Economic Review

Dr. Keith Jefferis
Chairman of Bifm Investment Committee

INTRODUCTION

The second quarter of 2011 was a particularly eventful period for the Botswana economy in view of the unprecedented eight-week strike by (some) government employees. Although we consider the strike to have had a relatively small economic impact in the short-term, it was indicative of deep-seated economic changes and will have longer-term ramifications. Other developments of note during the quarter include positive economic growth data, a tentatively positive budget outturn for 2010/11, and rising inflation pressures.

Internationally, the economic environment has become more uncertain after a positive start to the year, with mounting debt-related problems in Europe and the USA. There is considerable uncertainty over how these will play out, but the potential for significant disruption to the international economy is rising, in which case Botswana would undoubtedly be adversely affected.

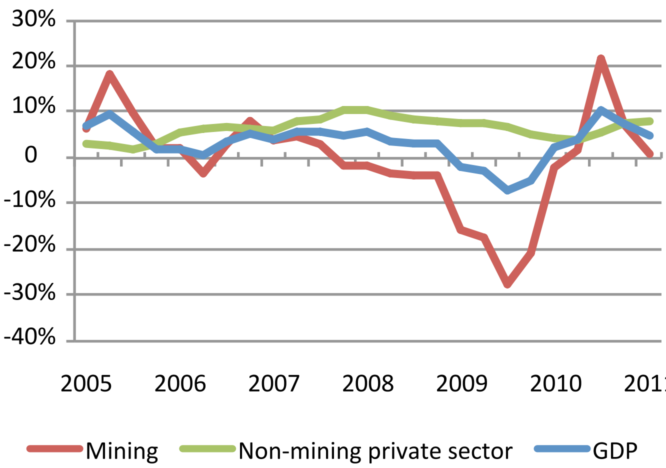
ECONOMIC GROWTH

Economic growth figures for the first quarter of 2011 show that annual GDP growth for the year to March fell to 4.9%, compared to 7.2% for the year to December 2010. The drop is not particularly surprising or worrying, as it represents a reversion to a more "normal" rate of growth, compared to the figures for the second half of 2010, which were dominated by the bounce back after the recession of 2008-9.

The growth rate of 4.9% is consistent with growth forecasts for the whole year, which range from 5-7%. However the overall growth rate conceals quite different growth rates in different sectors of the economy. In particular, the slowdown largely reflects a sharp reduction in the growth of the mining sector, which only expanded by 0.6% in the year to March.

Fig. 1: Annual GDP Growth

Source: Statistics Botswana, Econsult



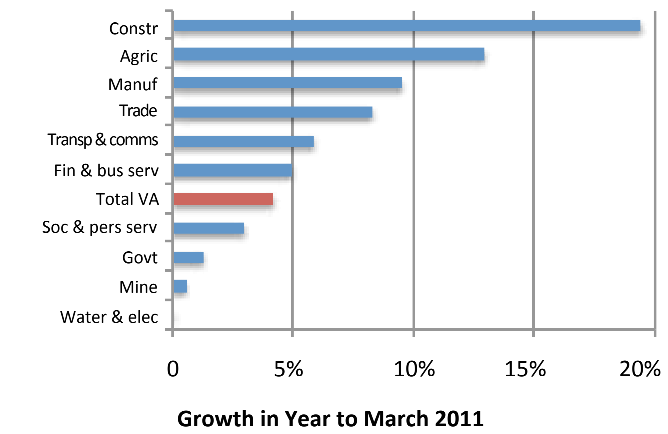
This is somewhat surprising, given that there has been much discussion of the recovery in mining and in particular, increased production of diamonds.

While mining (and government) have been hardly growing, the non-mining private sector has been experiencing a resurgence of growth, expanding by 7.7% in the year to March. This represents a continuation of the growth recovery experienced by the private sector since the recession. It is particularly encouraging given that much of the private sector is dependent upon government, which has been cutting back on the growth of spending.

Having said that, the GDP data continue to be full of puzzles and peculiarities. The fastest growing sectors of the economy in the year to March were construction, agriculture and manufacturing. Construction is normally heavily dependent upon public spending on infrastructure, and spending on new development projects is falling fast. The strong performance of construction may reflect ongoing projects (such as new schools), as well as private sector spending on retail and office space, plus major expenditure on power infrastructure and mine development at Jwaneng Cut 8 (diamonds), AK6 (diamonds) Morupule (coal) and Boseto (copper). Strong agriculture growth appears to be driven by the livestock sub-sector, which is perhaps odd given the problems with beef exports and the BMC. As for manufacturing, the source of the growth is "other manufacturing", which is a very large but ill-defined sub-sector, and hence the drivers of growth are difficult to pin down. As we have noted earlier, the GDP data are in the process of being re-based and revised, and we hope that this will lead to improved data quality in due course.

Fig 2: Sectoral Output Growth (VA)

Source: Statistics Botswana, Econsult



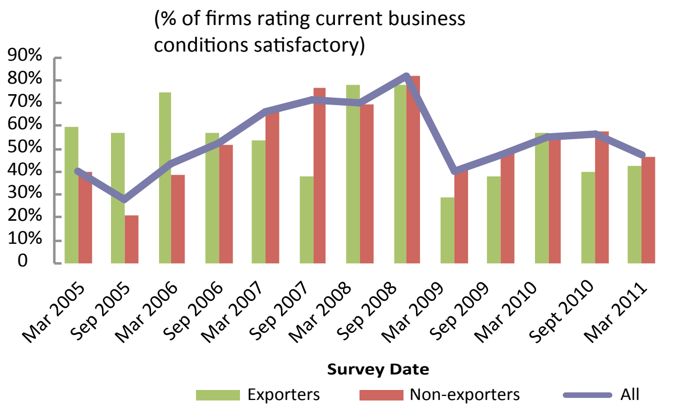
On a related note, there is a great deal of confusion over the reporting of GDP growth rates when the quarterly data are released. For instance, most press reports focused on the 2.2% contraction in real GDP between 2010Q4 and 2011Q1. However, this is not a useful measure of growth, for various technical reasons, nor is the annual growth figure (quarterly output compared to the same quarter a year earlier) that is also reported by Statistics Botswana (for more discussion of this, see http://econsultbotswana.blogspot.com/). Better to stick with annual year-on-year growth figures, which have the most information content, and which are the ones reported here.

Business Confidence

The Bank of Botswana's Business Expectations Survey for March 2011 showed a slight drop in business confidence – only 47% of firms rated current conditions satisfactory, compared to 56% in September 2010. The deterioration mainly related to firms selling to the domestic market, and this may reflect slower growth in government spending. Export firms saw a small improvement in confidence. More positively, the majority of firms anticipate an improvement in business conditions in 6 months (64%) and 12 months (67%) time.

Fig 3: Business Confidence Index

Source: Bank of Botswana

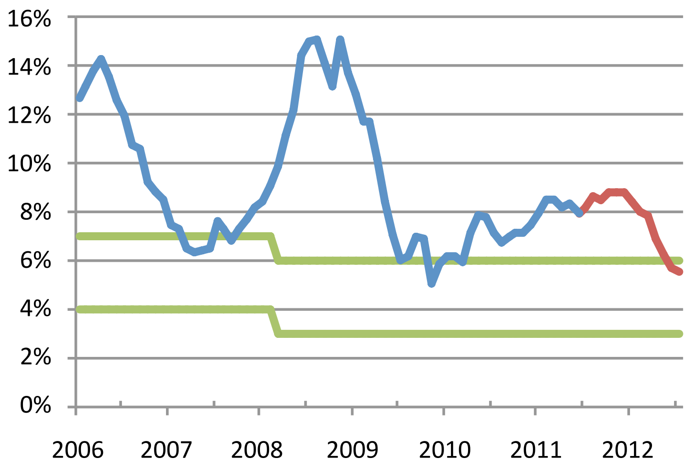


INFLATION AND MONETARY POLICY

The second quarter of 2011 has seen a deterioration in inflationary conditions, with inflation hovering around the 8% mark. Three months ago we expected inflation to moderate and to end the year around 7%. Now, we expect inflation to rise from the current level (7.9% in June) and to fluctuate between 8% and 9% for the rest of 2011.

Fig 4: Inflation & Forecast

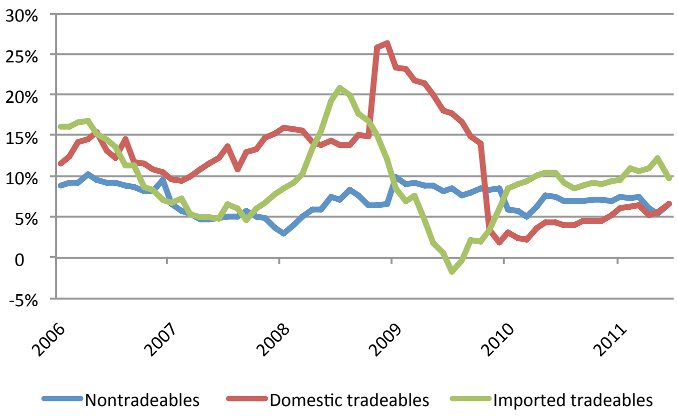
Source: Statistics Botswana, Bank of Botswana, Econsult



The reasons for this are largely out Botswana's direct control, with rising food and fuel price inflation amongst the main drivers. More generally, international and import price inflation has been increasing. Domestically, higher electricity prices – which have risen by a substantial amount for the second year running – are the main influence. But even here, there is little choice but to increase prices to reflect higher costs of imported power and new domestic generation capacity.

Fig 5: Inflation by Category

Source: Statistics Botswana, Econsult



What is not clear is the extent to which inflation is being driven by domestic demand as well as by domestic and international cost pressures. One of the main sources of domestic demand – government spending – is relatively weak, due to fiscal adjustment. However, national accounts data report rapid growth in household and investment spending.

Despite rising inflation, the Bank of Botswana has maintained interest rates at the same historically low levels throughout the quarter. As the Bank has mentioned, their focus is on medium term inflation projections relative to the 3-6% objective range. As it stands, inflation is forecast (by both the Bank and ourselves) to fall within this range by the second quarter of 2012. The Bank has also cited weak domestic demand – and the absence of inflationary pressures from this source - as a reason for keeping interest rates low. Domestic demand is of particular importance from a monetary policy perspective, as monetary policy impacts mainly on domestic demand while having a minimal impact on cost-push inflation, especially imported inflation. There would only be a need to respond to cost-driven inflation with tighter monetary policy if it showed signs of feeding through to inflationary expectations, in areas such as wage settlements. However, it may be that domestic demand is strengthening in 2011. Gross domestic expenditure (the sum of household and government consumption, and investment spending) increased by a reported 17% in real terms in the year to March 2011, and as noted above, output growth in the non-mining private sector rose to 7.7% over the same period. If these trends continue – and assuming of course that the data are accurate – the BoB may become concerned about the impact of domestic demand pressures on inflation, with implications for interest rates.

FINANCIAL SECTOR

2011 has been a difficult year for the banking sector, with weak demand for new credit and the persistence of high arrears rates on lending to households. Total credit growth over the year to April was only 9%, barely more than inflation and much less than the rate of nominal GDP growth. With the continuation of a low interest rate environment, and in particular low rates of interest on BoBCs, banks' key sources of income and profits are under pressure. This squeeze will be intensified by the raising of primary reserve requirements by the Bank of Botswana from 6.5% to 10% of pula deposits from July 1.

The real pressure is on lending to households, which accounts for 57% of total bank lending. Households are becoming increasingly indebted to the banks, with borrowing increasing faster than deposits. Of course many households also borrow from other sources besides banks, including employers, microlenders, cash lenders, furniture stores and pawn shops. Combined with stagnant or declining real incomes, at least for some households, this could lead to major household debt problems. Some relief is being provided by lower interest rates, but the level of debt stress is already reflected in arrears and bad debts on loans from banks. It may time for government to consider interventions to manage the level of indebtedness, curb irresponsible lending, and require reporting of all loans to credit bureaus so that lenders can reach a realistic assessment of the capacity of potential borrowers to take on more debt. While NBFIRA is in the process of introducing regulations to govern the activities of microlenders, the reforms need to go well beyond this and almost certainly require dedicated credit legislation.

Fig 6: Household Credit & Deposits

Source: CSO, Bank of Botswana, Econsult

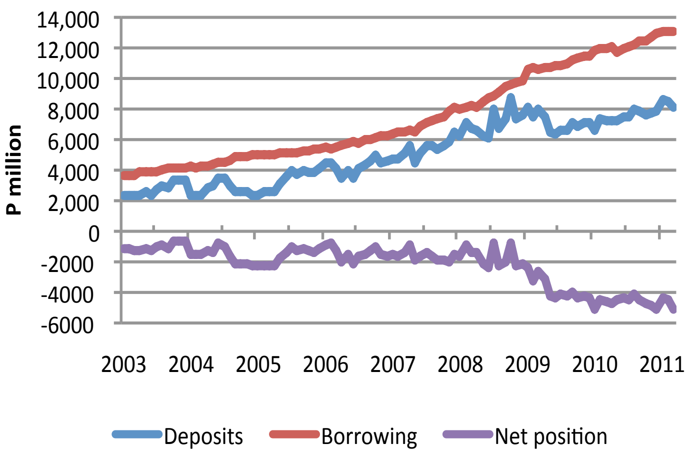
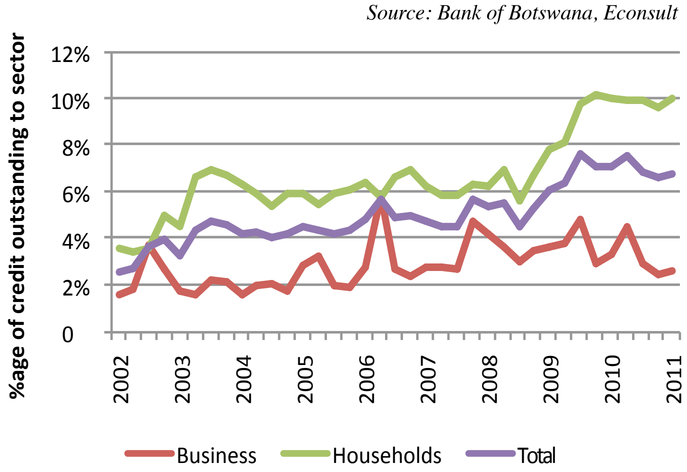


Fig 7: Arreas on Bank Lending

Source: Bank of Botswana, Econsult



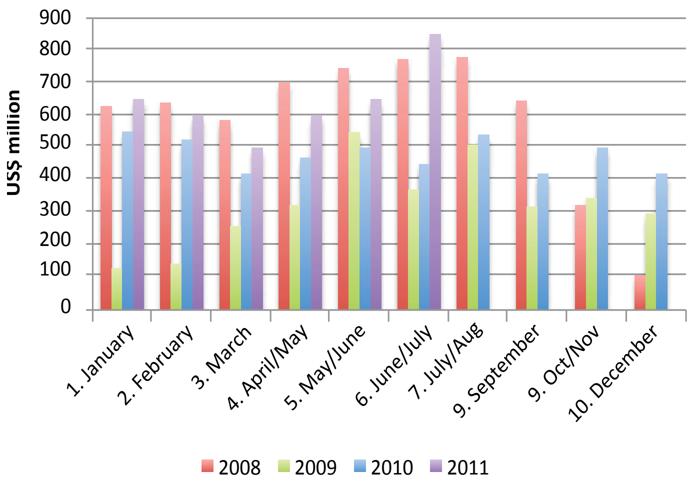
FOREIGN TRADE

Trade data for the first four months of 2011 show a continuation of the recovery in export performance. Total exports in the first quarter of 2011, at P9.5 billion, represented the second highest quarterly total ever, and were 23% higher than in the same period in 2010.

Much of this is being driven by the strong performance of rough diamonds, which have benefitted from robust international demand. Overall diamond sales through the Diamond Trading Company (DTC), of which Botswana provides the largest share, have continued to rise strongly through 2011. DTC diamond sales in the first half of 2011 were 22% higher than in the first half of 2010, benefitting from both improved volumes and, particularly, higher prices. This was followed by the highest ever sight value, at $850 million, in July. Various factors account for this, including strong demand from China and India, better than expected sales in the USA, and concerns about supply shortages. This situation is likely to persist for some time, and higher prices for rough diamonds compensate for the fact that Botswana's production of diamonds (in terms of numbers of carats) is well below previous peaks, and is likely to remain so.

Fig 8: DTC Diamond Sites

Source: Rappaport

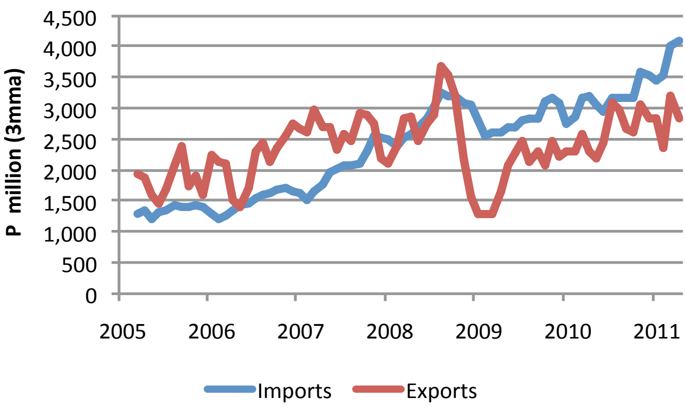


Other exports have had mixed performance. Copper-nickel exports have done reasonably well, although they will be adversely affected in coming months due to the shutdown of the BCL smelter for refurbishment and repairs, which will lead to the stockpiling of concentrate. Meat exports have been badly affected by the loss of the EU market due to non-compliance with relevant EU standards in the livestock sector. Textile exports have recovered somewhat following the sharp decline experienced in the first half of 2010.

Despite improved export performance, the overall balance of trade remains in deficit as imports have also risen. This is due to sharp increases in imports of fuel (higher prices as well as increased diesel consumption for electricity generation) and machinery (much of which is equipment for mines under construction). Although exports have now largely recovered to the level they reached before the global financial crisis in 2008, imports have continued to rise steadily. So, while exports of P3 billion a month in 2008 were sufficient to pay for imports and even generate a balance of trade surplus, imports now average over P4 billion a month and the balance of trade continues to show a deficit. This does not cause any immediate problems, but the deficit does have to be financed, whether by other inflows (such as investment income, SACU receipts or foreign investment) or by drawing down the foreign exchange reserves.

Fig 9: Exports & Imports (monthly)

Source: Statistics Botswana, Econsult



FISCAL SITUATION

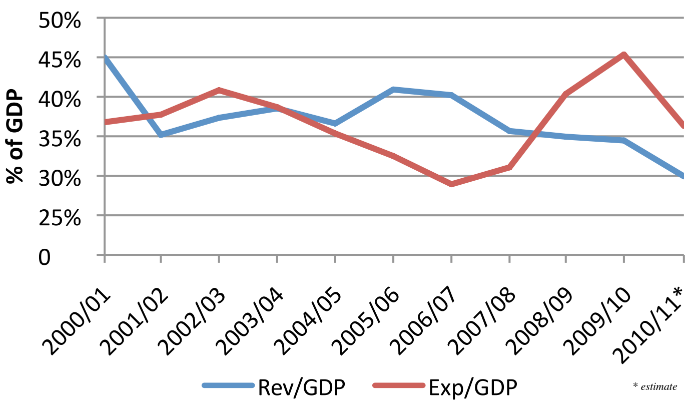
The government's budget situation is a key economic variable, especially at the present time when the budget has been under severe pressure with reduced revenues and large deficits, and the restoration of fiscal sustainability is one of the key country's economic challenges. The fiscal situation received even greater prominence than usual during the public service strike, given its relevance to the affordability of public sector pay increases.

Unfortunately monitoring of the fiscal situation is hampered by lack of up-to-date information on government revenues, expenditure and budget balance. The most recent full year for which budget data have been published is 2009/10, and data for the most recent fiscal year (2010/11) are still incomplete.

Our own estimates suggest that the budget deficit for 2010/11 will turn out to be somewhat smaller than was estimated at the time of the 2011 Budget, due largely to underspending. This will help the government to achieve its objective of a balanced budget by 2012/13. However, the underlying picture remains of great concern because of weak revenues, notwithstanding the recovery in diamond exports, and hence the need for further expenditure restraint remains.

Fig 10: Govt. Revenue & Spending

Source: MFDP, Econsult



The serious attempts being made by Government to restore fiscal sustainability were reflected in the announcement in May of an unchanged investment grade credit rating by Standard and Poors.

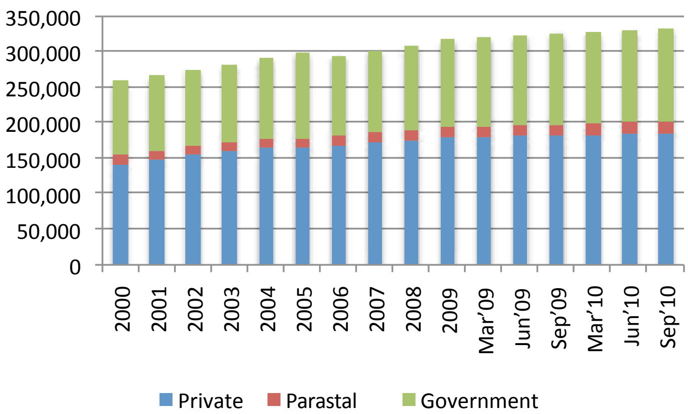
EMPLOYMENT

Information on formal sector employment has been published up to September 2010, and indicates that although the economy is recovering from the recession, it is failing to create sufficient jobs. Approximately 9,000 formal sector jobs were created in the year to September 2010, a growth rate of around 3%. This is only around one-third of the number of new jobs needed to cater for young adults leaving secondary and tertiary education each year. And of the jobs created, over 60% came from the public sector (central and local government, and parastatals), with less than 40% from the private sector. Boosting the rate of job creation, especially by the private sector, remains one of the overriding policy imperatives.

In the short term, some additional opportunities have been created by the Government's *Ipelegeng* scheme, which combines social welfare with work, mainly for unskilled adults. The number of *Ipelegeng* participants varies, but reached 41,000 in September 2010. The scheme has been controversial, for various reasons, but has at least provided an income for a large number of low-income households. *Ipelegeng* is about to undergo its first full evaluation, which should determine how effective it has been in achieving its objectives.

Fig 11: Formal Employment

Source: Statistics Botswana



OUTLOOK

The economic outlook in mid-2011 remains mixed. On the positive side, the international diamond market has recovered strongly from the recession and diamond exports are steadily increasing. Furthermore, economic growth data indicate that the non-mining private sector has been performing well, and is seemingly shrugging off the impact of slower-growing government spending. However, we still have serious concerns regarding the quality of some economic statistics, and any conclusions regarding growth should be treated cautiously – which is itself a serious problem with regard to economic policy formulation. The government budget data are cautiously positive, and the response to the public service strike – from an economic perspective – showed that there is a serious intention on the part of the authorities to deal with fiscal sustainability issues.

On the negative side, inflation continues to be a problem with underlying inflationary pressures mounting. It is also clear that despite the reported high rate of growth of the non-mining private sector, this has not translated into job creation, and unemployment among school leavers and college graduates remains a serious problem. And despite strong export growth, the balance of trade remains in deficit due to a surge in imports.

Internationally, there are both short-term and longer-term uncertainties arising from the European and US debt crises. In the Euro-zone, a short-term solution to the Greek debt crisis has been found, but uncertainties remain regarding long-term sustainability not just of Greek sovereign debt but also for Portugal, Ireland, Spain and Italy. More generally, it is still necessary to find a solution to the conflict between national sovereignty over fiscal policy and borrowing and the long-term sustainability of the single currency.

A more immediate concern at the time of writing is the prospect of a default on US government debt and/or a downgrade of the crucial triple-A credit rating status. Such a downgrade, which could be triggered either by a default or a more general failure to deal with longer-term budget sustainability issues, would be traumatic for global financial markets and could trigger another recession.

Looking ahead to the rest of the year, we see a continuation of trends from the first half of the year. Economic growth for 2011 as a whole will probably come in around 5-6%, marginally reduced from earlier expectations due to the impact of the public service strike (see discussion below). We expect inflation to hover around 8% or just above for the rest of the year, and the balance of trade to remain in deficit. Underlying problems relating to the over-indebtedness of households and high unemployment will provide a drag on the economy.

Overcoming these problems will require far more extensive and adventurous economic reforms than have been implemented to date. As Standard & Poors noted in their ratings review, "Botswana's creditworthiness could improve if reforms are implemented more quickly, dependence on mining continues to decline, and private sector development broadens. However, we do not expect this to be achieved within the current forecast period".

Box: Economic Impact of the Public Service Strike

Now that the 8-week public service strike is over, or at least suspended, we can attempt an assessment of its impact on the economy. As many commentators have noted, the strike was a seminal event in Botswana's economic and political history, although some of the reasons for the significance of the event are not well understood. And of course many aspects of the economic impact are difficult to quantify, or will only become apparent after a period of time, and so any assessment of the economic impact at this stage must be somewhat tentative.

In assessing the economic impact of the strike, we can consider various different impacts as follows.

(i) the direct impact on government
(ii) the indirect on the rest of the economy
(iii) the longer-term implications.

The main direct impact is reduced government output. Government is the second-largest contributor to GDP (after mining), and clearly some government activities were adversely affected during the strike. The extent of the reduction in government activities is very difficult to ascertain, however. It would appear that public education was the most severely affected sector, with many schools closed for a period of time. Some health facilities were adversely affected, and either closed for a period or operating at reduced levels of service. Some other government activities also operated at reduced levels.

How can this be quantified? One way is to consider how many people took part in the strike. Initial press reports claimed that 90,000 were on strike (representing some 70% of public sector employees). However, this number has never been substantiated, and may refer to the number that the unions were hoping would join the strike. Furthermore, it appears that many of the workers who originally participated in the strike returned to work quickly, and many – if not most - government services continued uninterrupted. Subsequent reports suggested that around 50 000 employees participated in the strike at its peak, with around 25 000 taking part on a prolonged basis, mostly in education and local authorities. This latter figure represents around 20% of the government workforce. Some 20 000 employees were subject to the "no work no pay" rule and had pay deducted for days not worked during the strike, and around 2 500 essential service employees were dismissed for striking illegally, most from the health services.

If government output was reduced in line with the absence of its employees, i.e. by 20% for some two months, the overall impact would be to reduce GDP by around 0.5% (i.e. to reduce GDP growth in 2011 by 0.5%, say from 6.5% to 6%). This loss would be reduced to the extent that the missing output is made up later in the year.

There are mixed reports as to the indirect impact of the strike on the private sector, varying mainly by the degree of dependence of particular firms or economic activities on government. Firms that have little or no dependence on government procurement were largely unaffected by the strike; this particularly applies to mining companies and other exporters. The main effect was delayed payments to some providers of goods and services to government, and this affects a significant proportion of the private sector, given the importance of government spending, leading to cash flow problems for some firms. There were some delays to other government services, e.g. licences, building permits and other approvals. The trade (retail & wholesale) sector was affected by reduced spending from government employees. We estimate that if 25,000 workers were not paid for two months, this would lead to P350-P400m of lost income and spending, although the impact on the trade sector would be lower if some spending was financed by drawdown of savings, or if incomes are partially made up by overtime payments after the strike. The lost income represents just under 1% of total annual household consumption, although the impact on private sector GDP would be much less than this.

There may be some impact on the financial sector, which is likely to have experienced a short-term rise in arrears as some borrowers were unable to meet repayment obligations. Much of this impact will be short-term, however, as borrowers will have to repay eventually. Many of the other negative impacts on the private sector are also being unwound (suppliers are getting paid, contracts are being awarded, and licences and permits are being approved).

While it is very difficult to quantify the indirect impact on GDP, we estimate that it is unlikely to be more than a further 0.5%. Overall, our estimate of the maximum impact is a reduction of GDP growth in 2011 by 1%, which is well within the margin of normal fluctuations in economic growth.

The longer-term impact of the strike is even more difficult to predict but there will undoubtedly be a range of social, political and economic implications.

In terms of the longer-term economic impact, the strike has already had some adverse impact on Botswana's image as a haven of peace and tranquillity (see e.g. The Economist, 9 June 2011). There is also the issue of the longer-term impact of the disruption of education. But it is not all bad – the fact that a two month strike by the largest workforce in the country passed off largely peacefully, with minimal use of force by the police, and although there were some incidents of violence and disorder, there were no deaths or serious injuries amongst either strikers or law enforcement officials, is positive.

Furthermore, government's response shows that it is serious about dealing with fiscal issues and controlling its spending, which is a positive sign (see, for example, comments by the ratings agency Moody's). While the strikers did enjoy considerable public support – at least until the period towards the end of the strike when incidents of disorder started to mount – government has also managed to gets its point across about the need for fiscal restraint.