Economic Review

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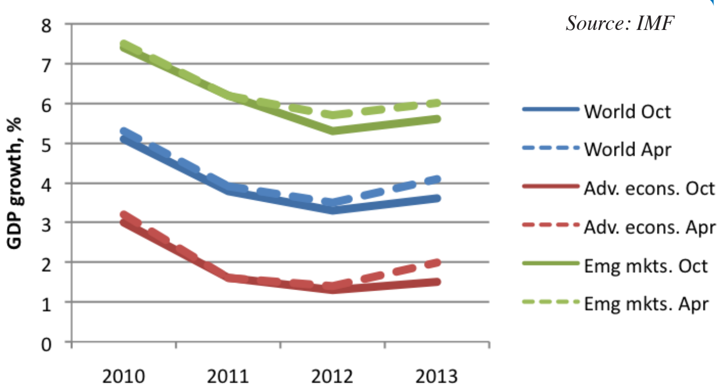
INTRODUCTION

The third quarter of 2012 was a period of mixed economic developments and news. Prospects for the global economy deteriorated as uncertainty mounted and growth forecasts were revised downwards. This has had an effect on the domestic economy, with reduced mining output. On a more positive note, Botswana's economic growth for the year to June 2012 held up well at 7.7%, and newly revised GDP data showed that in recent years the economy was more diversified and has grown faster than had earlier been thought.

GLOBAL ECONOMY

Global economic prospects remain highly uncertain and have gradually deteriorated through 2012. Although global economic growth has been recovering, the recovery is slow and growth forecasts for 2012 and 2013 have been steadily revised downwards. The IMF's forecasts, released in the October World Economic Outlook, now project global growth at 3.3% in 2012 and 3.6% in 2013, both significantly lower than the forecasts presented six months earlier.

Fig.1: IMF Growth Projections



The factors causing uncertainty and weak growth are familiar ones. In the advanced industrialised economies, the growth recovery is weighed down by fiscal austerity measures aimed at reducing government borrowing and weak financial systems, resulting in limited credit availability. This is compounded by uncertainty resulting from the still unresolved euro area crisis and the looming "fiscal cliff" in the USA - the automatic tax increases and spending cuts that are due to come into effect around the end of 2012 – which could severely undermine growth in the world's largest economy.

This environment has in turn led to reduced growth in China, which is still highly dependent upon exports to industrialised countries, and in other important emerging market economies such as Russia, Brazil and India. Capital flows, especially to emerging markets, have been volatile due to alternating "risk-on" and "risk-off" episodes.

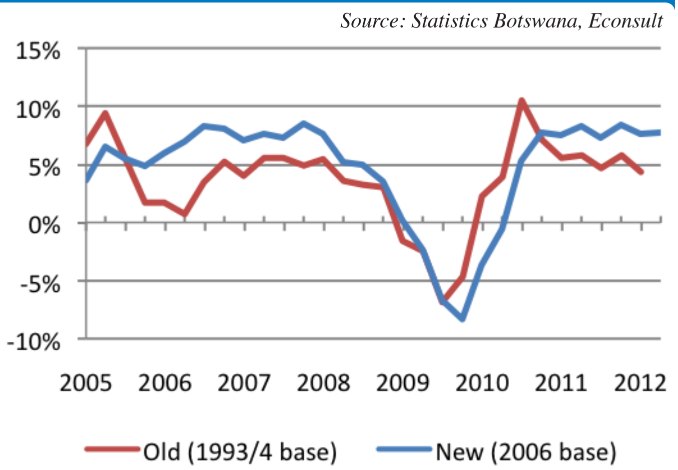
At present, risks to global growth are largely on the downside, especially those emanating from the euro area. While policy actions can help to build the conditions for a restoration of growth, it is evident that policy options are limited, especially in developed economies. Fiscal policy is constrained by high levels of public debt, and monetary policy by interest rates that are already at historically very low levels.

Botswana Economic Developments

ECONOMIC GROWTH

Despite the difficult global economic environment, economic growth in Botswana has held up well. Real GDP growth for the year to June 2012 came in at 7.7%, similar to the year to March at 7.6%. The 2012Q2 data are the first to be released on the basis of the rebased and revised GDP series (see Box later in this Review), and some historical growth rates have been changed. For instance growth in the year to March 2012 was previously recorded at only 4.3%. For the recent past – i.e. since the global financial crisis and recession in 2007/8/9 - the new figures present a picture of an economy that is faster-growing and more diversified than that depicted by the old data series.

Fig.2: Annual GDP Growth, Old and New series

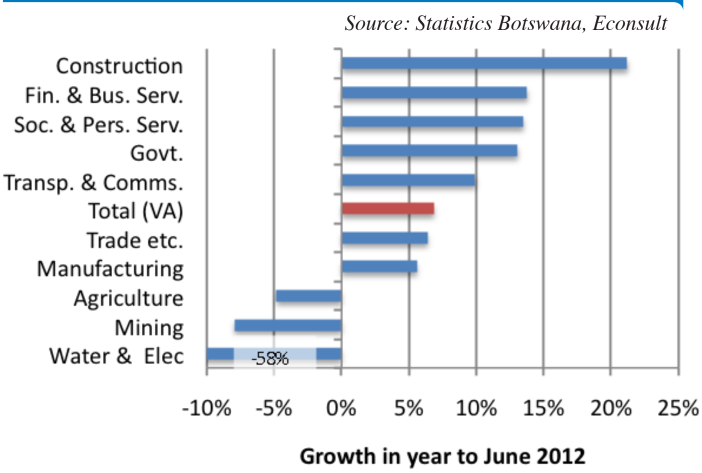


The strong overall growth rate was recorded despite a negative contribution from the mining sector, which contracted by 8.0% in the year to June 2012. The non-mining private sector grew by 9.7% over this period.

Several sectors recorded strong growth over the period: construction was the leading sector (as previously), with growth of 21.2%, followed by finance & business services (13.8%) and social & personal services (13.5%) and government (13.1%). Some of these numbers are difficult to believe, especially the high rates of growth for construction and government, which are completely at odds with reports of the levels of activity from those directly involved in these sectors. These inconsistencies (and other issues) suggest that the new GDP data still need to be carefully reviewed for accuracy.

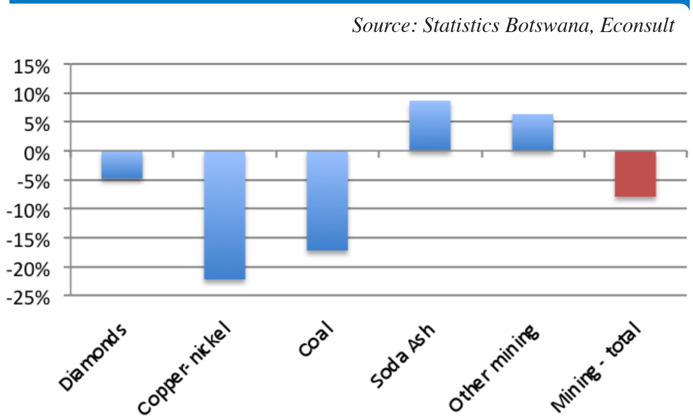
By contrast, agriculture, mining and water & electricity all contracted. The latter is particularly noteable, as the sector contracted by 58% over the year, despite the fact that Morupule B power station came (partially) on stream. The explanation is that what is being measured is "value added" in the sector, broadly speaking the difference between the value of output and the value of inputs (other than capital and labour). In the case of the electricity sub-sector, value added is negative, reflecting the fact that more and more inputs have been used to produce the electricity sold to customers. This may reflect the very high reliance on diesel-fuelled generation (rather than imports from South Africa, which were much cheaper), as well as overhead and administration costs within BPC.

Fig.3: Sectoral output growth (VA)



Although overall growth has held up well, the mining sector has contracted again, continuing a trend of negative growth that has been in place since the third quarter of 2011. The further slowdown in the year to June was driven by reduced diamond production, compounded by an even larger decline in the production of copper-nickel and coal, and only offset to a small extent by growth in the production of gold and soda ash.

Fig.4: Mining sub sector growth, year to June 2012



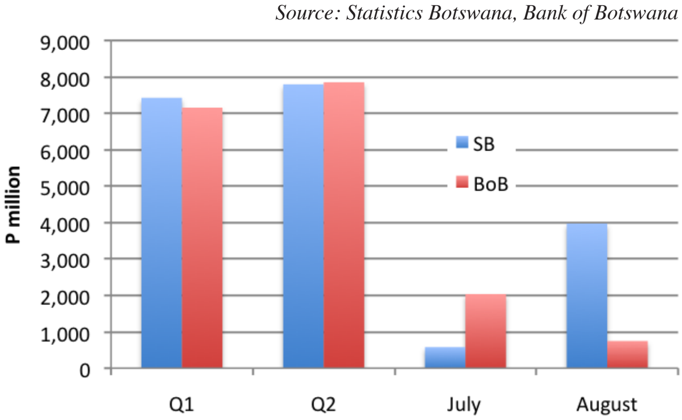
TRADE AND BALANCE OF PAYMENTS

Conditions in the international diamond market have continued to deteriorate in the third quarter of 2012. Demand in the traditional major markets in the USA and Europe has been weak for the past year, but this has to some extent been compensated by continued strong growth in the emerging markets of China and India. However, growth in these markets has now slowed, causing further weakness in the global market for rough diamonds. This has been compounded by liquidity shortages in the main cutting centres, meaning that cutting and polishing firms have had to cut back on their purchases. De Beers has cut the prices of diamonds on offer at DTC sights, which has at least had the positive effect of bringing rough prices more in line with polished prices. Rapaport Diamond Report estimates that overall DTC sales were down 17% in the first ten months of 2012, compared to the previous year.

The exact impact of this market weakness on Botswana's diamond exports is difficult to ascertain, due to conflicting data from different sources. Data on diamond exports are published by both Statistics Botswana (SB) and the Bank of Botswana (BoB). In principle, they are reporting the same quantity, but in practice they use different methodologies and data sources. The contrasts between the two were particularly extreme in July and August 2012, and no clear picture emerges of export trends. Whereas the SB data indicate that diamond exports were 11% lower in the first eight months of 2012 as compared to the same period in 2011, the BoB data indicate that the decline was 27%.

Fig. 5: Diamond Exports, 2012

Source: Statistics Botswana, Bank of Botswana



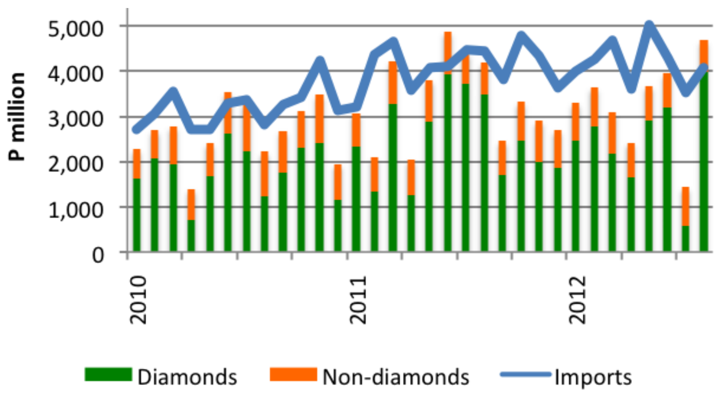
The current situation with regard to data on diamond exports is quite unsatisfactory, given that this is one of the single most important economic variables in Botswana. The export figure also receives a great deal of international attention, given that Botswana is the world's biggest diamond exporter. In our view, neither the SB data nor the BoB data are satisfactory. Due to the methodology used by SB (and BURS, which is the source of the SB data), it cannot accommodate supplementary payments due to price revisions that may occur between the time the diamonds are exported and the time that they are sold; these price revisions can be quite significant. The BoB data - which are published first and hence receive the most international attention – are incomplete, in that they do not (initially) include data on the exports of polished diamonds. Although this is clearly pointed out in a footnote to the BoB data, it may be counterproductive to prematurely publish inaccurate data, especially when the detailed qualifications and subsequent revisions are likely to be ignored.

But perhaps more importantly, it would be quite straightforward to improve the quality of the published data. First, by publishing separate data for exports of rough diamonds and exports of polished diamonds – neither BoB nor SB do this at present (or at least not in a readily accessible form). Second, by making use of the Government Diamond Hub office, which has to issue export certificates for every single consignment of diamonds, and which therefore has access to virtually real-time data on exports. Despite this being a seemingly obvious source of accurate export data, neither BoB nor SB appear to use it at present. Given the importance of accurate and timely information on diamond exports, it is crucial that the various official agencies co-ordinate their efforts to provide information that is better and more consistent than we have at present.

The uncertainty over the value of the country's largest export obviously means that the overall trade data are similarly uncertain. Nevertheless, the positive news is that, according to SB, in August Botswana experienced the first monthly trade surplus since June 2011, and only the third monthly trade surplus since the global financial crisis erupted in the fourth quarter of 2008. This is partly due to the levelling off of imports, which although still high by

Fig. 6: Exports and Imports

Source: Statistics Botswana, Econsult



historical standards, seem to have stabilised at an average of around P4 billion a month.

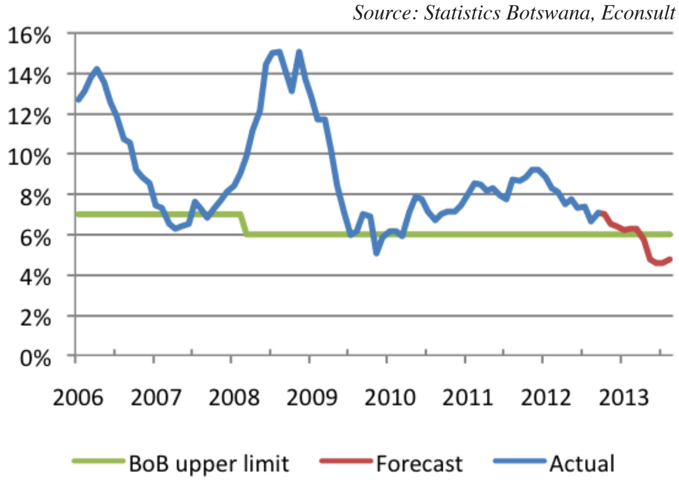
INFLATION AND MONETARY POLICY

Inflation

Inflation has behaved largely as expected and ended the quarter at 7.1% (September), down slightly from 7.3% at the end of the previous quarter (June). A temporary drop to 6.6% in August reflected the impact of fuel price increases, which were timed differently in 2012 as compared to 2011. Inflation should decline slowly through to the end of the year, and we expect a rate of around 6.5% by year-end.

Fig. 7: Inflation and Forecast

Source: Statistics Botswana, Econsult



Apart from the impact of fuel prices, there have been declining inflationary pressures in most other commodity groups. Even rising international food prices do not seem to have resulted in regional or domestic price pressures, and food price inflation has remained below 8%. Generalised price pressures – for all items excluding food, fuel & alcohol - have been subdued, with inflation for this category declining to only 5.1% in September. The major change to the inflation outlook this quarter relates to forecasts for 2013. Our projection is now that inflation will below the 6% upper end of the BoB's inflation objective range by April, and will then fall significantly to below 5% by mid-year. This primarily reflects recent changes to the pula crawling peg (see Box), which will gradually reduce the impact of imported inflation on the headline rate – assuming of course that exchange rate policy remains unchanged.

Apart from exchange rate effects, an important determinant of inflation shocks will be electricity prices. Tariffs have been held down for several years, as a result of political decisions, despite the rapidly rising cost of electricity supply; this in turn reflects the cost of building the Morupule B coal-fired power station, and the high level of dependence on very expensive diesel generating capacity in the interim before Morupule B comes fully on stream. The combination of rapidly rising costs and limited tariff increases has obviously led to huge losses at Botswana Power Corporation, a situation that is unsustainable. At some point electricity tariffs will have to rise sharply, which will inevitably have inflationary consequences.

Monetary Policy

Interest rates remained unchanged during the quarter. The Bank of Botswana's mid-year review of the 2012 Monetary Policy Statement noted that domestic-demand inflationary pressures remained weak – consistent with the trends noted above – and that the main risks to inflation came from domestic and international cost pressures (from fuel, utilities prices etc.). In this context, and given the Bank's expectation that inflation would decline through the remainder of 2012 and into 2013 (it is forecasting inflation of just over 4% by the end of 2013), the decision to keep interest rates on hold was expected. Our forecast is that the next move in interest rates will be downwards, but not until early 2013.

Box: Exchange rate policy

Since 2005, Botswana's exchange rate policy has been based on a crawling peg against a basket of currencies. This mechanism is intended to stabilise the real exchange rate, and thereby to support the international competitiveness of producers of tradeable goods and services. It is also intended to provide a mechanism to stabilise imported inflation – objectives that can sometimes be in conflict. Beyond the fact that the basket comprises the rand and the SDR (which is itself a basket comprising the US dollar, the euro, the pound and the yen), the specific details or parameters of the exchange rate mechanism are not made public by the Government or the Bank of Botswana. In particular, the rate of crawl and the weights of currencies in the basket are not disclosed. However, it is known that the rate of crawl is linked to the differential between projected inflation in Botswana and major trading partners, and that since the crawling peg was introduced, the crawl has been downwards – although in principle it could be an upward crawl if Botswana's inflation was expected to be lower than that of trading partners.

Nevertheless, it is fairly easy to calculate these parameters through simple regression analysis. Using this technique, changes in the weights or the rate of crawl can be detected, albeit with a lag.

Analysis of exchange rate data for 2012 shows that a significant change was made in the basket parameters earlier this year. Notably, the weight of the rand in the basket was reduced (and that of the US dollar and other SDR currencies increased). The rate of crawl was also reduced, so much so that the downward crawl is now almost non-existent. In deference to the wishes of the authorities, we will not report the calculated values of the basket weights and the rate of crawl here. Nevertheless, we continue to encourage the authorities to publish this information, in the interests of transparency in economic policy implementation, and to help decision-making in the private sector.

The changes will, however, have a considerable economic impact. First, the pass-through of imported inflation will be sharply reduced, which will help to bring inflation within the Bank of Botswana's 3-6% objective range during 2013, and we have revised our inflation forecasts accordingly. Second, by leading to a stronger pula (compared to what its value would have been under the previous downward crawl), it is likely to reduce competitiveness through an appreciation of the real effective exchange rate, notwithstanding lower inflation. This will make export-led growth (and import substitution) more difficult to achieve. The change seems, therefore, to reflect a renewed emphasis on bringing down inflation, and less on achieving economic growth and diversification. But perhaps this is reading too much into the rationale for the change. Under the old policy the Pula was likely, in time, to reach parity with the rand; under the changed policy this is now much less likely.

Fig. 8: Nominal Effective Exchange Rate (NEER)

Source: Bank of Botswana, Econsult

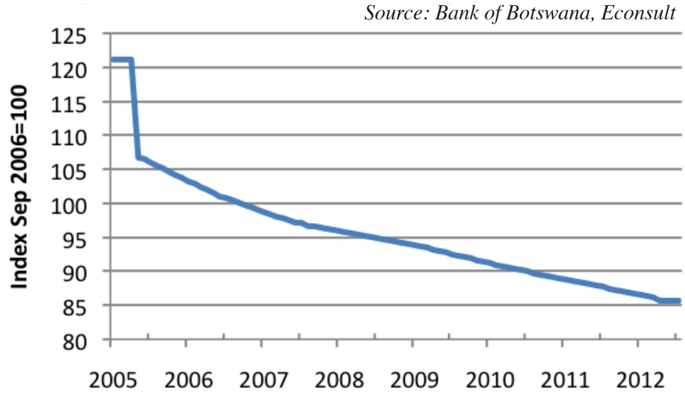
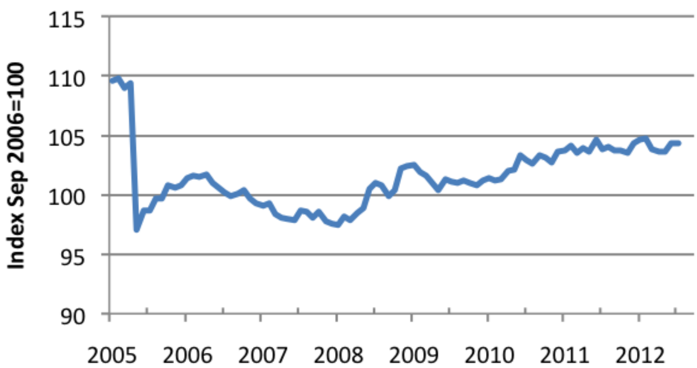


Fig. 9: Real Effective Exchange Rate (REER)

Source: Bank of Botswana, Econsult



FINANCIAL SECTOR

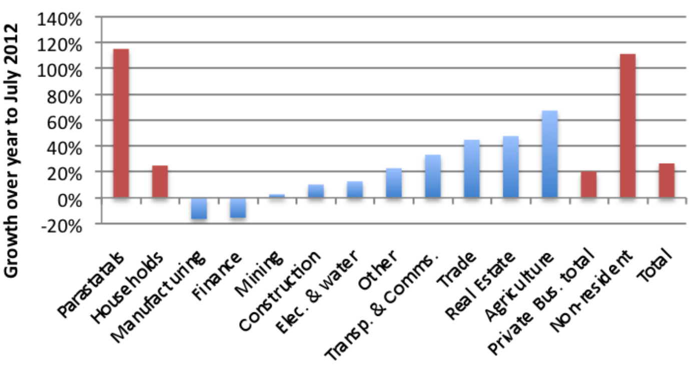
Bank Credit

Bank lending has continued to increase rapidly, growing by 27% over the year to July 2012. The balance has shifted slightly to lending to households, with a slowdown in the growth of lending to the private business sector.

It is now 12 months since the Bank of Botswana re-classified business sectors in the bank lending data and hence it is possible to get a more detailed picture of credit growth. There have been large increases in lending to parastatals, real estate, trade (wholesale/retail) and agriculture (although the latter remains very small in absolute terms) over the 12 months to July 2012. Within the household sector, borrowing for property has increased rapidly (37%). Of overall bank lending, an increasing share is for property purchase or development by either households or businesses. Although the overall share of bank lending for property – now around 20% - is not particularly high, the situation does need to be monitored to ensure that the banking sector does not become excessively exposed to a sector that is vulnerable to booms and busts.

Fig 10: Credit Growth by sector

Source: Bank of Botswana, Econsult

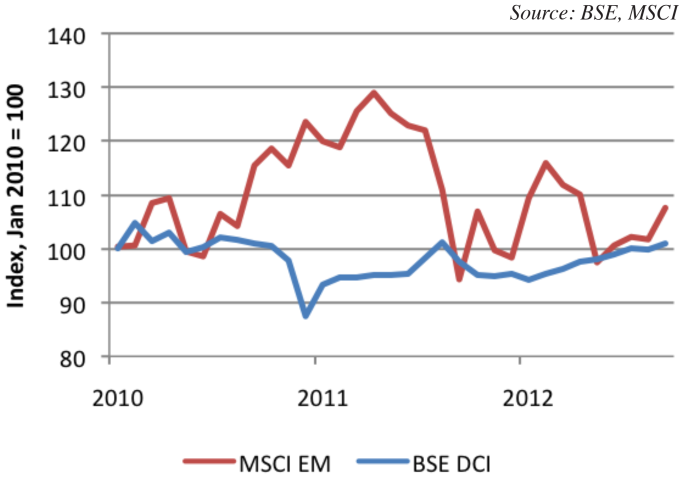


Capital markets

The Botswana Stock Exchange (BSE) had a positive quarter, with the DCI increasing by 2.1%, taking the year-to-date gain to 6.0%. This was mainly driven by recovery in retail (Choppies) and brewery (Sechaba) stocks. However the index has underperformed global markets – even before taking exchange rate changes into account - with the MSCI Emerging Markets index up by 7.0% over the quarter and 9.4% over the year. The relatively sluggish performance of the BSE partly reflects the lack of new financial inflows from both domestic and international investors.

Fig 11: BSE

Source: BSE, MSCI



Elsewhere in the capital market, the bond market remained almost completely inactive during the quarter, due largely to a lack of instruments available for trade. Expectations that government would make more effort to develop the market and provide liquidity through increased bond issuance were dashed at the September auction, when the issue was concentrated on Treasury Bills rather than longer-term bonds. The market remains characterised by a severe structural shortage of bonds, with demand from annuity providers far exceeding available supply, hence the lack of liquidity.

ECONOMIC OUTLOOK

Projecting the outlook for the economy is particularly difficult at the present time, given the high level of uncertainty in the global economy. This is compounded by the re-assessment of recent growth performance following the release of revised GDP data, which suggest that the economy has recently been growing faster than earlier thought, and as well is more diversified and less dependent upon mining.

The weakness of the international diamond market is likely to continue for the next few months at least, until there is some more clarity regarding developments in the international economy – crucial elements being progress towards resolving the eurozone crisis, how the USA deals with the looming contraction resulting from the "fiscal cliff", and whether there is an upturn in growth in China and India. This is in part dependent upon recovery in the major developed economies, but for China in particular sustained long-term growth requires less dependence on exports and investment, and more on demand from domestic consumers.

Box: Revised and Rebased GDP data

In view of the weak international diamond market, with both sales volumes and prices under pressure Debswana has cut back production by some 10% and this will impact on growth figures for the rest of the year, with continued negative growth in mining output likely. This will weigh on overall growth rates, and – despite the reported high growth of 7.7% in the year to June – our forecast is that growth for the year as a whole will be in the range of 5-6%. This is somewhat higher than the IMF's current 2012 growth forecast for Botswana of 3.8%, and largely reflects the revised GDP data and composition. Reduced diamond output, and lower prices will inevitably feed through to exports and government revenues, with the second half of the year likely to be less favourable than the first. It will make the government's target of achieving a balanced budget in the 2012/13 fiscal year more difficult, but we still expect the budget to be balanced, or close to it, for the year. Outside of mining we expect conditions to remain tough for businesses that are dependent upon government spending, but for those that have more diversified markets then conditions should be reasonably good. The high growth rate of bank lending; developments such as the relocation of De Beers' diamond trading functions from London to Gaborone and the development of independent diamond marketing platforms; and continued development of mining activities outside of diamonds, will all help to underpin economic activity.

Introduction

In early October 2012, Statistics Botswana released rebased and revised GDP data for Botswana, covering the period back to 1994. The exercise had four major components:

1. Rebasing: changing the base year for the calculation of constant price (real) GDP from 1993/94 to 2006. This in turn reflected the fact that the units used for the calculation of real GDP had become outdated, and had fallen far behind the internationally recommended practice of rebasing the national accounts every five (or at most ten) years.
2. Updating the calculations of value added in various economic sectors, incorporating new data sources and economic activities, reflecting the changing nature and structure of the economy.
3. Corrections: during the rebasing and updating exercise, various errors were discovered in the historical calculations, and these were corrected.
4. Technical adjustments.

The new benchmark year for the national accounts is now 2006. The GDP figures for the period 2000 – 2012 were revised in line with the new methodologies and calculations. For the period between 1994 and 1999, the constant price GDP series was rebased to 2006, and some minor adjustments were made to smooth the transition to the new 2000-onwards series.

Impact of the revisions

The impact of the revisions was quite dramatic, and affected a number of important national accounts aggregates, including the overall size of the economy, the shares of GDP accounted for by different economic sectors, and GDP and sectoral growth rates.

Overall GDP

Size of the economy: The revised data show that the economy was somewhat smaller than earlier thought. Notably, in the base year (2006) nominal GDP was P59.1 billion, 10% less than the original figure of P65.7 billion. In 2011, the economy was 7.4% smaller than originally thought in nominal terms, and 14% smaller in real terms.

The main reason for this is a downward revision in the estimated size of the mining sector. One of the errors uncovered in the revisions was that the size of the diamond sector had been consistently overestimated, largely due to a miscalculation of movements in stocks (inventories). Given that the mining sector is by far the largest in the economy, a downward revision in the size of the sector has a similar impact on overall GDP.

This change is not in itself of any major consequence – of course the actual economy is no smaller than it was. However, it may impact on Botswana's rankings in various international measures of comparative GDP. Perhaps more importantly, key measures that are calculated as ratios of GDP will rise. These include the budget deficit and public debt. Although these key indicators of fiscal sustainability are slightly worse on the basis of revised GDP, the difference is not substantial. Perhaps most importantly, calculations suggest that the level of external debt and guarantees is still below the statutory limit of 20% of GDP.

Growth rates

Growth rates: historical GDP growth rates have been changed as a result of the revisions. However most of the changes affect growth rates during the 1990s; average annual real GDP growth from 1994 to 2000 is now estimated at around 5.5%, compared to around 8.0% on the original data. From 2000 to 2011 growth rates are hardly affected, averaging just over 4% on both the original and revised data.

However, there have been major changes in growth rates at the sectoral level. Although the overall GDP growth rate is largely unchanged between the original and revised data, some sectors are now showing an increased growth rate while others have fallen, as shown in the table below. Agriculture; manufacturing; construction; trade, hotels & restaurants; and social & personal services have all had their growth rates revised upwards, while mining; water & electricity; transport & communications; finance & business services; & government have all had their growth rates revised downwards.

The revised figures show that the impact of the global financial crisis and recession of 2008-9 was more severe than had previously been reported. In 2009, total GDP contracted by 8.6% (previously 4.8%), while the mining sector contracted by 46% (previously 20.8%).

Table 1: Sectoral growth rates (real value added), 2000-2011 - original & revised

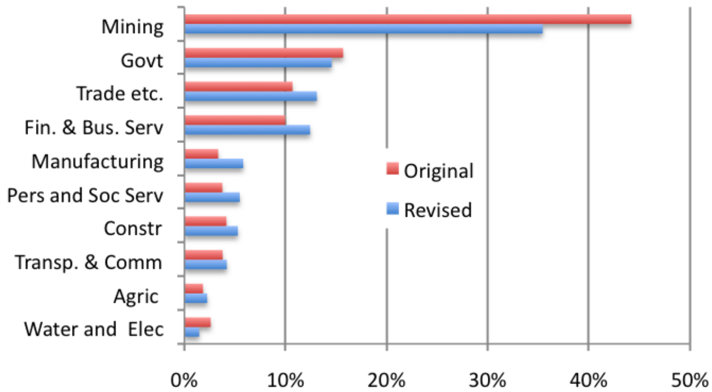
Sector	Original	Revised
Agriculture	2.3%	4.2%
Mining	0.7%	-2.9%
Manufacturing	4.9%	5.4%
Water & electricity	4.7%	-5.6%
Construction	5.1%	6.5%
Trade, hotels & restaurants	5.9%	9.4%
Transport & communications	8.3%	8.0%
Finance & business services	6.7%	5.5%
Government	5.1%	3.5%
Personal and social services	6.1%	10.2%
Total value added	3.8%	3.7%
GDP	4.1%	4.3%

Sectoral shares

With changes in sectoral growth rates, an inevitable result is a changed calculation of the contributions of the various sectors to overall value added – those with increased growth rates experiencing increased shares, and vice versa.

Fig 12: Sectoral shares of value added, 2006 original & revised

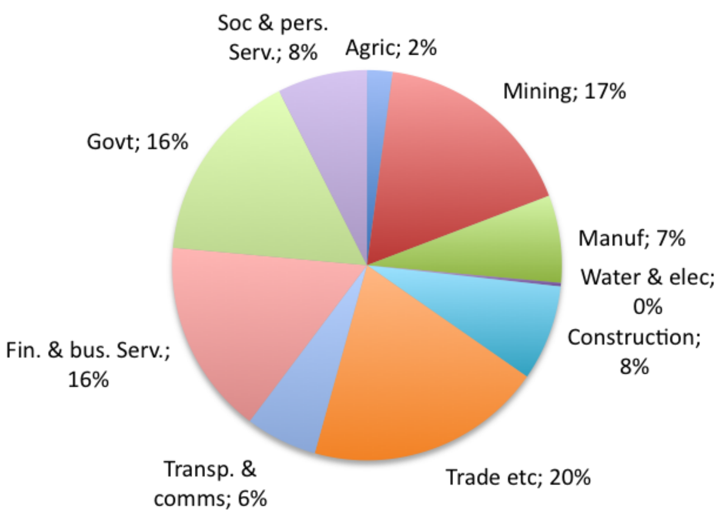
Source: Statistics Botswana, Econsult



The compounding effect of different growth rates is particularly apparent in the data for sectoral shares of GDP in 2011. The most dramatic result is that mining is no longer the largest sector of the economy (when measured at constant prices). In 2011, mining accounted for 17.1% of value added, less than half the 35.4% share in 2006. Instead, the largest sector of the economy in 2011 was trade, hotels & restaurants (19.7%). Mining was of a similar size to finance & business services (16.2%) and government (16.1%).

Fig 13: Sectoral shares of value added, 2011, constant prices

Source: Statistics Botswana, Econsult



These results show, of course, that the economy was far more diversified than had previously been considered, with mining and government less dominant, and manufacturing, trade etc., finance & business services, and social & personal services more important.

Other changes

The corrections to the calculation of mining value added have already been noted. Other corrections and revisions (as at the base year, 2006) include the following:

Water & electricity: correction of an error whereby imports of electricity from South Africa had not been recorded as intermediate consumption, hence significantly overestimating value added. With this correction, the size of the sector is much smaller, and the growth rate reduced.

Minerals: revised (upward) estimates of the size of coal, soda ash and "other mining".

Finance & business services: the inclusion of diamond valuing and sorting under "business services" - this had not previously been included in calculations of value added/GDP; upward revision of the size of the insurance sub-sector;

Manufacturing: revision of the size of the meat & meat processing, and textiles & garments sub-sectors, which had previously been underestimated.

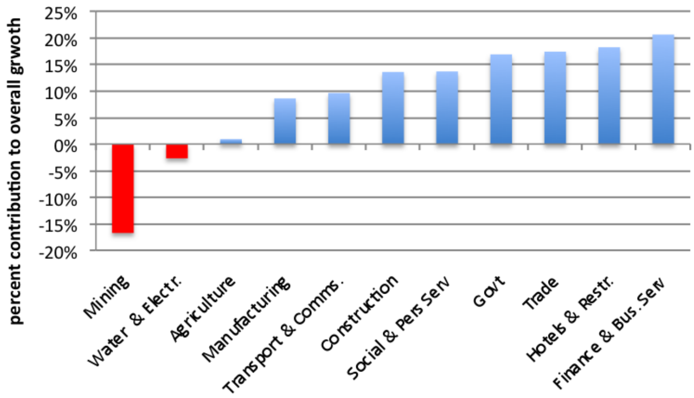
Government: downward revision of the size of government Informal sector: revised estimates, increasing the contribution of the informal sector to GDP.

Drivers of Growth

Using the new data it is possible to disaggregate the sources of economic growth in Botswana over the past decade (2001-2011). At the sectoral level the main contributors were finance & business services, hotels & restaurants, wholesale & retail trade, and government. On a positive note, this means that growth was diversified and not being driven by mining – which in fact made a negative contribution to growth.

Fig 14: Sources of Economic Growth, 2001-2011

Source: Statistics Botswana, Econsult



GDP by Expenditure

The above discussion relates to GDP output measures. There were also important changes to the GDP expenditure measures. The impact of the revisions (in 2006) was to reduce the size of government consumption, increase the size of household consumption, increase savings and investment, and increase the size of both exports and imports. Perhaps most welcome is the sharp reduction in the size of errors and omissions, which had seriously undermined the usefulness of this particular GDP measure. Following the changes, the Botswana economy emerges as more "normal" and less dependent on government than had previously been the case, with a better investment rate, and still a "high savings" economy.

Category	Original	Revised
Govt final consumption	19.0%	17.0%
Household final consumption	33.8%	38.7%
GFCF (fixed investment)	21.6%	26.2%
Change in inventories	2.1%	-0.3%
Gross domestic expenditure	76.5%	81.7%
Exports	47.0%	52.3%
Imports	30.7%	34.1%
Errors & Omissions	7.2%	0.2%
Gross domestic savings	40.0%	44.1%