Economic Review

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INTRODUCTION

As 2010 drew to a close, economic developments in Botswana have continued to be largely positive, with improved growth, rising exports, low inflationary pressures and a cut in interest rates. Budget data indicate that the fiscal position, while still poor, is somewhat better than expected. Moving into 2011, the positive developments of 2010 should continue. Nevertheless there will be several difficult economic challenges to be faced in the new year, including the need to contain government spending and further reduce the budget deficit, and possible power supply problems.

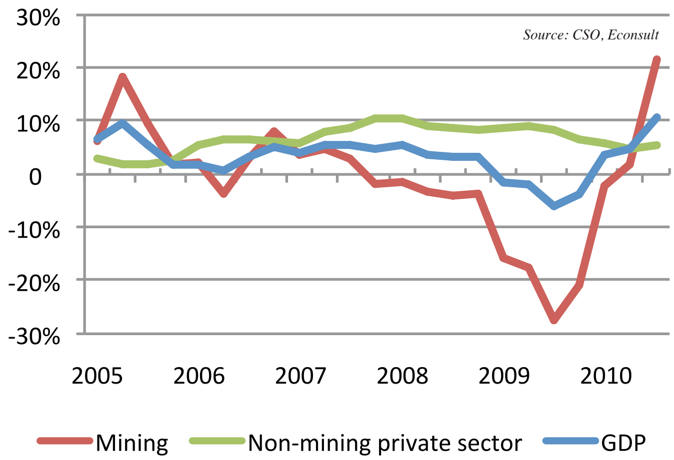
ECONOMIC GROWTH

GDP data for the period July to September 2010 have been released by the CSO, along with some revisions to earlier data for the first and second quarters of the year.

The impact of these revisions was to reduce recorded mining sector output – which we had earlier questioned as implausible and inconsistent with other data sources – resulting in a reduction in annual economic growth figures for the first half of 2010; annualised growth in the year to June is now presented as 4.6%, compared to the earlier figure of 9.2%.

While this may suggest that the recovery of economic growth in 2010 was not in fact as robust as had been earlier believed, the third quarter figures are encouraging, with real GDP growth reaching 10.7% in the year to September. This was largely driven by the recovery of mining, which grew by 21.7%. Other sectors that grew at a healthy rate include agriculture (40% growth), water & electricity (7.3%), transport & communications (5.7%) and trade, hotels & restaurants (5.2%). Sectors that grew slowly or even contracted were finance & business services (1.2% growth), manufacturing (minus 0.5%) and government (minus 1.8%). The contraction in government's contribution to GDP reflects the impact of expenditure restraint, following rapid growth in previous years.

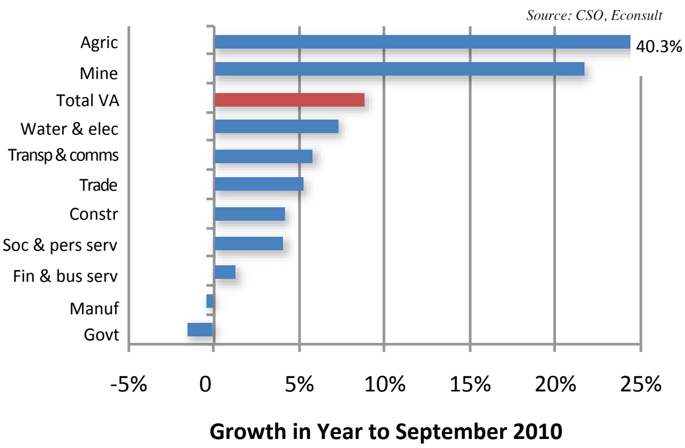
Fig. 1: Annual GDP Growth



Besides the robust overall growth rate, which was largely due to the recovery of mining output, there were signs of a stabilisation of growth in the non-mining private sector. Over the past two years, the growth of value added in the non-mining private sector – which is the focus of diversification efforts – has been declining, raising concerns that about the ability of the private sector to generate sustainable growth in the absence of the historical growth engines of mining and government. Between the beginning of 2007 and the second quarter of 2010, annual growth in the non-mining private sector fell by more than half, from 10.5% to 4.5%. In the third quarter of 2010, however, growth rose slightly to 5.1%. It is encouraging that the decline in non-mining private sector growth appears to have been halted.

Nevertheless, the dependence of economic growth on mining remains strong – mining contributed 58% of the overall GDP growth in the year to Sept 2010, while the non-mining private sector contributed only 23%.

Fig 2: Sectoral Output Growth (VA)



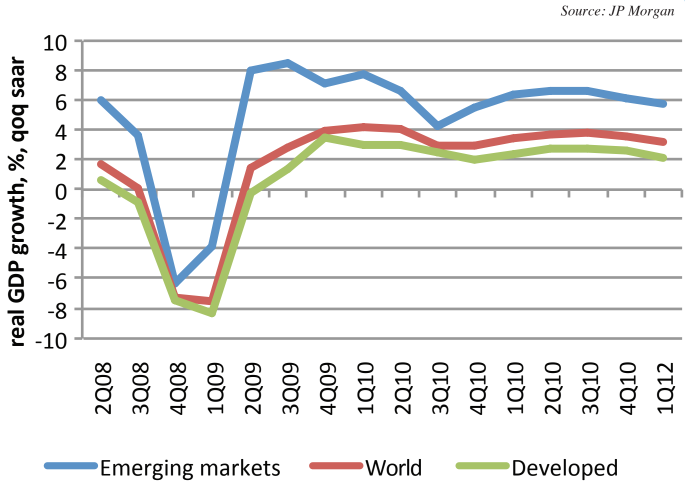
THE GLOBAL ECONOMY

Economic recovery in Botswana, which is being driven by the mining sector, is taking its cue from the recovery of the world economy.

Global economic growth appears to have picked up towards the end of 2010, after a mini-slowdown in the middle of the year. Fortunately the slowdown turned out to be just that – temporarily lower growth - and not the "double dip" recession that many had feared. There is still a clear divergence between developed and emerging markets – with the latter growing much faster than the former. There is a further divergence within the group of major developed economies, with the USA showing a stronger recovery than the euro zone and Japan.

While most developed economies remain concerned about slow growth, the persistence of high unemployment and fiscal deficits, the major emerging markets are more concerned about managing the impact of stronger growth. Therefore, while policy interest rates are still at very low levels – effectively near zero – in the USA, the UK, Japan and the Euro Zone, some emerging markets have already had to raise interest rates in order to contain inflationary pressures.

Fig 3: Global Growth Forecasts



TRADE AND THE BALANCE OF PAYMENTS

The main link between the global economy and Botswana's growth is through export firms and markets – primarily, but not exclusively, in the mining sector. Amongst Botswana's exporters there is a mixed picture. The market for diamonds has recovered more strongly than anticipated during the depths of the recession, which has enabled Debswana to increase diamond production above the originally projected level of 20 million carats in 2010. Prices for rough diamonds have also risen strongly, with an average increase of 21% during 2010. As a result, sales by De Beers Diamond Trading Company (DTC) rose sharply to an average of $484 million per sight in 2010, up from $325m in 2009. Nevertheless this remained well below the average of well over $600m per sight in 2007 and 2008.

Demand for diamond jewellery in the USA, the world's largest market, has improved, and retailers enjoyed reasonably good sales during the Christmas season. Nevertheless, the market remains turbulent and subject to fluctuations in consumer confidence. Globally, retail (polished) diamond prices rose by around 10% in 2010, less than the increase in rough prices, and as a result industry margins are being squeezed. This will limit the scope for further increases in rough prices in 2011, unless there is a stronger recovery in the retail market.

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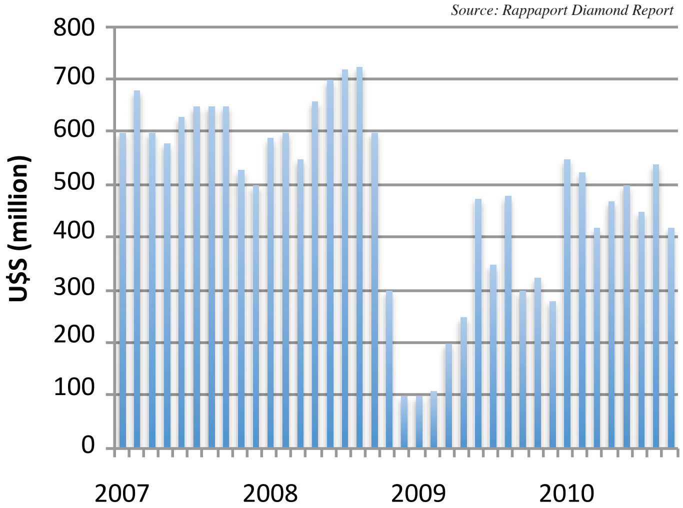
Fig 4: DTC Diamond Sales

Source: Rappaport Diamond Report



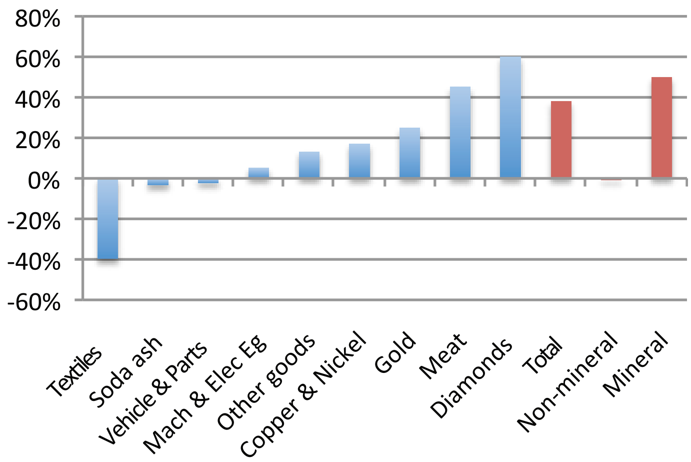
Traditionally all of Botswana's diamonds have been sold through the DTC, and as a result Botswana diamonds account for the majority of DTC sales. However, the Debswana sales agreement that governs this arrangement was due to expire at the end of 2010, and there has been discussion of the possibility that part of Debswana's production may be sold independently, outside of the DTC. The idea is that an independent marketing channel – say through a tender process – would give Botswana an independent view of the market, and would help to build up a skills base in diamonds sales and marketing that would support the country's intention of diversifying into diamond-related activities beyond mining – the Diamond Hub concept. By the end of the year, no announcement had been made of the outcome of the negotiations for a new sales agreement, or of whether Botswana had decided to establish an independent marketing channel.

Beyond diamonds, which remain Botswana's largest export despite the impact of the global crisis, copper and nickel also had a good year in 2010 with strong price growth. Copper prices hit record levels, while nickel prices were up 35% on the year. Botswana's modest gold exports also benefited from higher prices. Nevertheless, the gains of higher prices for mineral exporters were offset somewhat by the weakness of the US dollar.

Despite this, exports have been performing strongly, with annual growth of 38% for total exports in the year to October, and 50% growth for mineral exports. Outside of mining, beef exports have also risen sharply, while the weakest performer continues to be the textiles sector.

Fig. 5: Export Growth, year to Oct 2010

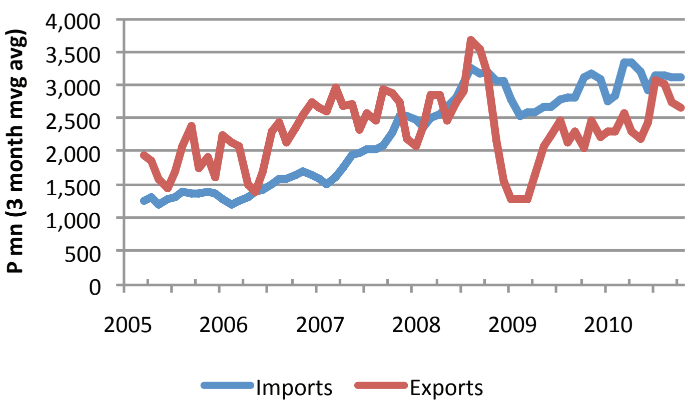
Source: CSO, Bank of Botswana, Econsult



The strong growth in exports has helped the balance of payments. However the export recovery was from a low base, in 2009, and despite the resurgence, exports have generally remained below imports. The balance of trade (exports minus imports of goods) has been in deficit for 24 of the 25 months to October 2010, although the deficit has generally been declining as exports have picked up.

Fig 6: Exports & Imports (Monthly)

Source: CSO, Bank of Botswana, Econsult



INFLATION AND MONETARY POLICY

Inflation has largely behaved as expected in the second half of 2010, with no great surprises. The increase in inflation from the recent low point of 6.7% in August to 7.4% in December – a trend that may continue into early 2011 – is not of great concern, especially as monthly inflation figures have typically come in slightly below expectation. Underlying inflationary pressures remain very low, with imported inflation - whether from South Africa or the rest of the world – at historically low levels, and little or no evidence of domestic inflationary pressures from aggregate demand or labour costs.

There are, however, some concerns regarding international prices, particularly for key foodstuffs traded on global markets, where prices have risen sharply in recent months, as well as for oil and other commodities such as base metals. These developments have not yet fed through to regional prices – for instance, good harvests in Southern Africa have kept grain prices relatively low – but it now seems likely that there will be modest upward movements in international and regional inflation over the next 18 months.

Despite, this, it remains our forecast that inflation in Botswana will fall sharply in the second quarter of 2011, and we anticipate inflation of around 5% by mid-year. Inflation may start rising before the end of 2011, but we still expect it to remain below 6% – and hence within the Bank of Botswana's objective range – through to the end of the year.

The positive inflation outlook enabled the Bank of Botswana to cut interest rates by 0.5% in December. While this was perhaps earlier than expected, the cut was consistent with the forward-looking monetary policy that has been proclaimed by the Bank. The continuation of low interest rates – at least by historical standards, given that interest rates are at their lowest since December 1990 – will help to support the private sector, and provide some compensation for the tightening of fiscal policy. There may still be scope for further interest rate cuts, if inflation falls as anticipated and assuming that government sticks to its commitment to move towards a balanced budget by 2012/13, although much will depend on the strength of emerging international inflationary pressures in respect of food and commodity prices.

Fig 8: Prime Lending Rate

Source: Bank of Botswana, Econsult

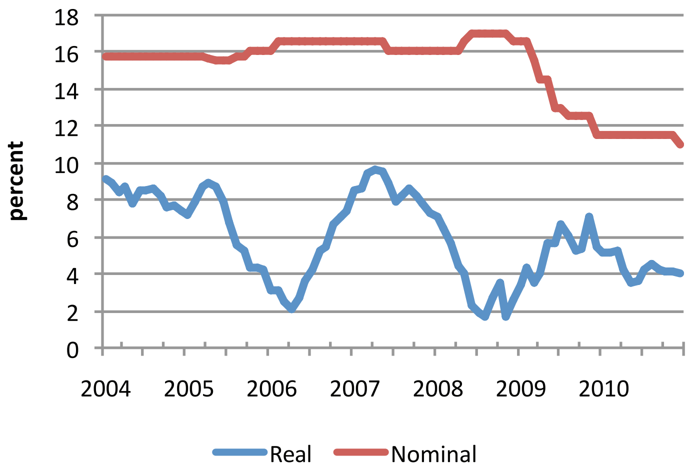
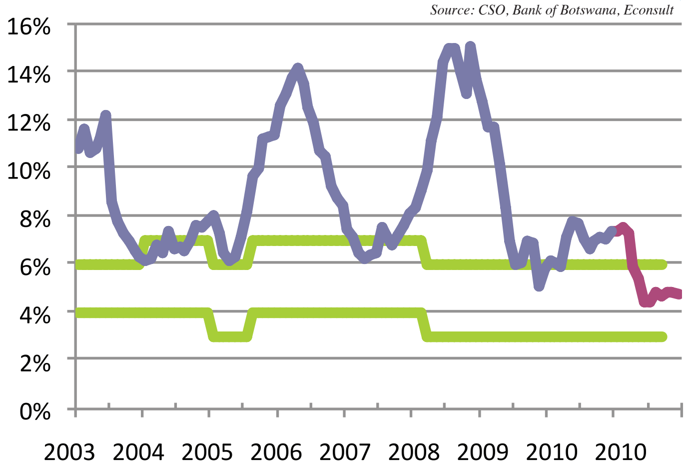


Fig 7: Inflation & Forecast

Source: CSO, Bank of Botswana, Econsult



EXCHANGE RATES

The exchange rate environment has been challenging for many firms in 2010, not least because exchange rates have moved unexpectedly. What has been striking has been the depreciation of the Pula against the SA rand – by 7.4% during 2010, to end the year close to parity (P1 = R1.027 as at 31 December). This has raised concerns about the impact on inflation through rising import prices. The cause of this has largely been the strength of the SA rand against the US dollar and other major currencies, which has in turn been driven by two major forces: short-term capital inflows into South Africa leading to a strengthening of the rand, and the weakness of the US dollar.

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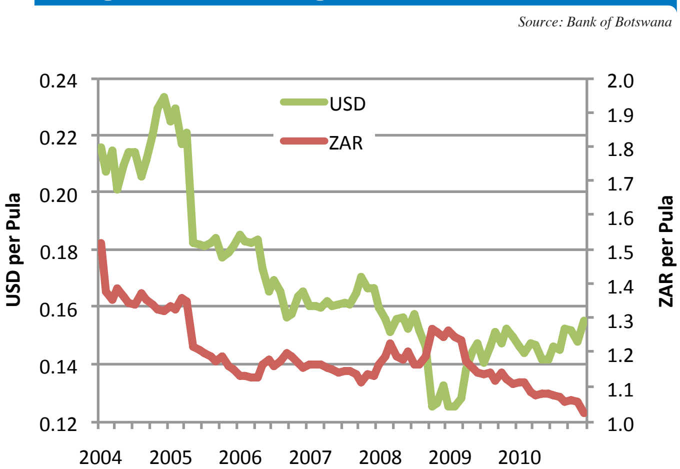
These developments have been interpreted as reflecting "Pula weakness". This is not really correct, as depreciation against the rand has been offset to some degree by appreciation against the US dollar. Overall, the Pula depreciated by 2.6% during 2010, in line with the crawling peg-basket arrangement. This figure reflects the impact of exchange rate changes on the economy as a whole, and provides a guide to the impact of the exchange rate on inflation. However, the impact may be more or less on individual firms, especially those that have costs and revenues in different currencies.

The general expectation is that the rand will weaken during 2011, and that the situation will "normalise" with the Pula strengthening against the rand. However, this was also the expectation at the beginning of 2010, providing further evidence that predicting exchange rates, especially short-term movements, is beset by uncertainty.

Fig.9: Pula Exchange Rates vs ZAR and USD



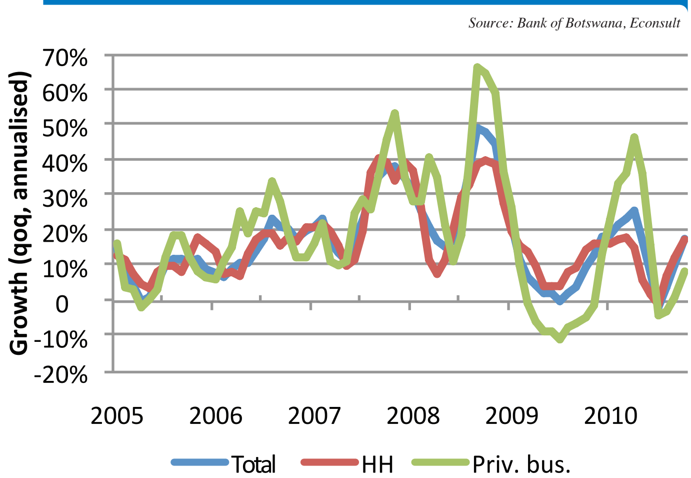
FINANCIAL SECTOR

The improvement in economic activity during 2010 has been associated with a normalisation of conditions in the financial sector. Arrears on bank lending, which had risen sharply during 2009, stabilised during 2010 and by September had fallen slightly, due to an improvement in arrears on business lending. Although household arrears remain at a high level, the situation has remained steady since late 2009.

The rate of growth of bank credit is a good indicator of economic conditions generally and particularly of business conditions in the banking sector. Ideally, credit growth should not be too high (which could indicate overheating in the economy and/or lead to over-indebtedness among borrowers) nor too low (which would indicate sluggish economic activity and/or debt stress). Credit growth should ideally be fairly stable and predictable.

Following the recovery from the "credit crunch" of 2009, credit growth rose steadily in late 2009 and into the first part of 2010, before experiencing a setback in mid-year. However, this seems to have been temporary, and credit growth has resumed at a reasonable rate. The increase in the growth of credit to households may reflect the pay rise given to public sector employees around September, following the coming into force of the new Public Service Act.

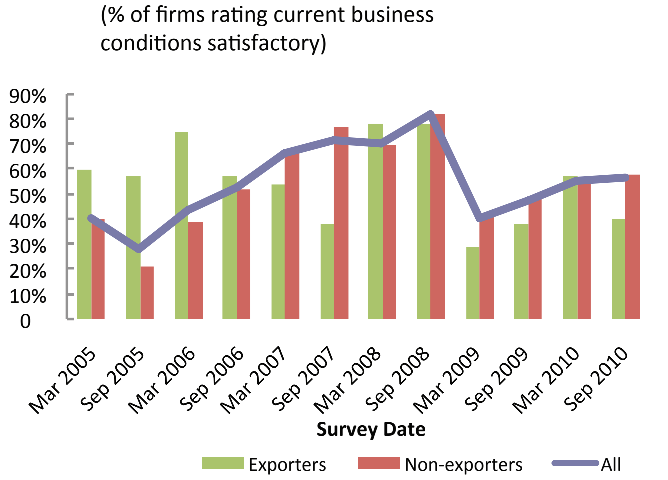
Fig 10: Credit Growth



ECONOMIC OUTLOOK

The Bank of Botswana released the results of the second 2010 Business Expectations Survey (BES) around the end of the year. Consistent with other indicators, the level of business confidence has improved, with 56% of businesses satisfied with current business conditions (in September – October 2010), compared to 55% six months earlier. There was a marked divergence between exporting firms and those focused on the domestic economy; exporting firms' confidence was lower and declining, while domestic firms' confidence was higher and rising.

Fig.11: Business Confidence Index



This is odd, given the recovery of the mining sector, rising global growth and improving international economic conditions, and declining growth in the non-mining sector of the Botswana economy, which is largely domestically focused. It is also surprising given the dependence of domestic firms on government procurement, and the tightening of fiscal policy and slowing of expenditure growth. The BoB suggests, however, that sentiment could be dominated by other factors, including the appreciation of the pula against major international currencies, which may squeeze the profit margins of exporters, especially those with costs denominated in pula or rand. Domestic sentiment could be influenced positively by increased efforts by government to procure goods and services locally.

Looking ahead, what are the prospects for the economy for the first half of 2011? The private sector expects a continued improvement in economic conditions, judging by the results of the BoB survey. We share the view that economic conditions should continue to improve, but would caution that this is unlikely to be evenly distributed across economic sectors. The most sustained improvement is likely to be in export sectors, particularly mining, with rising global growth supporting demand and prices. The fortunes of the mining industry will be boosted by the development of new mines – for diamonds (AK6) and copper-silver (Boseto) – and the re-opening of the Damtshaa mine by Debswana. Sectors focused on the domestic economy – particularly government and household consumption – are likely to find conditions more challenging, however. The government budget will remain tight, with little or no increase in overall spending and a possible scaling down of development spending, and as well there is unlikely to be an across-the-board public sector pay rise in 2011. A further potential threat to the economy is the likelihood of disruption to power supplies, given the reduced availability of imports from Eskom (South Africa) and insufficient domestic supplies, and load shedding is a very real possibility.

On the bright side, inflation should fall substantially during the year – our forecast is that inflation will average 5.8% in 2011, compared to 6.9% in 2010. As a result, interest rates should stay low and may even be reduced further.

Box: 2011 Budget Outlook

One of the most dramatic impacts of the global financial and economic crisis on Botswana was on the government budget, which moved from substantial surplus to substantial deficit between 2006/7 and 2009/10. The move into budget deficit was not just the result of the global crisis, however, but was also the result of longer-term trends that the global crisis simply accentuated.

At the time of the 2010 Budget, it was projected that the deficit for the 2009/10 fiscal year would be P13.5 billion, or around 15% of GDP – a magnitude that would be unprecedented in Botswana's history and large by international standards, even in a period of generalised high budget deficits. The 2010 Budget also put forward a fiscal stabilisation programme that would achieve a balanced budget within three years (by the 2012/13 fiscal year).

Although the 2009/10 fiscal year ended in March 2010, there was a long delay in providing data on the actual budget outturn – partial information was finally released in December 2010. This shows that the outturn was somewhat more favourable than that projected at the time of the Budget. The actual deficit for 2009/10 was P9.5 billion, or 11% of GDP, some P4 billion less than estimated. The reason for the improvement was both higher revenues and less spending than budgeted.

On the revenue side, mineral revenues were P2.3 billion over budget, as the diamond market recovered more quickly than had earlier been thought. As for other revenues, VAT and donor grants came in ahead of budget, but this was offset by non-mineral income tax and revenues from fees and charges, which were below budget.

On the spending side, expenditure was P1.8 billion below budget. Almost all of this was due to underspending on the development budget; approximately 90% of the P14.4 billion development budget was actually disbursed, resulting in a saving of P1.4 billion.

The budget outturn for 2009/10 therefore represents moderately good news, in that the deficit was smaller than had been feared, due to a combination of good fortune (recovery in the diamond market) and underspending.

Table 1: Budgeted and Actual Revenues and Spending, 2009/10 Fiscal Year (P million)

	Budget	Actual
REVENUES	**27,782**	**30,023**
Mineral	6,835	9,088
Non-mineral income tax	5,852	5,561
Customs Pool	7,931	7,931
Grants	313	769
VAT	3,687	3,944
Fees & charges	1,656	1,237
EXPENDITURE	**41,265**	**39,489**
Recurrent	26,378	25,732
Development	14,445	13,006
Net lending	442	751
BALANCE	**-13,483**	**-9,466**

Source: MFDP and BoB"

However, the outcome doesn't fundamentally change the fiscal challenge facing the country. Expenditure, even though slightly below budget, was still very high at 44% of GDP, and the deficit was at an unsustainable level. The challenge of achieving a balanced budget by 2012/13 remains. While this will be assisted by a continued recovery of mineral revenues, the overall revenue picture will be adversely impacted by the anticipated decline in SACU revenues, and hence the burden of fiscal adjustment will fall on the expenditure side of the budget.

The 2011 Budget Speech will be delivered by the Minister of Finance and Development Planning on February 7th. Amongst the key issues that the Speech should focus on are the following:

Revenue, Spending and Surplus/Deficit Forecasts: the Budget will elaborate how revenue estimates and forecasts have been affected by the recovery in the global economy (in the revised estimates for the current fiscal year 2010/11 -

and budgeted figures for the coming fiscal year - 2011/12); there will also be an update on the planned achievement of a balanced budget by 2012/13, and the expenditure levels consistent with this target. Crucially, the Budget will need to demonstrate a significantly reduced deficit in 2010/11 and 2011/12. It would also be helpful if the Minister would give a commitment to improved transparency and timely publication of government revenue and expenditure data in line with international standards.

Expenditure restraint: the projections for little or no spending growth made in the 2010 Budget are unlikely to change significantly, even though available resources will fall short of spending demands from Ministries. The interesting question will be how the burden of expenditure restraint will fall across the recurrent and development budgets; it is likely that the burden will fall mainly on the latter, which will require clear prioritisation of expenditures and projects, in order to minimise the potential adverse impact. Even with cuts in development spending, measures to contain recurrent spending will also be needed, especially the public sector salary bill. Given the need to reduce the deficit, and the unbudgeted public sector salary increase awarded in 2010, it is unlikely that the Budget will include a general public sector pay rise.

Policy reforms: reducing the budget deficit and achieving fiscal sustainability is an important objective, but in the short-term, expenditure restraint may have a negative impact on the domestic economy. Hence it is important to support the growth of the private sector to fill the gap left by government. This requires a whole range of reforms to reduce the dependence of the private sector on government spending, and to encourage export-led diversification. Botswana's deteriorating performance on international indicators such as the World Bank Doing Business exercise, and the World Economic Forum's Global Competitiveness Indicator, confirms that urgent reforms are needed to improve the business environment.

Privatisation: progress with privatisation and public-private partnerships (PPPs) has been extremely slow, and the Budget will hopefully include firm commitments to complete the privatisation of Botswana Telecommunications Corporation and the National Development Bank, and to put a range of PPPs in place.

Deficit Financing and Debt Management: the Budget will need to provide clear information on how government intends to fund the deficits anticipated for 20010/11 and 2011/12 – whether through bond issues, other forms of borrowing, or use of accumulated savings at the Bank of Botswana. There is also an urgent need for improved debt management, and improved dissemination of information regarding the Government's outstanding debt and guarantees, to enable independent monitoring of debt sustainability and compliance with statutory requirements.

Budget consolidation: recent years have seen a proliferation of levies - or hidden taxes – and off-budget spending, both of which go against best practice principles of public finance accountability and transparency. The Ministry of Finance and Development Planning wants to bring these into the budget and the established budgetary oversight process. The Budget will show whether they have been successful in this regard.