Economic Review

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INTRODUCTION

The fourth quarter of 2011 was one of mixed economic developments. Global economic conditions remained unsteady, with generally more negative than positive developments. Domestically, GDP growth for the year to September fell slightly, but the economy remains on course to record growth of around 6% for the year as a whole. Inflation remains a problem, but the fiscal balance is coming out ahead of expectations. Among other interesting developments, preliminary results from the 2009/10 Poverty Survey were released.

GLOBAL ECONOMY

The risky and uncertain global economic environment that we highlighted in the previous edition of the Economic Review has broadly persisted into the final quarter of 2011. In the Euro Zone, the existential crisis that it faces is still unresolved. Economic conditions in the zone have worsened, due largely to cutbacks in government spending in response to debt concerns, combined with a slowly evolving credit crunch as many banks face funding problems and have become more reluctant to lend. It is now very likely that 2012 will be a year of recession for many European economies, providing a drag on global growth. For these and other reasons, many commentators have revised global growth forecasts downwards, with relatively weak growth in the range of 2-3% now being seen as a likely outcome

In the USA, economic conditions have improved somewhat as growth, job creation and consumer expectations have generally come in ahead of expectations, and this has provided something of a counterweight to adverse developments in Europe. Unfortunately, two other threats to global economic conditions have emerged recently. The first is the likelihood of a growth slowdown in China, or even a "hard landing" as measures are taken to rein in inflationary pressures, and export growth declines due to the global slowdown. There is also concern about over-investment in property in China, and the risk that the property "bubble" will burst.

The second threat to global growth is the risk to oil prices as geopolitical tensions rise in the Middle East. Recent movements in oil prices have been upwards, whereas slowing global growth would normally be expected to lead to lower prices. Any further increases in tension, say over transit for oil supplies through the Straits of Hormuz or over Iran's nuclear programme, could cause prices to spike further, which would push up global inflation and reduce growth even further.

THE BOTSWANA ECONOMY

Economic Growth

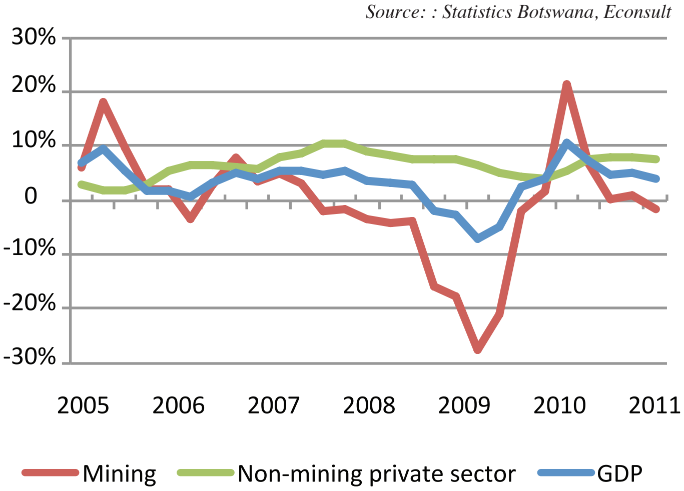
GDP figures for the third quarter of 2011 show that the economy grew by 4.1% in the year to September, down from 5.1% annual growth in the year to June. The decline was largely due to lower mineral output, with the mining sector contracting by 1.7% over the year. This in turn was due to both lower diamond output and sharp drop in copper-nickel production following the temporary closure of the BCL smelter. Outside of the mining sector, however, the growth story was more positive, with the non-mining private sector growing by 7.6%, only marginally down from the 7.9% recorded in the year to June.

At the sectoral level, growth continued to be led by the construction and manufacturing sectors. For construction, this is presumably reflecting the impact of new mines and power infrastructure as well as commercial property development. For manufacturing, the detailed source of growth is difficult to identify because it is largely coming from the all-encompassing

2 Economic Review

Fig. 1: Annual GDP Growth

Source: : Statistics Botswana, Econsult



but ill-defined "other manufacturing" sub-sector. However, manufacturing exports, apart from meat, have generally performed well. Other reasonably buoyant sectors with growth of over 5%, include transport & communications and trade. Slow growing (below average) sectors were agriculture, government, social & personal services, and water & electricity, as well as mining. As has been the case for some time, however, the interpretation of GDP and sectoral growth rates is complicated by concerns about the reliability and quality of the underlying data.

Although the GDP growth rate has declined, this should not be of too much concern as it is primarily driven by developments in the mining sector that are to a large extent an unintended consequence of the volatility of quarterly diamond production levels. It is likely that this negative impact will have fallen away in the fourth quarter of 2011, and as a result the GDP growth rate for the year as a whole should be around 6%.

Business Expectations

The results of the Bank of Botswana's Business Expectations Survey undertaken in September 2011 showed an improvement in business confidence. A small majority of firms (54%) rated current business conditions as satisfactory, up from 47% in March 2011. The main driver of this result was a very sharp increase in the confidence levels of exporters, which doubled from 43% to 86% - a surprising result that is perhaps more of a reflection of the poor response rate to the survey and hence the small size of the sample of exporters than of a fundamental change in underlying expectations. Amongst firms supplying the domestic economy, there was a small improvement in confidence from 47% to 49%.

Looking further ahead, exporters forsee a slight deterioration in business conditions over the next 6-12 months, leading to an overall balance of 50% of firms being optimistic in business conditions in 6 and 12 months time.

Fig. 2: Sectoral Output Growth (VA)

Source: Statistics Botswana, Econsult

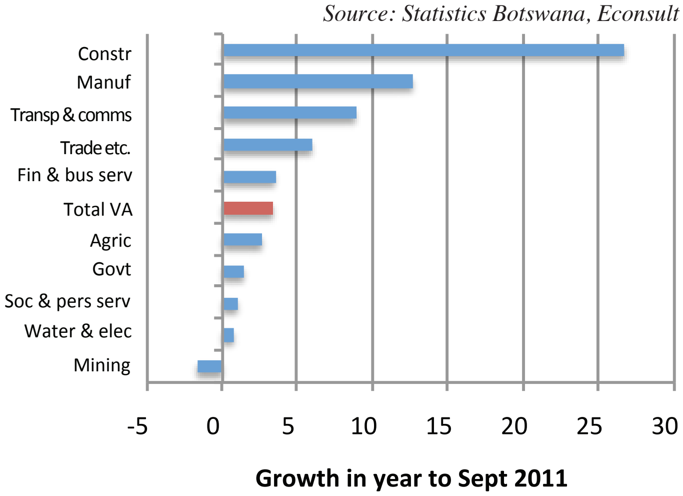
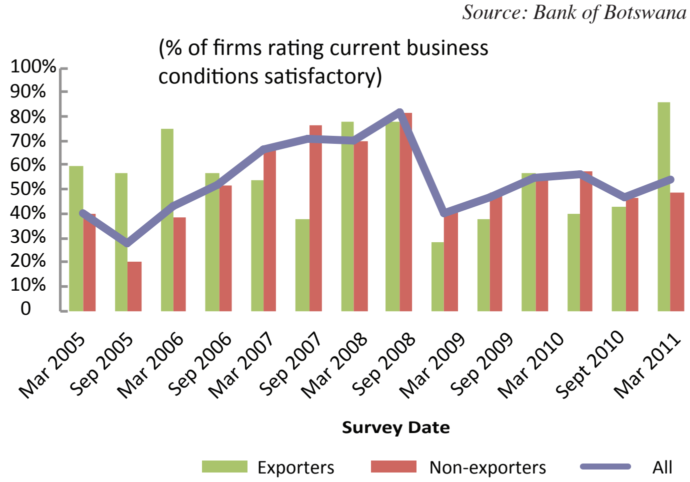


Fig. 3: Business Confidence Index

Source: Bank of Botswana



3 Economic Review

Trade and Balance of Payments

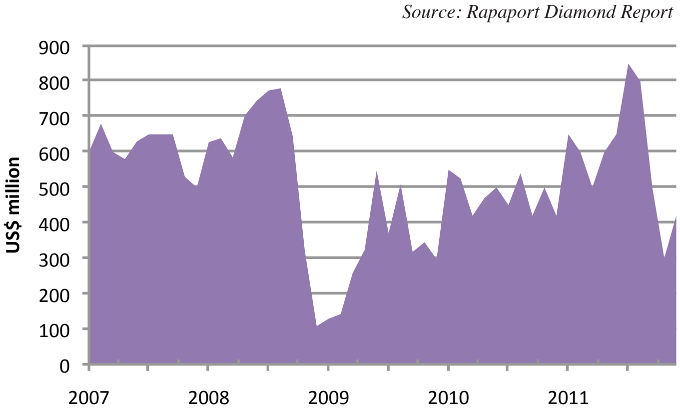
The main influence on trade performance continues to be the international diamond market, which had a year of two quite distinct halves. As explained by Rapaport diamond report:

"diamond price increases were spurred by strong buying in the first half of the year. However, global economic uncertainties and tight liquidity in the cutting centers caused prices to soften in the latter half. Price increases between January and June 2011 were influenced by an aggressive overheated rough market driven by over-easy credit in the Indian market, speculative demand and significant restocking by retailers in the Far East and subsequently in the U.S. The second half of the year was influenced by increasing uncertainty caused by the U.S. and European economic crises, volatile financial, currency and commodity markets, as well as continued political instability in the Mideast. Tight liquidity, particularly in India, impacted trading from July as manufacturers were unable to obtain replacement costs on the high rough prices they had paid earlier in the year".

Botswana's exports were dominated by the impact of this volatility. The last two DTC diamond sights of 2011 were the smallest of the year and were characterised by low volumes and weak prices. As a result the strong diamond export performance through to August gave way to sharply reduced exports from September onwards.

Fig 4: DTC Diamond Sights

Source: Rapaport Diamond Report

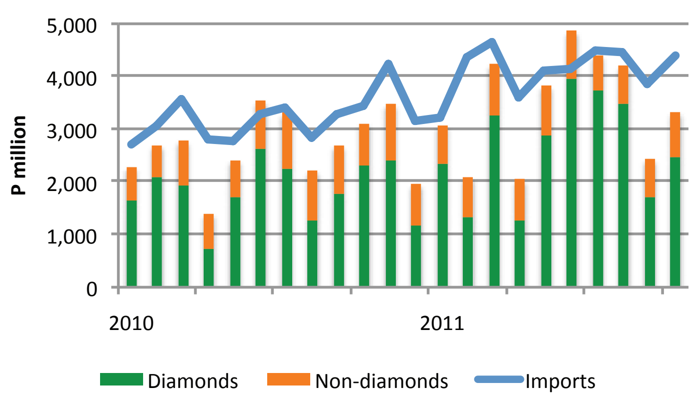


The weakening of diamond exports was compounded by reduced copper-nickel exports (due to the closure of the BCL smelter for maintenance), and low beef exports (as a result of non-compliance with EU veterinary regulations and hence inability to access the EU market).

In the meantime imports have been generally rising, averaging P4.1 billion a month during 2011 (to October), compared with an average monthly export value of P3.4 billion. The main drivers of increased imports have been machinery and equipment (mostly for mines and power generation) and diamonds (for the cutting & polishing industry). The balance of trade deficit increased in Q3, after declining in Q2. It is not possible to say whether this is accompanied by an overall balance of payments deficit, because the BoP data (from the Bank of Botswana) has a lag of 6-9 months (compared to 2-3 months for trade data). However, for most of the past three years the BoP has been in deficit, except for quarters when there have been large drawdowns of external loans.

Fig. 5: Exports & Imports (monthly)

Source: Statistics Botswana, Econsult



Although exports declined towards the end of 2011, the picture is not all gloomy, especially when viewed over a longer period. Over the 12 months to October 2011, overall goods exports were 27% higher than in the previous 12 month period. Other than the poor performance of meat and copper-nickel exports, most other categories did quite well, with diamond exports up 40%. There was strong performance across all categories of manufactured exports, apart from meat, ranging from 36% growth for machinery & electrical equipment to 91% growth for textile & garment exports. This is consistent with the strong manufacturing growth seen in the GDP data.

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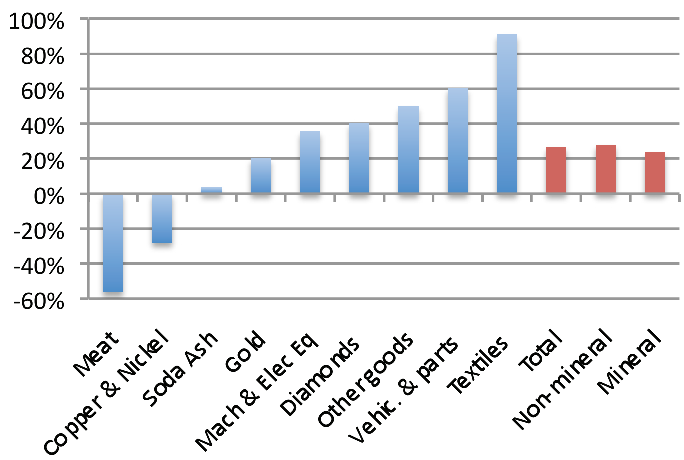
Fig 6: Export Growth by Category

Source: Statistics Botswana, Econsult



Box: Anglo American buyout of Oppenheimer family share of De Beers

The announcement that agreement has been reached for Anglo American to buy out the Oppenheimer family share of De Beers (40%) for $5.1 billion is potentially a significant development for Botswana. It will certainly mark a change in relationships at the level of Debswana – Anglo will take over the running of De Beers from the Oppenheimers, and hence the Botswana Government will now deal directly with Anglo American as its effective co-shareholder in Debswana. Anglo has a very different business ethic to the Oppenheimers – with a "business first" focus rather than a concern with "family history and tradition". A big issue is whether GoB will exercise its right to buy an additional 10% of De Beers (to take its total shareholding to 25%), and if so, at what price. With Anglo paying $5.1 billion for 40% of De Beers, a pro-rated 10% would cost $1.275 bn, or about P9.5 billion. This is a lot of money, and would make a big hole in government's accumulated savings; as at October 2011, these savings (in the form of deposits at the BoB) amounted to P25.7 bn. Even if the funds are available, it would still be a very large expenditure for the government, and needs to be assessed against other possible uses of the funds.

The purchase enabled Anglo to move from being a minority shareholder in De Beers to majority control. This was important for them, and was presumably reflected in the price paid. For Botswana, however, there would be less of a strategic benefit in increasing its shareholding – moving from a 15% shareholding to 25% offers little advantage, suggesting that purchasing the shares, especially at a time of budget constraints, would not be advisable.

Would the purchase be worthwhile simply as an investment? The purchase would represent around 15% of the foreign exchange reserves. Prudent portfolio diversification would not support investing such a large proportion of the reserves in a single asset. Indeed, a prudent investment diversification strategy more generally would suggest that Botswana should not increase its very high exposure to the global diamond industry any further, unless there are clear strategic economic reasons for doing so (as could be argued, for instance, in the case of the cutting and polishing industry).

As to whether the shareholding in De Beers would be worthwhile in terms of the returns it would generate, that is difficult to say. The price paid by Anglo American presumably reflects both expected future income and a "control premium". If Botswana has to pay the same pro-rata price, as a minority shareholder it may not be a good deal. And while future income streams are by necessity difficult to predict, it is worth noting that over the past few years De Beers' earnings have been very volatile; it is quite likely that such volatility will continue, making a shareholding in De Beers a potentially risky investment.

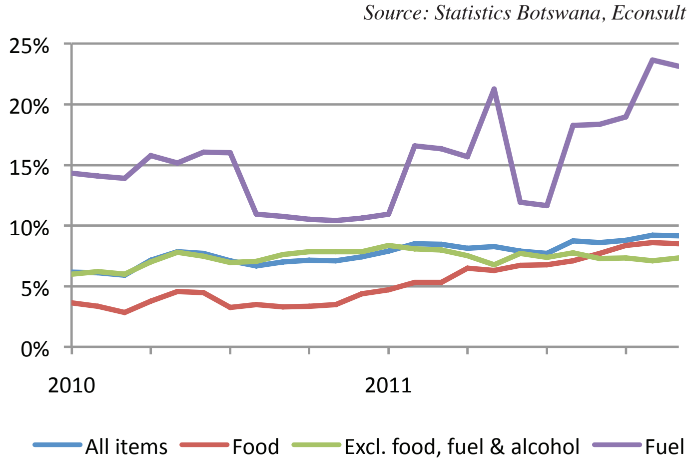
Although there has been negative comment in the press regarding the deal, it is difficult to see anything in it that could damage Botswana's interests. At worst it should be neutral, but it is more likely that it will benefit Botswana, by bringing about improvements in the management of De Beers and providing improved access to capital for the company.

Inflation and Monetary Policy

The inflation record has been disappointing in 2011. Inflation ended the year at 9.2%, up from 7.4% at the end of 2010, and averaged 8.5% for the year. The main driver of higher inflation has been international oil prices, with some additional pressure from food prices. On a more positive note, underlying inflation (excluding food, alcohol and fuel) has gradually declined during the year.

Fig 7: Inflation by sub-category

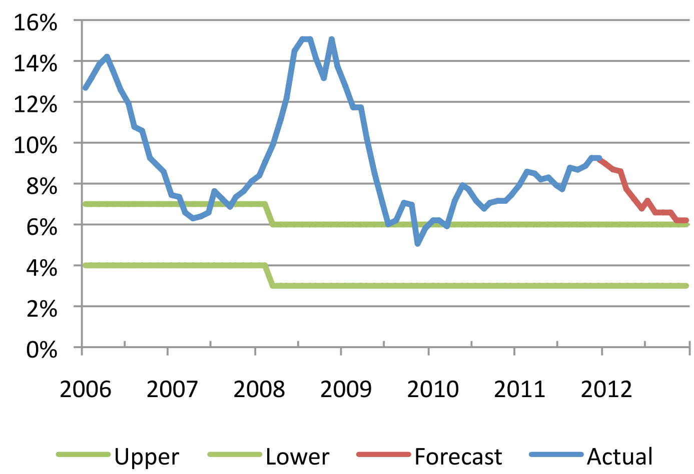
Source: Statistics Botswana, Econsult



The year-end inflation rate should mark the peak of the current inflation cycle, and inflation should decline steadily through 2012. Our forecast is for inflation to end the year around 6%, which is the upper end of the Bank of Botswana's inflation objective range. The main threat to this projection comes from international oil prices, with geopolitical issues threatening counter the downward pressure on prices that should otherwise result from a slowing world economy.

Fig 8: Inflation and Forecasts

Source: Statistics Botswana, Econsult



On the monetary policy front, the Bank Rate has been maintained at an unchanged level of 9.5% throughout the year. Given that the Bank Rate is used by the BoB as the main signal of its monetary policy stance, this indicates no change in monetary policy, despite rising inflation. The unchanged policy stance is justified by the fact that the medium term forecast is for inflation to fall within the target range within the next 12-18 months.

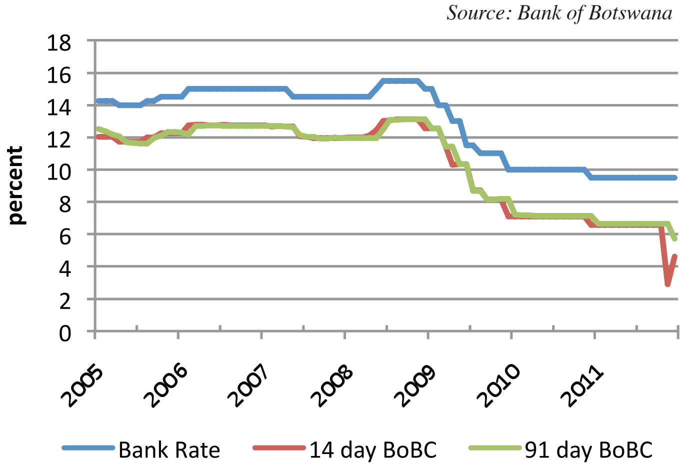
Nevertheless, there have been some major changes in the implementation of monetary policy in the last quarter of 2011, which have led to a de facto easing of monetary policy. In November, the BoB changed the management of Bank of Botswana Certificate (BoBC) auctions. Previously, sufficient BoBCs would be made available at weekly auctions to mop up all excess liquidity offered by the banks. The BoBC interest rates that emerged from the auctions were maintained in a stable relationship with the Bank Rate, and changes in the Bank Rate were matched by changes in BoBC rates.

With the decision to limit the availability of BoBCs, interest rates at auction dropped precipitously, with the 14-day BoBC rate falling from 6.6% to 2.9% during November. This inevitably fed through to bank deposit rates, many of which fell to close to zero. Given that this was not a desirable outcome, further changes were introduced in December, and the 14-day BoBC rate recovered to 4.6%.

The move was driven by concerns about the cost of absorbing excess liquidity through BoBCs. This cost reduces BoB's profits and the amount it can pay to government as dividends. An earlier move to increase the required reserve ratio imposed on bank deposits from 6.5% to 10% had been driven by the same concern.

Fig 9: Interest Rates

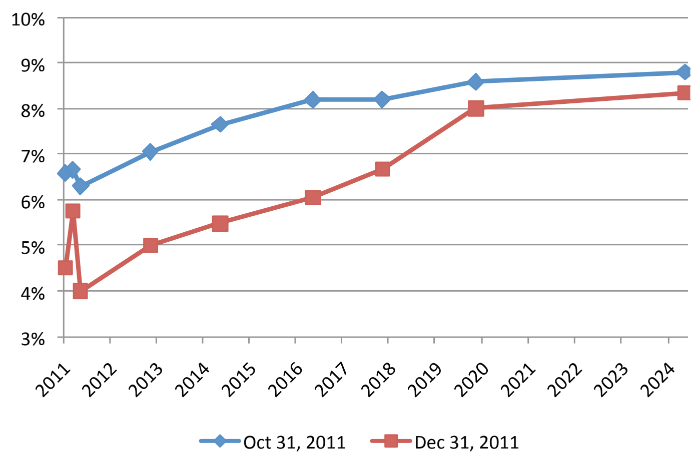
Source: Bank of Botswana



The result of all of these changes is that the yield curve has moved significantly with a sharp reduction at the short end and an overall steepening. This is probably good in many respects, and should encourage a shift to longer-term deposits. However, the cost will be lower interest rates for many depositors, who keep money in call or short-term deposits. It may also encourage some excess liquidity to flow offshore, which would also be beneficial.

Fig 10: Yield Curve (Govt Bonds & BoBCs)

Source: Bifm

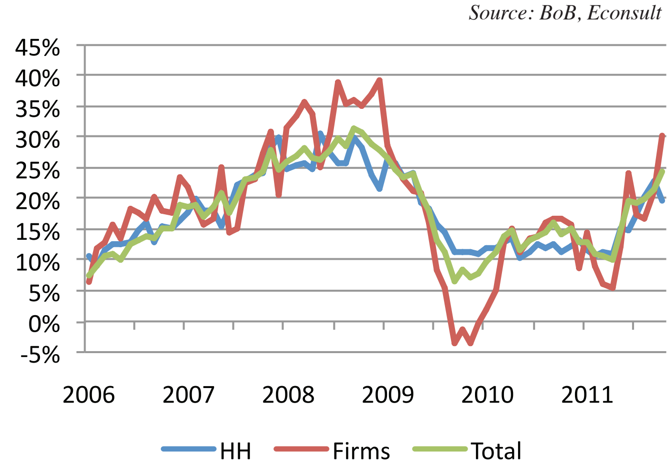


Bank Credit

The growth of bank credit is a useful indicator of general economic conditions, as well as being a direct measure of financial intermediation by the banks. As in many other countries, credit growth dropped sharply following the global financial crisis and recession, but has since recovered and has been increasing steadily during 2011. In the year to October, bank credit grew by 24%, reflecting growth of around 20% in household credit and 30% in credit to private businesses. The latter reflects in part the funding by a syndicate of banks of the Morupule Colliery expansion. Even without this, the relatively fast growth of credit to both households and business suggests an underlying dynamism in the economy, perhaps surprisingly

Fig 11: Credit Growth (Annual)

Source: BoB, Econsult



NB: adjusted for changes in definitions and coverage given the slow growth of government spending and perceptions of squeezed real incomes.

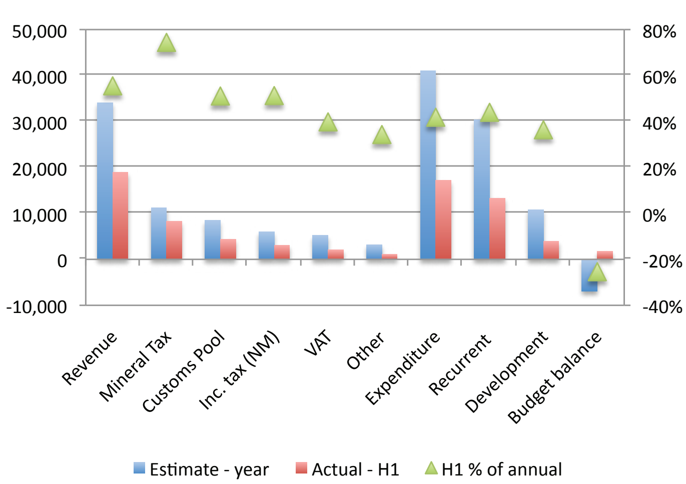
Fiscal Developments

As the Minister of Finance and Development Planning prepares his 2012 Budget, he will have been encouraged by fiscal developments in the first half of the 2011/12 fiscal year (April – September 2011). Revenues were ahead of budget at 56% of the estimate for the whole year, driven by buoyant mineral revenues, which had already brought in 74% of the estimated annual figure by the end of the half-year. Expenditure was somewhat restrained, with only 44% of the annual budget spent in the half year. As a result there was a budget surplus of P1.8bn for the period, compared to a projected deficit of P6.9 bn for the whole year.

The figures for the first half of the fiscal year cannot be extrapolated to the whole year, as the first and second halves of the year are likely to be different. Mineral revenues could be significantly lower in the second half, with the weakening of the global diamond market and reduced diamond exports. Expenditures tend to be higher in the second half, with a rush to spend before the financial year-end in March. So it would not be appropriate to conclude that there is likely to be a surplus for the year as a whole, or even a balanced budget, but it is likely that the budget outturn for 2011/12 will be more favourable than was anticipated at the time of the 2011 Budget.

Fig 12: Fiscal Balance - Actual vs Estimate

Source: BoB, MFDP, Econsult



These favourable budget developments, indicating that the government is on track to meet its objective of a balanced budget in 2012/13, underpinned the November decision by Moodys Investors Services to upgrade Botswana's sovereign credit rating outlook from negative to stable.

OUTLOOK

As we move into 2012, the economic outlook for the first quarter of the year is decidedly mixed. Internationally, the prospect is for weak global growth that will feed through to the demand for export commodities that Botswana is dependent upon. Diamond prices, for instance, are expected to fall again in early 2012, continuing the trend set in the second half of 2011. Nevertheless, barring any major adverse developments – such as a cascade of sovereign defaults and/or countries leaving the Eurozone, or problems over global oil supplies – the situation should be manageable.

Domestically, economic activity first quarter of the year has already been adversely affected by widespread power shortages and unpredictable load shedding, which has caused serious disruption. Many firms have incurred significant losses – whether material losses or inability to fulfil contract commitments – along with additional expenses for the purchase and operation of generators. Generally, power shortages – which fundamentally reflect poor long-term planning as well as poor short-term management of supply capacity – add to the risks and costs of doing business and undermine the business climate. While there should be relief later in the year when Morupule B comes on stream, the threat of power shortages will remain for at least the rest of Q1.

Other aspects of the domestic economy are perhaps more positive. Inflation should decline gradually through the year – barring any unexpected oil price shocks. The fiscal position has improved faster than seemed possible in the aftermath of the global financial crisis, and this will give the Minister of Finance & Development Planning some room to manoeuvre in the Budget to be delivered on February 1st, which will be welcome. The medium-term budget projection published at the time of the 2011 Budget envisaged a significant cut in government spending – around 12% - to achieve a balanced budget in 2012/13, including a massive 47% cut in development spending. It would be difficult to achieve spending cuts of this order of magnitude, and as developments in Europe have shown, such austerity – even when necessary for fiscal sustainability – have a negative economic impact in the short-term.

The improved fiscal situation will relieve some of this pressure. Spending restraint will still be necessary, and overall spending will probably still be cut in the coming budget, but by a lesser amount than anticipated a year ago. This will make it easier to maintain economic growth, and will also help to avoid some of the conflicts that necessarily arise when public spending is cut. There may also be some limited scope for a public sector pay increase.

However, favourable fiscal developments do not mean that the spending taps will be open again. The public spending reforms that have been outlined in the last two budget speeches are still necessary. In particular, there is a need for greater discipline in development spending. Public investment spending needs to be subject to proper evaluation to ensure that funds are only allocated to projects that are likely to have a positive socio-economic impact commensurate with the cost, that project planning and implementation is improved, and that maintenance and recurrent expenditure implications are properly provided for.

Botswana's GDP growth prospects for 2012 are reasonably positive, taken in a global context. The World Bank is forecasting 6.2% GDP growth for the year in its January 2012 Global Economic Prospects. Our forecast is slightly lower than that of the World Bank, at around 5%, on the basis that the growth of both diamond production and the non-mining private sector will be lower than in 2011. There are risks to this forecast of course, mainly on the downside. The primary risks are those emanating from the Euro Zone, where an intensification of the financial and fiscal crisis could tip the world economy into full-blown recession, rather than just a period of slower growth. This would have an adverse impact on Botswana, particularly on the mining sector, and make it difficult to sell more diamonds. Domestically, growth will be influenced by the fiscal programme presented in the 2012 Budget; if sharp cuts in government spending are necessary to balance the budget, the 5% growth target will be more difficult to achieve.

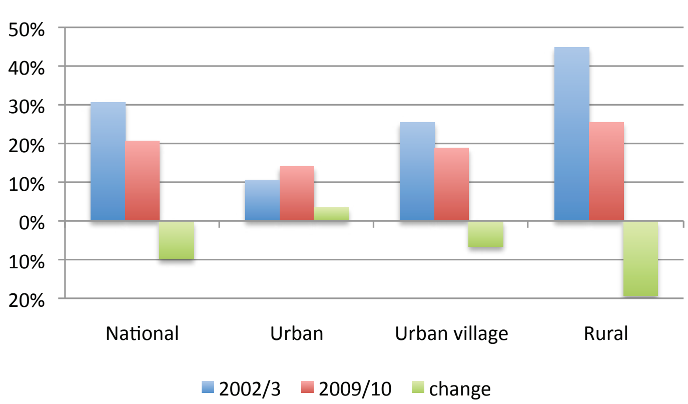
Box: Results of the 2009/10 Core Welfare Indicators (Poverty) Survey

Statistics Botswana released preliminary results from the 2009/10 Botswana Core Welfare Indicators Survey (CWIS) in December. The CWIS is a follow up to earlier Household Income and Expenditure Surveys (HIES) and, like them, can be used to obtain various measures of poverty and inequality, as well as information on household consumption and savings patterns, and sources of income.

The headline results of the 2009/10 CWIS show that the headcount poverty rate (the proportion of the population living in households with incomes below the poverty datum line) was 20.7%, down from 30.6% in the 2002/3 HIES. Although the poverty rate is still high by the standards of middle-income countries, the substantial drop is a very welcome development. Looking in more detail, the decline in poverty was most dramatic in rural areas, where it fell from 44.8% to 25.5%. Poverty also fell in urban villages, while urban poverty is reported to have increased slightly.

Fig 13: Poverty (Headcount) Rates, 2002/3 & 2009/10

Source: Statistics Botswana, Econsult



Economic Review

According to the CWIS, average monthly household income across the whole country in 2009/10 was P5,800, and had grown by 2.5% a year in real terms since 2002/3. This is consistent with the decline in the national poverty rate. What is odd, however, is the relationship between changes in poverty and real household incomes in different settlement types. Although urban poverty is said to have risen, it is urban household incomes that have risen at the fastest rate (5% a year on average), to an average of P11,500 a month. And while rural poverty is said to have declined, average rural household incomes have fallen, to P2,350. It is difficult to imagine how urban poverty could have increased at the same time as incomes were rising, or rural poverty falling at the same time as incomes were declining. It is only in urban villages that the results for changes in poverty and real incomes appear to be consistent.

These are only preliminary results and a more comprehensive assessment will need to await the release of the detailed results, including information on income distribution, and the full dataset, which is scheduled for February. But the results so far raise as many questions as they answer.

Fig 14: Change in Average Household Incomes (annual average, 2002/3 - 2009/10)

Source: Statistics Botswana, Econsult