Economic Review

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INTRODUCTION

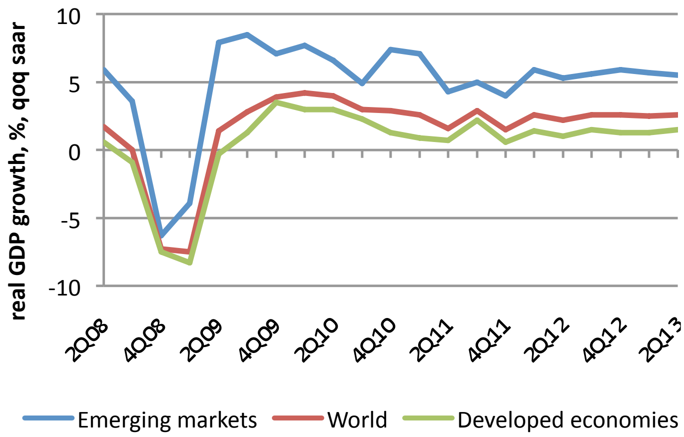
The first quarter of 2012 has been reasonably positive for the Botswana economy. Notably the international diamond market has shown some recovery from the dismal performance experienced towards the end of 2011, while the 2012 Budget reported a much more favourable – albeit still challenging - fiscal position than was anticipated a year ago. Inflation has continued to decline, in line with expectations. And although the mining sector underperformed in 2011, GDP growth figures show that the non-mining private sector has continued to perform ahead of expectations.

GLOBAL ECONOMY

The global economic picture during the first quarter of 2012 remains characterised by uncertainty, although the overall picture is somewhat more positive than it was in the last quarter of 2011. On the positive side, the immediate crisis in the Euro zone emanating from the Greek debt situation has been resolved, at least temporarily, and growth performance in some major economies – notably the USA and Japan – has come in ahead of expectations. Nevertheless, some concerns remain. Many commentators view the Euro zone crisis as having been merely postponed, with the focus moving to Spain and Italy, where the problems will be much more difficult to resolve. Growth in the emerging market powerhouse, China, is slowing – although in the Chinese context a "slowdown" means growth of "merely" 7%. Rising oil prices are a drag on global growth, and are being driven largely by geopolitical concerns emanating from tensions in the Middle East, notably those between Iran and Israel, as prices are much higher than would normally be expected in a weak global economic environment. Overall global growth, while showing signs of recovery, is likely to remain below trend, between 2.5% and 3%, for much of the next 12 months.

Fig.1: Global Growth & Forecasts

Source: JP Morgan Chase



BOTSWANA ECONOMIC DEVELOPMENTS

Economic Growth

Figures released by Statistics Botswana indicate that the economy grew by 5.1% in 2011, a reduction from the 7% growth experienced in 2010. The slowdown was driven largely by a small reduction in mining output, which did not continue the strong growth experienced in the previous year.

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Fig.2: Annual GDP Growth

Source: Statistics Botswana, Econsult

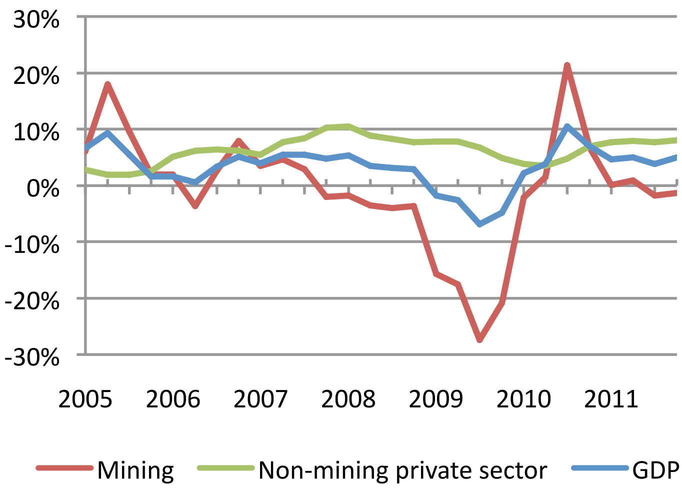
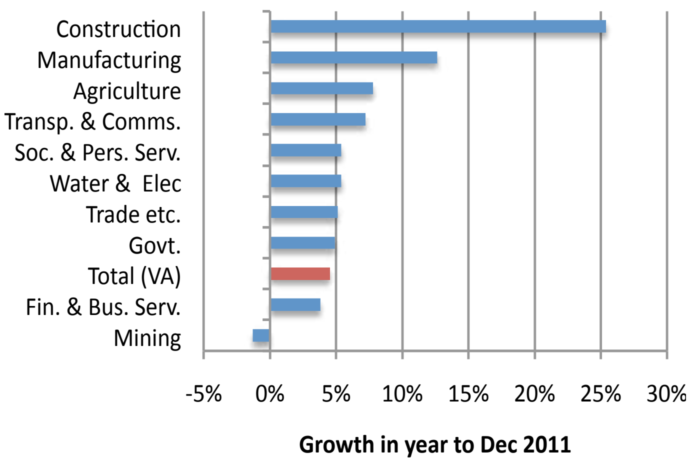


Fig. 3: Sectoral Output Growth (VA)

Source: Statistics Botswana, Econsult



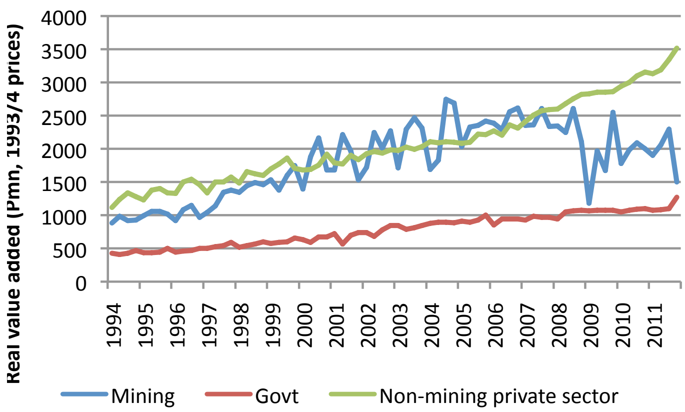
Because mining accounts for such a large share of GDP (albeit a declining share – it was only 28.4% in 2010, lower even than in the recession year of 2009) it has a marked effect on overall economic growth rates. However, a slowdown in growth driven by one (admittedly very important) sector should not cloud the relatively good performance seen in other sectors of the economy. The non-mining private sector has continued to grow at a brisk rate, with output expanding by 8.1% in 2011. The fastest growing sector continues to be construction, which grew by 25.4% in 2011, followed by manufacturing with 12.6% growth, with good performance in both the textiles and "other manufacturing" sub-sectors. Other sectors that performed well in 2011 included agriculture, transport & communications, social & personal services, water & electricity, and trade. Only the mining sector experienced negative growth, but the finance & business services sector grew relatively slowly.

The contraction in mining output was not unexpected. Diamond production has been carefully managed since the global crisis of 2008-9, with a focus on restricting supplies and pushing up prices rather than maximising production. In the face of weaker global diamond markets in the second half of 2011, Debswana cut back production in the fourth quarter of the year, resulting in a small (0.6%) decline in the real value of diamond output for the year. There was a much larger decline (43%) in the value of copper-nickel produced, reflecting the closure of the BCL smelter for several months as well as declining ore grades in the major mines. Perhaps surprisingly, coal production was recorded as falling by 4%, which is odd given the need to expand coal supplies to fuel the new Morupule B power station.

The relatively poor performance of the mining sector over the past five years comes across clearly in Figure 4, which shows quarterly value added in mining, government and non-mining private sector. Whereas the mining sector and the non-mining private sector were of approximately equal size between 2000 and 2006, since that time the mining sector has contracted, while the non-mining private sector has grown steadily, such that in 2011 the output of the non-mining private sector was 70% larger than that of mining. Although it is often held that the economy is not diversifying, these data suggest that over the past five years the economy has to some extent diversified away from dependence on the mining sector.

Fig.4: Real output by broad sector (quarterly)

Source: Statistics Botswana, Econsult



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Trade and Balance of Payments

At the end of 2011 the international diamond market had weakened considerably, reflecting both global economic uncertainty and industry-specific developments. The first quarter of 2012, however, has seen a welcome recovery, with a small improvement in prices and a significant jump in sales volumes. Total sales in the first three DTC sights of the year are estimated at $1.8bn, 45% higher than in the last three sights of 2011, and similar to the levels that prevailed earlier in 2011 when the market was very buoyant. The market recovery, if sustained, will provide the basis for an increase in Botswana's diamond production and sales during 2012.

Fig. 6: Exports & Imports (monthly)

Source: Statistics Botswana, Econsult

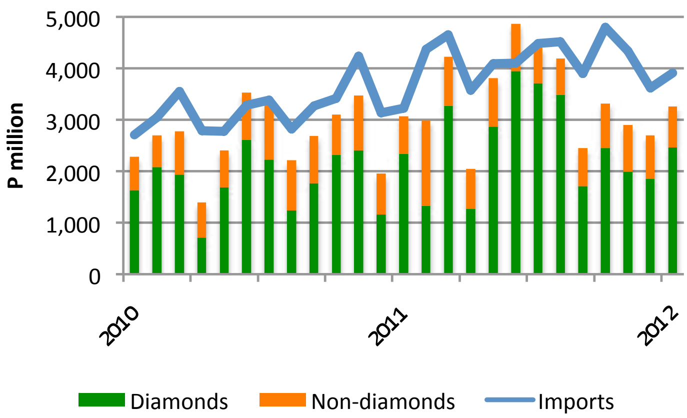


Fig. 5: DTC Diamond Sights

Source: Statistics Botswana, Econsult

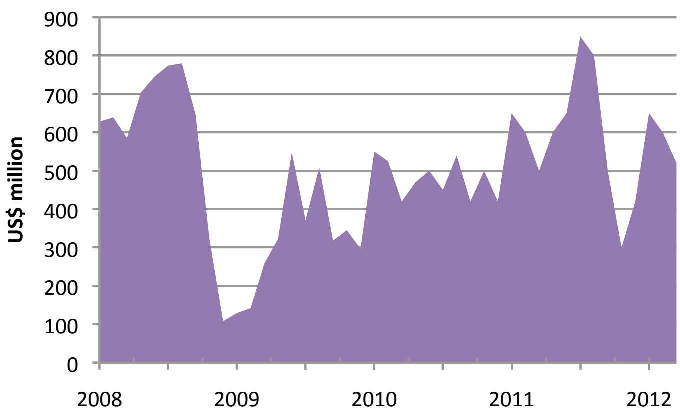
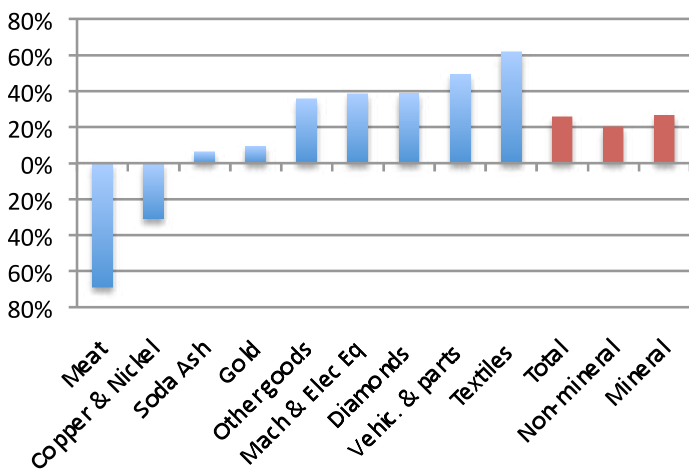


Fig.7: Export Growth, year to Dec 2011

Source: Statistics Botswana, Econsult



It will also feed through to an improvement in Botswana's overall trade figures in due course. The most recent figures, for January 2012, show a small reduction in the visible trade deficit (the gap between imports and exports). Export data for 2011 as a whole are reasonably positive, with total goods exports up 26% for the year according to Statistics Botswana. However this average conceals a wide range of sectoral performances, with exports of diamonds and manufactured goods (machinery, vehicle parts, and textiles) growing strongly while two of Botswana's most important "traditional" exports – meat and copper/nickel – had a dreadful year with a sharp contraction.

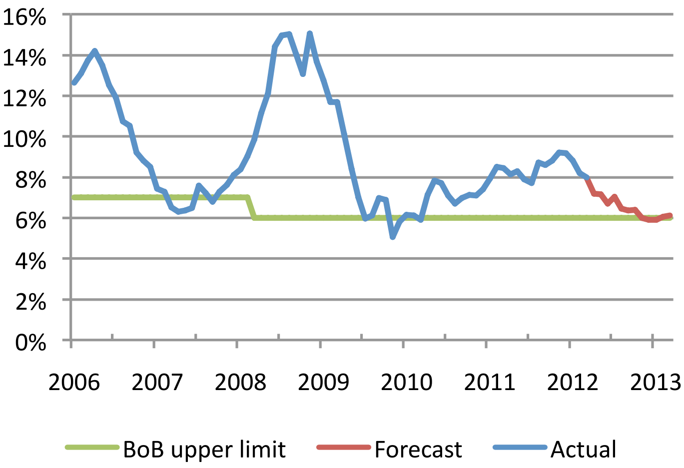
The recovery in exports in 2011 helped to drive an improvement in the balance of payments, notwithstanding the steady growth of goods imports, which increased by 28% over the year. Preliminary figures suggest that, for the first time since 2008, the balance of payments was in surplus in 2011, with a positive balance of P3.4 billion compared to a deficit of P6.5 billion in 2010. An improved current account balance along with increased net capital inflows accounted for some of the turnaround; however, the main drivers of the improvement cannot be identified due to data uncertainties and a very large "errors and omissions" figure in the balance of payments in some years. Nevertheless, the move to a surplus on the balance of payments helped to boost the foreign exchange reserves, which reached P60.3 billion at the end of 2011. However, because of the rapid increase in imports, import cover (of goods and non-factor services) fell to an estimated 14 months, the lowest level for more than 20 years.

Inflation and Interest Rates

Inflation declined in the first quarter of 2012, falling from 9.2% at the end of 2011 to 8.0% in March. This was much as expected, and inflation should continue to decline throughout the year. However, there remains a threat from rising international oil prices, which have not yet been fully reflected in domestic fuel prices, and it is likely that domestic prices will increase in the near future. However this will not necessarily cause inflation to rise, rather it will simply moderate the pace of the decline – largely because there were large fuel prices increases through 2011, which will be falling out of the inflation calculation during the current year. We still anticipate that inflation will just about reach 6 percent, the upper end of the Bank of Botswana's inflation objective range, by the end of 2012, barring any large oil price shocks.

Fig 8: Inflation and Forecasts

Source: Statistics Botswana, Bank of Botswana, Econsult

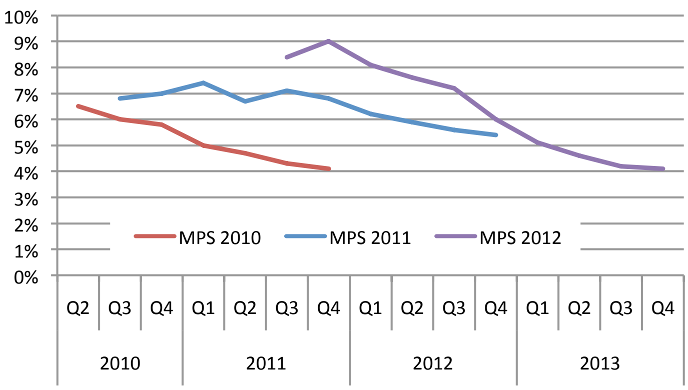


The BoB's 2012 Monetary Policy Statement (MPS) was released towards the end of February, and contained its usual detailed explanation of inflation developments in 2011 and a presentation of the Bank's inflation forecasts for 2012-13. There was no change in the inflation objective range, which remains at 3%-6. The Bank is forecasting that inflation should fall within the upper end of the range by the end of the year, and should decline further to below 5% in 2013. The Bank considers that domestic inflationary pressures should remain modest, with continued restraint in government spending and a negative output gap in the non-mining sectors of the economy. With this prospect, the MPS indicated that the stance of monetary policy was likely to remain unchanged, with relatively low real interest rates, subject of course to developments in the inflation outlook during the year.

However, a review of recent MPSs shows how difficult it is to forecast inflation. Both the 2010 and 2011 MPSs forecast that inflation would fall within the objective range within 12 months, but the actual inflation outturn has turned out to be much higher. This is largely due to unanticipated exogenous developments, such as increases in fuel prices and increases in administered prices (such as electricity tariffs) and taxes (VAT increased by 2% in 2010). This problem affects not just the BoB's inflation forecasts, but also our own and those of other agencies such as the IMF.

Fig 9: BoB Inflation Forecasts

Source: Bank of Botswana



Benchmark interest rates were unchanged during the first quarter, with the Bank Rate remaining at 9.5%. Other interest rates remained stable during the quarter, with relatively small moves in the 14- and 91-day BoBC rates. Nevertheless, both rates remain well below the levels that prevailed prior to the changes in the BoB's procedures for absorbing excess liquidity implemented in November 2011, despite the unchanged Bank Rate. The impact of reductions in many interest rates in recent months was also reflected in the results of the government bond auction held in early March, where most rates were considerably lower than at the previous auction maturities – confirming the steepening of the yield curve highlighted in our previous Review.

Fig 10: Interest Rates

Source: Bank of Botswana

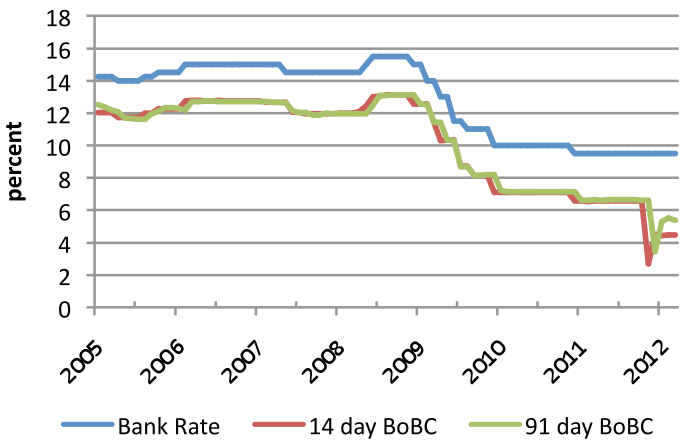
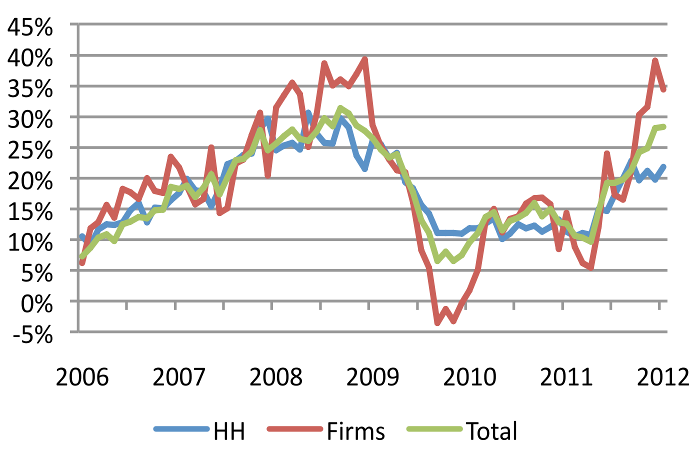


Fig 11: Credit Growth (Annual)

Source: Bank of Botswana, Econsult



FINANCIAL SECTOR

Bank credit

The surge in bank credit that began in the second quarter of 2011 has continued, with annualised growth rates of 32% in total credit, 25% in household credit and 43% in credit to the private business sector over the six months to January 2012. A faster rate of credit growth is generally positive for the economy, as it may reflect a combination of higher incomes, improved business and consumer confidence, and increased investment, as well as the level of interest rates. However, credit growth cannot increase indefinitely, as eventually it leads to an unsustainable debt burden (as reflected, for instance, in the ratio of debt service costs to household incomes), and may reflect overly-optimistic expectations and a sharp adjustment when these are not fulfilled. Annual credit growth rates are now at a level that has historically marked the peaks of credit growth in previous cycles, and hence it is likely that credit growth will now start to slow.

Generally, credit to the business sector has a more positive economic impact than credit to households, and this is a positive aspect of recent credit growth. Determining the business sectors where credit is growing most rapidly is made difficult by changes in the BoB's sectoral classification of business credit in mid-2011. However, it appears that mining, trade and transport have been amongst the main recipients of increased credit.

The Botswana Stock Exchange (BSE)

The BSE had a quiet quarter from January to March 2012, with the Domestic Companies Index (DCI) increasing by 1.0%. At 7037.5 at the end of March, the DCI has fluctuated around the 7,000 level since late 2009. Nevertheless, despite the sluggish performance of the DCI, there have been improvements in liquidity, and the BSE has continued a steady recovery from the impact of the global financial crisis of 2008-9 that brought a long period of strong growth to an end. Turnover surpassed P1 billion in 2011 (reaching P1008 million, approximately $148 million) for the first time since 2008, and market capitalisation reached P30.7 billion (approximately US$4.5 bn) at the end of 2011 – the highest since the end of 2007.

An important development was the listing of Choppies, the largest local supermarket chain, in January. Choppies' market capitalisation was P1.7 billion at the end of March, making it the most valuable non-financial company on the bourse, and the sixth largest out of 24 companies listed on the domestic board. The listing marks an important step in diversifying the BSE away from its domination by financial counters.

The 2011 financial results for the three banks listed on the BSE showed a mixed picture. The year showed little growth in certain key aggregates, notably assets and deposits, and what

Fig.12: BSE Index (DCI)

Source: Botswana Stock Exchange

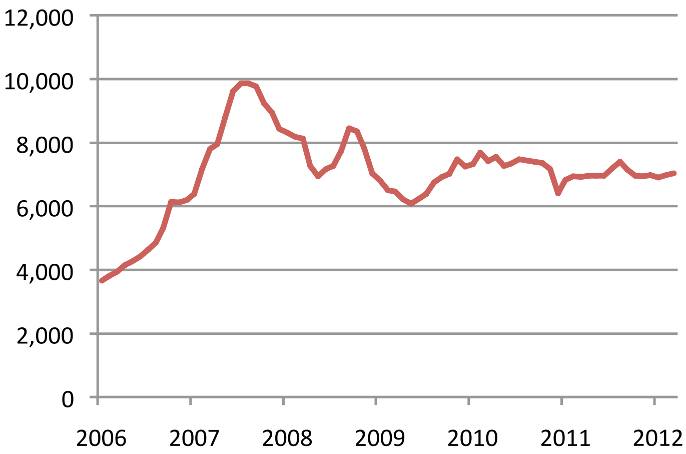


Table 1: Bank Results - 2011

		Barclays	FNBB	Stanchart
Net profit after tax	2010	500	260.2*	224
P million	2011	527	296.9*	281
Assets	2010	11,669	11,849	10,606
P million	2011	11,363	13,858	9,691
Advances	2010	5,572	6,513	3,492
P million	2011	6,092	8,062	4,096
Deposits	2010	9,348	9,940	9,212
P million	2011	9,093	11,559	8,074
Cost-income ratio	2010	39.5	35.8	57.1
%	2011	43.0	37.7	53.0
Impairments	2010	2.7	1.1	0.7
%	2011	1.0	1.2	0.5
Net interest margin	2010	9.1	5.7	5.5
%	2011	8.6	5.2	5.2
Return on Assets	2010	5.6	4.3	2.7
%	2011	5.5	4.6	3.6
Return on Equity	2010	45.3	45.2	44.2
%	2011	37.0	44.0	35.0

** half year results for FNBB*

Source: African Alliance, Econsult

growth there was, was concentrated in only one of the three banks. Advances, however, increased substantially across the board. Despite this, impairments generally declined as banks continued to pay attention to credit quality. Net interest margins were under pressure, most likely because of increased reserve requirements by BoB. Profits were up for all three banks, leading to generally higher return on assets.

Box: The 2012 Budget

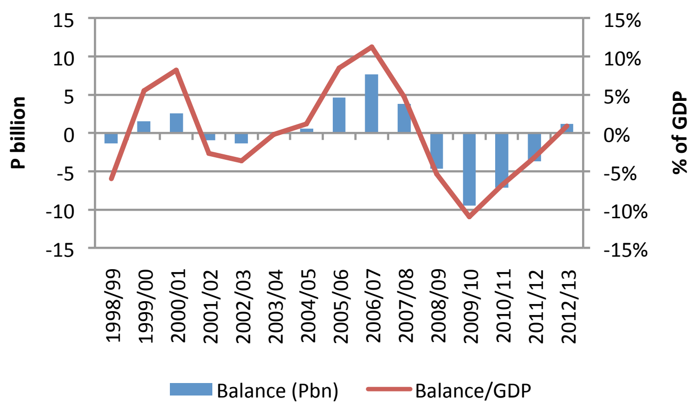
The 2012 Budget, delivered (earlier than usual) on February 2nd, marked a crucial stage in the fiscal stabilisation process that had been laid out during the global recession and subsequent fiscal crisis of 2008/9. Having promised that the budget deficit would be reduced to zero over a three-year period, the major test was whether the budget would indeed be balanced in the 2012/13 fiscal year, as per the earlier commitment. Other important questions to be addressed in the budget included how the expenditure restraint that would be required under this deficit reduction programme would be spread across different areas of government spending, and the extent to which revenues had exceeded initial expectations, given the good performance of diamond exports in the first eight months of 2011.

Revenue, Spending and Budget Balance

The revenue, expenditure and fiscal balance data presented by the Minister indicated that the target of a balanced budget in 2012/13 should be achieved, and indeed a small budget surplus is forecast. Achieving this was helped by the fact that the deficit for 2010/11 came in smaller than originally forecast (7% of GDP rather than 10%), and the estimate for the 2011/12 fiscal year is also for a smaller than budgeted deficit (3% of GDP rather than 6%). In the new fiscal year (2012/13), the deficit is set to be eliminated, and a small surplus (of 1% of GDP) is now being forecast. Small surpluses are also being projected for the two subsequent fiscal years.

Fig.13: Budget Balance

Source: MFDP, Econsult

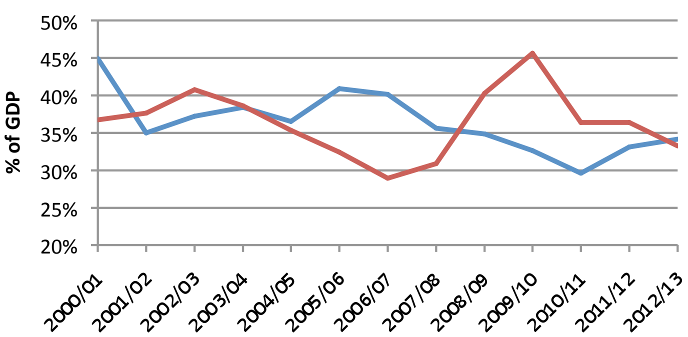


Achieving a smaller-than-anticipated deficit in 2011/12 and a small surplus in 2012/13 is being driven by increased revenues, while keeping expenditure reasonably steady in nominal terms (and hence smaller in real terms and as a proportion of GDP).

The task of balancing the budget has been assisted by buoyant revenues, now budgeted at at P43bn or 34% of GDP in 2012/13, compared to an estimated P37bn or 31% of GDP a year ago. Spending is now projected at P42bn or 33% of GDP, compared to P37bn or 31% of GDP a year ago. In other words, the Minister has managed to balance the budget without cutting spending (at least in nominal terms) – whereas a year ago, a spending cut of P4bn was pencilled in for the 2012/13 budget year.

Fig. 14: Govt. Revenue & Spending

Source: MFDP, Econsult

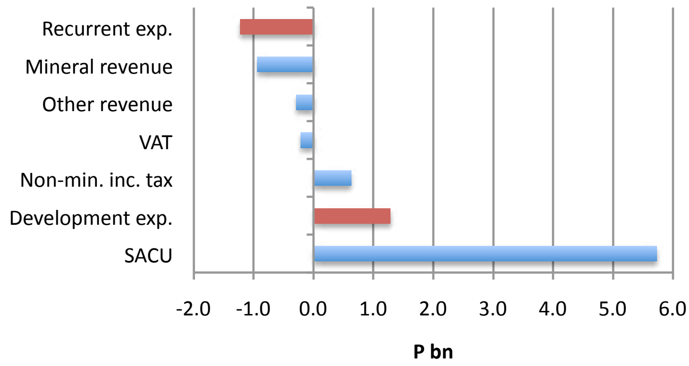


SACU to the rescue

The budget balance is projected to move from a deficit of P3.8 billion in 2011/12 to a surplus of P1.2 billion in 2012/13, an overall improvement of P5 billion. As the chart below shows, this is entirely driven by a massive increase of P5.7 billion in SACU revenues. Without this, the deficit would have worsened, as mineral revenues are projected to decline and other revenues are projected to be largely unchanged. In other words, without the increase in SACU revenues, it would have been necessary to increase taxes (such as VAT) or to cut spending drastically in order to achieve a balanced budget.

Fig.15: Revenues & Expenditure changes, 2011/2-2012/3

Source: MFDP, Econsult



The increase in SACU revenues is in part due to a "one-off" windfall payment of P2.4bn representing compensation for past underpayment. However, the bulk of it (P3.4bn) is due to an increase in the size of the SACU revenue pool, representing money available for distribution to SACU members; this has in turn been driven by the rapid growth of South African imports, driven in part by the overvaluation of the rand for much of the past 2 years.

At P14.2 billion, SACU revenues are forecast to be the largest source of government revenues in 2012/13, larger than mineral revenues (P12bn), Non-mineral income tax (P7.8bn), and VAT (P6bn). In a reflection of changing fiscal times, this will be the first time for 30 years that minerals will not be the largest source of government revenues.

Allocation of Spending

Within the spending total, the burden of restraint falls on development spending, which is set to fall from P11.3 billion in 2011/12 to P10.1 billion in 2012/13 – a 16% cut in real terms. This reflects a focus on the maintenance of existing infrastructure rather than building new infrastructure, and completing ongoing projects rather than starting new ones. It also reflects the re-classification of HIV/AIDS spending from the development budget to the recurrent budget (which is a more appropriate classification). However, the cut in development spending (-P1.3 bn) is almost entirely offset by an increase in recurrent spending (+P1.2 bn).

The approximate shares of spending by broad category are:

- wages & salaries 29%
- development 24%
- public debt interest 4%
- other recurrent 43%

The share of wages & salaries is much higher than in the past (e.g. it was only 20% in the early 1990s). The share of public debt interest is still small, but is rising sharply.

Generally, however, the allocation of spending by sector in 2012/13 has not changed greatly from the current year. The five largest recipients are (2011/12 in brackets):

- Education 20% (23%)
- General administration 13% (13%)
- Health 11% (12%)
- Housing & urban development 8% (8%)
- Electricity & water 7% (6%)

These five largest sectors account for 60% of total spending (62%).

Economic Impact of the Budget

The budget will have a mixed impact on the economy. The reduction of the deficit and restoration of a balanced budget is good news in terms of long-term fiscal sustainability. Indeed the running of deficits during a slowdown and the restoration of a balanced or surplus budget as the recovery takes hold are appropriate for a mineral economy. The budget outcome will help the country's credit rating and international credibility.

The continued reduction of government spending as a proportion of GDP means that the government contribution to aggregate demand will fall, particularly investment spending. This will inevitably have a dampening impact on GDP growth, both because government itself will not be growing, and because its spending on procurement from other agents in the economy will be, in relative terms at least, declining. Unless firms can find other sources of demand (from exports or non-government sources of domestic demand), GDP growth will fall. However, if the cutback in development spending falls mainly on low priority and low return projects, as the Minister has proposed, then the negative impact on growth of fiscal tightness will be minimised.

There is some evidence that government development spending is being concentrated on more economically productive projects. A large part of development spending is being devoted to activities that should have economic benefits, including electricity & water supply (26% of total development spending), urban and regional infrastructure (16%), roads (11%), air transport (5%), and telecommunications (4%). However, even within these broad headings some of the spending may be economically unjustified, such as some proposed road projects. And much of the spending on electricity is not really investment but simply compensating BPC for the very high costs of emergency power generation, which is itself the result of poor planning in the past. It may also be that there are some projects that are in principle good but in practice over-specified and over-priced (such as many recent school and hospital projects). Nevertheless, there are perhaps fewer such projects in the 2012/13 budget than there have been in the past.

There were some positive aspects of the budget for the private sector, including a commitment to further outsourcing of government activities. However, one disappointment was the lack of any detail regarding intentions for PPPs. Given the extent of funds available in the banking system and with institutional investors, some concrete opportunities for financing public sector projects would have been very welcome.

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Economic Outlook

Economic growth in 2012 is likely to be similar to or slightly lower than in 2011, around 4%-5% - healthy enough but not spectacular. This growth rate will be driven by an improved growth rate in mining, while growth in the non-mining private sector is likely to slow down. In particular, the large growth impetus that has come from the construction sector will fall away as large construction projects such as the Morupule B power station and Jwaneng Cut 8 wind down. At the same time, there is likely to be little or no growth in the output of the government sector, given spending restraint.

2012 should be a year of important mining-related developments. Hopefully the recovery in the international diamond market experienced in the first quarter will continue throughout the year, and enable Debswana to increase output from the 22.9 mcts produced in 2011 to 24 mcts or more. The year should also see the first production marketed from Lucara's Karowe diamond mine, and the completion of construction of Gem Diamond's Ghagoo mine, which is due for first production in early 2013. Lucara will be selling diamonds through a tender process, which will complement that already established by Firestone Diamonds. However, a more significant event will be the commencement of operations by the Okavango Diamond Trading Company, established by the Government of Botswana to market the share of Debswana's production which it has been agreed will be marketed independently of the DTC joint venture with De Beers. This will be a much more substantial tender process than those of the non-Debswana operations. Along with the transfer of DTC's London operations from to Gaborone during 2012-13, this will help to establish Botswana as a global diamond trading centre. In addition, five more cutting & polishing factory licences have been issued, bringing the total to 21. In the meantime, the Government will need to make a decision shortly on whether it is to take up its option of a further 10% share in De Beers (part of the deal under which Anglo American is buying out the Oppenheimers – see the 2011Q4 issue of the Review).

Outside of diamonds, Discovery Metal's Boseto copper mine is due to commence production in the second quarter of 2012, while Morupule Colliery will be expanding operations to supply the new power station. The coal mining sector more generally is set for a promising future over the next few years, although the full exploitation of Botswana's very large coal reserves requires the construction of a new railway to the coast – either east through Zimbabwe and Mozambique or west through Namibia. However, the recent trial shipment of coal to Maputo from African Energy's Sese bulk sample site shows that initial export shipments using existing rail and port infrastructure are possible.

Bifm

Dynamic Wealth Management

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