Economic Review

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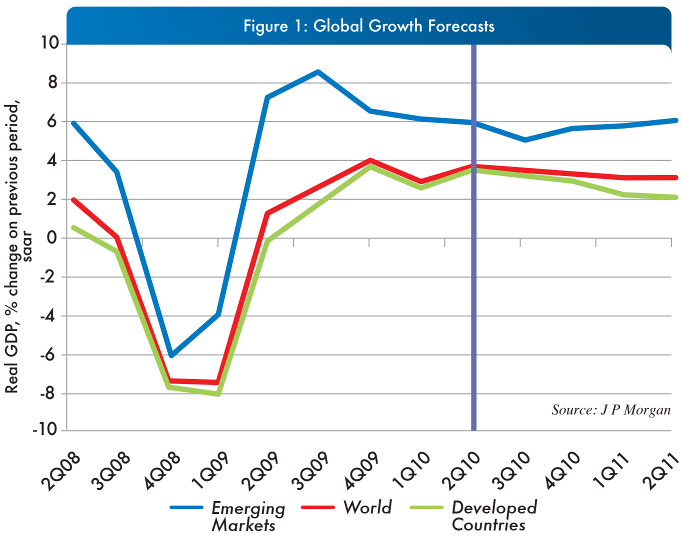
INTRODUCTION

The first quarter of 2010 marked a period of one year since the world economy was in the depths of recession. Twelve months on, global recovery is under way and the international economic environment is, with some exceptions (such as Greece), reasonably positive. The form of the recovery is benefitting emerging markets, which are in many cases in better economic shape than developed countries. Emerging markets – which were victims of the global crisis rather than its cause - are benefitting from higher commodity prices, a pick up in world trade, and a resumption of capital flows.

As a highly export-dependent economy, Botswana is seeing some benefits from global developments. In this Economic Review, we examine how international and domestic developments are impacting on the Botswana economy, and review two important policy developments during the quarter - the 2010 Budget and the Bank of Botswana's Monetary Policy Statement.

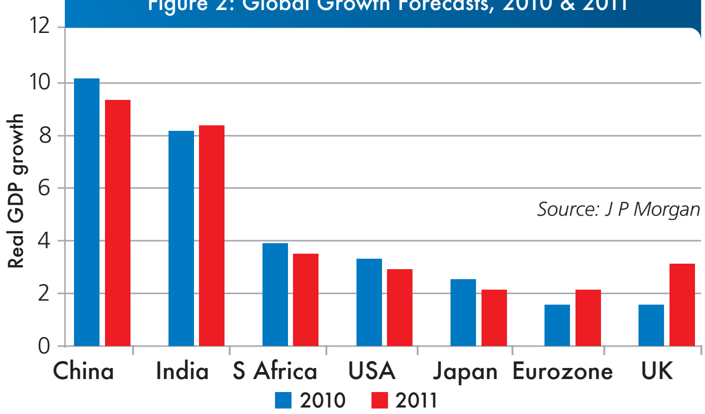
Figure 1: Global Growth Forecasts



GLOBAL ECONOMY

Recent months have seen a continuation of global economy recovery, with synchronised growth taking place across all regions of the world. Growth is most robust in emerging markets, which were less burdened by financial sector distress than developed markets. Chinese growth in particular has quickly to recovered to the 9% level, which is close to the growth rates that were being achieved before the global crisis.

Figure 2: Global Growth Forecasts, 2010 & 2011



Emerging market growth is in turn creating demand for exports, which is helping to boost commodity markets as well as stimulating more broadly based recovery. Nevertheless, developed countries are anticipated to grow at a much slower rate than emerging markets during 2010 and 2011. One of the most striking impacts of the global crisis has been a further shifting of the centre of global economic gravity away from developed markets and towards emerging markets. While developed markets remain in aggregate much larger than emerging markets, the latter have higher growth potential and are less burdened by financial sector and public finance problems.

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Although fears of a prolonged global recession have now dissipated, the potential dangers of a "double dip" recession have not. Many large countries are still grappling with the problems of when to withdraw the fiscal stimulus packages that have mitigated the impact of the global crisis, but at the cost of sharp increases in public debt. Withdrawing fiscal stimulus too early could undermine the growth recovery, while leaving it too late stores up even larger debt problems for the future. These debt problems are perhaps most apparent in the euro zone, where Greece's debt crisis has spooked the markets and undermined the common currency, even though the Greek economy is too small to be of any great significance in the euro area. The real fears relate to whether the Greek crisis is simply a sign of things to come in other larger and more important euro zone economies, or indeed outside of the euro zone where the UK and the US also have very large debt burdens.

The global recovery has had a dramatic impact on commodity prices, which have risen sharply. This is generally good for Botswana, as a major commodity exporter, although this is partially offset by the country's consumption of oil imports. Copper prices have almost recovered to their peak level of 2008, and nickel prices have more than doubled over the past year. Rough diamond prices have also surged on increased demand, and this has helped to stimulate a sharp increase in diamond sales through the Diamond Trading Company (DTC) in the first quarter of 2010. The main concern now is that the pace of recovery has been too fast, and that we may be seeing the emergence of unsustainable bubbles in some commodity (and stock market) prices.

Figure 3: Copper & Nickel prices

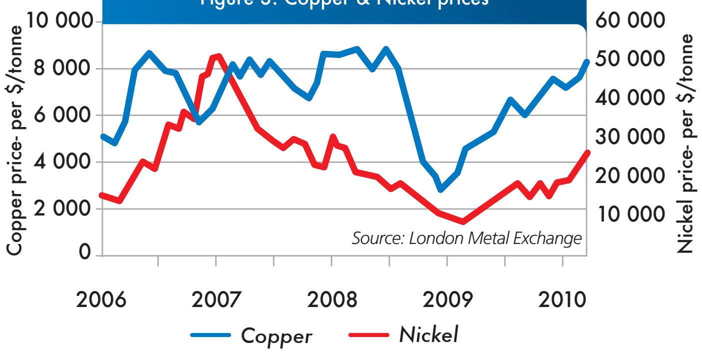
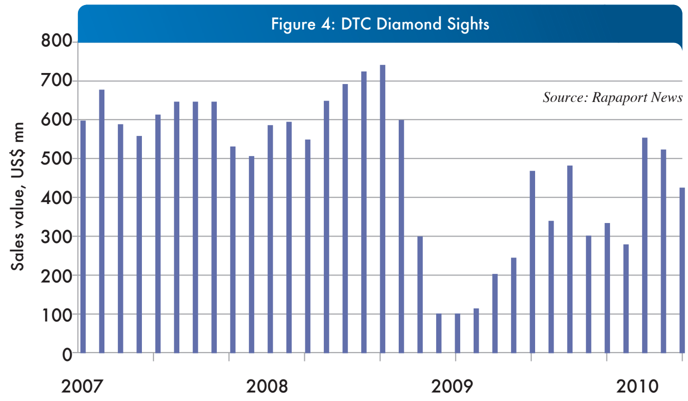


Figure 4: DTC Diamond Sights

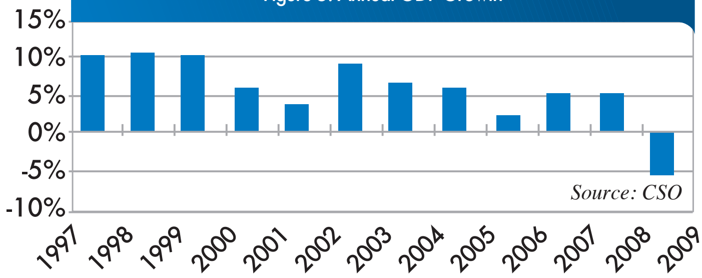


BOTSWANA ECONOMY

Economic Growth

The 2009 GDP figures released by the Central Statistics Office (CSO) have been subject to a variety of different interpretations and some misunderstanding. The annual data confirm that 2009 was a year of recession for Botswana, with GDP contracting by 6%. This is the lowest GDP growth figure recorded since the current data series began in 1975, and the only period of substantive recession over that period.

Figure 5: Annual GDP Growth



The GDP outturn for 2009 illustrates one dimension of the dramatic impact that global downturn had on the Botswana economy. This was mainly transmitted through the mining sector, which shrank by a massive 27%. Of the other economic sectors, only manufacturing was also in recession, with a contraction of 5%. It was the export dependent sectors (including tourism) that were badly hit, while other sectors experienced positive growth – particularly transport and communications, personal and social services, construction and agriculture, all of which grew by more than 10% during 2009.

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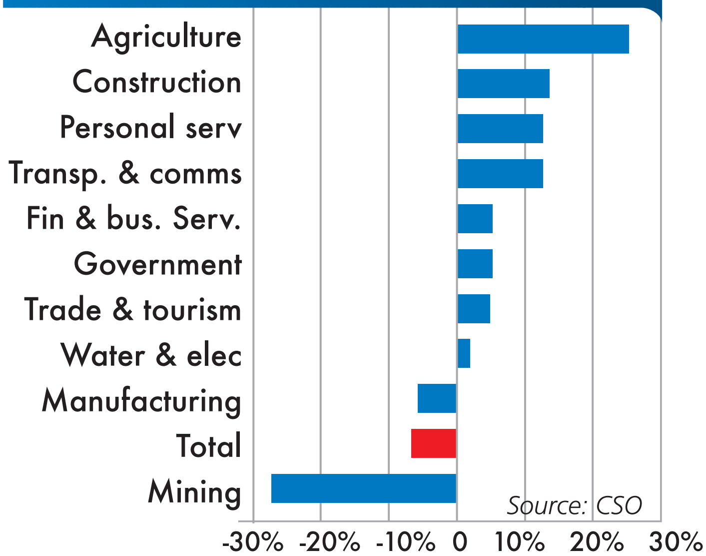
The good performance of agriculture is particularly striking, given the sector's dismal growth record over the past three decades. Identifying the source of this growth is not straightforward, however. The cattle sub-sector grew by only 11%, while crop production – which is in any case very small – shrank by 14%. Almost all of the growth came from "other agriculture", which comprises poultry, pigs, small-stock, bee-keeping, forestry etc.

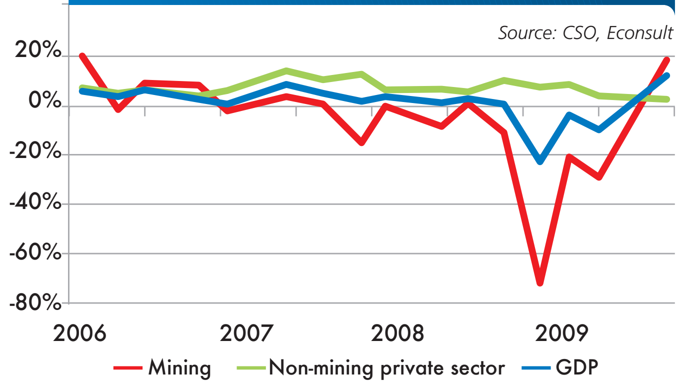
Figure 6: GDP Growth by Sector, 2009



Looking beyond the severe contraction of the economy in 2009, there are some positive developments. Quarterly GDP data, which are more sensitive to short-term changes in economic activity, show that output was picking up towards the end of the year. For the first three quarters of 2009, output was lower than in the corresponding period in 2008; in the fourth quarter, however, total GDP was 7% higher than a year earlier. Measured on this basis, GDP growth was at its highest since early 2007. The return to positive growth was driven by recovery in the mining sector.

However, it would be a mistake to read too much into this; the positive growth in 2009Q4 is relative to the previous year when the global recession was beginning to have a serious impact, and hence it represents growth from a depressed base. Second, while mining was recovering, the non-mining sector was slowing down, with output in the fourth quarter only 3% higher than a year earlier. So the economic growth picture is distinctly mixed – an improvement from a year ago, but with no broad-based recovery in sight.

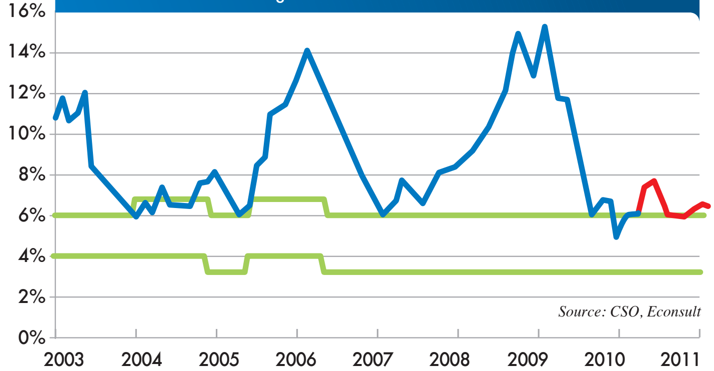
Figure 7: Quarterly GDP



Inflation and Monetary Policy

The sharp reduction in inflation from a peak of around 15% was one of the more positive economic developments in 2009, especially as it was accompanied by a large cut in interest rates. Since the end of 2009, inflation has remained around the upper end of the Bank of Botswana's 3%-6% objective range. However, the likelihood is that inflation will jump sharply in April and May once the impact of the 2% increase in VAT kicks in, along with higher electricity prices, and we forecast an increase to around 7.5% to 8% in the coming months. There are some reports that retailers are using the increase in VAT to opportunistically increase prices, but this would be unjustified and shortsighted in the light of weak household spending power. Fortunately, international inflationary pressures remain very weak, and the only real inflationary threat on the horizon is the steady upward movement in oil prices, which may well lead to an increase in domestic fuel prices in the near future.

Figure 8: Inflation & Forecast



BOX: Monetary Policy Statement, 2010

The Bank of Botswana's 2010 Monetary Policy Statement (MPS) was presented on February 25. It included a detailed explanation of inflation and interest rate developments during 2009 – one of the most difficult for policymakers in Botswana's recent history – and noted that "the Bank maintained a monetary policy loosening bias with a view to providing economic stimulus in an environment in which the potential for sustained fiscal stimulus was constrained by the decline in government revenue".

At the same time the MPS noted that even though interest rates had been reduced sharply during 2010 (by a total of 500 bps), inflation had fallen even more, and hence monetary policy had actually tightened during the year. As a result, real interest rates in Botswana at the end of 2009 were higher than in comparator countries (the UK, the USA and South Africa), as well as being higher than at the end of 2008.

Although the Bank acknowledged that inflation would rise in the short term due to VAT and potential cost pressures from utility charges and rising oil prices, it noted that these would be offset to some extent by slower economic growth and reduced demand pressures as a result of declining household incomes (due to the public sector wage freeze and increased VAT) and the slower growth of government spending.

Looking further ahead, the Bank expects inflation to fall within its 3% to 6% objective range early in 2011, and thereafter to be maintained between 4% and 5%. With the Bank expecting to maintain a neutral monetary policy stance, this would indicate scope for further interest rate cuts when inflation is brought sustainably within the objective range.

How feasible is it likely to be to bring inflation down to such levels, which would be the lowest for nearly 40 years? The MPS reports that the Bank's forecasting models indicate that inflation in the range of 4-5% is achievable. Certainly there is good reason to believe that international inflationary pressures will be minimal, and the anticipated cutbacks in government spending in Botswana will reduce domestic inflationary pressures. All of this bodes well for the achievement of much lower inflation.

However, one of the biggest challenges is achieving fundamental change in inflation expectations. As the results of the most recent Business Expectations Survey show, expectations of inflation remain high – at around 10% - and are adjusted downwards more slowly than the rate at which inflation actually falls. This is a barrier to achieving lower inflation, as it affects firms' price-setting behaviour.

The difficulties in changing expectations were well illustrated in the results of the March government bond auction, which for the first time offered a bond with 15 year maturity. Such a bond is quite risky, and valuations are particularly vulnerable to changes in inflation and interest rates over the period to maturity. The bond auction resulted in a yield of 9.1%, but with most of the issue remaining unsold as many bids were above this level, and were considered to be too high.

This outcome illustrated a gap in expectations between the Government and the market. The Government and Bank of Botswana took the view that with inflation expected to be structurally lower over the next 15 years than it has been over the past 15, interest rates should continue to fall, and an interest rate of 9% would yield an attractive real return.

BOX: Monetary Policy Statement, 2010

However, the market view was that with short-term interest rates having come down by 5.5% since November 2008, the economy was at a low point in the interest rate cycle, which might not be a good time to buy a long-term bond. Other factors also contributed to the outcome, including a lack of portfolio demand for long maturity bonds, and limited interest from foreign investors.

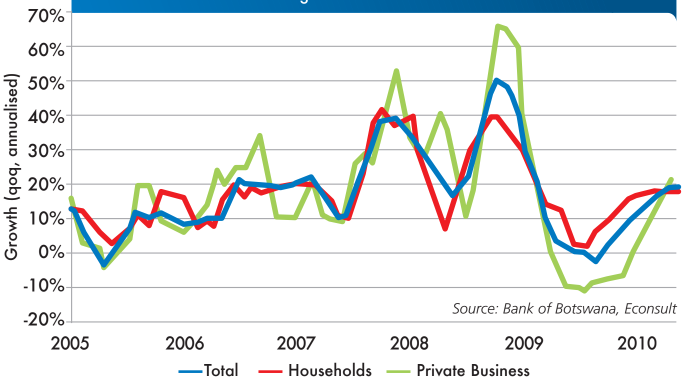
Furthermore, with inflation having averaged around 8.5% over the past 15 years, a yield of 9% did not seem so attractive. Given that private sector expectations seem to be backward-looking and slow to adjust, it will take a prolonged period of low inflation for those expectations to change.

Financial Sector

The financial sector is recovering slowly from the credit crunch, and activity has since been picking up since the fourth quarter of last year. In 2009, uncertainty amongst potential borrowers, an income squeeze on households, and more cautious lending behaviour by banks had caused credit growth to slow to zero by the middle of the year; for the private business sector, credit growth had actually turned negative. In the second half of the year, and particularly in the final quarter, conditions improved and credit growth has turned positive. This suggests an improvement in business confidence and a willingness by banks to take on more risk.

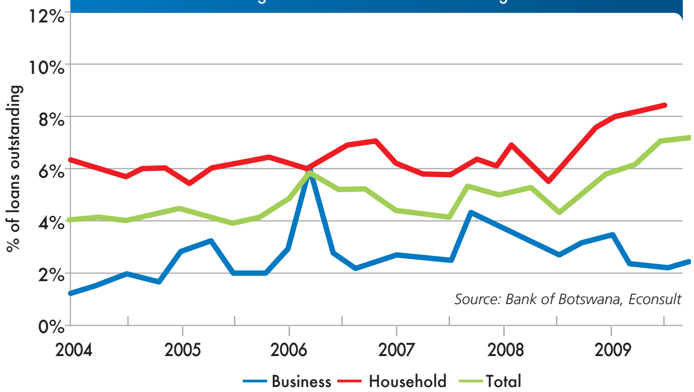
Although lending to households continues to dominate total bank lending, this appears to be more risky than lending to businesses. The value of loans in arrears has risen during 2009, but this deterioration has been almost entirely confined to lending to households, and this will constrain future lending growth, especially while real incomes remain under pressure from pay restraint in the public sector. While the overall level of arrears remains of concern, the relatively low level of arrears on lending to businesses should encourage banks to lend more in this area, which will help to support diversification and growth.

Figure 9: Credit Growth



Source: Bank of Botswana, Econsult

Figure 10: Arrears on Bank Lending



Source: Bank of Botswana, Econsult

Box: The 2010 Budget

The 2010 Budget, delivered in early February, had to address a very difficult economic and fiscal situation. A sharp increase in government spending, planned before the global crisis took hold, helped to sustain the economy through the global recession and the downturn in the mining sector. Even without the global crisis, this would have posed challenges for fiscal sustainability. But the crisis led to a sharp drop in government revenues from the mining sector, which was compounded by a decline in revenues from the Southern African Customs Union (SACU), leading to a dramatic escalation in the fiscal deficit. The deficit has been financed by a combination of drawing down of accumulated savings and an increase in public debt, which, for the first time, has risen to levels that need careful monitoring and management.

The crux of Botswana's fiscal problem is that the global crisis has compounded adverse long-term fiscal trends. The economy had become accustomed to a high level of fiscal revenues, which had averaged 40% of GDP until 2006/7, and government spending was geared to this level of revenues. Indeed, the "Fiscal Rule" adopted during the Mid-term Review of NDP 9 stated formally that government spending would average 40% of GDP over the economic cycle.

While this may have been reasonable on a historical basis, it has become clear that it would not be sustainable in the future. Government revenues have been declining in relation to GDP since 2006/7, a trend that the global crisis has accelerated. In the medium-term, government revenues are likely to fall further as the importance of diamonds declines.

A typical middle-income country would expect government revenues in the region of 25%-30% of GDP, or even less – for instance revenues and spending in Mauritius fall between 20% and 25% of GDP. For Botswana, the expectation is that revenues will decline to under 30% of GDP, and hence spending will have to be cut substantially in order to achieve medium-term fiscal sustainability. This is a formidable challenge, as spending has to be cut by around one-quarter, relative to the size of the economy, as compared to the NDP 9 Fiscal Rule.

The global crisis has made this even more difficult. In 2009/10, spending rose to an estimated 46% of GDP – driven by both a sharp increase in spending as well as a decline in GDP. Estimated revenues fell to 31% of GDP, resulting in a massive budget deficit of 15% of GDP.

Although the medium-term fiscal requirement is to cut spending considerably, judging the appropriate timing for this is very difficult. As in many other countries, one major concern is that premature spending cuts and withdrawal of fiscal stimulus will undermine economic recovery and growth during a difficult period. But delaying fiscal adjustment will lead to the rapid depletion of the savings that have been accumulated over many years of mineral-led growth, and/or the accumulation of high and possibly unsustainable public debt.

The 2010 Budget entails a modest containment of expenditure, which is set to fall by around P2 billion in 2010/11 compared to the previous year. What is striking is that revenues are expected to continue at very weak levels, even with recovery in the global economy. For diamond revenues, the problem is that even with the global market recovering, sales are projected to remain below recent peaks for some time. Furthermore, the capital spending required for the Cut 8 Jwaneng expansion also has the effect of reducing government mineral receipts. In addition, SACU revenues are expected to fall sharply because of the need to return past overpayments.

For the first time, the Budget included medium-term fiscal projections, giving revenue and expenditure forecasts for three years ahead, in contrast to the normal one year. This is a welcome development, although more detail is needed in the medium term forecasts to improve their usefulness. However, these forecasts indicate that efforts will be made to restore fiscal sustainability and achieve a balanced budget by 2012/13. While an improvement in revenues is expected in due course as the diamond market recovers and SACU revenues normalise, the main tool for achieving the planned balanced budget is the curtailment of spending, as well as modest tax increases such as the 2% increase in VAT in April this year.

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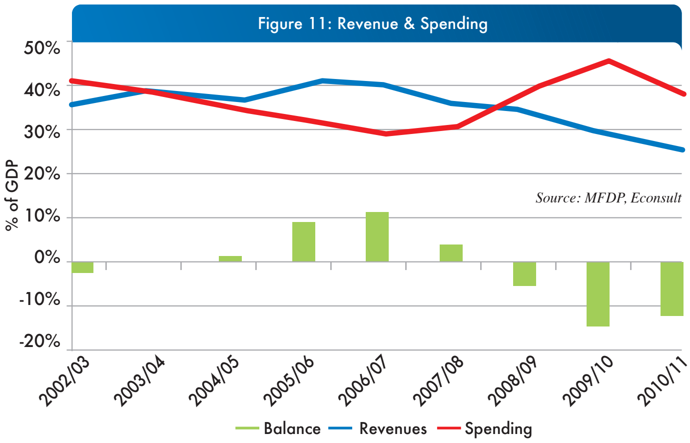

Spending is planned to be flat in nominal terms for the next three years, indicating lower spending in real terms and as a share of GDP – indeed spending is set to fall from 46% of GDP in 2009/10 to 32% in 2012/13. The balance will shift back towards recurrent spending with a smaller share for development spending. The development budget, which ballooned from P4.0 billion in 2006/7 to P14.5 billion in 2009/10, is to be reduced to P9.1 billion in 2012/13.

For 2010/11, a second large budget deficit is projected, at P12 billion or 12% of GDP. This also illustrates the need for rapid fiscal adjustment. Going into the crisis, government's net financial position (assets at BoB less domestic and foreign debt) amounted to P42 billion as at March 2008.

The deficits projected for the four financial years 2008/9 – 2011/12 amount to P36 billion. In other words, four years of deficits are projected to deplete 87% of government's net financial assets built up over years of budget surpluses.

Further large deficits would transform the government from being a net creditor into a net debtor. Given this rapid depletion of financial assets, it was perhaps inevitable that Botswana's credit rating has been downgraded, given that it was initially based to a large extent on the strength of the public sector balance sheet. While the credit rating remains investment grade, maintaining this position depends on convincing the markets and ratings agencies that the country is on course to achieve fiscal sustainability in the medium term.

OUTLOOK

The end of 2009 and the first quarter of 2010 has seen the economy perform better than was perhaps anticipated a year ago during the depths of the global financial and economic crisis. Commodities markets have recovered strongly, including the international diamond market. This has helped to stimulate activity in Botswana's mining sector, which should contribute to a strong GDP growth performance in 2010 after causing a sharp contraction and recession in 2009.

Relative to expectations a year ago, performance has been good. But the emphasis is on the word relative. The recovery in exports has only been partial; at least up until the end of 2009 the trade balance was still negative and the foreign exchange reserves were continuing to fall. The recovery in the diamond market is partly driven by restocking and rebuilding of inventories in the pipeline that were run down during the crisis, assisted by the easing of credit conditions. Retail conditions in the main developed country markets – the USA and Europe – remain uncertain. The private sector is de-leveraging, which means that expenditure will rise more slowly than income. Unemployment remains persistently high, putting a damper on consumer confidence. And the lack of clarity over how high levels of public debt are going to be dealt with, raising the prospect of future tax increases, all suggest a weak recovery in the main developed country markets.

The sectors of the economy that depend on domestic rather than export demand are facing a difficult time in 2010. The main sources of that demand – government spending and household consumption – are under pressure and are unlikely to be leading growth over the next 18 months. So although the headline GDP growth figure in 2010 is likely to look good, at between 5% and 10%, driven by recovery in the mining sector, conditions in much of the economy will feel worse. The key policy tasks remain improving the efficiency of government, enabling key priorities to be addressed but with fewer resources, and improving the business climate to support recovery and growth in the non-mining private sector.

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