Economic Review

Dr. Keith Jefferis
Chairman of Bifm Investment Committee

INTRODUCTION

TThe second quarter of 2012 was less positive for the economy than the first quarter of the year. The international diamond market experienced some stress, with reduced sales volumes and a softening of prices. Prospects for the second half of the year are not particularly encouraging, particularly in view of reduced global economic growth and increased uncertainty over economic and financial conditions, especially in the Eurozone. In Botswana, economic growth declined in the year to March, to 4.3%, driven by a contraction in mining output. Non-mining growth, however, held up reasonably well. On a more positive note, inflation continued to fall, and should drop further in the second half of 2012. Lower international fuel prices should continue to help, although there are some risks from recent increases in global grain prices.

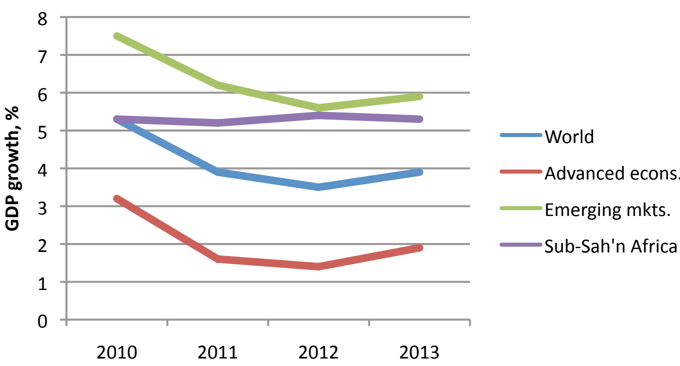
GLOBAL ECONOMY

Developments in the global economy during the second quarter of 2012 have been generally negative, and the overall picture is much gloomier than it was back in March. Slowing global growth, uncertainty in the Eurozone, and weaker performance in the emerging markets that were the main drivers of recovery from the past recession, all suggest that the second half of 2012 will be more difficult than the first.

IMF growth projections published in the updated World Economic Outlook in early July estimate that global growth will be 3.5% in 2012, slightly lower than the April projections. This represents a slowdown from 3.9% global growth in 2011.

Fig.1: Global Growth

Source: IMF



The main reason for the deterioration is the escalating crisis in the Eurozone. This combines elements of a sovereign debt crisis, a fiscal crisis, and a banking crisis, with an additional political element adding to the uncertainty. Although the Greek election in June produced a result that enabled Greece to remain in the euro in the short term, there is still a great deal of uncertainty as to whether there is a viable long-term solution for Greece. And the Eurozone crisis has in any case spread way beyond Greece, with banking sector problems in Spain needing a co-ordinated rescue intervention from other countries, and concerns about debt sustainability in Portugal, Cyprus and Italy.

It is still far from clear how the economic and financial situation in Europe will evolve, whether the solutions that have been proposed will work, and even whether there is enough political commitment to see those solutions implemented. At best, the Eurozone is likely to experience a recession (negative growth) in 2012, with a return to marginal positive growth in 2013. At worse a precipitous unravelling of the Eurozone could lead to a much deeper recession.

The USA has felt the impact of the Eurozone problems, with the recovery that seemed to be taking hold earlier in the year running out of steam as confidence has dissipated. The USA should do better than the Eurozone, with estimated growth of 2% in 2012, but also has growing uncertainty with an approaching presidential election and perhaps more seriously, the looming "fiscal cliff" whereby automatic mechanisms will cut spending and increase taxes at the beginning of 2013, which would be certain to push the US into recession. Although this is some way off, and there may be a way of preventing it from happening, the associated uncertainty has already dampened confidence and growth.

In the past, the major emerging markets – China and the other BRICS countries – have stimulated global growth when the major developed economies have been weighed down by financial sector and then sovereign debt problems. Now, however, even the emerging markets are experiencing slowing growth momentum. This reflects both a weaker external (global) environment and also a slowing of domestic demand. Although emerging markets are forecast to be the fastest growing group of countries in the world in 2012, at 5.6% this growth is well below the rates that they – and the world - have become accustomed to.

Interestingly the one region that is forecast to be somewhat immune to the global growth slowdown is sub-Saharan Africa, where growth in 2012 is projected to be slightly higher than in 2011. This does not mean that there will be no impact of the global slowdown, rather that the impact will be small and should be compensated by increased output of oil and other minerals.

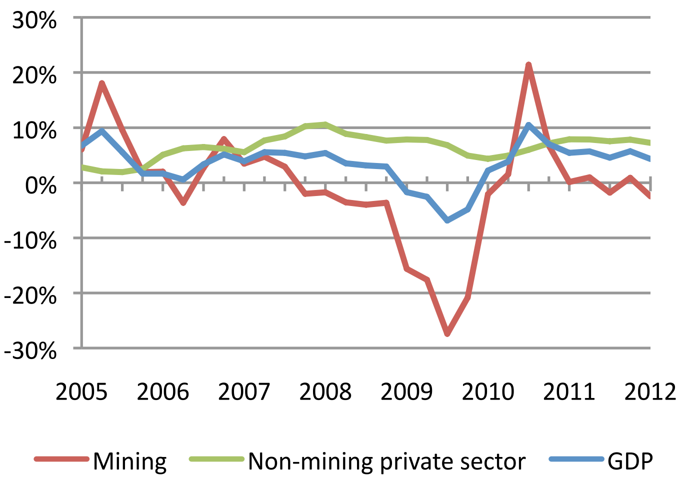
BOTSWANA ECONOMIC DEVELOPMENTS

Economic Growth

GDP figures for the first quarter of 2012 show that overall economic growth fell to 4.3% over the 12 months to March, down from 5.7% in the year to December 2011. The main reason for this was a slowdown in the growth of the mining sector, which contracted by 2.5% over the period. This in turn reflected a reduction in output of diamonds and copper-nickel. Outside of mining, growth remained reasonably robust, with the non-mining private sector growing by a 7.2%. Although this is a healthy growth rate, it was down from 7.8% in 2011.

Fig.2: Annual GDP Growth

Source: Statistics Botswana, Econsult



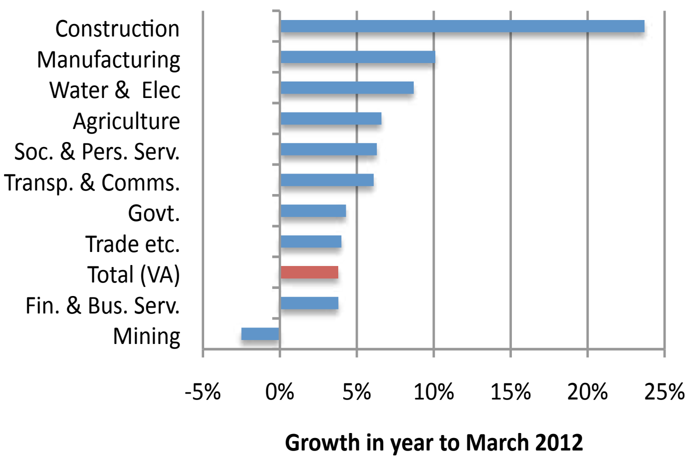
The pattern of sectoral growth was largely unchanged from the previous quarter. Construction remained the fastest growing sector by far, expanding by 25% over the year to March, still being driven by major mining and power projects as well as commercial property development in Gaborone. Manufacturing also grew rapidly, at 10%, and there was growth of over 5% in the water & electricity, agriculture, social & personal services and transport & communications sectors.

Although these non-mining growth figures are reasonably strong, there is a puzzle, in that many firms report that economic conditions are not particularly good, and anecdotal evidence does not seem to corroborate the reported figures. However, the GDP data are being revised and updated, and it may be that the new data will report a different growth picture.

3 Economic Review

Fig. 3: Sectoral Output Growth (VA)

Source: Statistics Botswana, Econsult



International Trade

The international diamond market weakened during the second quarter of 2012. The overall value of diamond sales through DTC during the first half of the year was 12% lower than in the first half of 2011. By mid-year, however, there was increased resistance to asking prices at DTC sights, and reports that some goods offered for sale to sightholders were not being taken up. This reflects a number of factors. First, weakness in the main consuming markets with demand for diamond jewellery adversely affected by declining economic growth and increased uncertainty over economic prospects. Second, this was compounded by developments in India where the depreciation of the rupee increased the local currency costs of imported rough diamonds, and reductions in bank lending to cutters and polishers meant that liquidity was tight. There is a general expectation that diamond sales will remain weak in the second half of the year and rough prices are likely to fall.

Business Confidence

The Bank of Botswana's Business Expectations Survey (BES) for the first half of 2012 shows a small deterioration in business confidence. The survey, carried out between March and May 2012, shows that 51% of firms rated business conditions to be satisfactory, compared to 54% in the second half of 2011. Confidence was significantly higher amongst export-oriented firms than amongst firms oriented towards the domestic market. There is, however, a positive outlook and firms generally expect business conditions to improve over the next 6-12 months.

Fig. 5: DTC Diamond Sights

Source: Rapaport Diamond Report

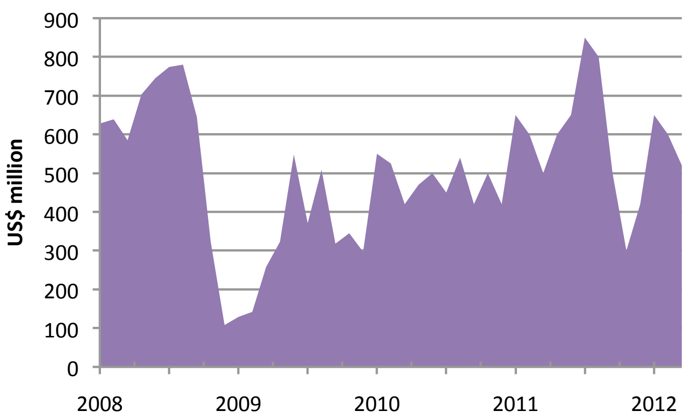
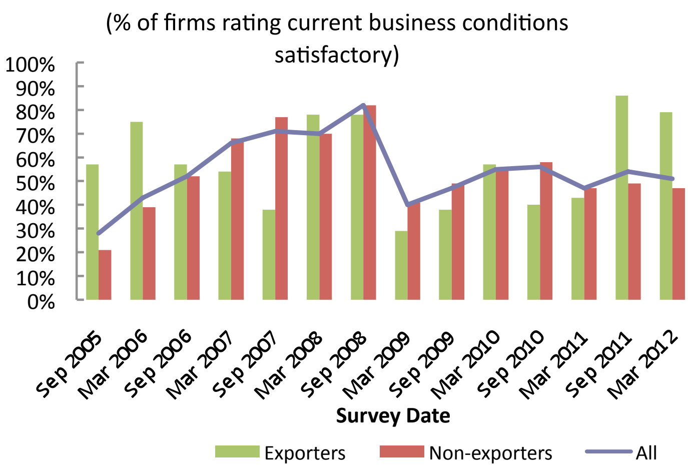


Fig.4: Business Confidence Index

Source: Statistics Botswana, Econsult

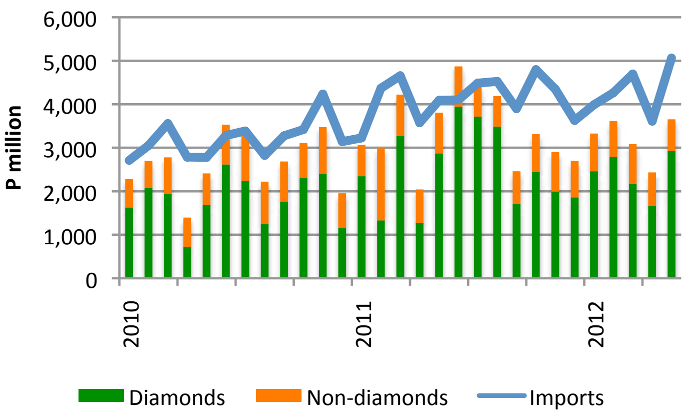


The impact of this on Botswana's diamond exports is difficult to determine, due to conflicting data. According to the Bank of Botswana, diamond exports in the first five months of 2012 totalled P11.2 billion, while according to Statistics Botswana the figure was P12.0 billion. This is due to different methodologies for measuring diamond exports. The two institutions also differ as to whether diamond exports in this period were higher or lower than in the first five months of 2011. This is obviously unhelpful, given the importance of diamond exports to the economy. Whatever the true picture, with the global diamond market likely to remain under pressure in the second half of the year, export performance is unlikely to improve in the near future.

On the broader trade front, imports remain well above exports, and reached a monthly total of over P5 billion for the first time in May. However, this was mainly due to a large increase in the imports of diamonds for the local cutting and polishing industry (diamonds are exported first before being re-imported for cutting and polishing). But even non-diamond imports continue to grow, notably fuel and machinery & electrical equipment. This is despite an expectation that the growth of imports should tail off, with major mining and power projects nearing completion.

Fig. 6: Exports & Imports

Source: Statistics Botswana, Econsult



INFLATION AND MONETARY POLICY

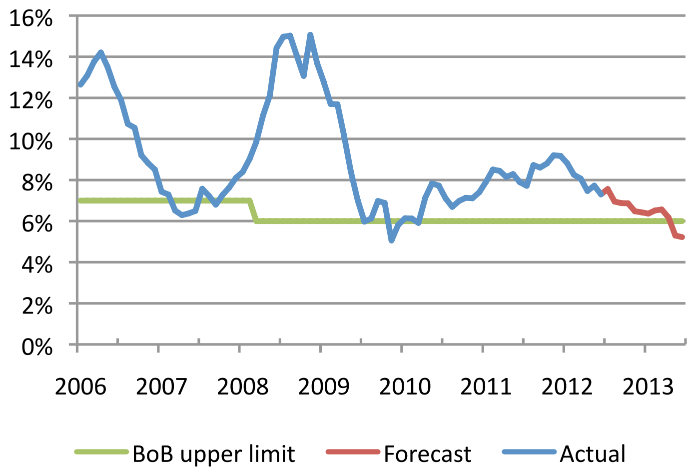
Inflation

Inflation fell from 8.0% in March to 7.3% in June. The decline was largely in line with expectations, although there had been some hope that inflation would have declined even faster.

The good news with regard to inflation is that it declined across almost all categories of goods and services. Food price inflation, which had been increasing through the first quarter, moderated in Q2. More importantly, general underlying inflation (excluding food, fuel and alcohol) fell sharply. However, this may have been largely due to the falling away of the May 2011 increase

Fig.7: Inflation and Forecast

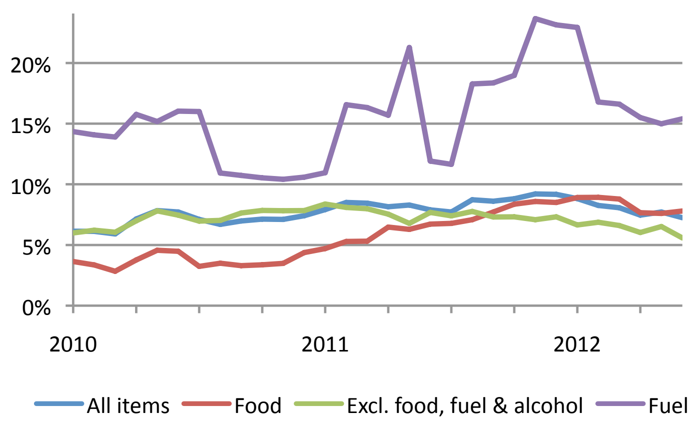
Source: Statistics Botswana, Bank of Botswana, Econsult



in electricity prices, and if electricity prices increase again in the near future, as is expected, this decline may prove to be only temporary. The reduction in food price inflation may also prove to be temporary, given that global prices for wheat and maize have risen sharply in recent weeks as a result of adverse weather conditions.

Fig 8: Inflation by Sub-category

Source: Statistics Botswana, Econsult



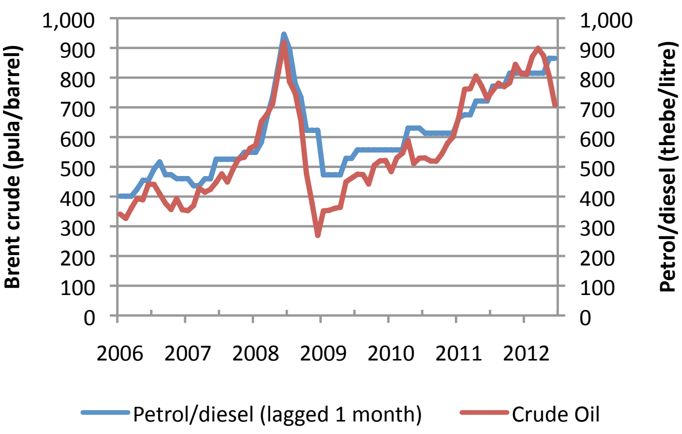
A major concern in recent months has been fuel price inflation, especially as international oil prices were increasing rapidly during the first quarter. For instance, Brent crude – the main benchmark price for Botswana's fuel costs – rose from US$108/barrel at the end of 2011 to $128 in mid-March 2012. The impact on Botswana's import costs was reinforced by the weakness of the rand and pula against the US dollar during this period. However this trend was sharply reversed in Q2, with Brent falling to a low of $89 in late June.

This was fortunate for Botswana, as the delay in increasing domestic fuel prices – which were unchanged between November 2011 and May 2012 – had depleted the National Petroleum Fund, which is used to buffer the impact of global fuel price changes. Furthermore, the situation had led to a sharp increase in arrears in the payments due to fuel suppliers – effectively representing unauthorised government borrowing from the fuel industry, which had to finance the shortfall through bank overdrafts.

The decline in international prices has helped to stabilise the situation, and by the end of June Botswana fuel prices were above international prices, with the consequent "over-recovery" enabling the NPF to start paying off its arrears. Nevertheless, it is unlikely that Botswana fuel prices will be reduced anytime soon. In early July, Brent rose to over $100 again. Furthermore, a prolonged period of "over-recovery" may be necessary to enable the NPF to fully discharge its arrears to fuel importers.

Fig 9: Crude Oil and Fuel Prices

Source: Statistics Botswana, Econsult



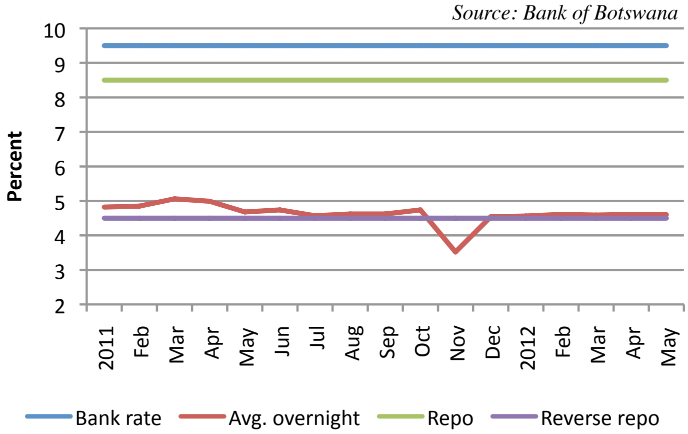
The slower-than-anticipated decline in inflation during the first half of 2012 means that, although inflation should continue to drop in the second half of the year, it is unlikely to fall below the upper end of the BoB's inflation objective range by the end of the year. Our forecast is for inflation to finish the year around 6.5% and to fall below 6% in the second quarter of 2013. Inflation risks remain mainly on the upside, relating to rising international oil and food prices, and domestic electricity prices.

Interest Rates

Interest rates were unchanged during the quarter, with the Bank Rate remaining at 9.5%. With a softening of global economic conditions and a further loosening of monetary policy in both developed and emerging markets, it is now more likely that the next move in Botswana rates will be downwards. However, no changes are likely until inflation falls further towards the top end of the BoB's inflation objective range.

Fig 10: Interest Rates

Source: Bank of Botswana



FINANCIAL SECTOR

Bank credit

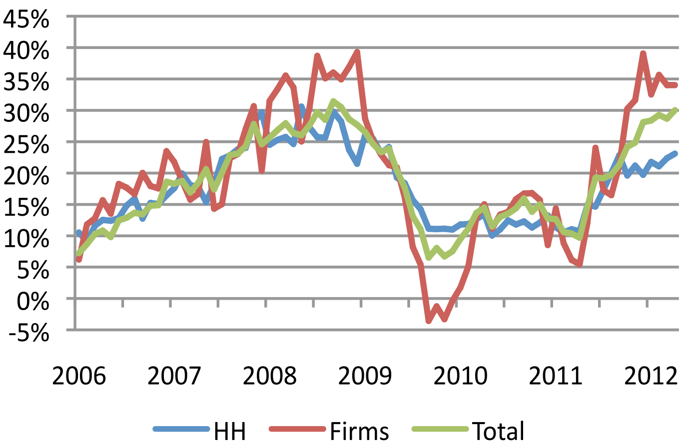
Bank credit growth has remained at fairly high levels, and total credit increased by 30% over the year to April 2012. This has been driven more by credit to the private business sector (up 34%) than credit to households (23%), although the latter has been increasing slowly. There has also been a dramatic increase in lending to parastatals.

These results are positive from an economic point of view. The fact that the majority of new credit is going to businesses (private sector and parastatals) rather than households marks a turnaround from earlier periods when lending to households dominated credit growth. The robust growth of credit to private businesses suggests economic conditions remain positive. Also, it means that the intermediation performance of the banking sector is improving, in that an increasing proportion of deposits is being used to finance lending (rather than being invested in BoBCs).

The Bank of Botswana has recently changed the way in which it reports arrears on bank lending, which means that long-term trends can no longer be identified. As at March 2012, arrears on lending to households, at 4.5% of lending, were much higher than those on lending to businesses (1.9%). Arrears on lending to households were also, on average, overdue for a longer period.

Fig 11: Credit Growth (Annual)

Source: Bank of Botswana, Econsult

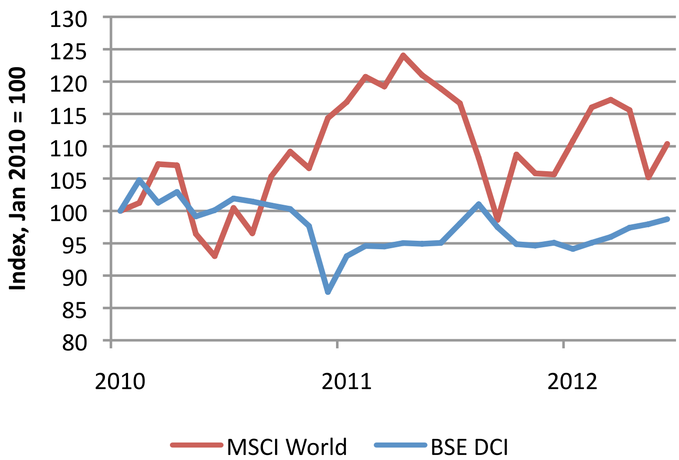


Botswana Stock Exchange

The BSE domestic index has continued a slow recovery, increasing by 2.8% during the second quarter. By contrast, over the same period, the MSCI Global stock market index declined by 5.8%. Over the past two years the BSE has been much less volatile than global markets, although since January 2010 the BSE has underperformed the global index.

Fig.12: Stock Markets

Source: Botswana Stock Exchange

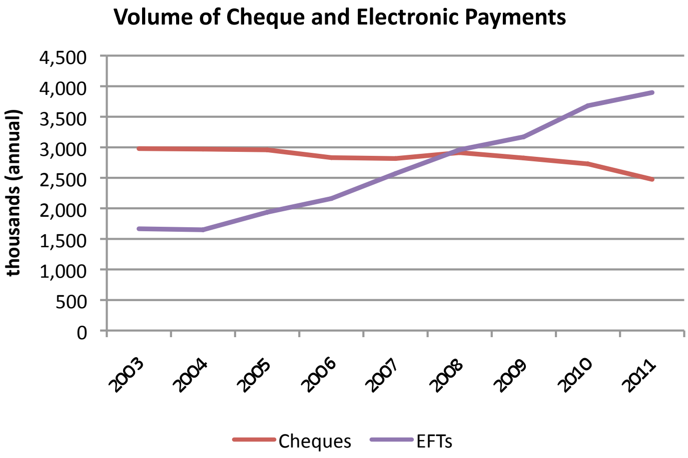


Box: Payments trends

In many countries cheques are going out of style as a means of payment, and Botswana is no exception. Although cheques are convenient for those who are spending money, for the recipient they are risky (they may not be honoured) and slow (receiving value can take several days). They are also expensive for banks to process, and hence the charges for using cheques are high. As a result, many people are reluctant to accept cheques as a means of payment.

Fig.13: Cheques/EFTs

Source: BoB, Econsult



Cheques are being replaced by electronic funds transfers (EFTs), particularly for bulk payments such as wages and salaries, but also for general transactions. Electronic payments are faster, safer and cheaper. Hence the number of cheques being issued is declining – the number processed through electronic clearing house (ECH) fell from almost 3 million in 2005 to less than 2.5 million in 2011. The number of EFTs processed through the ECH has been increasing rapidly, and surpassed cheques in 2008, reaching 3.9 million in 2011. There has also been a shift to card payments at point-of-sale (POS) machines, which increased to 10.3 million in 2011.

However the shift to cards and electronic transactions does not mean we are entirely moving away from cash. The largest number of transactions was for withdrawals from ATMs, of which there were 19.4 million in 2011.

Table 1: Payments Instruments, 2011

	Number (mn)	Value (P mn)	Avg. value (P)
Cheques	2.5	41 632	16,821
EFTs	3.9	78 388	20 114
POSs	10.3	2 617	255
ATMs	19.4	12 671	652

The very largest payments do not go through any of these streams, but are routed through the Botswana Interbank Settlement System (BISS), which is used mainly by the commercial banks and the Bank of Botswana.

Data on cheques, EFTs, POS, ATM and BISS transactions are published by the Bank of Botswana. However, a number of new, and potentially important payments channels are omitted from the published data. These include most online purchases using credit / debit cards, and money transfers using mobile phones. A comprehensive picture of payments trends will need to include these new channels, which in other countries have been the fastest growing of all.

Economic Review

Economic Outlook

The economic outlook for the second half of 2012 is dominated by uncertainty over developments in the global economy, and the likelihood of a further slowdown in global growth. The main impact of this on the Botswana economy will be felt through the diamond sector. Global diamond sales are already slowing, and prices will be under pressure in the second half of 2012. This may require cutbacks in production, which will in turn impact on GDP growth figures. However, production has already been affected by the temporary closure of Jwaneng mine following a fatal accident in early July, and further cuts may not be necessary. Our current estimate is that GDP growth for 2012 will be in the range of 3.5%-4%, some way below the 2011 growth rate of 5.7%.

The slowdown in diamond sales will have broader implications. First, for exports, and second – more importantly – for the government budget. Figures presented at the time of the Budget Speech in February indicated that the government expected to achieve a balanced budget in the 2012/13 fiscal year. However if mineral revenues are adversely affected by lower than expected diamond sales – due to reduced sales volumes and/or prices – this may be difficult to achieve.

Nevertheless, the Botswana economy is reasonably well-placed to withstand the impact of a short-term slowdown in global growth. Both the foreign exchange reserves and government's financial balances can provide a cushion against sort-term declines in exports and government revenues.

The real danger would come from a global recession – a "double dip" – of the kind that could be triggered by a full-blown financial and currency crisis in the Eurozone. While there is still hope that this can be avoided, the fact that the Eurozone is in uncharted territory means that it is very difficult to predict how events will evolve. Should this happen, Botswana – like most countries - is not as well placed as it was before the global recession of 2008-9. This is because the foreign exchange reserves and government financial assets – net of borrowing - are smaller than they were prior to the previous crisis.