Botswana's exchange rate policy

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1. Introduction

In the construction of a market-based development strategy, a key policy consideration is the selection of an appropriate exchange rate regime, which should be consistent with the attainment of macroeconomic stability. In particular, the policymaker's preferences are external competitiveness and price stability. At the extremes, the choice lies between a fixed exchange rate regime, achieved through an anchor to a single currency or a basket of currencies, and a flexible exchange rate regime. The choice of either of the two extremes or an intermediate arrangement reflects preferences with respect to macroeconomic objectives. In Botswana, the desire is to foster sustainable growth through diversification and export competitiveness. The currency, the pula, is pegged to a basket of currencies that reflects the country's trading patterns and comprises the South African rand and the Special Drawing Right (SDR). The objective is to stabilise the trade-weighted real exchange rate. The performance of the pula exchange rate as well as, broadly, the monetary policy framework has largely reflected this objective.

2. Exchange rate regimes

Exchange rates are typically categorised as floating or fixed. A fixed exchange rate is one in which the value of one currency vis-à-vis another currency is held constant by government intervention in the foreign exchange market. The general case in favour of a fixed exchange rate is that it can serve as a nominal anchor against inflation if the exchange rate is fixed against the currency of a country with relatively low inflation. Pegged exchange rates also benefit from a discipline effect since there are generally political costs associated with abandoning the peg, as there may be a need to adjust other policies. In addition, there is a confidence effect whereby the connection of the exchange rate with a stable foreign currency engenders a willingness to hold the domestic currency or assets denominated in the domestic currency. Fixed exchange rates in developing countries have also been justified in instances where the financial sector is not well developed and because of the large role of the public sector as a supplier of foreign exchange. Although keeping the exchange rate fixed may help stabilise the price level, it is not viable in the presence of a large current account deficit and a foreign exchange or external borrowing constraint.

A floating exchange rate is one in which the value of the currency in terms of another is determined by demand and supply in the foreign exchange market. A floating exchange rate does not, however, imply that the authorities are unconcerned about the level of the exchange rate. Rather, the authorities employ domestic policy instruments - especially interest rates - to realise their objective with respect to the exchange rate. This is particularly important given the fact that although, in a floating exchange rate regime, a nominal depreciation may improve the trade balance and the balance of payments, it might lead to inflation, thus eroding competitiveness. Therefore, there should be other instruments available to stabilise inflation.

In practice, there is a range of intermediate exchange rate regimes. Intermediate exchange rate arrangements provide scope for short-term flexibility within exchange rate margins and medium-term parity adjustments. The variability of any exchange rate regime is determined by the structural characteristics of an economy and the environment within which policy is operated. For example, the choice of a basket as opposed to a peg to a single currency, apart from being necessitated by trading patterns, is also intended to dampen the impact of external sources of exchange rate instability arising from large fluctuations among the real exchange rates of industrial countries. Alternatively, the crawling or adjustable peg is an attempt to avoid domestic sources of instability, in particular to alleviate periodic overvaluations and exchange rate crises associated with a fixed peg where there is high inflation. A crawling peg can be subject to discretionary change with a future path announced or

not announced. It can also be subject to a non-discretionary feedback rule that may or may not be made public.

Alternatively, the credibility of a fixed exchange rate regime may be derived from belonging to a monetary union; effectively surrendering the power to alter the exchange rate through a common currency. This arrangement establishes the credibility of an anti-inflationary policy while there are institutional features that make it costly to alter the exchange rate. There are, however, costs associated with forgoing the use of the exchange rate as a policy instrument, particularly in the presence of large external shocks.

3. Botswana's exchange rate regime and policy objective

Whether fixed, floating or an intermediate arrangement, the objective of any regime is the realisation of a stable exchange rate. As indicated above, exchange rate policy is usually driven by two distinct, and sometimes competing, objectives: external competitiveness and maintenance of price stability. The first objective is aimed at improving the balance of payments while the second objective is pursued insofar as low inflation is desirable from the point of view of macroeconomic stability, and to the extent that it also contributes to efficiency in resource allocation.

In Botswana, the exchange rate policy reflects the emphasis given to the strategy of economic diversification, the need to promote the competitive position of Botswana's non-traditional exports and import substitution activities. In the endeavour to reach these goals, most of the nation's exchange rate history has seen the government, through the Bank of Botswana, pursue a policy best described as that of exchange rate protection.[1] This policy has sought to counteract a potential squeeze[2] on the tradable sector by facilitating a shift out of the non-tradable goods sector and into the tradable goods sector; hence boosting the prospects for employment, output and profits of the latter.

In an attempt to mitigate the susceptibility to volatility of an independent float and the straitjacket of a fixed exchange rate, Botswana, like several other developing countries, has chosen an intermediate exchange rate regime, which enables it to benefit from the positive aspects of the two extreme exchange rate mechanisms. Significantly, in a situation where there is a large inflow of diamond revenues, a free float might lead to an appreciation of the exchange rate to levels that would make non-diamond production unprofitable (the so-called "Dutch disease"), which would be inconsistent with the country's development and diversification objectives.

Botswana has since the introduction of the pula[3] in 1976 adopted a fixed but adjustable peg system. Initially, the pula was pegged to the US dollar and, prior to 1980, the peg was revalued on one occasion for anti-inflationary reasons. The single currency peg coincided with a period in which the South African rand was also pegged to the US dollar. Specifically, the exchange rate at which the pula was pegged to the US dollar was equivalent to that of the rand against the dollar. This implied equality between the pula and the rand. This effect expired when the rand was taken off the US dollar peg and allowed to float. To subdue the effects of exchange rate volatility between the pula and the rand, the pula basket was introduced in 1980. From 1980 to 1991, the exchange rate of the pula was subject to both discrete changes to the composition of the basket as well as devaluation and revaluation (Table 1). However, since the last publicly announced devaluation in 1991, the management of the exchange rate has involved technical adjustments of the basket composition aimed at maintaining real exchange rate stability.

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[1] Exchange rate protection occurs when a country protects its traded goods sector (export and import-competing activities) relative to the non-traded goods sector by depreciating the exchange rate or preventing an exchange rate appreciation.

[2] A tradable squeeze refers to the negative impact of a strong domestic currency on domestic export activities. Typically, this effect arises when a boom in a country's mineral (or more generally natural resource) sector produces a decline in other export industries. The mechanisms that produce this result are normally a combination of a nominal appreciation of the domestic currency and continuous increases in nominal wages.

[3] From independence in 1966 up to 1976, Botswana retained its membership of the Rand Monetary Area, a regional monetary union controlled by South Africa and including Lesotho, Namibia and Swaziland, which are still members. See the paper in this volume by van Zyl for further information.

Table 1

Chronology of exchange rate events from 1996

Date	Action	Comments
1966-76	Participation in rand monetary union.	No independent exchange rate or monetary policy.
August 1976	Introduction of the pula, pegged at USD 1.15.	Rand pegged to US dollar at same rate ensuring parity between pula and rand.
April 1977	5% pula revaluation.	Anti-inflation measure.
January 1979	Rand taken off US dollar peg and floated.	Rand appreciates against US dollar as gold price rises.
June 1980	Pula taken off US dollar peg. Introduction of pula basket comprising SDR and rand.	To reduce volatility of rand/pula exchange rate.
November 1980	5% pula revaluation.	Anti-inflation measure as imported inflation rises following pula depreciation against rand.
May 1982	10% pula devaluation.	Part of stabilisation measures in response to 1981-82 balance of payments crisis.
February 1984	Foreign debt standstill for South Africa and run on the rand.	Rapid depreciation of the pula against the dollar as rand continues to depreciate.
July 1984	5% pula devaluation.	Competitiveness measure following rand collapse and rapid pula appreciation against the rand.
August 1984	Rand weight in pula basket adjusted.	To reduce drift of pula from rand.
January 1985	15% pula devaluation.	Additional competitiveness measure in response to rapid pula appreciation against rand.
January 1986	New pula basket introduced.	Due to rapid rand appreciation.
June 1989	5% pula revaluation.	Anti-inflation measure.
August 1990	5% pula devaluation.	Competitiveness measure.
August 1991	5% pula devaluation.	Competitiveness measure.
June 1994 to date	Technical adjustments.	Changes to the basket to reflect trade patterns and reversal of weight drift aimed at maintaining competitiveness and real exchange rate stability.

Source: Bank of Botswana.

The choice of to which currencies to peg the pula was guided by trade patterns and the vehicle currencies used in international trade and payments. Botswana has an undiversified trade pattern, whereby the bulk of the traditional exports (diamonds, copper and nickel, soda ash and beef) are denominated in US dollars and sterling while non-traditional exports and most imports are denominated or invoiced in South African rand. The pula is, therefore, pegged to a trade-weighted basket of currencies - comprising the rand and SDR - so as to smooth exchange rate fluctuations among the trading partners.[4] The rand has a greater share in the basket reflecting the need to protect the interests of the majority of Botswana's domestic firms, whose consumption, expenditure and revenue decisions have a significant rand-denominated component.

In addition, for a long time the adjustable peg adopted by Botswana was such that the rand/pula exchange rate was monitored closely in order to maintain stability. Adjustments were, therefore,

[4] The appropriate weights (which are not publicly disclosed) of the respective currencies used in the pula basket are determined in part by the bilateral share of trade of the respective country. In Botswana's case, the trade weighting abstracts from diamond sales, since those exports are basically insensitive to exchange rate fluctuations.

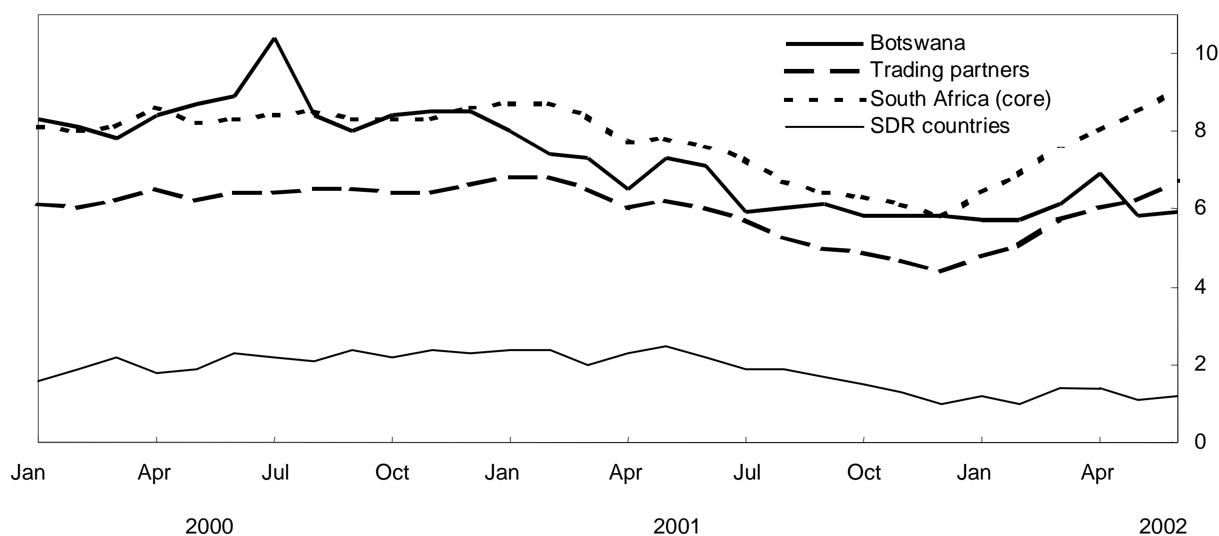
occasionally made to the peg if it was considered that the rand/pula exchange rate had fluctuated too much. In effect, this implied that the country maintained a managed exchange rate vis-à-vis the South African rand. Thus, for most of the time the exchange rate moved in line with the South African rand although the magnitudes were moderated by the presence of the SDR component.

An important goal of exchange rate policy is stabilisation of the real exchange rate in relation to Botswana's main trading partners. In line with this objective, it follows that the authorities closely monitor relative inflation performance between Botswana, South Africa and SDR countries. More generally, if the price level in Botswana is rising relative to that of trading partner countries, the equilibrium value of the pula will be falling in relation to the basket, and vice versa. If the inflation differential is considered inimical to the attainment of real exchange rate stability, then corrective interventions are effected by the authorities, in order to restore the given exchange rate objective. Corrective measures are, however, not limited to the exchange rate mechanism but include monetary policy action to achieve an inflation objective that given the inflation in trading partner countries is consistent with maintaining real pula exchange rate stability. In general, monetary policy action is preferred while discretionary devaluation or revaluation has not been used for some time now. As evident from Graph 1, although Botswana's inflation has tended to be higher than that of its trading partners, recently this difference has narrowed.

Graph 1

International inflation

In percentages



Source: Bank of Botswana.

4. Recent developments in the exchange rate

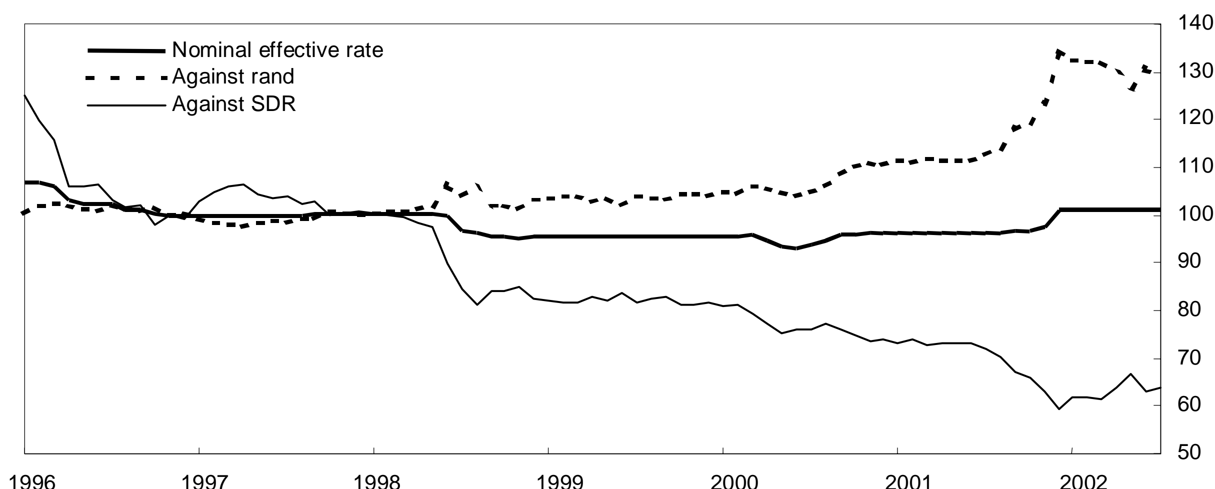
The adjustable peg regime presently in use in Botswana provides the authorities with a certain degree of flexibility to manipulate the exchange rate in a manner complementary to the exchange rate policy objective. To date, Botswana's authorities have by and large avoided overvaluation of the pula, by not keeping the exchange rate too rigid in the face of differential inflation or allowing the currency to move upwards too much so as to threaten export competitiveness.

Up to the middle of 2000, the movements of the pula reflected the relatively high weight of the rand in the basket as well as the fact that its fluctuation vis-à-vis the rand was closely managed. Thus, the pula tended to depreciate and was unstable against the major international currencies as the rand weakened but was relatively stable in nominal terms against the rand (see Graph 2).

Graph 2

Nominal exchange rate indices

November 1996 = 100



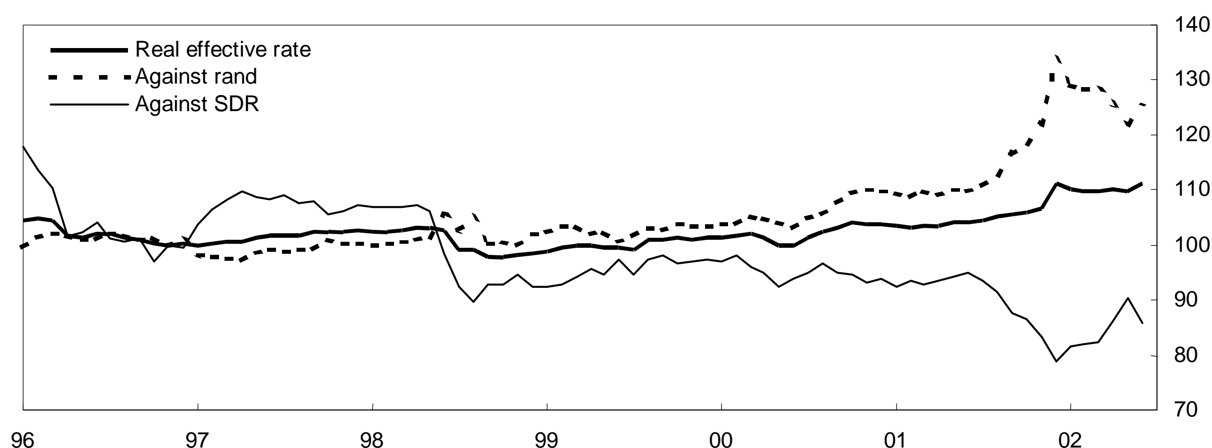
Source: Bank of Botswana.

From the middle of 2000, a greater focus on real exchange rate stability vis-à-vis the basket and removal of the band surrounding the rand meant that the nominal exchange rate of the pula against the rand appreciated beyond what had hitherto been experienced. In particular, the pula has gradually appreciated against the rand, while that currency has fallen in international foreign exchange markets. Targeting the stability of the pula vis-à-vis a trade-weighted index implies that the emphasis is on maintaining nominal effective exchange rate stability (as opposed to focusing on bilateral exchange rates), in an attempt to diversify the nation's export base (in terms of both products and markets). The policy of keeping the nominal effective exchange rate stable also implies that competitiveness is most appropriately measured by the real effective exchange rate (Graph 3). Hence, exchange rate policy, in tandem with monetary policy, is designed to keep Botswana's inflation rate no higher than the weighted average of the inflation rates of major trading partners.

Graph 3

Real exchange rate indices

November 1996 = 100



Source: Bank of Botswana.

5. Conclusion

The exchange rate regime in Botswana can be characterised as an adjustable peg, which over time has had elements of both unannounced discretionary change as well as a non-discretionary feedback rule. The policy, consistent with other government policies, supports the development objectives of export competitiveness, diversification and growth within a stable macroeconomic environment. In particular, the discretionary approach to the exchange rate and the monetary policy framework aim to achieve real effective exchange rate stability. Botswana's inflation has not been substantially higher than that of its trading partners, contributing to real exchange rate stability. Over time, the performance of the trade-weighted real exchange rate has largely reflected the stability objective, albeit appreciating somewhat. The trade balance and overall balance of payments have been positive while there has been growth and diversification of non-traditional exports and broadly satisfactory non-mining output expansion.