Bifm Economic Review

3rd Quarter 2011

Economic Review

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INTRODUCTION

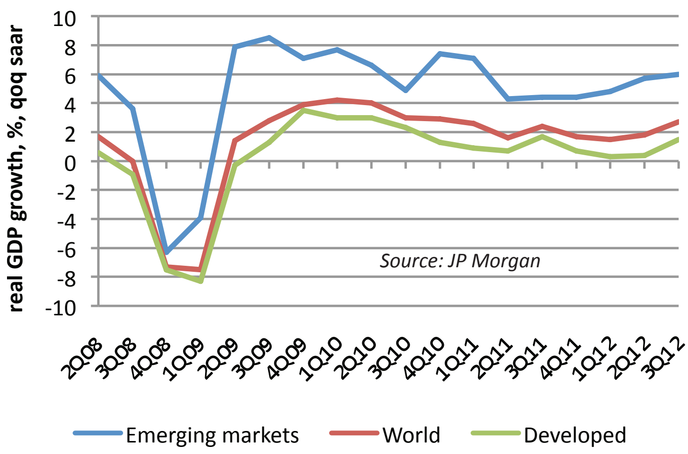
The third quarter of 2011 has proved to be a somewhat turbulent period for the world economy, with a slowdown in growth and an increase in uncertainty and risk aversion. This has already had an impact on the Botswana economy, with a downturn in the diamond market following a very successful first half of the year, as well as lower prices for copper and nickel exports. Exchange rates have also proved volatile. Economic developments in the coming months will be determined mainly by international economic developments, which are very difficult to call.

ECONOMIC GROWTH

The outlook for the global economy has deteriorated sharply in recent weeks. Global growth projections have been revised downwards, with the major developed economies as a whole projected to barely keep out of recession, even in what might now be termed a "best case" scenario. What is also striking is that the level of uncertainty has risen sharply, and there is now discernible fear that further shocks could cause major economic (and social and political) disruption.

What has changed so much over the last couple of months? There is no single explanation. In the USA, growth has remained sluggish and unemployment high despite very loose monetary conditions (low interest rates and quantitative easing) and an expansionary fiscal policy (the large budget deficit), suggesting that conventional policy tools are proving ineffective. The US Government's credit rating was downgraded by S&P, an action that reflected an assessment of the functioning of the political system as much as concerns about the debt level of the US government. The one thing that is working in the US's favour is that despite their own problems, there are worse problems elsewhere, and the US currency and bond markets are benefiting from a "flight to quality".

Fig.1: Global Growth & Forecasts



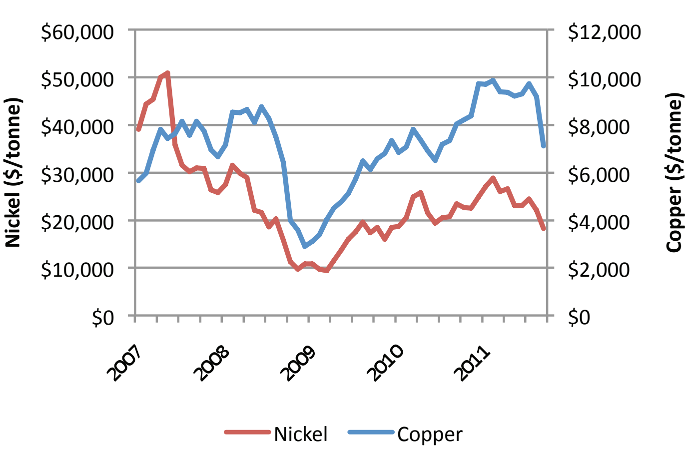
While the hoped-for economic recovery in the US continues to prove elusive, the situation in Europe is even more risky and uncertain. Eurozone governments are grappling with a range of problems centered on Greece's fiscal crisis and unsustainable debt, but with deeper roots in the structure and governance of the single currency. Greek default is now almost inevitable, and will not be prevented by the austerity measures being demanded of the economy and the population, but has much wider implications than for Greece alone. In the short term, the challenge facing Eurozone policy makers is to accept the inevitable and to contain the collateral damage. This in turn requires managing the impact of Greek default on Europe's highly interconnected banking system, and preventing a run of contagion to the sovereign debt markets of Portugal, Ireland, Spain and Italy, which would be very difficult to contain. In the longer term, assuming the short-run crisis is successfully contained and managed, there are major implications for the reform of Eurozone governance, and the relationship between national and regional (supra-national) sovereignty in a monetary union.

So far, however, the political process in Europe has been behind the curve and has responded in a way that is "too little too late", and as a result, the markets have taken fright – for good reason. A full scale European banking crisis and disorderly collapse of the euro would have a devastating impact on the global economy, and would be more serious and long-lasting than the global financial and economic crisis of 2007-9. Even if this worst-case scenario is avoided, it is likely that Europe will still dip into recession in 2011-12.

What does all of this mean for Botswana? As an export-dependent economy, Botswana is of course vulnerable to disruptions in the global economy. If the outcome is a modest slowdown in global growth, as depicted in Figure 1, then the main impact would be on export prices, and hence on the balance of payments and the government budget, which would both be adversely affected by lower earnings. Indeed this is already happening, with copper and nickel prices falling by more than 25% between July and September. Diamond prices, which rose sharply in the first half of the year, are also under pressure as the market has softened. However, there is unlikely to be any short-term impact on GDP and economic growth, as production and output levels would most likely remain unchanged, even at lower prices. Nevertheless, a prolonged period of lower global growth, or a sharper collapse of global output as in 2007-9, would inevitably feed through to lower growth in Botswana, as well as renewed fiscal problems.

Figure 2: Copper & Nickel Prices

Source: LME



A second dimension of the deteriorating global economy that has already affected Botswana is the problems in financial markets. Global equity markets had one of their worst quarters on record from July to September 2011, and this has inevitably had an impact on the foreign exchange reserves and offshore pension fund assets. Although a Greek default would not have a significant impact on the reserves or pension funds, more widespread sovereign defaults in Europe could cause problems.

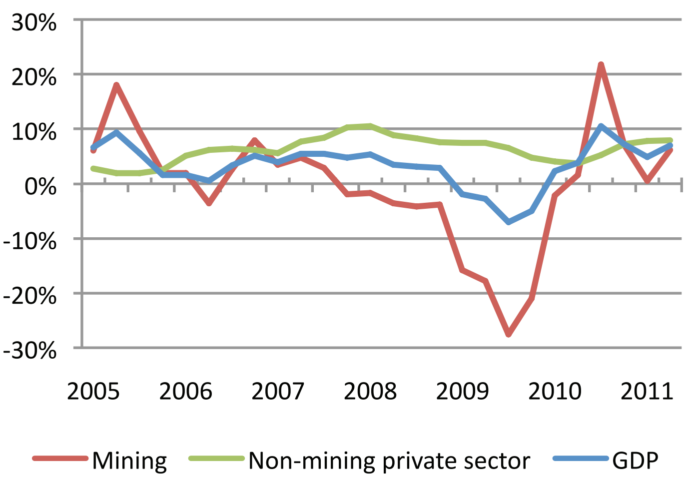
THE BOTSWANA ECONOMY

Economic Growth

Growth figures for the period prior to the recent deterioration in global economic conditions – i.e. for April-June 2011 – have recently been released by Statistics Botswana. The figures are on balance quite positive, and show continued recovery from the earlier economic slowdown. Headline numbers are that over the year to June 2011, the economy grew by 7.0%, up from 4.9% in the previous quarter. The upturn in growth was mainly driven by the mining sector, where annual growth rose from 0.6% in the year to March 2011 to 6.2% in the year to June. The good performance was shared by the non-mining private sector, with growth of 7.9%, similar to the 7.8% recorded in March.

Fig. 3: Annual GDP Growth

Source: Statistics Botswana, Econsult



The sectoral pattern of growth has changed somewhat compared to the previous quarter. As noted, the performance of the mining sector –driven by diamonds - improved considerably. Construction remained the best-performing sector, growing by 25% over the year to June, driven by major investments in power generation (Morupule B) and mining (Jwaneng Cut 8 (diamonds) and Boseto (copper)). Manufacturing performed surprisingly well, with growth of 12.4%. Identifying the drivers of manufacturing sector growth is difficult. We know that meat production contracted and that beverages grew, but most of the manufacturing sector falls under the ill-defined "other manufacturing" sub-sector in the statistical classification. This includes everything from furniture to pharmaceuticals to vehicle parts to boats to chewing gum (all of which, incidentally, are quite successful activities). From a policy perspective, it is important to know which activities are doing well, and which are not. It would therefore be helpful if Statistics Botswana could provide a more meaningful breakdown of manufacturing production in the GDP data.

Other fast-growing sectors include transport and communications and trade, hotels and restaurants. Agriculture, which has previously been one of the fastest growing sectors, has now fallen to being one of the slowest. This is due to contraction in the "crops" and "other agriculture" sub-sectors. Finance and business services is also growing slowly, which is odd given the strong results and recovery in profitability reported by the banks in their mid-2011 results.

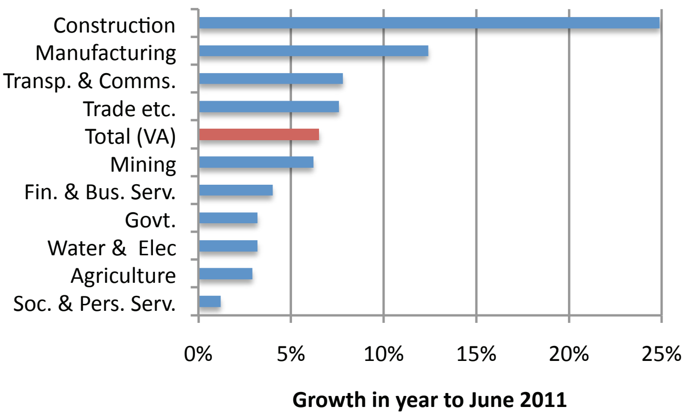
Another of the puzzles in the GDP data is the performance of government. Based on earlier assessment of the impact of the public sector strike in the second quarter of 2011, a negative impact on the output of the government sector, and GDP as a whole, was expected. However, no such impact is evident. In fact, the output of the government sector was higher in Q2 than in Q1, and higher than in Q2 of 2010. Given that one of the main determinants of government output is expenditure on wages, this is odd. It suggests that either participation in the strike was lower than earlier thought, or that the implementation of the "no work no pay" rule was very weak. But whatever the reason, there is no evidence that the strike will have a noticeable impact on (measured) GDP growth for the year as a whole.

Trade and Balance of Payments

The dominant feature with regard to international trade in recent months has been the performance of diamond exports, at least through to August. With continued strong recovery in the diamond market, prices rose sharply both on the open market and for sales through the Diamond Trading Company. DTC prices rose by 30%-50% between January and July, with robust demand for rough diamonds from cutters, polishers and

Fig.4: Sectoral Output Growth (VA)

Source: Statistics Botswana, Econsult

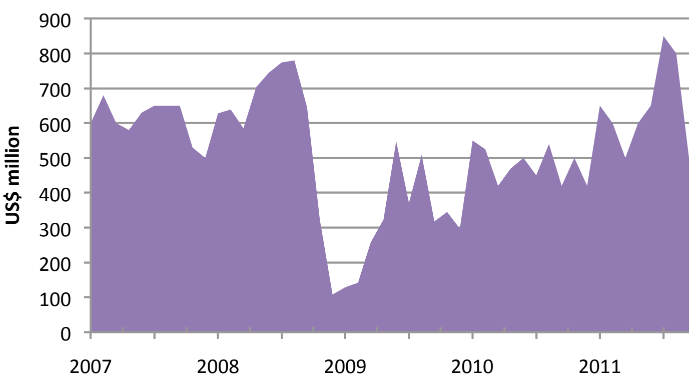


traders. DTC had its two largest sights ever in July and August, in both cases over $800 million, driven by both higher volumes and higher prices.

By August, however, the diamond market – like other commodity markets – was beginning to feel the effect of slower global growth and increased uncertainty. It also became evident that the higher prices paid for rough diamonds were meeting resistance in the jewellery and retail industry, where consumer demand was not strong enough to support those higher prices. By September the price trend had reversed, with diamonds offered through tender processes fetching lower prices or not finding buyers. Reflecting this changed market dynamic, the September DTC sight was much smaller.

Fig.5: DTC Diamond Sights

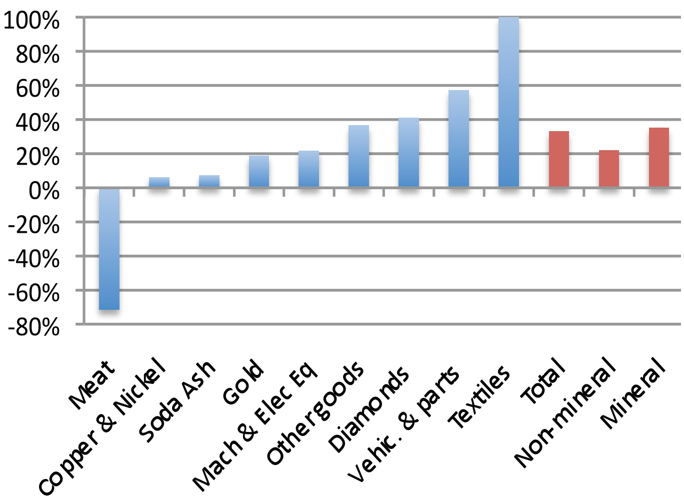
Source: Rapaport Diamond Report



Complete trade data are available only up to mid-year (like much of Botswana's statistical output, the data have been delayed by work on the 2011 Population and Housing Census). This covers a period of reasonably healthy global growth, and in particular strong demand in commodities markets. As a result, export performance in the first half of 2011 was good, with total exports up 33% compared to the first half of 2010.

Fig.6: Export Growth, First Half of Year

Source: Statistics Botswana, Econsult



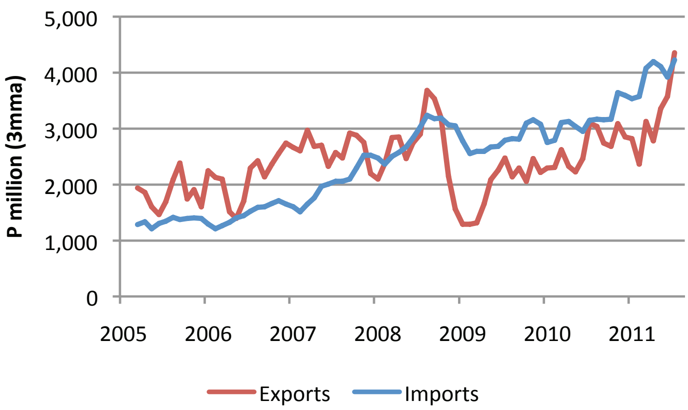
Exports in most categories grew in the first half of the year, although to differing degrees. Diamond exports were up 41%, but the performance of other minerals (copper-nickel, soda ash and gold) was more lacklustre. Exports of manufactured goods also grew strongly, with textile exports increasing sharply along with exports of vehicles & parts and general "other manufactures". The major disappointment was beef exports, which dropped by 71% following the suspension of exports to the EU due to non-compliance with veterinary requirements.

Exports of goods are of course complemented by exports of services, such as travel, tourism and business services. Unfortunately, due to problems with the quality of data on trade in services produced by the Bank of Botswana, it is not possible to draw any reliable conclusions about whether or not exports of services have also been performing well.

Despite the healthy growth of exports this has not been sufficient to generally bring the balance of trade back into surplus, because imports have also continued to increase dramatically. Total imports were up 32% in the first half of 2011 compared to the same period in 2010, particularly driven by imports of machinery & electrical equipment (up 99%), metals & metal products (up 56%) and fuel (up 41%). This partly reflects imports of equipment for the Morupule power project and mine developments at Jwaneng and Boseto, while expenditure on fuel imports reflects both higher prices and diesel supplies for emergency power generation facilities. In most months, imports are still exceeding exports, despite improved export performance.

Fig.7: Exports & Imports (Monthly)

Source: Statistics Botswana, Econsult



Box: The New Diamond Agreement with De Beers

After lengthy delays, a new marketing agreement between the Government of Botswana and De Beers in respect of the marketing of Debswana's diamond output was concluded in September. The previous agreement had expired in December 2010, and the process of reaching a successor agreement was clearly problematic. From what has been said in public, the key elements of the new agreement are as follows:

- Agreement to run for ten years (as opposed to five for previous agreements)
- The majority of Debswana's diamonds will be marketed through the Diamond Trading Company (DTC), but unlike in the past it will not be 100%;
- A small share of Debswana's "run-of-mine" production will be made available for independent marketing outside of DTC; initially this will be 10%, rising to 15% over five years;
- All of DTC's London operations will be transferred to Gaborone by the end of 2013;
- Continued support by DTC for Botswana's domestic cutting operations by ensuring adequate diamond supplies;

Considerable effort was made by the Botswana government to make sure that commitments were enforceable – and that there would be penalties for non-implementation. For instance, there was a previous commitment to move DTC operations from London, but this was not followed through. This time it seems certain to happen.

The new agreement is positive for Botswana and should, over time, lead to considerable benefits. First, the transfer of all DTC activities to Botswana will lead to Gaborone becoming the centre for marketing and sales of all De Beers' production, from its own mines and joint venture mines in Canada, South Africa and Namibia, as well as Botswana. This will directly lead to additional economic activity in Botswana, additional tax revenue for the government, and jobs for both Batswana and some personnel who will transfer from London. In addition De Beers' sight-holders will visit Botswana ten times a year for diamond sales, which will lead to additional tourism revenue (travel, accommodation etc.) and will hopefully stimulate the provision of additional facilities such as hotels and restaurants, and international flights. There would also be indirect economic benefits through the provision of support services.

The second benefit will be through the establishment of the independent marketing channel. This is being spoken of as primarily for the purposes of "verification" by providing the Government with an independent "window on the market", through which it can ascertain price trends and market conditions more generally. But a further consequence is that a new diamond sales mechanism will be established. While details have not been provided of exactly how this will work, it will most likely involve the establishment of a government diamond trader that will buy diamonds from Debswana and then sell them through a tender process. This will require the establishment of additional sales and marketing infrastructure, which will complement that already being established by independent producers Firestone (for the BK11 mine) and Lucara (for AK6). This may in time attract the selling of diamonds from other countries outside of the De Beers group – in the way that diamonds from Lesotho are already being sold in Botswana by Firestone. Both moves will help to establish Botswana as a global diamond hub, with a range of activities beyond simply mining and cutting/polishing.

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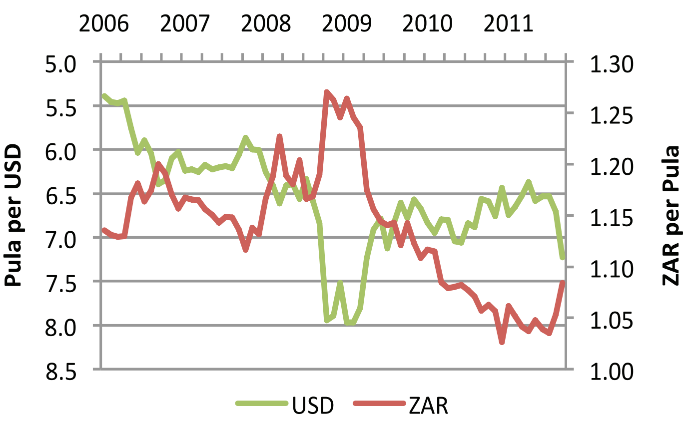
Exchange Rates

After a long period of relative stability, bilateral exchange rates experienced considerable volatility in August & September. The Pula appreciated by 4.7% against the rand and depreciated by 9.6% against the US dollar over the two month period, with the Pula reaching R1.10 and P7.5 to the US dollar in early October – levels that had not been seen for some time. This was driven by rand weakness against the US dollar and the operation of the Pula basket mechanism. Rand weakness in turn resulted from greater global risk aversion and capital outflows from South African capital markets as concerns mounted over the global economy. The rand is particularly vulnerable to such shifts in sentiment and global risk appetite, due to high levels of liquidity and its status as a benchmark Emerging Market currency. Another driving force has been the strength of the US dollar in global markets – somewhat ironically given the US's economic problems and the government's credit downgrade, but despite this, the US currency is still seen as a "safe haven" in times of distress, especially when the Eurozone is in even deeper trouble.

Fig.8: Exchange Rates

Source: Bank of Botswana



The main impact of these exchange rate changes will be to improve profitability for mineral producers (who have many costs denominated in pula or rand but revenues generally in US dollars), but to reduce profitability for non-mineral exporters (notably manufactured items such as textiles & garments), which primarily export to South Africa. It will also impact (negatively) on inflation (see below).

Although the rand has partially recovered from the lows it reached against the US dollar, the recovery has only been partial and the rand is still considerably weaker than it was in mid-year. This partly reflects the fact that the rand – at least in the view of many observers – was overvalued at previous levels. The weaker rand should help to boost the South African economy, in particular exports, albeit at the cost of temporarily higher inflation.

Botswana's exchange rate policy remains unchanged, with a peg to a rand/SDR currency basket adjusted through a crawling peg. The exact weights of the currencies in the basket and the rate of crawl are not disclosed, despite many recommendations for greater transparency from both local and international observers.

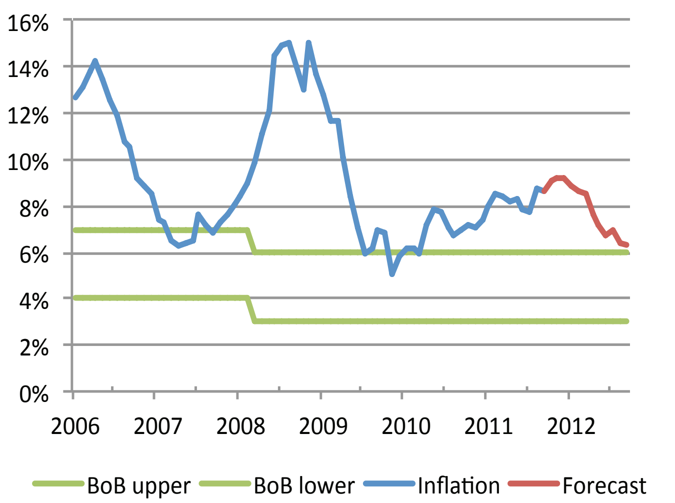
Inflation and Monetary Policy

Inflation has been stubbornly high during 2011 and is likely to remain so in the coming months. The increase in inflation – it reached 8.7% in August and only fell slightly to 8.6% in September – has been mainly driven by higher fuel prices as well as associated price changes such as for public transport fares. Other contributory factors have been higher electricity tariffs as well as food, clothing and furniture prices.

Despite higher domestic fuel prices they still lag international costs (driven mainly by crude oil prices) and a further price adjustment will be necessary unless international crude prices fall further. Although the price of Brent crude (the main benchmark for Botswana prices) has dropped – the dollar price was about 15% lower in early October than in late July - the beneficial impact of this has been partially offset by the depreciation of the rand and the pula against the dollar.

Fig 9: Inflation

Source: Statistics Botswana, BoB, Econsult



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Inflation has been stubbornly high through much of 2011 and the near-term outlook has deteriorated due to higher expected inflation in South Africa following the sharp depreciation of the rand. This will feed through to Botswana and will be only partially offset by the appreciation of the Pula against the rand. Our forecast is that inflation will end 2011 around 9% and will then decline slowly through 2012, and should fall back below 6% by end of 2012.

Interest rates have been on hold through the past quarter – with the Bank Rate at 9.5% - despite rates being relatively low in real terms by historical standards. The BoB's thinking was elaborated in the Mid-Term Review of the 2011 Monetary Policy Statement, released in August. Despite high inflation in the short term, the Bank's medium term forecasts are for inflation to fall over next 24 months, reaching 5.5% by the end of 2012 and falling well below 5% in 2013. Despite the lack of domestic demand pressures, much will depend on the extent to which high inflation in the short-term feeds through to wage settlements and inflation expectations.

Government Budget

Partial budget figures for the 2010/11 fiscal year were released in September, and show that the overall deficit for the year was P6.8 billion, considerably lower than the budgeted deficit of P10.2 billion. The smaller than expected deficit was due to both above-budget revenues and below-budget spending. At P31.6bn, revenues were P1.3bn (4%) above budget. Expenditure, at P38.3bn, was P2.2bn (5%) below budget – almost all due to underspend on the (highly ambitious) development budget. Information has not yet been released on the performance of different revenue categories, but it is likely that mineral revenues were above budget.

Good fiscal performance appears to have continued into the first quarter of the 2011/12 fiscal year, with revenues of P9.7 billion, spending and net lending of P8.7 billion, and hence a budget surplus of around P1 billion. This is a far better outturn than the budgeted figures for 2011/12 would suggest, which imply a pro-rated deficit for the quarter of P1.7 billion. Again, the driver of this favourable outturn is likely to have been revenues from diamonds, where prices have turned out to be much higher than when the 2011 Budget was formulated. However, budget performance in the second half of 2011 may be much less favourable, given the adverse developments in the diamond market – with lower prices and sales volumes - from August onwards. Nevertheless, recent results should make it easier for government to achieve its target of a balanced budget in 2012/13.

ECONOMIC OUTLOOK

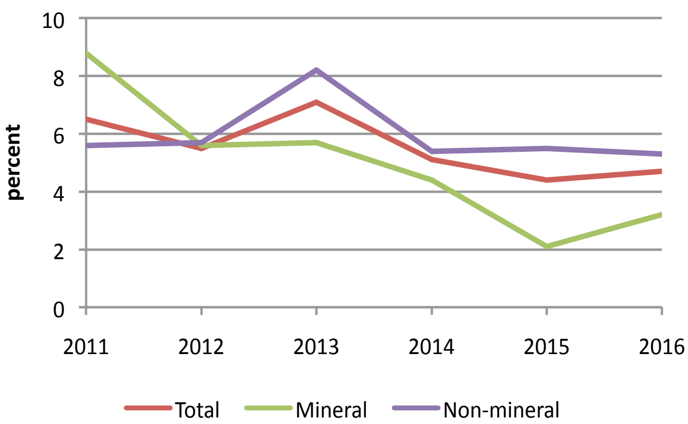
The generally favourable economic performance experienced so far in 2011 may not be sustained through the rest of the year, as international economic developments and uncertainty take their toll. Already it is clear that diamond prices and earnings will be less favourable in the final months of the year, which has implications for the balance of payments and government revenues. Despite this, the fiscal outturn for 2011/12 should be more favourable than projected at the time of the 2011 Budget. This increases the likelihood of achieving balanced budget next year, and may provide the fiscal space for a public sector pay rise in 2012 – although this depends crucially on global economic developments.

The global economy is where the main economic threats lie, at least in the short term. At best a period of sluggish growth is in store, and a worse a more serious financial and economic crisis leading to recession or depression, if the Eurozone's problems cannot be managed and contained. Botswana, like other emerging markets, is heavily dependent upon developed economies for exports and income, and the prospects are for a slowdown through the rest of 2011 and into 2012.

Looking further ahead, the IMF has recently released updated medium-term growth forecasts for Botswana (and other member states). These suggest that growth will continue at relatively healthy rates in 2012 and 2013 (assuming that there is no global economic crisis), and then declining slowly thereafter – although still remaining in the 4-5% range. The main driving force is a slowdown in mining sector growth rates after 2011 as the recovery in diamond output levels off. Non-mineral growth is set to continue at reasonably healthy levels of 5-6% a year – but only on the assumption that government implements reforms to improve the business and investment climate.

Fig 10: IMF Growth Forecasts

Source: IMF



Box: Preliminary Results, 2011 Population and Housing Census

Following the national population and housing census conducted in August 2011, Statistics Botswana has very quickly released preliminary results. These are based on an initial tally of the results from districts immediately following the enumeration, and as such the data have not been checked or cleaned. Highlights of the results were as follows:

- The total resident population of Botswana is 2.038 million, and population growth between 2001 and 2011 averaged 1.94% a year;
- The growth in the population was significantly higher than had earlier been predicted; CSO projections anticipated a population increase of approximately 169,000 between 2001 and 2011, whereas the actual increase was more than double this, at 357,000;
- The population growth from 2001-2011 was also considerably higher than had been projected by the UN Population Division earlier in the year; the UN had projected the population increase at around 25,000 a year (the actual was 36,000) with a population growth rate of 1.3% a year (actual, 1.9%).
- Possible explanations for the higher than anticipated population growth included:
  - the impact of widespread ART rollout, which was not fully factored into the earlier projections, and hence lower mortality from HIV/AIDS;
  - a high level of immigration from Zimbabwe;

  A full explanation will only be available when the data have been fully analysed with calculations of fertility, mortality and migration rates etc.

- The most dramatic population growth has been in the villages surrounding Gaborone (5.3% a year) and to a lesser extent Francistown (3.9%). Interestingly the cities themselves have not grown particularly fast (around 2%), presumably reflecting the shortage of land within urban boundaries and difficulties in expanding the housing stock. However, there are contrasting results for Lobatse and Selebi-Phikwe, which experienced virtually no population growth.
- The population of the Gaborone "travel to work" area (the city and surrounding villages as far as Ramotswa, Mochudi and Molepolole) now totals 534,000.