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Botswana's International Trade Policies

by

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BOTSWANA'S INTERNATIONAL TRADE POLICIES

by

J. Clark Leith*

1 INTRODUCTION

1.1 Every country in the world must settle on an international trade policy. Does it engage in any international trade, and if so, to what extent does it pursue a set of policies which in some way restricts the free flow of international trade? Few countries, if any, choose either extreme -- no trade or perfectly free international trade. Thus, at least some intervention is commonly encountered. Botswana is no exception.

1.2 Botswana's policy interventions in the arena of international trade are, however, more varied and complex than most countries'. Botswana simultaneously is a member of a customs union with one group of neighbouring countries, has a free trade agreement with another, participates in a highly successful cartel governing its principal export, has preferential access to a large, highly protected market for another major export, and has pursued an exchange rate policy which has led to the accumulation of 2 years worth of current account payments. As if this were not enough, negotiations are currently underway to overhaul the customs union, and to add overlapping free trade agreements between the customs union and several more neighbours, and another one with the European Union.

1.3 Overall then, it is clear that Botswana's trade patterns have been influenced significantly by a wide ranging set of trade policies. This mix of policies is in part the result of historical accident, and in part the outcome of deliberate choices made by the authorities over the years. The purpose of this chapter is to describe the main features of the policies, and identify their principal effects. In the process, a number of important issues in negotiations and policy discussions currently underway are highlighted.

2 TRADE PATTERNS

2.1 By way of background it is important to note a key feature of Botswana's trade picture: high commodity concentration of exports and geographic concentration of imports. This concentration is both the cause and the result of the policy choices.

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* The Author is Professor of Economics, University of Western Ontario, and Senior Policy Advisor, Bank of Botswana. He is indebted to colleagues in the Botswana Ministries of Commerce and Industry, and Finance and Development Planning for extensive discussions on many of the issues taken up here. However, none of the institutions mentioned bears any responsibility for the analysis presented here. In addition, the paper has benefitted considerably from the comments of an anonymous referee.

2.2 Diamonds account for 75% or more of Botswana's merchandise exports in recent years, which in turn represent over 40% of GDP. Because of this dominant position, changes in diamond exports have a significant impact on total exports and the entire economy. Figure 1 shows diamonds versus all other exports in recent years. Of the other exports, copper-nickel is responsible for 5% to 8% of the total and beef about 4%, while textiles now account for over 3%, with assembled vehicles growing rapidly to over 6%. The major non-diamond exports are depicted in Figure 2.

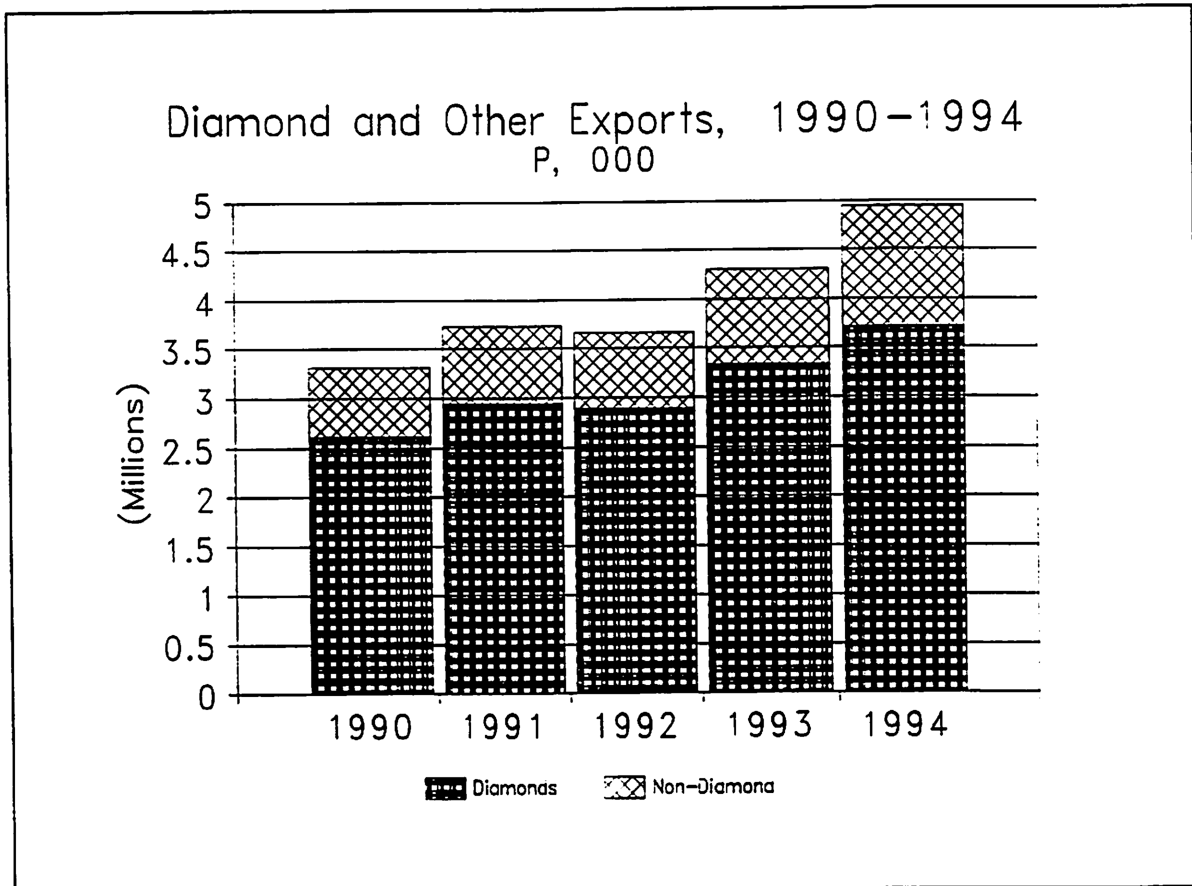

Figure 1

2.2.1 On the import side, the vast majority of Botswana's imports come from the Southern African Customs Union (SACU) consisting of Botswana Lesotho, Namibia, South Africa, and Swaziland, with relatively small shares coming from other sources. (See Figure 3.)

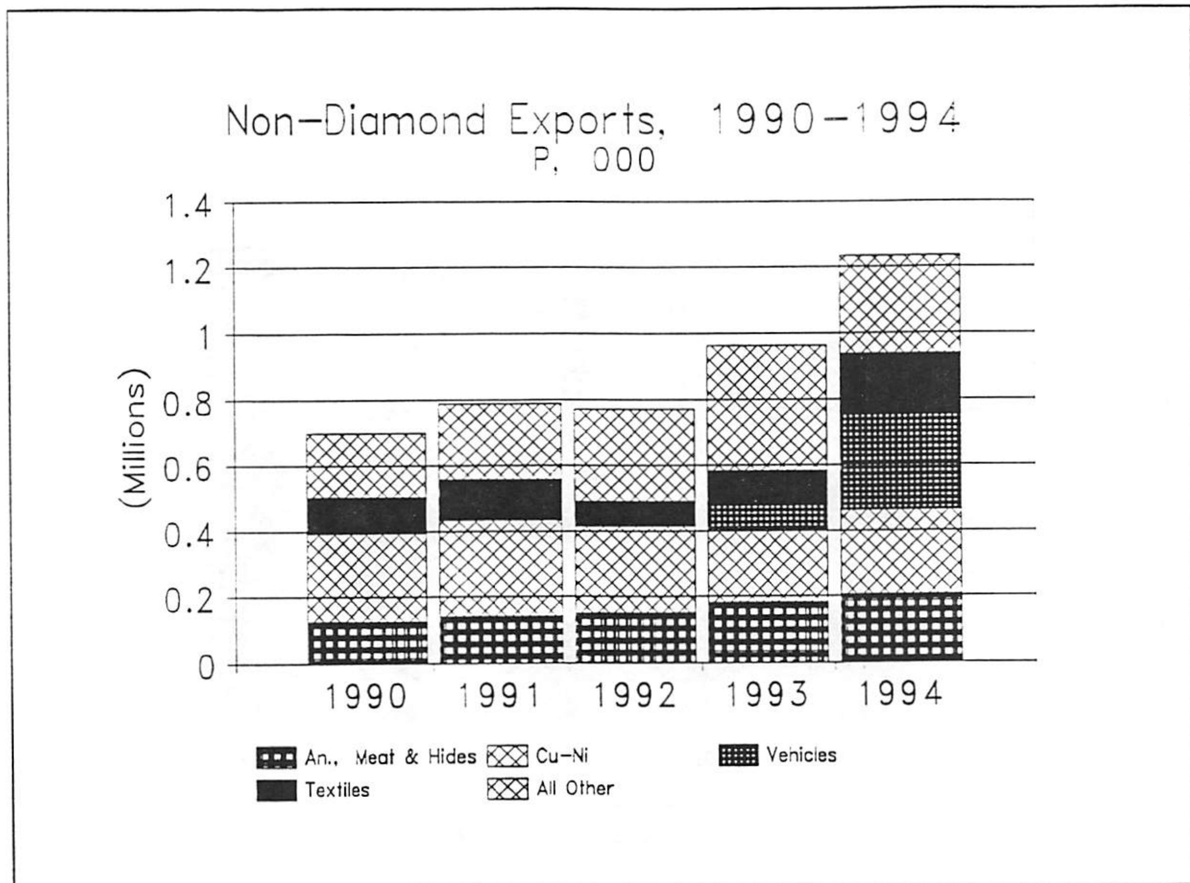

Figure 2

3 PARTICIPATION IN DIAMOND CENTRAL SELLING ORGANIZATION

3.1 Diamond exploration was commenced by DeBeers of South Africa before Botswana's Independence, but it was not until shortly after Independence that diamonds were discovered. At a very early stage a decision was made to participate in the diamond Central Selling Organization (CSO), under the auspices of DeBeers. At that point, it could be argued, Botswana had little choice. The country was surrounded by minority white regimes, and DeBeers was in a very powerful position to extract a deal tilted to its interests.

3.2 Yet there are a number of important features of the diamond market which made it possible for a mutually profitable deal to be struck between Botswana and DeBeers. The CSO had already been successfully managing the diamond market for several decades, in sharp contrast with repeated failures of many other international commodity agreements covering raw materials of various kinds. This was due, in large part, to inherent characteristics of the diamond market which made it a prime candidate for a

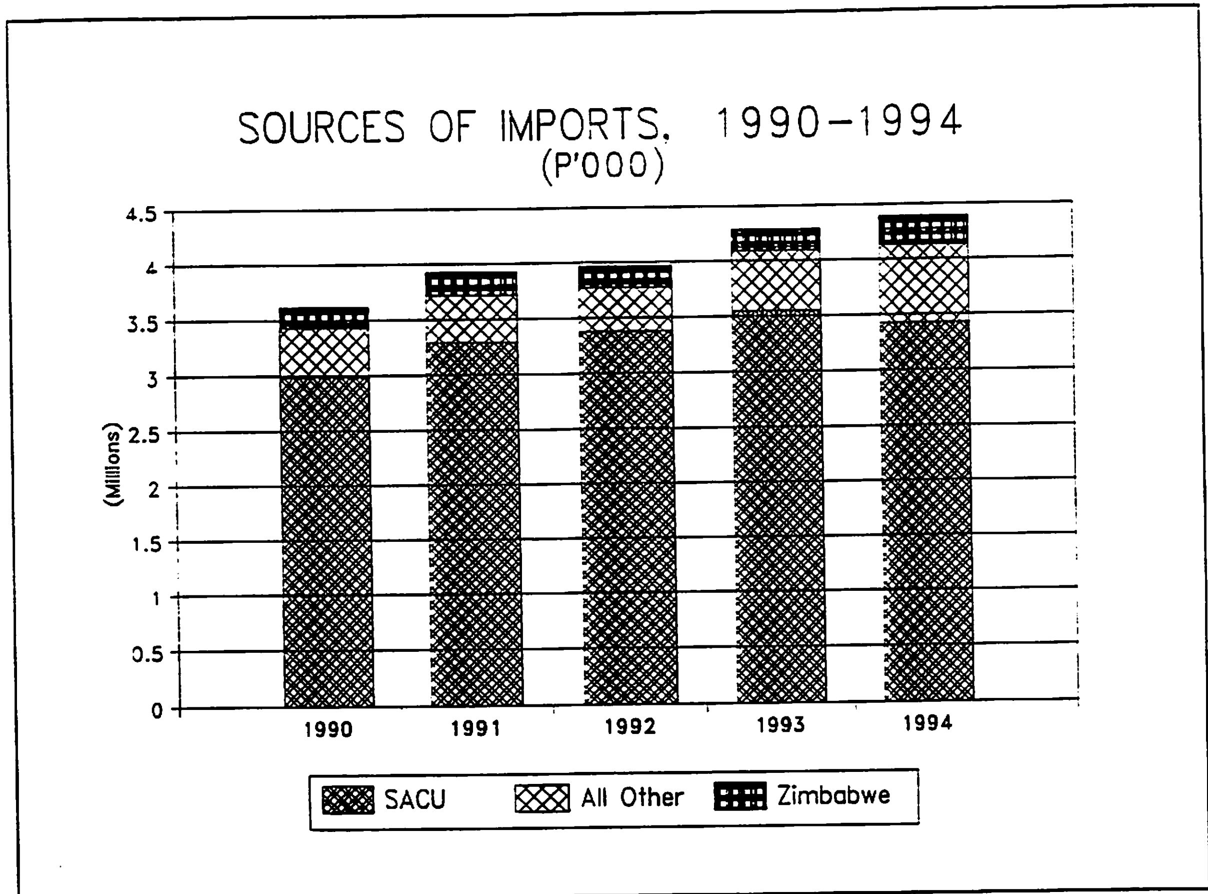

Figure 3

successful cartel, but also to the skilful management of that market by CSO over the decades. Demand for gem diamonds is inherently inelastic, as there are few substitutes. Both the level of demand and its inelasticity have been reinforced by the CSO advertising, emphasizing the unique nature of the gem, its characteristic use for engagements, and the message implicit in the slogan "diamonds are forever" that they do not lose their value.

3.3 There are relatively few producers of gem quality diamonds in the world, making it more manageable to reach agreement among them, and to enforce marketing restrictions, in contrast with the situation of the Organisation of Petroleum Exporting Countries. Such restrictions are essential when there is a significant gap between price and marginal costs, and this is especially serious in the short-run where production costs are largely sunk (as they are in diamonds). Stabilization is especially important when the problem is disturbances arising from the demand side. In the absence of intervention, this would tend to make both price and producer income unstable.

3.4 Successful market interventions of this type require that the buyers are unable or unwilling to organize countervailing actions. Partly because the buyers are individuals widely dispersed throughout the world. and because the existing holders of diamonds have an interest in ensuring that the price does not fall, there is unlikely to be any effort on the consumer side to break the market hold by CSO.

3.5 Nevertheless, the CSO has had to enforce strict discipline on the buyers at the ten per year "sights" when it offers diamonds for sale. Further, reportedly it has had to spend substantial sums buying up stocks which reach the market from non-participants. The internal situation in several such source countries. including Angola, Russia. and Zaire, have exacerbated this problem.

3.6 The Botswana deposits of diamonds are relatively low cost ones to mine. This has meant that the profits from the success of the CSO in maintaining diamond prices are potentially greater than for marginal producers, while the short-run gain from cheating would be very large. In light of these conflicting incentives, Botswana was able to negotiate a mutually beneficial deal with DeBeers and thus with CSO. such that the principal export has earned significantly more revenue, and that revenue has been substantially more stable, than would be the case in the absence of such an arrangement. Those agreements have been renewed from time to time over the years, indicating that this continues to be a central feature of Botswana's trade policy.

4 OTHER EXPORTS

4.1 In recent years. while diamonds have accounted for about 75% of exports. three other exports have each accounted for about three to five per cent of the total: copper nickel. meat. and textiles. In addition. starting in 1993, assembled motor vehicles have grown to be the largest gross (but not net of imported kits) non-traditional export. While small relative to diamonds. each has particular features and different destinations. (See Figure 2 above.)

4.2 The copper nickel mine, which opened in the 1970s, sells its output effectively on the world market. While the matte is sent to countries endowed with cheap hydro-electricity for refining, the refined copper goes on from there and has no concessional markets. Consequently, Botswana has suffered the instability of the world market for this primary commodity . The mine has, nevertheless, enabled Botswana to repatriate a significant portion of the miners that had been working in South African mines.

4.3 In recent years Botswana has developed a textile export industry. A significant portion of the textile exports are the result of special trade arrangements. The industry began largely as the result of Government assistance provided under an industrialization incentive programme known as the Financial Assistance Policy (FAP). The FAP commenced in the early 1980s, shortly after the time of Zimbabwe's independence, and for a variety of reasons attracted a number of firms from that neighbour. Not only was there uncertainty about the future in Zimbabwe, but Botswana and Zimbabwe continued the colonial free trade arrangement, so that firms moving to Botswana continued to maintain access to the Zimbabwe market. The arrangement also, crucially, included favoured access by Zimbabwe importers to foreign exchange to purchase imports from Botswana. For its part, Botswana, had no foreign exchange rationing. The overvalued Zimbabwe dollar made it profitable for the textile producers to locate in Botswana to serve the Zimbabwe market.

4.4 Following Zimbabwe's independence in 1980, negotiations were carried on sporadically to replace the colonial free trade agreement between the Bechuanaland Protectorate and Southern Rhodesia with an agreement between the two sovereign nations. Finally, in 1988 an agreement was signed which updated the arrangement.

4.5 Botswana's trade with Zimbabwe grew rapidly in the second half of the 1980s. However, when Zimbabwe eventually realigned its currency in 1991, producers located in Botswana were considerably less competitive, and exports to that destination, especially textiles, tailed off.

4.6 Since under a free trade arrangement each party is free to set its own external tariff, thus potentially allowing low cost imported inputs to be used in exports to the free trade partner, a central concern of both parties has been the issue of rules of origin. Under the 1988 renewal, rules of origin based on material content, rather than an economic concept of value added were adopted. Further, the decision over whether or not a particular establishment would satisfy the domestic value added requirement was lodged ultimately in the customs service of the importing nation. Since customs services almost invariably respond to domestic producer rather than consumer interests, this feature has seriously limited the potential growth of trade between the two countries.

4.7 Meanwhile, Botswana's membership in the SACU provided textile producers with potential access to the large South African market. Initially that access was not utilized substantially. Somewhat fortuitously, as local producers found it difficult to compete in the Zimbabwe market due to Zimbabwe's major real depreciation, Botswana's competitive position vis-a-vis South Africa improved, and several new producers were able to penetrate that market.

4.8 In the late 1980s, some Asian textile producers were unable to fulfil their export quotas under the Multi-Fibre Agreement, thus making the markets available to producers from other sources. At the same time, in an effort to provide a more stable employment base for the region around the copper nickel mine, the Botswana Government established an additional incentive programme[2] for firms to locate in that region, but only for exports destined outside the Southern African Customs Union. More recently, the company profits tax rate has been set at 15% (half the regular rate) for activities qualifying as "manufacturing", regardless of location.

4.9 Motor vehicle assembly has become a rapidly growing source of Botswana exports to SACU. Semi-knocked down kits are imported from outside SACU at low duty and excise tax rates under a special provision of the common external tariff, and the assembled vehicles are sold within SACU at highly protected prices. These exports, which began in 1993, grew to exceed the value of each of meat, copper nickel, and textile exports (but not domestic value added) by 1994. South Africa took exception to the use of what they regarded as a "loophole" in the duty/excise tax rates, and after considerable discussion it was agreed to allow the principal producer to continue only if it switched to using completely knocked down kits. At the time of writing this had been agreed to, with a grace period allowed for the switch over to occur.

4.10 A further special trade arrangement applies to beef exports. Botswana's vast grazing lands accommodate a cattle herd that on average exceeds 2 million. The cattle destined for the export market are slaughtered locally, producing a high quality cold dressed beef. Part of the beef is shipped to the region, especially South Africa under the protection of the common SACU external tariff. The majority of beef exports, however, are destined for the EU under the special provisions of the Lome Convention. This arrangement provides for a rebate to Botswana of 90% of the EU import levy, which is sufficiently lucrative that the Botswana Government spends substantial sums to ensure that the beef meets EU standards, especially that it is free of foot and mouth disease. Despite this, Botswana has not been able to fulfil the EU quota in recent years, due largely to the slow spread of fully commercialised cattle ranching. The remaining beef exports go to South Africa, and some to the Indian Ocean island of Reunion.

4.11 The next Lome Convention is to come into effect early next decade. It is expected that there will be a phasing out of these special concessions. This will require a major increase in efficiency by Botswana beef producers if they are to remain competitive in world markets.

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[2] The incentive programme was in addition to the incentives available under the FAP. As a consequence the total incentive packages available were quite substantial.

4.12 The combination of rapidly growing exports of assembled vehicles and textiles, together with the continued traditional beef exports, have made South Africa the largest destination for Botswana's non-diamond exports.

5 IMPORTS

5.1 The vast majority of imports are also subject to preferential arrangements. As a member of SACU, Botswana provides duty free access to imports from the other partners, while imports from other sources face the SACU common external tariff. In addition, the free trade agreement with Zimbabwe provides goods which meet local content requirements with duty free access to the Botswana market.

5.2 The benefits and costs of Botswana's SACU membership as of 1987 have been quantified.[3] The three principal effects are summarized in Table 1. The common external tariff, which under the current arrangement is set unilaterally by South Africa, means that purchasers of importables who reside inside the common external tariff, must pay the world price plus the tariff for those goods. The principal impact of this on Botswana is the escalated cost of imports from all sources, both SACU and non-SACU, amounting to over 10% of GDP in 1987. Offsetting this slightly is the effect of the SACU tariff raising the prices on Botswana's exports to SACU, amounting to less than 1% of GDP.

[3] See J. Clark Leith, "The Static Welfare Effects of a Small Developing Country's membership in a Customs Union: Botswana in the Southern African Customs Union," World Development, Vol. 20, No. 7, (July 1992) pp. 1021-1028.

Table 1: Effects of SACU, 1987
(% of GDP)

Effect	**% of GDP**
Price-raising on:	
• imports from all sources	-10.13
• exports to SACU	+0.81
Compensation	+8.08
Net Gain (+) or Loss(-)	-1.24

Source: Leith, *op. cit.*

5.3 An important feature of SACU is the compensation arrangement, whereby South Africa compensates the other members for the costs of membership. The formula, provides for a sharing of total SACU customs revenue, based on recent import shares. It takes no direct account of the height of the common external tariff, especially when the common external tariff is in excess of the maximum revenue[4] level, as it has been for some time. It does include a factor which amplifies the share of the customs revenue which is intended to compensate the smaller members (Botswana, Lesotho, Namibia, and Swaziland, or BLNS) for certain negative effects of the SACU, including the fact that the BLNS pay higher than world prices for South African goods, the polarization of industry in South Africa and away from the smaller members, and the lack of fiscal discretion for the BLNS due to the fact that the common external tariff and the excise taxes are determined unilaterally by South Africa. The formula does not deduct anything for the exports by BLNS to other SACU partners at prices above world prices. All of this is over-ridden by a provision which yields the BLNS a minimum of 17% of the value of imports, paid with a two year lag. The compensation paid to Botswana for 1987 amounted to just over 8% of GDP.

[4] Thus, as the tariff rate increases from a low level, the total revenue collected increases to a maximum, but if the rate continues to increase, the revenue collected falls, and eventually reaches zero if the tariff becomes prohibitive.

5.4 Overall, adding these effects together. the net cost to Botswana in 1987 was 1.24% of GDP. This net negative position has been the source of dissatisfaction with the SACU terms for some time, and discussions among the members about reforming the customs union have been undertaken sporadically since about 1980. It was not until the new Government in South Africa took power in 1994 that renegotiations began in earnest. At the time of writing those negotiations are still underway. The following issues are under discussion.

5.5 First and foremost, the compensation formula is in contention. As the common external tariff comes down in the next few years, in keeping with the South African commitment to WTO, the price-raising effect on imports will fall, but the current formula would continue to compensate the BLNS members on the basis of their imports from all sources. When the tariff reductions have been completed, and if import composition remains roughly as it is at present. the BLNS members will end up being overcompensated for the price raising effect on their imports. This is because the price-raising effect on imports will fall (as will the much smaller price-raising effect on Botswana exports to SACU), while the compensation will not fall. For example, if the tariff level drops by 1/4, and the volume and composition of trade remained constant relative to GDP, then the numbers in Table 1 would be (as a % of GDP):

price-raising effect on imports = -7.6%

price-raising effect on exports to partners = +0.6%

for a net -7.0%, while compensation would still exceed 8%.

5.6 Further, since the current formula takes no account of the price-raising effect of the common external tariff on BLNS exports to partners, as those exports grow (e.g., Botswana's exports of textiles and motor vehicles), there is no reduction in the compensation which South Africa pays to the BLNS.

5.7 In addition to this concern, South Africa would like to try to cap the entitlements to compensation at the value of the customs duty collections on imports from outside the SACU. The grounds for this approach are based on the logic of bureaucratic compartmentalization -- that funds in one pot could be redistributed within that category, but not between pots -- rather than economic analysis of South Africa's extra benefits from its preferred access to the BLNS markets. Given past experience with South Africa's unilateral actions changing the common external tariff, such as the 1988 imposition of surcharges which more than doubled the net loss to Botswana. the BLNS members have been wary of agreeing to any arrangement which would leave the funds available for compensation determined by South Africa independently of the price-raising effects.

5.8 A new agreement is likely to contain changes in a second major area: decision-making, including the setting of the common external tariff. The existing agreement states simply that the South African external tariff shall be the common external tariff for the SACU. A South African body, listening largely to South African specific interests, has administered the tariff, making changes as it saw fit, which then had to be immediately implemented by the BLNS. It is likely that the new agreement will contain new provisions for making decisions, including procedures for making changes to the common external tariff. The approach is likely to include a voting scheme for major issues which would not allow either South Africa, or the BLNS as a group, to achieve a majority alone.

5.9 One consequence of the old procedures for setting the tariff is that the common external tariff is both very high and very complex.[5] The nominal and effective rates of protection corresponding to the major tradeable producing sectors in Botswana for 1995 are reported in Table 2. (See Appendix for details of the calculations.) Particularly noteworthy are the very high rates for the dairy, and the textile and clothing sectors. Also noteworthy is the negative value added at world prices found in the meat sector. This reflects the extent to which the combination of the common external tariff and the preferred access to the EU market has permitted costs in Botswana to escalate.

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[5] For example, the average nominal tariff rate on dutiable imports (weighted by imports) into the US in the early 1990s was less than 5%, while the average for Botswana was well in excess of 20%.

Table 2: Nominal and Effective Rates of Protection, 1995
(percentage)

Sector	Nominal	Effective
Farming	22.5	29.3
Minerals	1.1	0.8
Meat & Products	19.3	∞
Dairy & Other Agric. Products	49.9	239.7
Beverages	30.4	24.2
Textiles. Clothing, etc.	46.9	150.7
Petroleum, Chemicals, & Plastics	10.7	-0.7
Metal Products	12.4	14.3
Other Manufactures	15.8	19.3

Source: Appendix

Notes:

a. The "nominal rate of protection" or "nominal tariff" refers to the tariffs or other import duties which an imported good must pay, as a proportion of the foreign price. Since this raises the price of foreign goods by that proportion, it provides domestic producers of competing goods with the opportunity to raise their prices by that same proportion.

b. The "effective rate of protection" refers to the extent to which the tariffs permit the prices of the final goods to increase, net of the increases in tradeable input costs due to tariffs on those inputs, expressed as a proportion of value added in that industry, calculated at world prices.

c. The rate ∞ indicates that the value added, when deflated to world prices, is negative, and hence the denominator of the effective rate of protection is less than zero.

5.10 Establishing a new voting procedure, and a new tariff-making arrangement within that framework, will only be the beginning. Sorting out the details of the new common external tariff will not be easy. Botswana has signalled that it would prefer a common external tariff which is **low, simple, uniform, and**

stable.[6] Such a tariff would lower the costs to the purchasers of imports from the very high common external tariff. and thus permit a reduction in the compensation claims by the BLNS. It would also provide a basis for the development of internationally competitive industry within the SACU, and would minimize the manipulation of the tariff by specific interests. A low tariff might also reduce the revenue. but for the Botswana Government, in contrast with other SACU members, this would be manageable because of the robust other sources.

5.11 Another area of likely change concerns industrial promotion arrangements. The existing agreement contains two provisions which allow the BLNS to promote industrial development within their territories. The first is an "infant industry" clause which allows the smaller members to protect industries within their territories against imports from all sources, including elsewhere in the SACU. The protection must be for a limited period of time. up to a maximum of eight years.

5.12 A few industries in Botswana have been accorded this protection, including beer and soap. The duties paid on imports of such goods to Botswana go to the customs revenue pool, and not to the Government of Botswana. To minimize this, the infant industries have typically been granted very high protection, with the intention of making the duty paid cost of competing imports prohibitive. To protect the Botswana consumer, price controls were employed linking the price to that of the former imports from South Africa.

5.13 The device of infant industry protection has not proved effective in creating new industries in the BLNS. In most cases. because the market was so small. there would only be one domestic producer licensed to produce behind the protective wall. Despite the monopoly position. (or perhaps because of it) the initial interests frequently faced serious quality problems. resulting in consumer rejection. The protected industries found that cost reduction during the period of protection proved extremely difficult to achieve. and when the period of protection ran out. they faced serious adjustment problems. In both the beer and soap cases that adjustment has been successfully made.

5.14 A second type of infant industry protection permitted under the existing agreement is one which allows one of the BLNS members to seek a change in the common external tariff in order to permit an industry to be established in its territory to serve the entire SACU market. Such protection would only be

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[6] See Ministry of Finance and Development Planning, "An Overview of the SACU from the Botswana Perspective: Implications of the Historical Record and Contemporary Situation for Re-negotiation of the Agreement." Bank of Botswana Research Bulletin. Vol. 12, No. 1 (September 1994), pp. 13 -32.

granted by the common external tariff if the industry could be expected to supply a substantial portion of the SACU market. This arrangement has been little used, but was employed by Botswana to launch the soda ash project at Sua Pan, to serve the South African market for this industrial chemical.

5.15 Alternatives to these types of protection arrangements have been proposed. In particular, the use of reduced duties on material inputs as a means of increasing the effective rate of protection, would be less costly to the consumer, and would maintain a competitive environment.

5.16 The experience with the soda ash has revealed another weakness in the current agreement: anti-dumping procedures. The Sua Pan project came on stream just as a major world recession hit, and the world supply of soda ash moved to surplus, leading many offshore producers to cut prices in international markets substantially below the cost of production. The response of the SACU to this dumping was largely ineffective, leaving the Botswana producer with a much smaller share of the market than had been anticipated, eventually forcing the original firm into bankruptcy. Consequently, Botswana wishes to see more effective anti-dumping procedures, designed to deal both with dumping from outside and within the SACU.

5.17 Botswana's imports from Zimbabwe began to grow following the 1988 agreement, but it took the major real exchange rate depreciation by Zimbabwe in 1991 to improve their competitive position in Botswana. Since then, those imports have plateaued in nominal terms, largely due to the erosion of Zimbabwe's real exchange rate due to internal inflation.

6 EXCHANGE RATE POLICY

6.1 In addition to policies acting directly to affect commodity trade, another policy instrument, the exchange rate, has been used effectively over the years to further Botswana's interests. The principal thrust of policy has involved pegging of the currency at a level which accumulated and then maintained substantial foreign exchange reserves. The Pula is pegged in value against a basket of currencies consisting of the South African Rand and the SDR. This is a genuine peg in that the Bank of Botswana buys and sells foreign exchange at the posted rates without any rationing of foreign exchange. While there are some modest exchange controls still present, these effectively do not restrict current account payments. Over the years the Bank has built up substantial exchange reserves, to the point that the reserves currently represent about two years' worth of current account payments. (See Figure 4.) The level of the exchange rate, in the face of the substantial foreign exchange reserves, reveals the deliberate decision to avoid the well-know "Dutch Disease" effect of a strong currency crowding out all but the most robust export activities.

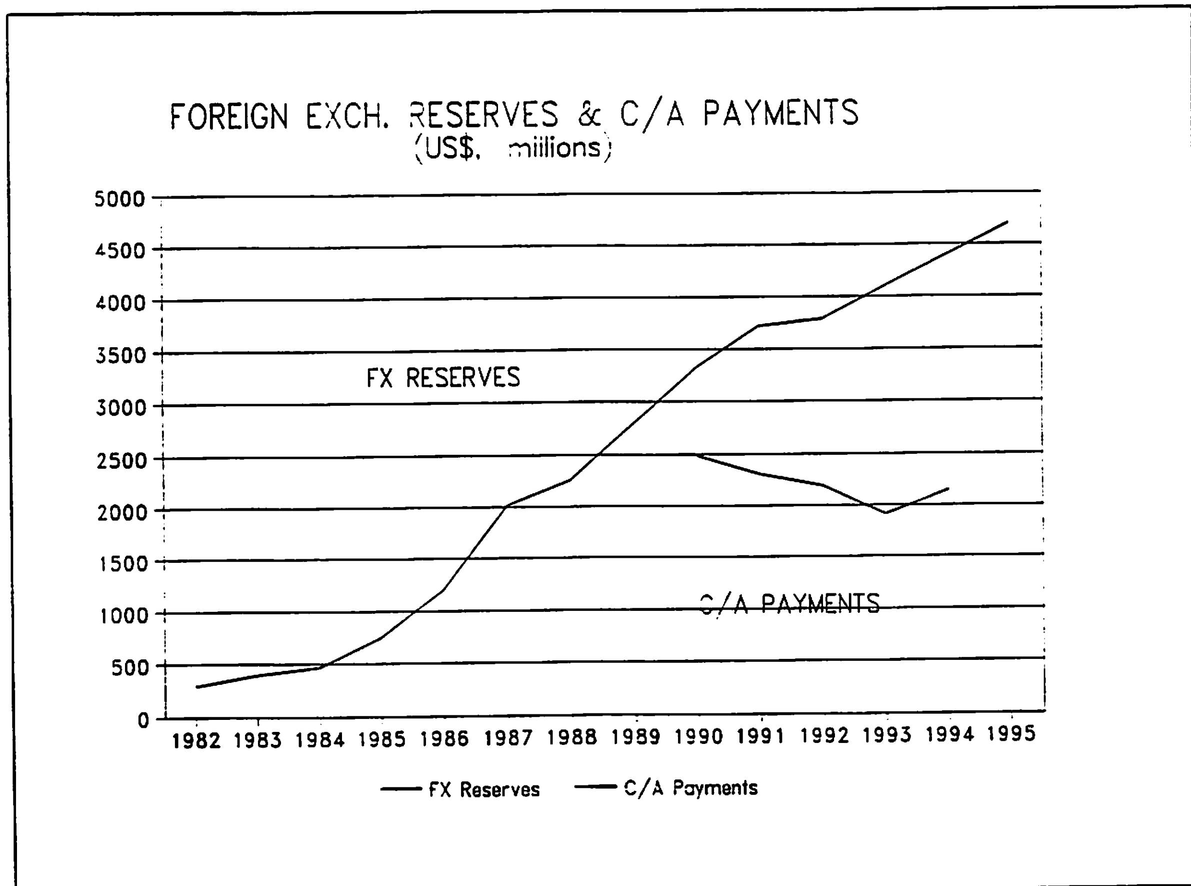

Figure 4

6.2 A sub-theme of policy has been to place considerably greater emphasis on the exchange rate with the South African Rand. This reflects the greater importance of the Rand relative to the SDR for imports and for non-traditional exports. It emerges in two related ways: in the selection of the weights in the basket. and the choice of focus for real exchange rate monitoring.

6.3 The Rand now has a very heavy weight in the basket: and over the past few years. the policy has emphasised the maintenance of a stable real exchange rate against the Rand.[7] (See Figure 5.) This was not always the case. for in the early years after the Pula was established as a separate currency from the Rand (1976) the Pula was initially pegged against the US Dollar. This was changed to a peg against a basket consisting of 50% Rand and 50% SDR in 1980. In addition. there have been various revaluations

[7] The real exchange rate calculations use the bilateral consumer price indexes as this is the only series available in Botswana on a timely basis.

and devaluations from time to time, when the choice of weights did not yield the desired outcome. For example, from late 1980 the Rand began a long period of depreciation against the US Dollar, initially due to a sharp fall in the price of gold, but later due to the capital outflow from South Africa associated with divestiture. With the 50% Rand weight in the basket, this meant an appreciation of the Pula against the Rand. This led to modest devaluations of the Pula in late 1984, twice in 1985, and again in 1986.

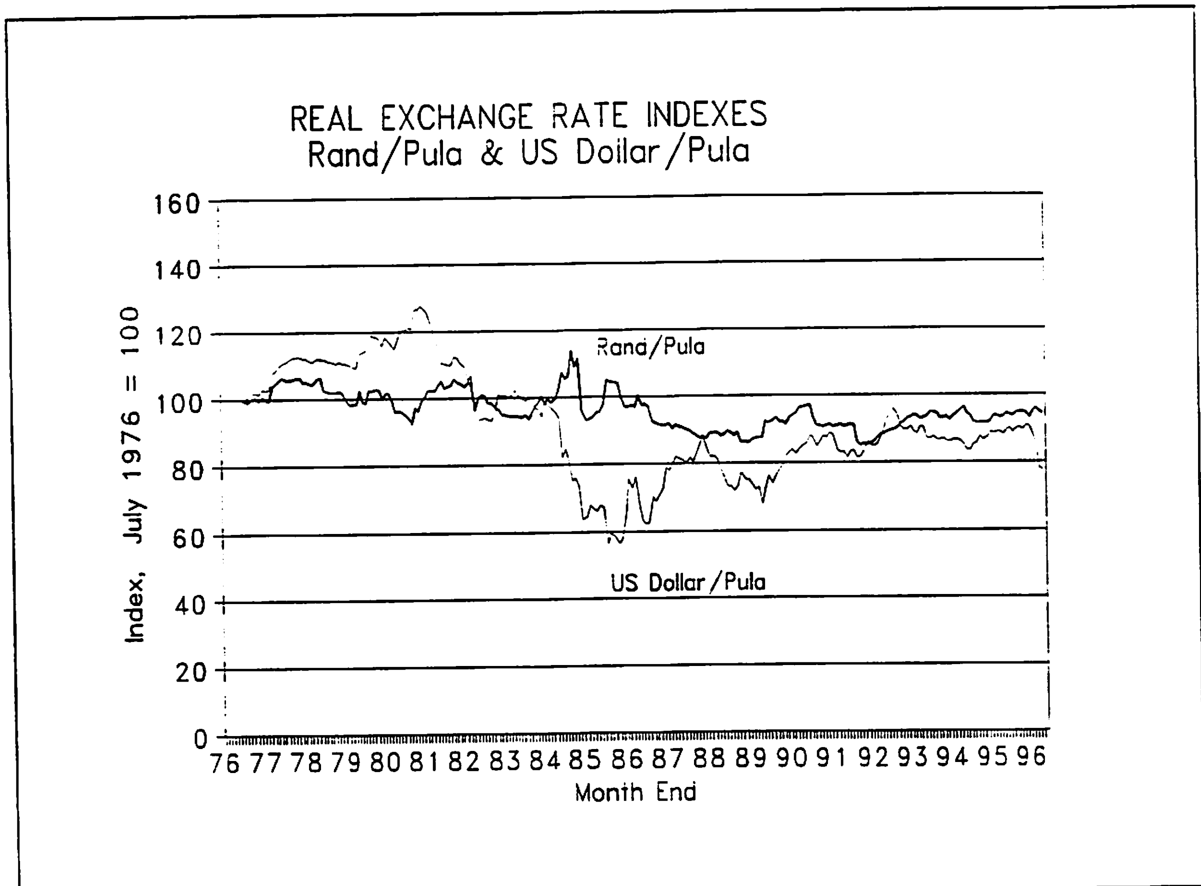

Figure 5

6.4 The period of the early 1980s reveals an interesting terms of trade effect arising from exchange rate changes. Since the vast majority of Botswana's exports are denominated in hard currencies, and the vast majority of imports are in Rands, the rapid depreciation of the Rand and hence the Pula against the Dollar and other hard currencies meant that Botswana obtained a terms of trade windfall during the period from 1981 through 1986. However, between mid 1986 and 1990, the real appreciation of the Pula against the Dollar while the real exchange rate against the Rand remained roughly constant, effectively meant that most of that gain was wiped out.

7 FURTHER PREFERENTIAL ARRANGEMENTS ON THE HORIZON

7.1 As if the foregoing tangle of overlapping special arrangements governing Botswana's trade were not enough, two further major changes are on the horizon at the time of writing. While it is too early to tell precisely what the likely outcomes will be, the nature of the issues is clear. The proposed new arrangements are: (1) a free trade agreement between the members of the Southern African Development Community (SADC), consisting of the five SACU members plus seven other countries of the region (Angola, Mozambique, Malawi, Mauritius, Tanzania, Zambia, and Zimbabwe); and (2) a free trade agreement between South Africa, and hence SACU, and the European Union.

7.2 These proposed arrangements are under discussion while the SACU renegotiation process is still underway. Since some of the features of the new SACU treaty are still to be decided, it is virtually impossible to identify with certainty how a SADC free trade agreement or an EU-SACU free trade would interact with the new SACU. Nevertheless, certain key effects can be identified.

7.3 SADC Free Trade

7.3.1 In mid 1996, at a ministerial meeting of the SADC members, a trade protocol committing the members to move towards free trade among themselves was signed. The intention appears to be to transform SADC into a free trade area, and perhaps more, by early in the next decade. Given Botswana's major role in SADC, as the seat of the secretariat, and simultaneous membership in SACU, the potential interaction between the two arrangements is significant.

7.3.2 There are three effects of a simultaneous SADC free trade and an ongoing SACU which are worth noting. Needless to say, these effects will depend on the precise arrangements made, but the potential effects can be identified.

7.3.3 First, since a SADC free trade arrangement would presumably include the current SACU members, South Africa would continue to have duty free access to the SACU markets, which collectively make up South Africa's largest market for its non-gold exports. Unless South Africa agreed to continue to pay the BLNS compensation in some form for the price raising effect of the SACU tariff on the BLNS imports, the latter could lose a significant source of Government revenue. In recent years this has run at 15% of Botswana's Government revenues, and about 6% of GDP. Not only is this Government revenue, but it is a real income transfer which is, as noted above, only partial compensation to for the loss of real income to Botswana arising from the price-raising effect of the SACU tariff on imports. For the other BLNS

members. the loss of the compensation would be an even larger share of Government revenues and of GDP.

7.3.4 Second, even if South Africa agreed to continue to compensate the BLNS, but not the rest of SADC, there could be a significant impact on BLNS revenues. This could occur in the following way. If imports into South Africa from the rest of SADC were to displace imports which currently come from outside the common external tariff. the customs revenue pool could be reduced significantly. South Africa, for its part, as noted above, has sought to limit its compensation payments to the BLNS to the size of the common customs revenue pool. If such a limit were part of a renegotiated SACU, and a SADC free trade agreement were implemented, then the compensation to the BLNS would be reduced significantly.

7.3.5 Third, the status of the SACU common external tariff would have to be sorted out if a SADC free trade agreement were implemented. If the common external tariff of SACU remains in place for the BLNS. the other SADC members could use their own tariff schedules to affect their input costs to gain a competitive advantage over firms located in the BLNS producing for any of the BLNS, SACU or SADC markets.

7.3.6 In brief, there is the possibility that a SADC free trade agreement, while keeping SACU in place. could put Botswana at a serious disadvantage with high priced imports. low compensation, and no freedom to reduce tariffs to maintain the competitive position.

7.4 SACU Free Trade With EU

7.4.1 Following South Africa's 1994 election. the possibility of the European Union including South Africa in some form of preferential arrangement was broached. South Africa wanted to be granted access on the same basis as members of the so-called Lome Convention governing trade between the EU and its former colonial territories. South Africa wanted an arrangement which would not require it to make reciprocal concessions. At the time of writing the matter had not been settled. although the EU position was that South Africa did not merit non-reciprocal concessions. Thus, preferential entry to the EU market would require South Africa to grant similar concessions to European goods entering South Africa. This would inevitably have a dramatic effect on the implicit SACU common external tariff and hence affect the entire BLNS-South African trading and compensation relationship.

7.4.2 There would be two significant. but offsetting, effects of preferential SACU tariff rates for EU goods. First, concessional entry to SACU of imports from the EU could significantly reduce the price-raising effect

of the common external tariff on BLNS imports, both from the EU and from South Africa. The size of this effect clearly depends on the magnitude of whatever concessions are agreed, but this could be a means whereby the SACU common external tariff is reduced at a rate much faster than is currently committed under the WTO.

7.4.3 While reducing the cost of imports to the BLNS, the concessional imports from the EU could readily erode the common customs pool. As noted in paragraph 6.3.2 above, this could affect the compensation payments to the BLNS.

7.4.4 The likely net impact of these two effects together is inherently uncertain, for it depends on which goods and the magnitude of the concessions which are adopted. As so often happens with overlapping layers of trade distortions, the possibility that the outcome might be inferior to the starting point is serious.

8 CONCLUSION

8.1 For thirty years Botswana has been able to take advantage of its unique position to employ trade policy to enhance the usual gains from trade. The great bulk of exports are sold at prices above competitive world prices. Imports are purchased at above world prices as well, but much of this effect is offset via compensation payments. This outcome is in contrast with the usual presumption that a small open economy has no effect on its terms of trade. Botswana has effectively improved its terms of trade by the use of trade policy.

8.2 Looking to the future, however, there are some clouds on the horizon. The renegotiation of SACU, the potential of a SADC free trade area, a SACU-EU free trade area, and the potential emergence of major non-CSO diamond sources, all raise the distinct possibility that many of these gains might evaporate. Whether or not this occurs, will depend crucially on the details of what is negotiated in the various special arrangements which affect Botswana's interests.

APPENDIX: CALCULATION OF NOMINAL AND EFFECTIVE RATES OF PROTECTION[8]

1 This appendix reports on the methodology employed in calculating the nominal and effective rates of protection reported in Table 2 of the text.

2 Formula

The formula for the effective rate of protection is:

$$ERP_j = (t_j - \Sigma_i a_{ij} t_i)/v_j$$

where: ERP_j = effective rate of protection

t_j = nominal tariff rate on imports of good j

a_{ij} = tradeable inputs of good i per unit of output of good j, at world prices

t_i = nominal tariff rate on imports of good i

v_j = value added per unit of output in production of good j, at world prices.

3 Data

3.1 The underlying **nominal tariff rates** were calculated by the Industrial Development Commission of South Africa, inclusive of estimated agricultural tariff equivalents, for the year 1995.

3.2 The **input-output** information is from the Botswana Social Accounting Matrix for 1992/93, constructed by the Botswana Central Statistics Office. This provides data on 29 producing activities and 54 commodities.

3.3 Nineteen **output sectors** were constructed from the 29 producing activities. This was necessary because in a number of cases the production classification and commodity classification overlapped, and the only way to achieve a correspondence between production activity and commodities was to aggregate more than one production activity.[9] For each output sector, a nominal rate of protection was calculated. Where a sector included more than one commodity, the commodity nominal tariff rates were weighted by

[8] The participation of S. Chakrabarti and K. Ndobano of the Botswana Ministry of Finance and Development Planning in the calculation of the nominal rates of protection for is gratefully acknowledged.

[9] For example, the commodity classification distinguishes between cattle and other livestock, while the production classification includes cattle produced by traditional agriculture as one activity and all livestock produced on freehold farms as part of another activity. The only solution was to aggregate all agricultural production activity into one producing sector.

total commodity use within the sector. The correspondence between production activities, commodities, and sectors is recorded in Table A.1.

3.4 The nominal tariff rates were aggregated into the 54 commodities using a software package developed by the World Bank, called SINTIA-T. Since at the time of the work, trade data for 1993 were the latest available, the weights were 1993 imports. The nominal tariff rates for tradeable commodities are recorded in Table A.2.

4 Methodological Issues

4.1 If there are **non-traded input** sectors in an economy, it is possible for some of the effective protection to be shared with these non-traded inputs. The solution normally adopted is to treat such input sectors as part of domestic value added when calculating the effective rate of protection, which has been followed in this case. The non-traded commodity inputs were defined as those for which there were no imports from the rest of the world.

4.2 Another methodological choice concerns the treatment of **depreciation.** In these calculations it has been treated as part of value added.

4.3 The SAM is constructed using **domestic prices**. Hence the value added and input coefficients are calculated in terms of domestic prices. These had to be deflated to world prices.

TABLE A.1: CORRESPONDENCE BETWEEN SECTORS, PRODUCTION ACTIVITIES, & COMMODITIES

SECTOR	PRODUCTION	COMMODITIES
S1	P1 TA Cattle P2 TA - Other P3 Freehold Farms P4 Hunting Fishing & Gathering	C1 Cattle C2 Other Livestock C3 Fruits, vegetables, Nuts C4 Cereals C5 Other Agricultural.. Nil
S2	P5-10 Mining	C6-8 Mining Minerals C54 Soda Ash C9 Sand & Gravel C10 Cement
S3	P11 Meat Processing	C11 Meat and Products
S4	P12 Dairy & Other Agricultural Products	C12 Dairy Products C13 Oils and Fats C14 Flour C15 Prepared Foods
S5	P13 Beverages	C16 Beer & Soft Drinks C17 Other Beverages C18 Tobacco
S6	P14 Textiles	C19 Textiles C20 Clothing & Footwear C21 Hides & Skins
S7	P15 Chemicals	C22 Petroleum C23 Chemicals C24 Plastics
S8	P16 Metal Products	C28 Metals C29 Metal Goods
S9	P17 Other Manufacturing	C25 Wood Products C26 Paper Products C27 Bricks Glass and Ceramic C30 Mechanical Engineering C31 Electrical Engineering C32 Vehicles C33 Other Manufacturing
S10	P18 Water	C34 Water
S11	P19 Electricity	C35 Electricity
S12	P20 Construction	C36 Construction
S13	P21 Wholesale & Retail Trade, Hotel & Restaurants	C37* Wholesale & Retail Margins C38 Hotel and Restaurant

S14	P22 Rail Transport P23 Road Transport P24 Air Transport P25 Other Transportation	C39 Rail Transport C40 Road Transport C41 Air Transport
S15	P26 Communications	C42 Communications
S16	P27 Banking Insurance	C43* Financial Institutions
S17	P28 Business Services	C44 Business Services
S18	P29 Ownership of Dwelling	C45* Rent C46* Ownership of Dwelling
S19	P30 Central Government P31 Local Government P32 Domestic Services & Traditional Dress P33 Other Private Services P34 PNPISH	C47* Central Government C48* Local Government C49 Education C50 Health - Private C51* Health - Subsidised C52* Domestic Services C53 Personal Services

* indicates a non-traded commodity

TABLE A.2: COMMODITY NOMINAL TARIFF RATES

COMMODITY	NOMINAL TARIFF RATE (%)
C1	0.0
C2	0.0
C3	11.1
C4	51.5
C5	14.2
C6-8	1.1
C9	3.8
C10	0.0
C11	19.3
C12	53.7
C13	35.9
C14	60.5
C15	43.5
C16	16.4
C17	75.8
C18	44.7
C19	32.4
C20	55.7
C21	24.3
C22	7.6
C23	13.1
C24	12.5
C25	13.4
C26	10.4
C27	12.9
C28	10.6
C29	15.4
C30	6.0
C31	11.9
C32	27.5
C33	17.6
C34-C54	0.0