Bifm Economic Review

4th Quarter 2009

Economic Review

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Introduction

December 2009 marks the end of the most difficult economic year that Botswana has faced in decades. On the bright side, it is fair to say that the year ended on a more positive note than it started. The worst fears of a prolonged global depression have not been realised, and positive growth has returned to the world economy. Stock markets and commodity prices have recovered strongly during the year. In Botswana, the diamond mines have re-opened, diamond exports have resumed, and the impact of the global crisis on the non-mining economy has, so far, been limited. Inflation and interest rates have fallen sharply.

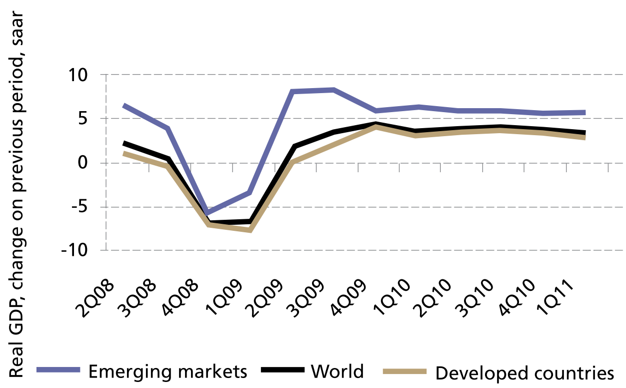
Nevertheless, it would be unwise to be too complacent, and the impact of the crisis has certainly not passed. Many risks face both the world economy and Botswana. Globally, there are risks of a resurgence of inflation driven by higher oil prices; continued weaknesses in parts of the financial sector; and the challenge of dealing with very high levels of public borrowing in many countries. In Botswana, 2010 will not see a return to “business as usual”, and as H.E. President Khama noted in his Christmas message, it will be a difficult year. The recovery in the diamond industry will only be partial, and both exports and government mineral revenues will remain well below previous trend levels. As in other countries, government will face challenges in sustainable management of public finances that will limit its ability to use public spending to support economic growth in 2010, in contrast to 2009.

Below, we review global economic developments in the last quarter of 2009, developments in the Botswana economy, and highlight some of the issues that will be faced in the 2010 Budget to be presented in early February.

The Global Economy

As we move from 2009 into 2010, global economic developments continue to be broadly positive. A synchronised global economic recovery is taking place, such that most countries should have exited from recession by the end of 2009. It now appears likely that economic growth rates should be quite respectable during 2010, with J P Morgan forecasting global real GDP growth of 3.4% for the year. Within the overall global recovery, there is, however, a sharp contrast between developed and emerging markets, with the latter forecast to grow more than twice as fast as the major developed economies. Growth in industrial countries is constrained by a range of problems, including fiscal deficits, high levels of debt for both governments and households, continued financial sector weakness, high unemployment and weak consumer confidence. Fiscal issues will be amongst the most acute challenges facing many developed country governments – notably the USA, Japan, the UK, Italy, Spain, Ireland and Greece. These countries face difficult decisions regarding the continuation of fiscal stimulus packages: if they cut back on government spending too quickly, there is a danger of undermining the growth recovery, but if fiscal stimulus is continued too long there is a danger of building up an unsustainable debt burden. The most heavily indebted countries, such as Ireland and Greece, have no choice but to cut back on spending immediately because of debt concerns, but for most governments there is a fine balancing act with regard to timing.

Figure 1: Global Growth Forecasts



Source: JP Morgan

Major developing countries, by contrast, are enjoying a speedier recovery from recession, and as a result are continuing to increase their share of global output; emerging markets in aggregate now account for a larger share of global demand than the USA, and are now a key engine of global growth.

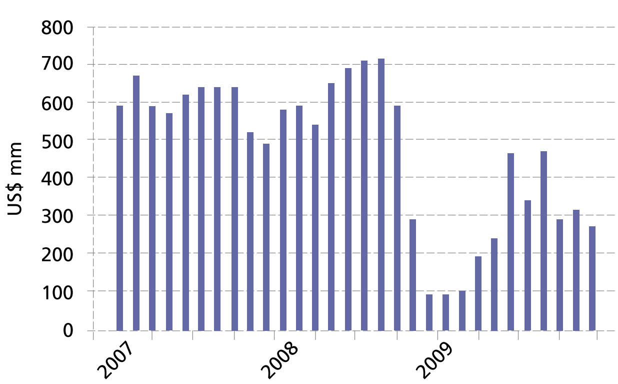
The pace of global recovery has been reflected in rapid increases in some commodities prices - particularly oil and industrial minerals - and stock markets. Some commentators question whether these increases have been too rapid, and may indicate further bubbles that will eventually burst.

These developments have a range of implications for Botswana. The global growth recovery is certainly good for Botswana; as an export-dependent economy it will generally benefit from improved trade volumes and higher prices. The high level of growth in emerging markets is pushing up demand for industrial minerals; this is good for copper and nickel exports, with prices up 150% (copper) and 100% (nickel) from recent lows. Other parts of the mining industry will also benefit, especially prospecting and mine development activities that have been put on hold (for copper, nickel, silver, uranium etc.). Not only have market conditions improved, but with financial markets functioning again and the return of risk appetite, capital is now available again for the junior mining companies that are typically involved at the early stages of mine development.

Diamonds, however, are much more dependent upon growth in developed countries, and hence are benefitting less from global recovery as growth in those markets is slower. This is compounded by diamonds' status as a luxury good, which may not be a priority when times are bad and consumer confidence is low. Besides general economic weakness, demand for luxuries is particularly vulnerable to the increase in savings rates (and hence a reduction in spending) that is taking place in the USA. Diamond sales through De Beers DTC recovered in the second half of 2009 but are still well below the levels of 2007 & 2008. The retail market is still weak, particularly in the USA, and Christmas season sales were disappointing. On a more positive note, the diamond pipeline has been "unfrozen"; cutters & polishers are buying again, rough diamond prices are rising, and for certain types of diamonds shortages are developing, all of which suggests that sales should improve in 2010, although full recovery will probably not happen until 2012.

The impact of the growth recovery has been less dramatic in some other export sectors. Manufacturing industry around the world still has substantial excess capacity, especially in textiles, garments and motor vehicles, which means that competitive pressures are intense and conditions difficult for marginal producers such as Botswana. Also unfortunately for Botswana, South Africa is expected to continue to lag emerging market growth more generally; South African growth is forecast by JP Morgan at 3.0% for 2010, compared to 5.9% for emerging markets as a whole, and hence this will restrict opportunities in one of the important markets for Botswana's non-traditional exports.

Figure 2: DTC Diamond Sights



Source: Rapaport TradeWire

Botswana Economy

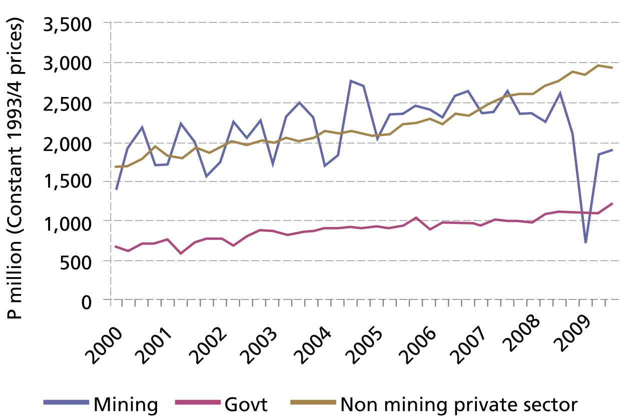
As with the international economy, the domestic economy is ending the year generally in better shape than it started. Diamond production has restarted and has recovered faster than had been initially anticipated. Inflation has continued to fall steadily. The non-mining sector of the economy has continued to perform well, and has seemingly managed to shrug off the effects of the global crisis and the slowdown in the mining sector.

Economic Growth

GDP data for the period to September 2009 shows a continuation of trends apparent earlier in the year. Over the year to September, total GDP contracted by 4.6%. During this period there was a major slowdown in mining, which contracted by 31.4%, whereas the non-mining private sector grew by 8.9%. The non-mining sector has continued to show resilience in the face of the global financial and economic crisis.

The most recent quarter (July-September) indicates a different trend, with overall GDP 4.1% higher than in the previous quarter. However, this was largely driven by recovery in the mining sector (output up 2.3%) and the expansion of government (which grew by 10.4% during the quarter), while the non-mining private sector shrank by 0.8%. While not too much reliance should be placed on data for one quarter – quarterly figures can be quite volatile – this does perhaps indicate that the impact of the recession is spreading beyond the mining sector.

Figure 3: Real Output (quarterly)



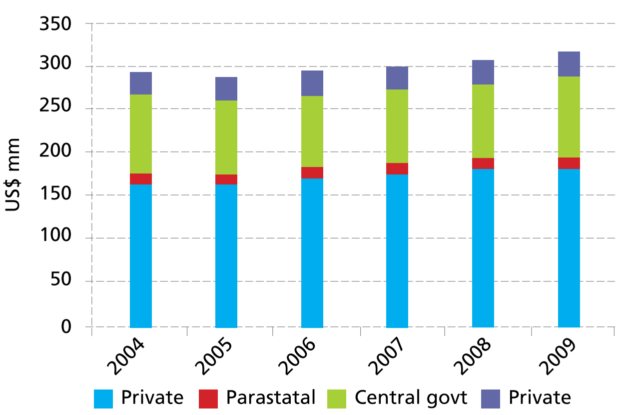
Source: CSO Econsult

Employment

One of the major impacts of the global crisis in many countries has been an increase in unemployment, with widespread job losses as firms have closed or downsized. To what extent has rising unemployment been a problem in Botswana? The data do not permit this question to be answered directly, as unemployment is only measured infrequently and the most recent published unemployment data are from 2006 (when two separate surveys gave conflicting unemployment rates of 17% and 27% of the labour force). However, there are data on formal sector employment, from surveys carried out at last once a year. The most recent data, for March 2009, show that at least until that time employment had continued to grow: over the 12 months to March, total employment grew by 3%, although this was driven by faster growth in public sector employment (central and local government, up by 5%) than private sector employment (up only 2%). The only sector where employment had fallen was, not surprisingly, mining, which was down 9%. In addition, government has expanded the *Ipelegeng* labour intensive public works scheme, which provided 66,800 jobs as at March 2009.

However, it is likely that employment in the private sector has fallen since March 2009, most notably following the closure of Botswana's largest garment/textile producer (Caratex) in December.

Figure 4: Employment (Formal Sector)



Source: CSO
Note: Employment on Ipelegeng scheme excluded

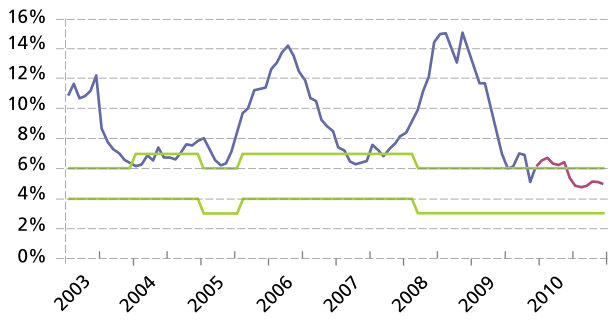
Inflation and Monetary Policy

Inflation fell sharply to 5.0% in November, the lowest inflation rate in Botswana since July 1972. The decline was driven by base effects as the introduction of the 30% alcohol levy in November 2008 fell out of the calculation, combined with the impact of declining oil and fuel prices. The decline was to a certain extent transitory, as inflation then rose again to 5.8% in December, again driven by base effects related to fuel prices.

Nevertheless, underlying inflationary pressures remain weak with, for instance, a sharp drop in food price inflation. Going forward, imported inflation should be benign, with inflation in developed economies forecast at around 1% in 2010, and in South Africa around 4-5%. Even with the impact of the pula crawling exchange rate peg factored in, imported inflation should remain well within the Bank of Botswana's inflation objective range in 2010, and this should be supported by weak domestic inflationary pressures as domestic demand growth slows.

The main threat to inflation is international oil prices. These have been rising steadily throughout the year while domestic fuel prices have only risen modestly, partly because rising US dollar prices have been partially offset by the strength of the rand and the pula. However, any sustained rise in international oil prices or weakness of the rand would require an increase in domestic fuel prices, which would have a large impact on domestic inflation.

Figure 5: Inflation and Forecast



Source: CSO Econsult

Nevertheless, inflation prospects are good, even with a modest increase in fuel prices factored in. We forecast that inflation will rise slightly above the upper end of the Bank of Botswana's 3-6% inflation objective range during the first half of the year, but should then fall back within the range and remain there through the second half of the year.

Positive inflation developments have enabled a further loosening of monetary policy, and the Bank of Botswana cut the benchmark Bank Rate by a further 1% in December, resulting in a cut in the commercial banks' prime lending rate to 11.5%, the lowest figure in nearly 20 years. This brings the real prime lending rate to around 5%, which is probably appropriate for the Botswana economy at the present time. More generally, the aggressive interest rate cuts by the BoB during 2009 have been an appropriate response to global economic developments, and provide some support to the economy as domestic sources of aggregate demand (and growth) weaken.

Bank Lending

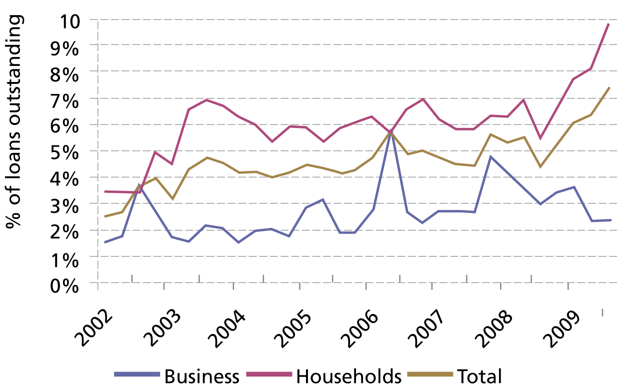
We have earlier noted that Botswana experienced its own "credit crunch" in the first half of 2009, with virtually no growth in bank lending during the six months from January to June. This reflected a combination of tightened lending criteria by the banks, who were especially concerned about risk following developments in other countries, and a limited capacity to take on and service additional debt by potential borrowers – in other words, the slowdown in credit growth reflected both supply side and demand side constraints.

The situation appears to have eased in recent months, with credit finally growing again over the three months to October (the most recent data available); credit to households and businesses was up by 4% and 2% respectively over this period. This reflects both a renewed appetite for lending by the banks and an improvement in business confidence.

However, the picture is not all rosy. While the renewal of credit growth will help to support demand and hence growth in the economy, concerns remain about debt sustainability and the structure of lending. Essentially, it is lending to households that is driving the resumption of credit growth, even though households are in many respects over-borrowed and should not be incurring more debts, especially for consumption-related spending. At the same time, the corporate sector is under-borrowed, and it would be much better for the economy if the resumption of credit growth was driven by corporate borrowing, especially for investment.

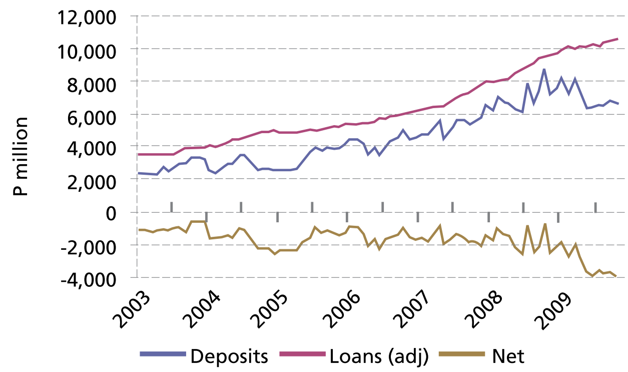
These concerns can be seen in the figures for arrears. Data for the period to September 2009 show that arrears on household lending have jumped sharply since the beginning of the year, and are at historically unprecedented levels. Arrears on corporate lending have however been quite stable, showing no adverse trend. These data suggest that firms have much more capacity to take on bank credit than do households. In addition, households have been running down their savings – presumably to maintain spending levels in the face of declining real incomes – but this leads to a sharp increase in net indebtedness to the banks and is not sustainable.

Figure 6: Arrears on Bank Lending



Source: BoB, Econsult

Figure 7: Household Savings & Borrowing



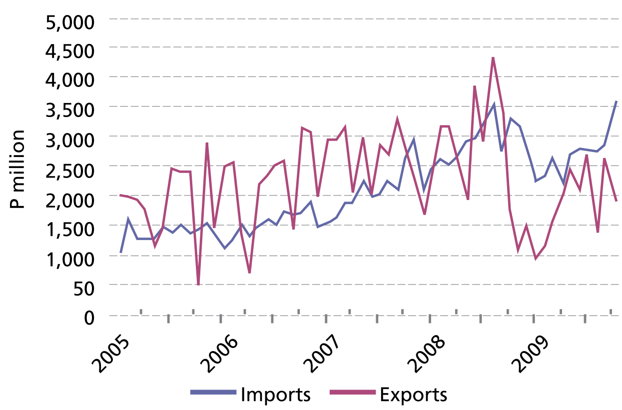
Source: BoB, Econsult
Note: Lending is adjusted to take account of changed arrangements for credit card debt by one of the banks, which would otherwise distort comparisons

Foreign Trade

As with most other aspects of the economy, foreign trade presents a mixed picture. Diamond exports have recovered, but only partially and remain well below pre-crisis levels. Indeed, most categories of exports have increased in Q3 (July-Sept) compared to Q2, but generally have only seen partial recovery. Even with this recovery, all categories of exports – apart from meat – were significantly lower in Q3 of 2009 than they were in the same period in 2008. At the same time imports have picked up. As a result, exports continue to fall short of imports, such that there has been a visible trade deficit every month since October 2008.

While the international trade picture has improved since the beginning of the year, it still remains worrying. It is likely that for 2009 as a whole, the current account of the balance of payments will be in deficit, for the first time since 1982. Botswana has undoubtedly benefitted from the recovery in global trade and economic growth, but so far the recovery has been weak in respect of Botswana's key export products.

Figure 8: Exports & Imports



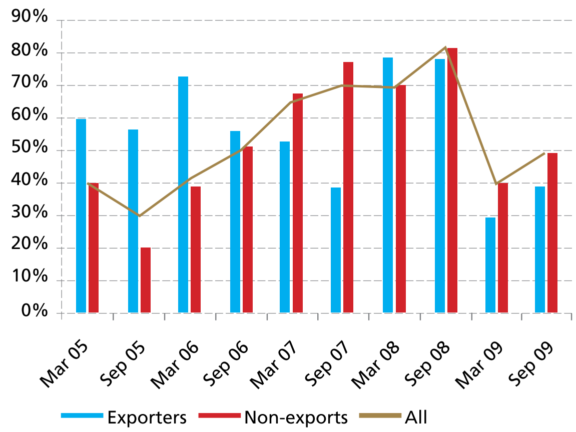
Source: CSO, Econsult

Business confidence

The Bank of Botswana's semi-annual business confidence survey shows an improvement in September 2009 compared to 6 months earlier; 47% of firms rated current business conditions as satisfactory, compared to only 40% in March 2009. Confidence is higher amongst firms selling to the domestic market than amongst exporters, although both have shown an improvement. There has also been an improvement in forward-looking expectations, with an increasing proportion of firms expecting business conditions to improve over the next 12 months. A further encouraging sign is that investment intentions have improved, although this is offset by indications that the majority of firms intend to reduce employment in the first half of 2010.

The increase in business confidence presumably relates the improved international economic outlook as well as the resilience of the domestic economy. However, confidence remains much lower than in 2007 and 2008.

Figure 9: Business Confidence *(% of firms rating current business conditions satisfactory)*



Source: BoB

Economic Outlook

The economic position at the end of 2009 is better than it was at the beginning of the year. The global economy has avoided the worst-case scenario of a prolonged depression, with trade, economic growth and commodity prices showing a recovery. This has helped Botswana, in particular stimulating some recovery in the mining sector. At the same time, the non-mining sector has continued to perform reasonably well, showing resilience in the face of the international crisis and the mining sector slowdown.

The picture in 2010 may be somewhat different, however. The mining sector should have a better year than in 2009, with improved prices for copper, nickel and diamonds – although there is always the danger of a price bubble that may not be sustained. Improved global prospects should also help to stimulate a recovery of prospecting activity and support emerging projects that had been put on hold during the depths of the crisis. Hence, there are prospects of significant developments with regard to new diamond, copper/silver and uranium mines during the year. These projects will also be supported positive developments in international capital markets and the return of risk appetite by investors, making capital-raising easier.

By contrast, 2010 is likely to be a difficult year for the non-mining sector of the economy. Much of the resilience that the sector showed during 2009 was driven by government spending – Botswana's own fiscal stimulus package – which was broadly appropriate in the circumstances. In 2010, however, attention will have to turn to issues of medium-term fiscal sustainability – discussed in more detail in the Box below - and as we move into the second year of NDP10 there will be no real growth in resources available from government to drive growth directly.

Non-mining export sectors – notably manufacturing and tourism – are likely to find conditions highly competitive and challenging during the year. Sectors of the economy dependent upon household consumption may also find conditions difficult. Household spending power is under stress, and as with households in other countries, many have excessive debts and need to start saving more – and spending less – in order to restore sustainability. Lower interest rates will help here – and should also help to stimulate corporate investment – but the underlying problem of over-indebtedness remains.

This means that banks will have to be very cautious as the growth of lending to households resumes. While non-mining economic growth should remain positive through 2010, it will be lower than in 2009. Nevertheless, overall GDP growth will be driven by the recovery of the mining sector, and the headline figure should reach a respectable 10% or more. Despite this, conditions will feel difficult for many sectors of the economy.

Box: 2010 BUDGET PREVIEW

The 2010 Budget to be delivered in early February will require a delicate balancing act from the Minster of Finance and Development Planning. In 2009, government experienced a major reduction in revenues, due mainly to the problems faced by the diamond industry, lower export earnings and the consequent drop in mineral revenues from taxes and royalties etc. Notwithstanding this shock, government took a decision to maintain spending levels, and if necessary run a substantial budget deficit, in order to support economic activity at a time when other sources of demand and growth were under pressure. As a short-term measure to maintain economic activity, this appears to have worked, and although GDP in the mining sector dropped sharply in 2009, leading to a negative overall GDP growth rate for the economy, activity in the non-mining sector has been quite robust and non-mining growth has remained steady. Botswana's own fiscal stimulus package has therefore achieved its objective of ameliorating the adverse impact of the global recession, and as far as possible, preserving incomes and employment levels in the economy.

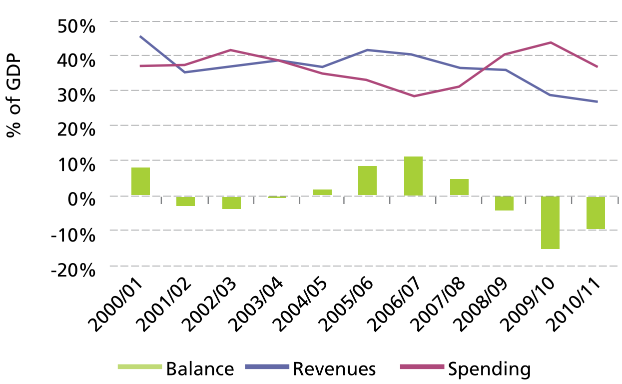
This approach has been similar to that of many other governments that have implemented fiscal stimulus packages in the extraordinary circumstances of the global financial and economic crisis. However, as the crisis eases, the fiscal challenge facing governments around the world is to balance two competing objectives: on the one hand, maintaining fiscal stimulus in order to provide a boost to economic demand and growth and compensate for lower demand from other sources, and on the other, maintaining sound and sustainable public finances by keeping spending and deficits at manageable levels and avoiding the accumulation of unsustainable debt (or running down accumulated savings balances). In the short-term, the two objectives are in conflict: reducing spending in order to protect the public sector balance sheet will reduce the fiscal stimulus, and vice versa. While the details of the appropriate balance between these two objectives will vary from country to country, the challenge facing Botswana is no different, in principle, to that facing most other governments.

What balance should the Minister of Finance and Development Planning strike in the forthcoming budget? Last year, the then Minister indicated in the Budget that while in the short-term the emphasis would be on fiscal stimulus and supporting economic activity, further ahead there would have to be shift from stimulus to sustainability. In particular, the 2009 Budget speech stated that "we will seek to limit total Government expenditure in light of the evolving situation to a deficit of no more than 10 percent of GDP averaged over the two financial years 2009/2010 and 2010/2011".

The 2009 Budget projected total revenues of P24.4 million in 2009/10 and spending of P37.8 million, resulting in a deficit of P13.4 million, or an estimated 15% of GDP. Our forecast is that actual revenues will be slightly higher than this. However, budgeted expenditure will also be higher, due to large supplementary budget allocations, so the revised budget for 2009/10 will probably show a deficit similar to that originally projected.

The test will be the 2010 Budget. Total revenues are likely to be similar to those in 2009/10, with a fall in SACU revenues offsetting any improvements in revenues from other sources. Meeting the commitment made in the 2009 Budget (a deficit averaging 10% of GDP over the two years) would therefore require very large cuts in spending. We consider this to be unlikely. However, it will be important for government to show that it is acting so as to achieve medium-term fiscal sustainability, and some spending cuts will be needed. The size of the budget deficit in 2010/11 needs to be reduced from 2009/10; in our view, anything higher than P10 billion – around 10% of GDP – is unlikely to be consistent with a sustainable fiscal outlook. Achieving this will require cuts in recurrent spending, a zero (or very low) pay rise for civil servants, possible tax increases, and the deferral or cancellation of development projects. There also needs to be a binding commitment not to resort to supplementary budgets during the fiscal year – if some high priority individual budgets run short of funds during the year, they should be financed by moving funds from other, lower priority activities, not by increasing overall spending. The need for fiscal sustainability will not permit the government to provide the same level of fiscal stimulus in 2010 as it did in 2008 and 2009.

Figure 10: Revenue and Spending



Source: MFDP, Econsult
Note: Figures through to 2008/9 are from MFDP; figures for 2009/10 and 2010/11 are Econsult forecasts, based on reducing the budget deficit to 10% of GDP in 2010/11.

The challenge of restoring fiscal stability is somewhat different in Botswana's case compared to many other countries. Because Botswana has avoided debt accumulation in the past, and hence has the capacity to borrow, and furthermore has accumulated reserves, means that large deficits can be financed in the short run. But adverse longer-term revenue trends make this potentially dangerous. The fact that mineral revenues will eventually decline (as diamonds run out) and SACU revenues are likely to fall means that the government's two largest revenue sources are under pressure. As a result, spending has to be cut significantly as a share of GDP in the medium term if a sustainable budget is to be achieved. Borrowing now, or running down savings, to maintain spending in the short-term makes the longer-term adjustment to lower spending levels much more difficult to achieve. The challenge facing the government is not just getting through the current crisis, but putting government expenditure on to a path that is sustainable in the medium to long term.

This cannot be achieved simply by mechanisms such as across-the-board cuts in recurrent or development budgets – while this may appear to spread the burden of adjustment equally, it misses the point that sustainable budget reform requires not just spending cuts but changes in the way that public funds are allocated, based on prioritization and focusing cuts on low priority activities and projects that yield the lowest benefits for the country. This has far reaching implications for the whole planning and budgeting process.

The system of National Development Plans and annual budgeting that has been in place for the past 40 years played a useful role in the early years after independence and in the period when mineral revenues were growing rapidly. However, it has a number of shortcomings and is not well suited to current and future challenges. For many years, Botswana was considered to be a leader amongst developing countries in planning and budgeting practices. However, the world has moved on, while our systems have remained unchanged. We now need to learn from international best practice, reform our planning and budgeting processes, and move beyond the NDP system. Such a change will help to effectively address the public finance challenges that Botswana now faces.

Bifm
Dynamic Wealth Management

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