botswana Residents to purchase direct investments abroad. The best known of these is the cold store company in London owned by the Botswana Meat Commission. The best known of the permitted portfolio investments abroad is the holding of shares in De Beers by the Debswana Diamond Company.

A18.1.2 Income accruing to Residents from officially sanctioned foreign investments is part of Botswana's Gross National Product

A18.1.3 Generally the pre-conditions for Residents to invest abroad are highly restrictive and some Residents have had apparently reasonable foreign investment applications turned down; while many Residents do not even bother to apply for approval for foreign investment projects, in the expectation that approval would not be given

A18.1.4 A small number of Residents, mainly individual Residents of high net worth, would like to buy a house or apartment outside Botswana, but this would not generally be permitted under present rules.

A18.2 The rationale for the restriction on foreign investment

A18.2.2 In 1976 the reasons for tight control over foreign investment were twofold:

(a) In order to conserve scarce foreign exchange the BoB was given a virtual monopoly as virtual sole investor of the nation's foreign exchange reserves.

(b) There was a strongly felt wish that wealthy individuals, and businesses with money to invest, should prefer to invest their savings inside Botswana rather than outside of Botswana.

A18.3 Recent changes

A18.3.1 The above concepts were appropriate in 1976 but are no longer relevant today. The high level of foreign exchange reserves, currently approaching P10 billion, shows that Botswana is not short of reserves. In fact the high level of the reserves indicates an absorption problem, i.e. total savings inside Botswana exceed the demand from available viable investment opportunities.

A18.3.2 Forcing businesses and individuals to continue to invest inside Botswana will cause prices of domestic assets to be bid up, with the attendant risk of creating an asset price bubble. Indeed this could be part of the reason why prices of consumer goods in Botswana are often significantly higher than in South Africa.

A18.3.3 The position is further exacerbated, as far businesses and individuals are concerned, by the ever increasing volume of long term savings coming onto the domestic investment market from

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pension and life assurance schemes. A rough estimate is that they are currently receiving around P100 million of premium income, and P80 million of investment income, per year. Even if (say) 25% of the P180 million of investible money goes offshore, with exchange control approval, this still leaves around P135 million of new onshore savings looking for suitable investment opportunities each year.

A18.3.4 Consequently the argument that exchange controls are required to keep domestic savings inside the country so as to finance investment no longer applies, and private savers should be able to diversify their assets by investing offshore should they so desire.

A18.4 Macroeconomic considerations

A18.4.1 The foreign reserves are currently invested by the BoB in predominantly low risk, short term financial assets. If private foreign investment by Residents were more freely allowed, it is likely that at least some of them would exercise a preference for higher risk, longer term assets which would bear a higher expected rate of return. As a result, Botswana's Gross National Product would increase.

A18.4.2 If the existing stock of Residents' unsanctioned foreign assets were to be legitimised, the income from such assets could be brought back to Botswana. At present they are unlikely to do this as the assets may be held illegally. As a result foreign exchange earnings and reserves would increase.

A18.5 Conclusion

A18.5.1 There is a compelling case to relax the rules and allow Residents much greater freedom in respect of direct investment abroad.

A18.5.2 There is also a good case for allowing Residents more freedom to buy at least some portfolio investments abroad. Alternatively, and perhaps as a prior step, a small number of foreign high quality shares and bonds (e.g. World Bank and Eskom bonds, shares in De Beers, Anglo American, etc. etc.) could be bought and sold on the Botswana Stock Exchange.

A18.5.3 Consideration should also be given to allowing Residents to buy one house or apartment abroad.

A18.5.4 If foreign investments by Residents are to be sanctioned on a gradual basis, there could initially be some kind of rationing. For instance, a Resident wishing to invest outside Botswana could be required to demonstrate a substantial prior investment inside the country.

A18.5.5 If it is desired to make such investments abroad recallable, there could be a requirement that the title deeds to the foreign assets should be kept at a suitable foreign bank, to the order of an Authorised Dealer in Botswana.

A18.5.6 The question of how to compensate for the tax lost on the income stream of assets moved abroad is dealt with at Appendix 6.

Appendix 19

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Mr. B.K. Mswaka	Senior Manager
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LIST OF CONTACTS
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Mr. Postmus, J.H.	General Manager, Exchange Control	South African Reserve Bank

Appendix 20

TERMS OF REFERENCE

1.	What are the existing EC's in Botswana?	Executive Summary, Chapter 1, introduction to EC liberalisation
	What purpose do they serve?	Chapter 3, rationale for EC, early history Chapter 3, the cost of EC Chapter 7, conclusions and recommendations Appendix 12, remaining current account constraints Appendix 13, permitted capital account transactions Appendix 14, present EC anomalies
2.	Are the present regulations administered efficiently and in a timely manner?	Executive Summary Chapter 1
3.	In what industries are they currently a binding constraint?	Chapter 4, the impact of EC on foreign investment inflows
4.	If Botswana moved to Article VIII status at the IMF	Appendix 15
5.	If Botswana totally suspended exchange controls	Chapter 5, macro-economic management without EC Chapter 6, the immediate risk of capital outflow Appendix 1, impact of short term outflows: forecast to 2003
6.	What new investment would be likely to be attracted to Botswana?	Chapter 4, the impact of EC on foreign investment inflows
	Establish B as a regional centre?	Chapter 4, Foreign Investment Inflows, Chapter 7, conclusions and recommendations
7.	Impact on determining the exchange rate of the pula? Would pula have to float?	Chapter 1, EC and exchange rate policy. Chapter 7, conclusions and recommendations
8.	Impact on level of forex reserves?	Appendix 1, impact of short term capital outflows: forecast to 2003
9.	Value and stability of the pula?	Chapter 12, also Appendix 3

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10.	The Botswana share market	Chapter 7
11.	Staffing at Bank of Botswana	Executive Summary; Chapter 7
12.	Interest rates	Chapter 5, chapter 7, Appendix 3
13.	Employment, investment, disinvestment	Chapter 4
14.	Pension and life assurance funds	Chapter 4, Appendix 3, Appendix 13
15.	Level of domestic savings	Executive Summary, Appendix 1
16.	Government's ability to intervene if necessary	Chapter 5, Chapter 7
17.	Lost tax revenue	Appendix 1, Appendix 6
18.	Amend tax legislation	Appendix 6
19.	Relations with South Africa	Appendix 16
20.	Industries that could be opposed to liberalisation of EC	Appendix 7, the Botswana insurance industry
21.	Should EC's be phased out over time, and in what order? Would there be a greater benefit from immediate abolition?	Executive Summary, Chapter 7, Appendix 3

FOREIGN EXCHANGE STUDY

REVISED TERMS OF REFERENCE

OVERVIEW:

BOCCIM requires a study of the benefits, costs and risks of removing foreign exchange controls in Botswana. The successful contractor will be expected to visit Botswana over a two to four week period, interview relevant government officials and representatives of the business community, and submit a draft written report that presents the results of specific required analyses as described below. The contractor will also conduct a brief literature survey of the experience of selected countries that have abolished exchange controls in recent times and include within the report a synopsis of the impact of this liberalisation and other related policies on the economies of these countries and individual sectors.

The contractor will work with the assistance of a resident economic consultant and under the guidance of a study reference group to be appointed by BOCCIM. Following submission of the draft report, the contractor will also make an oral presentation of the study results to the reference group. The contractor will be expected to provide a final report within two weeks of receipt of BOCCIM'S comments on the draft report. It is anticipated that a total of three meetings will be held with the reference group over the course of the study, including the oral presentation of results.

The total professional level of effort is estimated to be forty days. It is anticipated that a fixed price contract will be awarded to the successful tenderer. BOCCIM reserves the right to award the contract to a tenderer other than the lowest bidder. All proposed study personnel should have strong English language speaking and writing skills.

Tenderers should:

1) demonstrate relevant experience in studying similar problems in other countries;

2) provide a brief description (three to five pages) of their approach to conducting the required analyses;

3) furnish relevant biographical information concerning all members of the proposed study team;

4) provide a business proposal itemizing professional fees, expenses, and total price.

BACKGROUND:

Botswana's current exchange control regime is among the most liberal in Africa and other parts of the developing world. The current regime has been in place since Botswana introduced its own currency in 1976. The controls are designed to allow relatively free movement of funds for imports of good and services and foreign travel of Botswana residents, and to encourage investment by foreign firms and individuals. However, large movements of capital are restricted to prevent capital flight.

In view of the large foreign exchange reserves held by the Bank of Botswana (approximately USD 5 billion), the question is whether Botswana should further liberalize controls in an effort to attract new investment, to diversify the economy, and increase employment.

SCOPE OF WORK:

The contractor will conduct analyses to address the following questions:

1. What are the existing exchange controls in Botswana? Under the current economic conditions, what purpose do they serve?

2. Are the present regulations administered efficiently and in a timely manner? In what industries, if any, are they currently a binding constraint on business activity or new investment?

3. If Botswana moved to IMF Article VIII status (i.e. no restrictions on current payments) or totally abolished exchange controls:

    a) What new investment or industries would likely be attracted to Botswana, and what is the level and timing of such new investment that could realistically be expected? What would the impact be on new job creation?

    b) If businesses or individuals wished to invest outside Botswana by using Botswana as a regional financial services centre, what measures or incentives could be brought in to ensure that Botswana benefitted from such investments.

    c) What other impacts, positive or negative, could be expected, and how strong would they be? Specifically, what would be the impacts on:

        (i) the level of foreign exchange reserves;

        (ii) the value and stability of the Pula;

(iii) the Botswana share market;

(iv) the employment levels and staff utilization within the Bank of Botswana;

(v) interest rates;

(vi) net employment: specifically, quantify the extent to which there may be disinvestment as a result of capital flight.

c) What measures would be required in advance of abolition or liberalization of exchange controls to avoid undesirable effects, e.g:

(i) would it be necessary to move to a system of worldwide taxation (as opposed to the current source-based tax system) to prevent erosion of the tax base?

(ii) considering likely developments in the southern Africa region, would modification be required in Botswana's economic treaties with neighbouring countries to assure reciprocally fair competition in financial service industries such as banking and insurance?

(iii) what industries or other organizations would be opposed to removal or liberalization of exchange controls, and what measures would be necessary to overcome their objections?

d) In view of the findings of the above analyses, should exchange controls be phased out over a protracted period of time, and in what order? Conversely, would there be a greater benefit (e.g. in terms of investment promotion) from elimination of controls all at once? What is the "window" of time during which controls would have to be removed in order to capture the full benefits of liberalization?

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