Bifm Economic Review 2nd Quarter 2009

Economic Review

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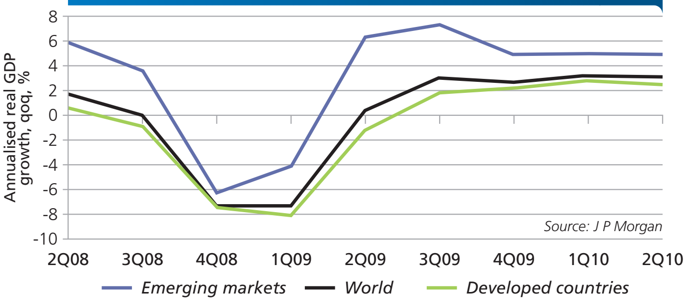
Introduction

The second quarter of 2009 has been a period of very mixed developments, both locally and internationally. The global economy remains in deep trouble, but there are signs that the worst of the recession is over and that the beginnings of a recovery are in place, even if the pace of the recovery is still expected to be slow and uncertain. Exactly the same can be said of Botswana's mining sector, which experienced a major contraction in the first quarter of the year, but which is now seeing signs of recovery, even if it is unlikely to return to the heady days of 2007 in the foreseeable future. Headline growth numbers look bad, with the economy now confirmed as being in recession according to the most recent GDP data. However, this mostly reflects developments in the mining sector, and the non-mining sector has so far proved remarkably resilient. In the short-term, we do not expect the non-mining economy to experience any sharp contraction, or for there to be any major jump in unemployment. However, business conditions will remain generally challenging into the medium term as government comes to terms with a difficult fiscal situation and the private sector awaits further business-friendly economic reforms.

The Global Economy

The world economy has continued its roller-coaster ride during the second quarter of 2009. As GDP growth figures have become available for the last quarter of 2008 and the first quarter of 2009, it is evident that the global recession has been deeper than was thought even three months ago, with world GDP contracting at an estimated annualised rate of over 7% during that six month period. Nevertheless, in the second quarter of 2009 there have been signs that the recession is easing, and forecasts are now of a reasonably robust recovery towards the end of 2009 and into 2010.

Figure 1 - Global Economic Growth Estimates & Forecasts, July 2009



The most striking signs of recovery have been in financial and commodity markets, with many stock exchanges around the world experiencing rapid gains since March. Commodity prices are also up, with copper and nickel prices rising by 50%-70% in the first half of 2009, and oil prices more than doubling from recent lows. There have also been improvements in consumer and business confidence. Financial markets have begun to return to normality after the trauma that caused them to seize up in the last quarter of 2008. Liquidity has returned to interbank markets as banks have begun to lend to each other once again, and risk premiums have fallen, while capital flows to emerging markets have tentatively resumed.

There are a number of explanations for these developments. One reason that the recession was so deep was that firms cut back production sharply in the face of declining demand, and allowed inventories to run down, meaning that the decline in production was even sharper than the fall in demand. However, this could not continue indefinitely, and the need to start rebuilding inventories has been one reason for improving output figures, even while final demand remains weak. There have also been substantial fiscal stimulus packages in the USA, China and some European countries, which has helped to restore confidence, demand and growth. Rising stock markets and commodity prices partly reflect expectations of economic recovery, although they also reflect a turnaround from the overshooting (moving too far, too fast) to which asset markets are particularly vulnerable.

However, while the world economy may no longer be in technical recession (global growth is thought to have turned marginally positive in the second quarter), it does not mean that the impact of the recession has passed. News from the real economy is less optimistic than news from financial and commodity markets. Global growth may be positive again, but this is largely being driven by emerging markets. In most developed countries, growth remains negative (although less so than before) and unemployment is still rising. For many firms, sales are still lower than a year ago, although the good news is that the pace of decline has slowed. However, the level of corporate bankruptcies and credit defaults is still rising.

Even once it is technically over, the impact of the recession will last much longer than the period of negative economic growth. With current projections, the anticipated period of renewed growth from mid-2009 through to 2010 will do no more than recover the lost ground over the past 12 months.

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Although there are signs of recovery, the world economy still faces major problems. This is particularly the case in the financial sector, where balance sheets still contain bad assets and there will be further losses, even as the level of business picks up. Large segments of the corporate sector still face fundamental problems of excess capacity and outdated and uncompetitive business models – the motor industry being perhaps the most striking example.

Even as economic growth resumes, it is likely to remain sluggish, for a number of reasons:

- Unemployment in developed countries is likely to continue rising until 2010, as it tends to lag developments in the real economy, but this will undermine the recovery of consumer spending, which is the largest single component of aggregate demand;
- Savings rates are rising, especially in the USA, in response to the reductions in household wealth resulting from collapses in housing and financial markets, and this will further slow the recovery in consumer spending;
- The dramatic increases in the level of government borrowing in major economies, to finance bank bail-outs and fiscal stimulus packages, will in due course cause long-term interest rates to rise, and this may "crowd out" private sector investment spending;
- Oil and commodity prices are rising, which will squeeze household incomes, corporate profit margins, and hence expenditure – essentially a replay of one of the triggers of economic collapse in 2008;
- Although liquidity in the financial system is improving, a continuing shortage of trade finance is impeding the recovery of world trade.

What does all of this mean for Botswana? The global financial and economic crisis has impacted on the global economy in three main ways. First, we saw systemic financial crises as banking systems came close to collapse. Second, there was a rise in risk aversion and a dramatic collapse of international capital flows and investments. Third, the result was a major economic crisis, with a collapse in real growth rates and global trade flows.

The first of these impacts was largely felt by the advanced developed economies, as banking systems in most emerging markets, including Botswana, were largely unaffected and remained sound. The second channel of impact has affected many emerging markets, particularly those dependent on capital inflows to finance balance of payment deficits. South Africa falls into this category, and a shortage of capital inflows was one reason for the weakness of the rand in late 2008. Botswana has been largely unaffected, however, as it is much less dependent on capital inflows, and indeed has generally been a capital exporter.

The third channel has been by far the most important for most emerging markets, including Botswana, as economic recession and contraction in world trade has impacted on demand for diamonds and other exports. As has been extensively discussed, the diamond market has been badly affected. The seizing up of the diamond pipeline due to weak final demand and a lack of credit for buyers of rough diamonds led major suppliers (notably De Beers and the Russian producer Alrosa) to sharply cut back, in turn leading Debswana to halt production for four months and reopen mines at lower production levels.

Diamonds have been a major driver of growth in Botswana, and the downturn in the international diamond market has had substantial impact on the country, mainly through export earnings, the balance of payments and foreign exchange reserves, GDP growth and the government's fiscal position. Below, we review recent developments in the Botswana economy and examine the extent to which it has been, and will be, affected by the global crisis.

Botswana Economic Developments

International Trade

Perhaps the most dramatic impact of the global crisis has been on Botswana's exports. Data are available for the first four months of the year, and these show that total exports were down nearly 50% on the same period in 2008. The most dramatic reductions were for diamonds and copper-nickel exports, both of which were down by 55%.While some categories of exports grew (gold, soda ash, textiles and other manufactured goods), these account for a relatively small proportion of the total. Nevertheless, it is encouraging that at least some exports have held up well despite the crisis.

Figure 2: Components and Impact of the Global Financial & Economic Crisis

Sequencing →

	Systemic banking crisis	Cross-border financial flows	Growth & trade effects
Advanced countries	I		III
Emerging markets		II	III
Less-developed countries		II	III
Botswana			III

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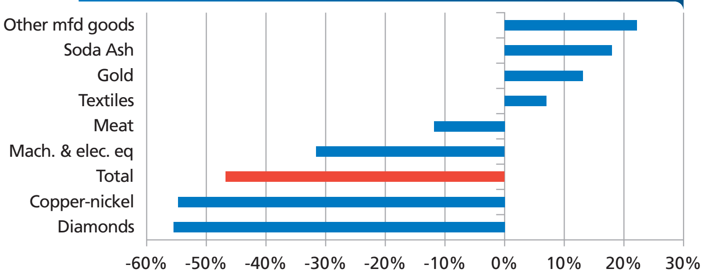
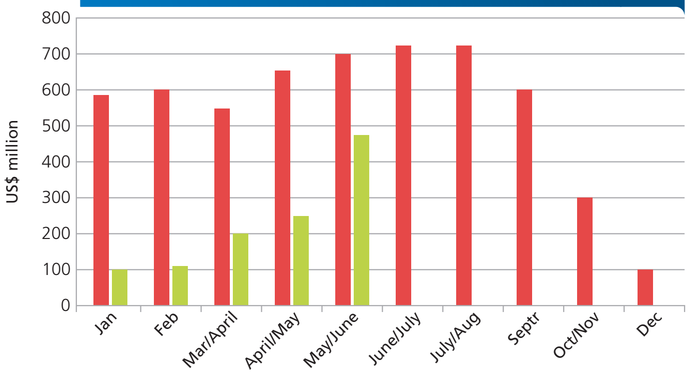
Figure 3 - Change in Exports, Jan-April 2008/9



Source: Econsult, based on CSO data

It is also clear that export performance improved during the first four month of the year, with exports much higher in March and April than in January and February. This largely reflects improvements in diamond sales. As Figure 4 shows, diamond sales through De Beers' Diamond Trading Company (DTC) have picked up, and the cycle of weakness that began in the last quarter of 2008 has clearly turned. In the fifth sight of the year, held in June, diamond sales were only around one-third lower than in 2008, although for the full half-year, the value of sales was 80% lower. Nevertheless, evidence suggests that the worst of the crisis may be over with regard to Botswana's exports, even if recovery to historical levels may still be some way off.

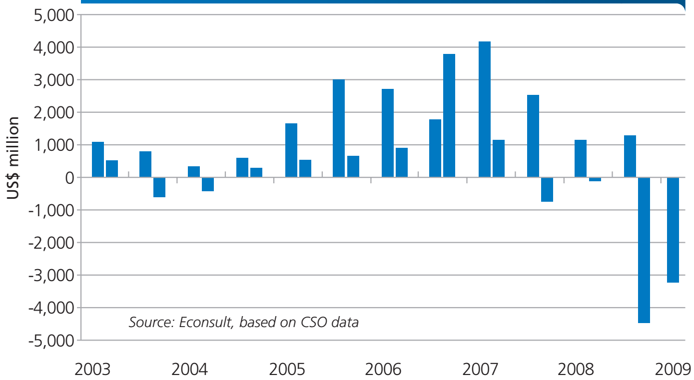
Figure 4 - DTC Diamond Sights



Source: Rapaport Group

While Botswana's exports are lower, imports are also down, although not by as much – total imports fell by 8% in the first four months of the year compared to 2008, largely reflecting lower fuel and diamond imports. In these circumstances – exports sharply down and imports only marginally lower – the balance of payments has inevitably deteriorated. Data from the Central Statistics Office on the balance of trade (exports less imports of goods) for the first quarter of 2009 show a second very large deficit (Figure 5), although the size of the deficit is slightly smaller than that of the last quarter of 2008. However, balance of payments data from the Bank of Botswana suggest that the trade balance was larger in the first quarter of 2009. In fact there are large unexplained discrepancies between the trade data produced by the CSO and the BoB, which is particularly unhelpful at a time of crisis in the international economy; given the need for an accurate picture of trade developments, more effort needs to be devoted to producing consistent data.

Figure 5 - Balance of Trade (Quarterly)



Source: Econsult, based on CSO data

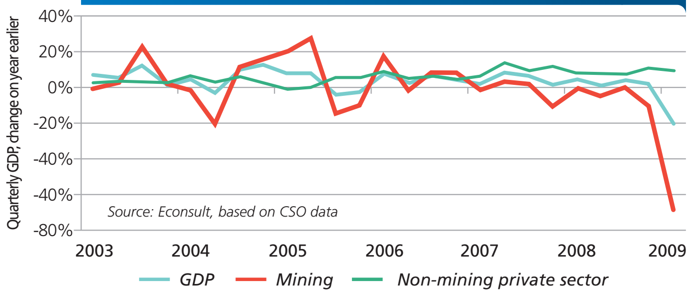
Also as expected the foreign exchange reserves have been falling. By the end of April, the reserves were around 20% below their peak in both pula and US dollar terms. This decline reflects both draw-downs to finance balance of payments deficits as well as valuation changes. Despite the decline in the reserves, the level remains comfortable at around 21 months of import cover, and with an improving trade position, the rate of decline should slow down.

Economic Growth

Data are now available to measure the direct impact of the global crisis on the Botswana economy as a whole. GDP data for the first quarter of 2009 show that production in the mining sector was much reduced, down by nearly 70% compared to the first quarter of 2008. This was expected, given the closure of the diamond mines for most of the quarter.

As a result, total GDP was 20% lower than in the same period of 2008, and the economy is in technical recession, having experienced two successive quarters of negative GDP growth. However, the encouraging news is that outside of the mining sector, the impact the global crisis on the Botswana economy has, so far, been limited. Real output in the non-mining private sector was 9.4% higher than a year earlier, with no sign – so far – any growth downturn outside of mining.

Figure 6 - Economic Growth



Source: Econsult, based on CSO data

The data are consistent with forecasts from organisations such as the IMF, which predicts that Botswana's real GDP will contract by 10.2% for the whole of 2009, driven by a major reduction in diamond output. While this is the largest decline in GDP forecast for any country in sub-Saharan Africa, the impact on most sectors of the economy will be much smaller. The main impact in the short term has been felt in the mining sector and by suppliers and contractors to the mining industry. The fact that mining is something of an enclave in the broader economy – a point of criticism in the past but now perhaps an advantage – means that the direct impact on the rest of the economy is limited, and it is developments in the non-mining sector of the economy that are of more direct relevance to the bulk of the population.

Fiscal Impact

Besides the balance of payments, the area where Botswana is most vulnerable to the impact of the global recession is the government budget. As discussed in the previous Economic Review, the 2009 Budget appeared to be highly ambitious and seemed to pay little attention to the impact of the recession on revenues, and was planning for an unsustainably large deficit.

Since that time some adjustments have been made, and ministries have been instructed to cut their spending by around 6% from the 2009 Budget figures. Furthermore, the preliminary outturn for the 2008/09 budget year has resulted in a deficit of just over P2 billion, compared to the P6.2 billion that was mentioned in the 2009 Budget. The reduced deficit is most likely because of underspending, and means that there is a more favourable starting point going into the 2009/10 financial year. Nevertheless, the global crisis has caused the fiscal situation to deteriorate rapidly. The most recent fiscal data available shows that in the period since the crisis first hit – the five months from October 2008 to February 2009 – government revenues were 25% lower in real terms than in the previous year. At the same time, government spending was around 25% higher, resulting in a turnaround from a P3 billion surplus over this period in 2007/8 to a P2 billion deficit in 2008/9.

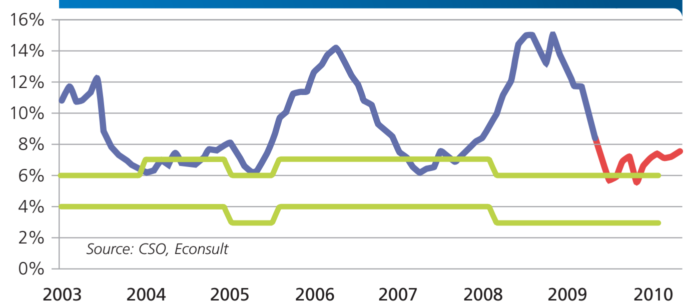
Despite the modest reduction in spending growth in the current year, expenditure is set to grow substantially and the budget is still forecast to be in substantial deficit in 2009/10. The somewhat gloomy fiscal prognosis is reflected in the revisions to National Development Plan 10 (NDP 10), which is being considered by the current session of Parliament. Expenditure allocations for development projects have been cut, and only small increases in recurrent spending are being budgeted for the Plan period. Overall, the NDP 10 proposals envisage virtually no real growth in total government spending over the entire period from 2009/10 to 2015/16. Even so, a large budget deficit of around P32 million is being projected, an amount that is roughly equal to government's accumulated balances at the Bank of Botswana.

The current NDP 10 may not, however, prove to be a very accurate guide to government spending over the relevant period. Several major projects that require government funding appear to have been omitted – these include further funding for Morupule B power station; the cost of emergency diesel generating capacity as Eskom supplies are reduced further and before Morupule B comes on stream; the second university; and the second North-South Water Carrier. As all of these are likely to proceed in one form or another, the growth of government spending may in fact be significantly greater than NDP 10 currently indicates, and the deficit commensurately larger, all of which is of great concern from a fiscal sustainability perspective. It would have been appropriate for these expenditure items to be included in the NDP 10 projections, in order to present a more accurate and realistic picture of expenditure commitments, funding needs and the likely increase in public debt.

Finance, Inflation and Monetary Policy

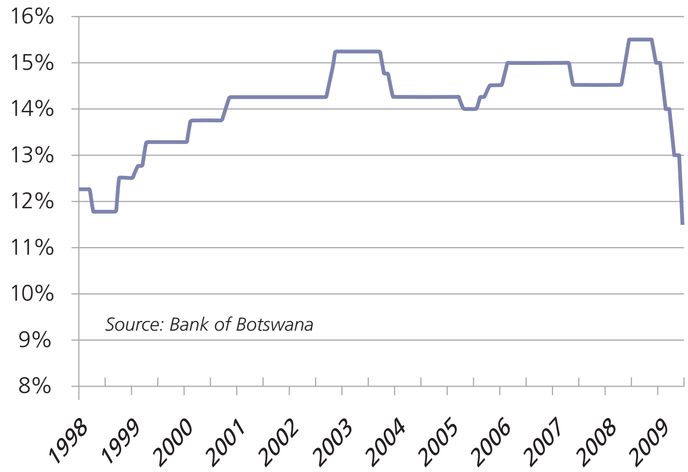
Inflation developments have continued to be positive, with the annual inflation rate falling to 7.0% in June. The increase in fuel prices in June 2009 is not expected to significantly derail the decline in inflation; our estimate remains that inflation will soon fall close to, or within, the upper end of the Bank of Botswana's 3%-6% inflation objective range. Inflation should then settle around 6%-7% for the rest of the year, although there remains considerable uncertainty from international oil price developments. Any sustained movement of oil prices above \$65-\$70 per barrel would put further pressure on domestic fuel prices and push up inflation. Inflation prospects for the rest of the year also depend on whether any changes are introduced to the rate of crawl of the pula basket exchange rate mechanism; any speeding up of the rate of downward crawl – which might otherwise be appropriate given the weakness of exports – would tend to push inflation up further. Generally, however, the inflation outlook is favourable, with very low inflation underlying pressures internationally and domestically given the growth slowdown.

Figure 7 - Inflation and Forecast



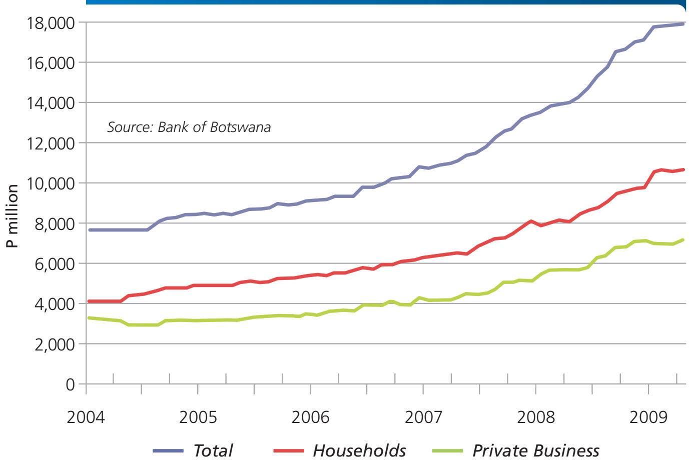
The rapid decline in inflation and positive outlook has enabled interest rates to be reduced sharply. The Bank Rate was cut by 1.5% to 11.5% in June, on top of cuts totalling 2% earlier in the year. The speed at which interest rates have been cut is unprecedented, and the Bank Rate is now at its lowest for 18 years. This is appropriate, given the weak current economic environment. Furthermore, the appropriate inflation measure from a monetary policy perspective is the rate excluding the impact of the increase in the liquor tax in November 2008; on this measure, inflation is already below 6%, and may fall below 4% in coming months. However, it is now likely that interest rates will be on hold for a while, until there is more clarity regarding the speed of recovery of the international economy and potential inflationary pressures arising from commodity prices or exchange rate effects.

Figure 8 - Bank Rate



Despite sharply lower interest rates, there is evidence that credit availability has deteriorated sharply in recent months. Credit growth has ground to a halt: after making allowances for a technical change in the data that occurred in January 2009, the annualised growth rate of total credit was only 3.6% in the four months to April, and credit to the private business sector did not grow at all over this period. The credit slowdown reflects a number of factors. First, arrears rates rose sharply in the first quarter of 2009, indicating that some firms, but particularly households, are facing problems in repaying their debts. Second, the economy is in uncharted territory with uncertain prospects in the short and medium term, which has made banks more cautious in extending credit. Third, banks around the world have become more risk averse in the light of major losses and capital write-downs, and a global tightening of credit policy is being passed down to subsidiaries, including those in Botswana.

Figure 9 - Bank Credit



Economic Outlook

What is the outlook for the Botswana economy at this time of great international and domestic uncertainty? Recent data present a mixed picture. On the negative side, headline economic data are poor: the economy is in technical recession, economic growth in 2009 is forecast by the IMF to be the lowest of any country in Africa, exports have dropped sharply, and the government budget has moved from surplus to deficit. While Botswana may not be experiencing a credit crunch as yet, bank credit is less readily available than in the past, and bad debts are rising.

On the positive side, the negative impact of the global recession on growth has so far been largely confined to the mining sector, and the non-mining sector appears to be growing at a healthy rate. Diamond exports are recovering. The foreign exchange reserves have fallen, but not excessively, and have provided the intended cushion to support the economy and the exchange rate. The financial sector remains sound and profitable. Negative GDP data largely reflect dramatic adverse developments in the global diamond industry, but are not very representative of the rest of the economy.

So far, Botswana has weathered the impact of the global financial and economic crisis better than many countries. But that does not mean that Botswana has escaped, and the economy is still likely to face problems in the coming years as the impact of the global recession combines with longer-term developments. The main risks and concerns are as follows:

- **Speed of global recovery:** while the global economy is likely to improve in the remainder of 2009 and in 2010, the recovery is likely to be slow and erratic; the same is likely to apply to the international diamond market, so that while Botswana's diamond exports should continue to recover, they are likely to remain below the levels of 2007 and early 2008, with implications for the balance of payments and the government budget;

- **Speed of regional recovery:** while emerging markets generally are expected to lead the global recovery, some – including South Africa - are expected to lag; as a result, regional economic developments may well be a negative influence;

- **Non-mineral exports:** there are signs that these are feeling the impact of the global recession, particularly tourism and textiles (Botswana's 3rd and 4th most important exports respectively), which will spread the impact to the non-mining sector of the economy; these are more important employers than the mining industry, so any slowdown in non-mining exports would have a negative impact on unemployment;

- **Credit constraints:** the reduced availability of bank credit to the business sector, if it continues, will also begin to impact negatively on the non-mining sector, and will tend to offset the beneficial impact of lower interest rates;

- **Government Budget:** rapidly increasing government spending has helped to shield the economy from the worst effects of the global recession; however, this cannot be sustained indefinitely, as revenues from diamonds and other important sources such as the Southern African Customs Union are likely to be weak into the medium term. As government spending growth is cut back in order to ensure fiscal sustainability, a historically important driver of economic growth will be much less evident;

- **Electricity supplies:** the economic slowdown has temporarily taken pressure off of regional and domestic electricity supplies, but this should not encourage complacency. Eskom supplies to Botswana are due to be cut from 350MW at present to 250MW in 2010 and 150MW in 2011 – all of which will happen before Morupule B is due to come on stream in 2012. Emergency (and very expensive) diesel generation capacity has been lined up for 2010, but there is still a major shortfall in supplies predicted for 2011, unless new gas generation capacity from coal-bed methane comes to the rescue. Expect further load-shedding and much higher electricity tariffs.

Botswana has so far avoided a severe generalised short-term impact from the global recession, reflecting the country's limited dependence upon foreign capital flows, aid and inward remittance flows; high levels of accumulated savings and foreign exchange reserves; and limited linkages between mining and the rest of the economy. Relatively few redundancies can be attributed directly to the global slowdown – the troubled Mowana copper mine and Lerala diamond mine being among the few examples. Looking forward, we do not expect there to be a sharp contraction in economic activity outside of the mining sector, or a dramatic increase in unemployment. Nevertheless, incomes are likely to experience a progressive squeeze as the impact of the slowdown in exports spreads to the rest of the economy, as credit constraints bite, and as fiscal sustainability requirements lead government spending to be held in check.

Despite some encouraging economic news, underlying challenges remain as we have pointed out before:

Fiscal sustainability: NDP 10 makes it clear that government revenues are not expected to grow significantly over the next few years, and hence spending levels must be contained in order to prevent unsustainably large budget deficits. The focus has been on cutting back on the development programme; while this is necessary, the development budget makes up only 20% of total projected spending in NDP 10, and it is also necessary to cut back on recurrent spending which makes up the other 80%. The fundamental problem is that government is too large, and employs too many people; the long-term need to make government smaller still needs to be addressed. There are also concerns regarding the fiscal and debt sustainability implications of spending commitments that have not been included in NDP 10.

Public sector financial management: financial constraints have meant that the range of projects to be included in NDP 10 has had to be cut back. However, Government has faced problems in deciding which projects to cancel or postpone. Most projects that are put forward have not been subject to a proper evaluation of their likely economic and social impact, and as a result there is no coherent system for prioritising projects. Government therefore struggles to make rational or objective decisions as to which projects should be included in the development programme, and which should be excluded as resources become scarce. In the light of current economic difficulties, NDP 10 needs to focus on projects that will maintain and sustainably diversify the economic base of the country, rather than those that are primarily driven by other factors.

Debt management: the need to finance the major budget deficits projected during NDP 10 poses challenges for government, some of which are discussed in the Box on the following page. The level of public debt, both domestic and foreign, is projected to rise sharply in the coming years. This will in turn pose new challenges: historically Botswana has not been seen as a debtor nation, debt service obligations have been limited, and debt management has not been a major challenge. Going forward, the situation will be different as interest costs are likely to add significantly to government spending and debt repayment obligations will need to be carefully managed in order that the debt position remains sustainable.

Reform and deregulation: there have been some achievements in recent years in improving the business environment, and this has been acknowledged in assessments such as the World Bank's annual "Doing Business" survey. But the process remains incomplete, and in some cases there have been reversals. Long-standing problems such as obtaining work permits for skilled foreign workers, accessing land, border delays, and business-unfriendly licensing procedures remain constraints to investment, and in some cases these are being compounded by new problems. Given that the private sector needs to take on a greater role as the driver of economic growth as the role of government diminishes, it is important for the constraints to private investment to be progressively removed. A key challenge for the new Hubs that are being developed to spearhead growth in selected fields (such as agriculture, transport, education, downstream diamond activity etc.) will be to ensure that the enabling environment for investment in the respective sectors is improved, as much as promoting specific projects.

The global crisis – and the impact of being unable to sell diamonds – provides an insight as to what life could be like for Botswana when diamonds begin to run out, which is expected to happen in a decade or so from now. Hence the importance of dealing with these challenges as a matter of urgency.

Box: Financing the Budget Deficit

In recent months Botswana has secured two loans from the African Development Bank (AfDB), totalling nearly US$1.6 billion, or around P11 billion. These loans have received considerable attention both locally and internationally, for good reason. In the past, the AfDB has concentrated on lending to poorer countries, or for infrastructure projects, and as a middle income country Botswana has not had access to finance on concessionary terms. The major portion of Botswana's borrowing from AfDB, $1.5 billion, is from a new lending facility designed to provide budget support to countries affected by the global financial and economic crisis, and is the largest loan made to date by AfDB from this facility. The Government is also in discussion with the World Bank regarding further borrowing.

The AfDB loan marks a change of practice for Botswana, which has in the past only borrowed small amounts from international lenders. Indeed, as at March 2009, total foreign borrowing by the government (including guarantees) was only P2.31 billion (approx $330 million). Hence the new loan dwarfs previous international borrowing.

The borrowing of such a large amount of money reflects the changed fiscal situation as a result of the global financial and economic crisis, combined with longer term fiscal trends. NDP 10 envisages a large budget deficit (currently estimated at around P32 billion over seven years, but likely to be much larger), which has to be financed. The choices open to the Government are to draw down accumulated balances at the Bank of Botswana, to borrow domestically, to borrow internationally, or some combination of these. It could also use more innovative financing mechanisms such as Public-Private Partnerships (PPPs).

The Government must take into account a range of issues when considering which combination of sources of finance to use, including the costs, risks and benefits associated with each, as well as legal constraints.

Foreign borrowing is typically from concessionary sources, whether bilateral (e.g. foreign governments) or multilateral (e.g. the World Bank or AfDB), with a relatively low interest rate. Hence the direct cost is low. However, over the long term exchange rate changes - as the pula depreciates against the dollar - are likely to add to the effective interest rate and the burden of repayments, and so the true cost in pula terms will be higher than the headline interest rate. Nevertheless, foreign borrowing has the advantage of adding to the foreign exchange reserves as well as government balances, and it may even be possible to make a profit on the loan, if it remains unspent and the additional earnings on the reserves are greater than the interest cost.

The government has also considered borrowing by issuing a **sovereign international bond**. This has the advantage of establishing a presence in international capital markets, which may yield long-term benefits. However, the interest cost would be relatively high, especially in current market conditions which do not favour emerging market borrowers.

Domestic borrowing (e.g. through government bond issues) may look more expensive than concessional foreign borrowing due to the higher interest rate. However, once exchange rate changes are taken into account, the true cost of domestic borrowing may not be much higher. Domestic bond issues have further important advantages. First, they will reduce the amount of money tied up in BoBCs, and reduce BoBC interest costs which are already being paid indirectly by government. Second, additional bond issues will help to develop the domestic capital markets, which should have further benefits for the private sector.

The deficit can also be funded by **drawing down accumulated government balances** at the Bank of Botswana, which have been built up partially for the purpose of financing cyclical budget deficits. But it would be inappropriate to use these balances in their entirety: their second and more important purpose is to generate income for future generations, in lieu of the mineral wealth that has been exploited to build up these balances. Hence most, if not all of Government's Pula Fund balances should be preserved. The current circumstances illustrate that perhaps stricter rules are needed to prevent this "Fund for Future Generation" from being used to finance current expenditure and deficits.

Some expenditures can be kept "off balance-sheet" by using mechanisms such as **Public-Private Partnerships**, which use private sector institutions to fund capital expenditure (e.g. buildings), while government services the cost over the life of the asset. This reduces the immediate budget deficit, but adds to future expenditures. However, there are other potential advantages of PPPs, such as improving efficiency and boosting the private sector.

Overall, it is appropriate for government to use a mix of financing sources, balancing the advantages and disadvantages of each. However, a few rules should be followed.

First, loans are not income, and while they can be used to finance a given deficit, they should not be used to finance additional spending unless it can be clearly demonstrated that it will generate sufficient returns to service the loan. In other words, just because loans are available, it does not mean that government should go on a spending spree.

Second, Botswana has built up an enviable position as a country with a strong net international credit position – as is appropriate for a mineral-dependent economy. Indeed, this is the main reason for Botswana's investment grade credit rating. Excessive or inappropriate debt-financed spending would undermine this position, and would make it more difficult to deal with the post-diamond future.

Third, there are legal limits to the extent of government borrowing. The Stocks, Bonds and Treasury Bills Act requires that government's foreign borrowing and guarantees be limited to no more than 20% of GDP, with domestic borrowing and guarantees limited to a further 20% of GDP. The AfDB loans, combined with existing foreign debt and the guarantee provided to BPC for its borrowing for Morupule B Power station, takes total foreign debt very close to that limit. Hence any additional borrowing should be from domestic bond issues.

Source	Advantages	Disadvantages
Foreign – multilateral (e.g. AfDB)	Low interest rate Repayment flexibility May be profitably reinvested Boosts FX reserves	Exchange rate adds to risks and costs
Foreign – commercial (e.g. sovereign bond)	Establishes a presence in international capital markets Boosts FX reserves	High interest rate & issue costs Exchange rate adds to risks and costs Adverse market conditions
Domestic - bond issues	Contributes to capital market development Reduces BoBCs and cost of absorbing excess liquidity	High interest rate
Drawdown of accumulated balances	Flexible and readily available No direct interest costs	Should be preserved for future generations Reduces government income