Bifm Economic Review 2nd Quarter 2010

Economic Review

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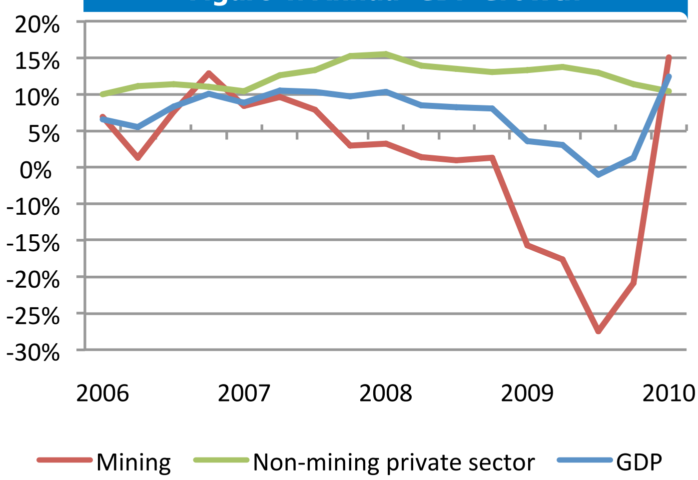
Introduction

As we reach the mid-point of 2010, economic conditions have continued to improve alongside the global economic recovery. GDP data for the first quarter of 2010 show healthy growth as the mining sector has recovered. There has been an improvement in exports as diamond sales have improved, with diamond prices recovering to pre-crisis levels. Domestically, bank credit growth has returned to healthy levels with a welcome focus on business rather than household lending. And despite the global crisis and recession, employment has continued to grow.

Nevertheless, these developments should not be interpreted as suggesting that Botswana has survived the global financial and economic crisis unscathed, or that economic difficulties have passed. The country has a large budget deficit, government borrowing has jumped, and the government's net financial position has deteriorated sharply. Global recovery will help to offset this, but the fundamental fiscal problem resulting from adverse medium and long-term trends, which has been exacerbated by the global crisis, still has to be addressed.

Figure 1: Annual GDP Growth



Source: CSO, Econsult

Economic Growth

Botswana GDP

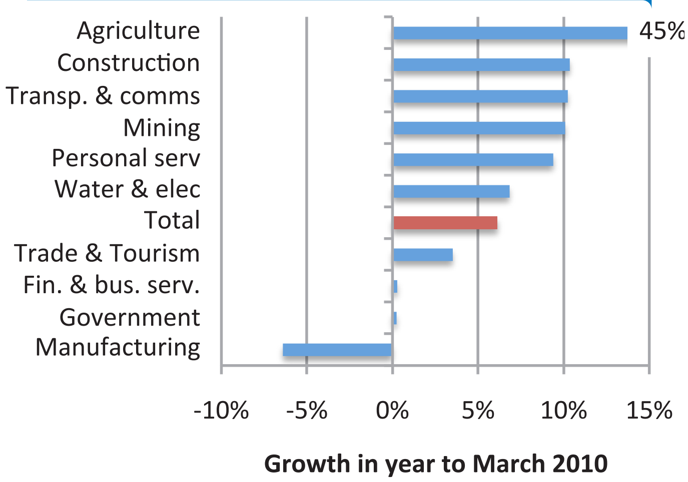
Data on real GDP for the first quarter of 2010 shows an overall improvement in economic growth. Over the 12 months to March 2010, the economy grew by 7.5% - the first time that the economy has shown positive growth over a 12 month period since the final quarter of 2008. Although the data only cover the first quarter of the year, this is in line with our forecasts for full year growth for 2010.

The recovery in growth has been largely driven by the mining sector, which grew by 10.1% over the year to March. The non-mining private sector did less well, with overall growth falling to 5.5%. Although this growth rate was still respectable, there was a mixed picture across the non-mining sector of the economy. Manufacturing contracted by 6.4%, while finance and business services output was more or less flat, with only 0.3% growth. There was healthier growth in construction (10.3%), transport & communications (10.2%), and social and personal services (9.4%). Agriculture boomed with 45% growth over the year to March, although the source of this growth is difficult to pin down as it mostly emanated from the nebulous "other agriculture" sub-sector rather than crops or livestock. Government output was static, with growth of only 0.2%.

While reasonably encouraging, these data should, however, be treated as tentative. Some of the numbers are questionable and may well be revised in future, which could affect the level of economic growth recorded.

The latest data include revisions to 2009 GDP figures. These now indicate that the Botswana economy contracted by only 3.7% in 2009, as compared to the 6.0% previously indicated. If this is correct, Botswana experienced a less severe recession than some of the large developed economies such as Germany, Italy, Japan and the UK.

Figure 2: Sectoral Output Growth

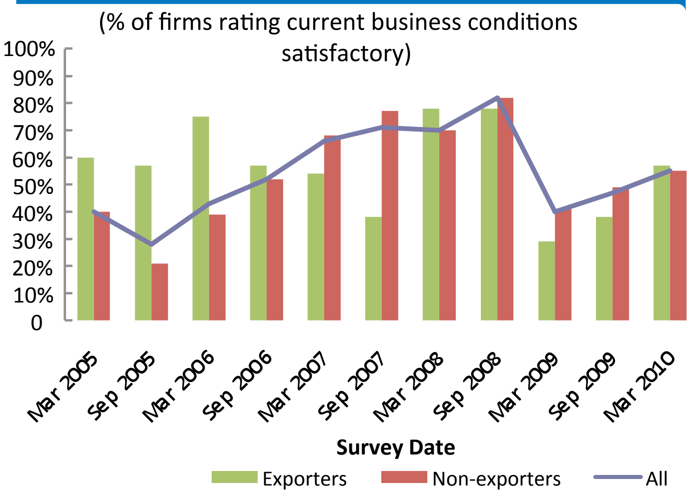


Source: CSO

Business Expectations

The improved growth environment is reflected in the results of the Bank of Botswana's latest Business Expectations survey, carried out in March/April 2010. Overall confidence – the proportion of firms considering current business conditions to be satisfactory – rose to 55%, compared to 47% in September 2009, although it remains much lower than in the more bullish years of 2007 and 2008. There is also a strong anticipation that the economic environment will be much better in 2011, with 71% optimistic about business conditions then.

Figure 3: Business Confidence Index



Source: Bank of Botswana

Notwithstanding the improvement in confidence, other results from the survey suggest that private sector expectations are more pessimistic than official forecasts:

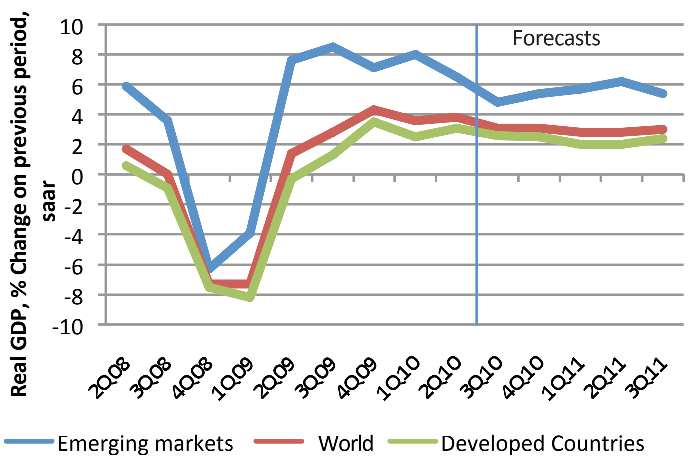
- Businesses expect GDP growth of 2.7% in 2010 and 3.3% in 2011; this compares with a forecast of 5% for 2010/11 in the 2010 Budget Speech, and IMF forecasts of 6.3% in 2010 and 5.1% in 2011;
- Businesses expect inflation to average 8.8% in 2010 and 9.5% in 2011; this compares with the Bank of Botswana's inflation forecasts of around 6.5% in 2010 and 5% in 2011 given in the 2010 Monetary Policy Statement.
- There is no expectation of significant employment growth over the next 12 months.

The overall impression from the survey is of improving, but still difficult, business conditions.

International Developments

Botswana's economic recovery is in line with international developments, as would be expected for an economy that is highly dependent upon international trade. The global economy continues to show robust growth. However the divergence between growth in developed countries and emerging markets has become broader, with the latter showing much higher growth.

Figure 4: Global Growth Forecasts



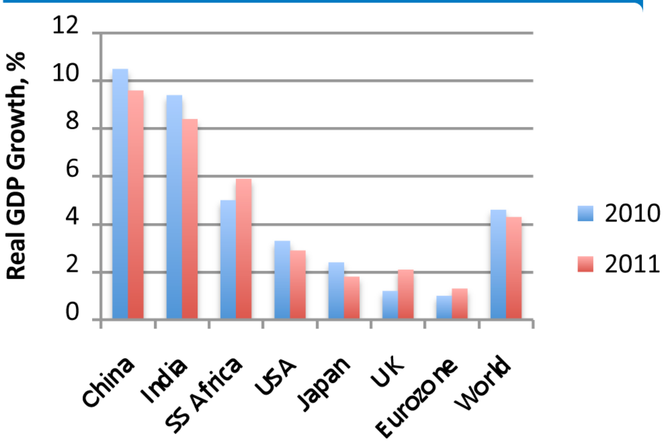
Source: JP Morgan

Over the past few months, however, the risks surrounding the global economic recovery have risen, and in particular there are greater concerns regarding downside risks that could undermine that recovery and possibly lead to a "double dip" recession. It has long been known that policymakers would face major challenges in managing the recovery, in particular attaining the appropriate balance between the withdrawal of fiscal stimulus and containing public debt levels. Premature cutting of government spending runs the risk of undermining the recovery, while delayed cutting runs the risk of accumulating unsustainable debts. A second major uncertainty relates to the soundness of banks and other financial institutions, and to what extent the global financial crisis and proposed regulatory changes has impacted on the banks.

Both of these issues have been evolving in a negative direction. The debt crisis in parts of the eurozone – notably Greece but with contagion to Portugal, Spain, and Italy - has pushed policymakers towards greater concern with debt sustainability, and a greater readiness to cut spending earlier, which will slow down growth, at least in the short-term. But the debt crisis has wider implications. The European Central Bank has had to bail out governments - contrary to the intentions of the designers of the eurozone - which may undermine monetary policy credibility. Sovereign debt problems have also led to concerns about the stability of European banks, which have exposure to government borrowing, and which may impact on their ability to extend credit to finance economic recovery. More generally, the Greek crisis has raised serious concerns regarding the stability of the European Monetary Union, which adds to economic uncertainty. As a result, economic growth in Europe is likely to remain very weak.

Conditions in the USA are somewhat better, but the recovery in consumer confidence has been sporadic and unemployment remains high. Both factors will weigh down on growth. Emerging markets do not really face the same problems, as they have much healthier public finances and more sound financial institutions. There, the problem is more related to potential overheating –as in China's property market - as economies recover, requiring measures such as higher interest rates to contain inflationary pressures.

Figure 5: Growth Forecasts, 2010 & 2011



Source: IMF World Economic Outlook

While the IMF has slightly raised its projections of global growth in its most recent forecasts – to 4.6% for 2010 – it points to a range of risks that could hinder the recovery. These include the above points (reduced bank lending due to new financial regulations and concerns about government debt; reduced consumer and business confidence; and the impact of deficit cutting and reduced government spending). In addition, the IMF considers that American property prices could fall further, and that exchange rates could be quite unstable, adding further to global economic uncertainty. All in all, the IMF sees only downside risks to global growth, despite the upward revision in the global growth forecast.

Foreign Trade and Exchange Rates

Exports, Imports and the Trade Balance

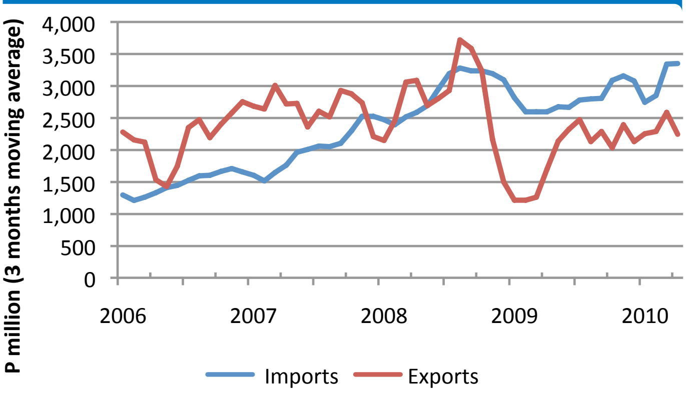
Exports have continued to recover in 2010, in line with the growth of the global economy and world trade. In the first three months of 2010, exports averaged P2.6 billion per month, compared to only P1.3 billion in the first quarter of 2009. This compares well with pre-crisis monthly average exports of around P2.7 billion in 2007 and 2008.

The recovery has been most striking in respect of diamond exports, which of course fell to very low levels in the first months of 2009 – so that recovery is off a low base. The recovery reflects higher diamond production and sales volumes, as well as a strong recovery in diamond prices. There has also been good export performance – compared to the first quarter of 2009 – for a range of other exports including meat, gold, vehicle parts, and machinery & equipment. The main problem area has been textile & garment exports, which fell by 55% in the first quarter of 2010 compared to the same period in 2009. This follows the closure of Botswana's largest garment manufacturer and exporter, Caratex, and problems faced by other exporters.

Although exports have picked up, this does not mean that all is well on the foreign trade front. Exports have recovered from the low of early 2009, but in the meantime imports have been growing steadily. For most of 2007-8, monthly exports of P2.7 billion comfortably exceeded imports, but by the first quarter of 2010, monthly imports averaged well over P3 billion. The last time that exports exceeded imports was September 2008. Notwithstanding the export recovery, therefore, the balance of trade has remained in substantial deficit.

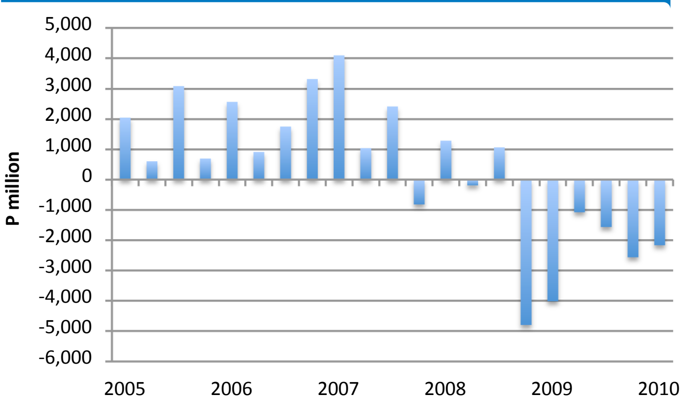
The main drivers of increased imports appear to have been diamonds, as cutting and polishing activity has resumed, and fuel costs, given the large quantities of diesel required for emergency electrical generation capacity.

Figure 6: Exports & Imports



Source: CSO, Econsult

Figure 7: Trade Balance (quarterly)



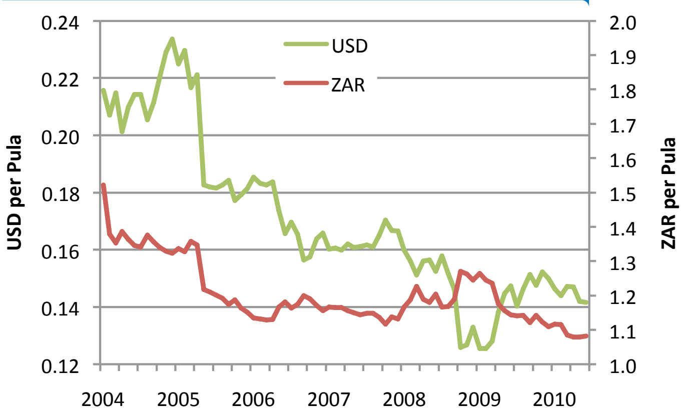
Source: CSO

Exchange Rates

In recent months one of the main topics of discussion with regard to the exchange rate has been the weakening of the pula against the rand. The rand/pula exchange rate has been below R1.10 for much of 2010, a level that is almost unprecedented over the past 30 years. The apparent weakening of the pula has raised concerns that this will push import prices and inflation, and that the exchange rate will soon approach parity.

As Figure 8 shows, in the short term, the pula/rand exchange rate tends to move in the opposite direction to the pula/US dollar exchange rate (a weakening of the pula against the rand tends to be associated with a strengthening against the US dollar, and vice versa). This is because of the operation of the pula basket mechanism, under which movement in the rand/US dollar exchange rate is a major determinant of the exchange rate of the pula against each of these currencies, especially in the short-term. For most of the period since the beginning of 2009, the rand has been strengthening against the US dollar, and also strengthening against the pula. The apparent weakening of the pula is, therefore, largely a consequence of a strong rand.

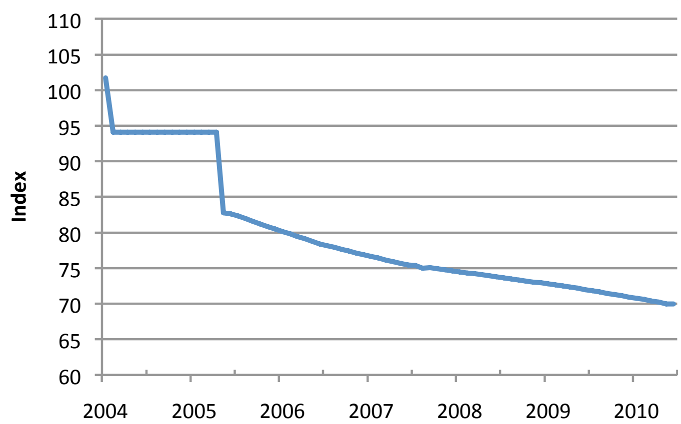
Figure 8: Pula Exchange Rates vs ZAR and USD



Source: Bank of Botswana

In the longer-term, however, the exchange rate policy governing the pula basket mechanism – such as the current crawling peg – probably has more influence on the value of the pula than bilateral cross exchange rates. As Figure 9 shows, the crawling peg has led to a gradual depreciation of the nominal effective exchange rate (NEER - the value of the pula against the basket) over the past five years.

Figure 9: Nominal Effective Exchange Rate



Source: Econsult

What are the implications of this? The rand/pula exchange rate is determined by a combination of bilateral rates (especially the rand/dollar rate, but also, to a lesser extent, the exchange rates of the euro, yen and pound) and the crawling peg. In the coming years, these influences are likely to be pulling in opposite directions. With regard to the rand, there is a widespread view that the currency is overvalued, and that a weaker rand would be beneficial for the

South African economy. If the rand does weaken in the medium term, which we consider likely, this will tend to push the value of the pula up against the rand. However, the crawling peg, assuming that it continues at something around current rates, will tend to push the value of the pula down against all currencies, including the rand. On its own, the crawling peg would indeed move the pula/rand exchange rate towards parity. Our view is that the balance of these pressures will probably cause the pula to weaken further against the rand over the next 6-9 months, but that it will not reach parity. Eventually the rand will weaken, and this will cause the pula to strengthen against the rand, and most likely recover to above R1.10 by the end of 2011.

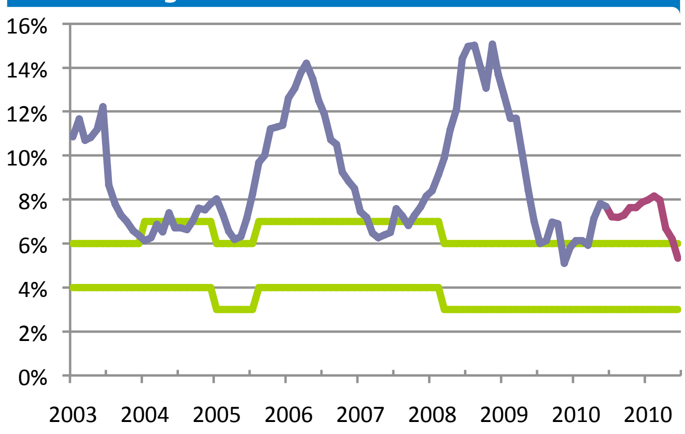
What will the impact of this be on inflation? A weaker pula against the rand adds to the inflation imported from South Africa. But as noted earlier, this tends to be offset by the strengthening of the pula against the US dollar, which therefore tends to subtract from the inflation imported from the rest of the world. As the pula has strengthened against the US dollar, we have therefore been spared some of the impact of rising international oil prices (which are denominated in US dollars). It is the crawling peg that adds to imported inflation on a consistent basis, not movements in bilateral exchange rates such as the pula/rand. And at current rates of crawl, this impact is fairly modest.

Inflation and Monetary Policy

Inflation

Inflation has been rising in recent months, driven by cost pressures relating to the 2% increase in VAT in April, and higher electricity and fuel prices. During the second quarter of 2010, inflation rose from 5.9% to 7.7%. Whereas inflation fell within the Bank of Botswana's inflation objective range of 3-6% for a few months at the end of 2009 and early 2010, it has since risen significantly above the upper end of this range.

Figure 10: Inflation and Forecasts



Source: CSO, Econsult

Despite this increase, underlying inflationary pressures remain low. Internationally, inflation in the major developed economies is forecast to remain below 1.5% during 2010 and 2011, while in South Africa inflation is forecast to remain within the country's inflation target range of 3-6%. Hence import price pressures should remain modest over the next 18 months. Botswana's crawling peg exchange rate regime will add slightly to imported inflation, but even so, imported inflation in pula terms should remain below 6%. Domestically, demand pressures from households, firms and government are likely to remain subdued, and are unlikely to add to inflation. The main risk to inflation comes from potential cost pressures, which could include wage increases, further increases in electricity tariffs, and international fuel prices. On balance, Botswana inflation is likely to remain around 7.5-8% for the next 12 months, but should fall back below 6% by the middle of 2011.

Monetary Policy

After an aggressive period of rate cutting between late 2008 and the end of 2009 – during which the Bank Rate came down by 5.5% - the Bank of Botswana has kept interest rates on hold during the past six months. There may have been some expectations that rates would increase as inflation picked up, but this was always unlikely. The BoB's monetary policy framework makes it clear that it is the expected medium-term path of inflation relative to the monetary policy objective that determines the stance of monetary policy, not short-term movements in inflation. The mid-year review of the Monetary Policy Statement will make it clear whether BoB has revised its expectations regarding inflation through 2010 and 2011. However, we doubt that forecast inflation will have changed much from that presented in the 2010 MPS in February. Our own forecasts support BoB's expectations that inflation will fall back within the inflation objective range by mid-2011. Unless there are any major shocks to inflation (such as from large increases in international fuel or food prices), we consider it likely that interest rates will remain on hold for the foreseeable future. With uncertainties regarding the strength of domestic economic activity as government spending is cut back to restore fiscal balance, it is clearly appropriate for monetary policy to keep interest rates relatively low to support the economic recovery.

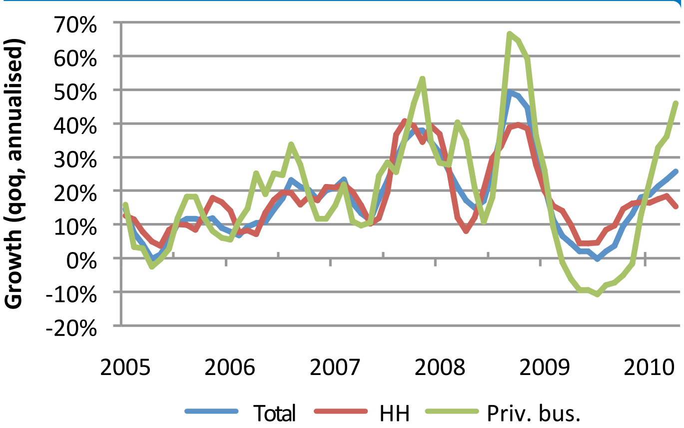
Financial Sector

The GDP data show that the financial sector experienced a severe growth slowdown in 2009, after many years in which Finance and Business Services had been one of the fastest growing sectors of the economy. The slowdown mainly affected the banks but also extended to other financial activities such as insurance – presumably because the squeeze on household incomes has put pressure on resources available for premiums, while the global recession has reduced the value of financial assets such as pensions.

There are some signs of recovery in the first half of 2010, however. Credit growth has been rising and continues to show steady recovery. The recovery has largely been driven by renewed lending to the private business sector, while the banks are being much more cautious regarding lending to households.

This is not surprising: arrears on household lending remain much higher than on lending to businesses, indicating the risks of lending to households while real incomes remain squeezed and many households are over-borrowed. Increased lending to businesses rather than households is also preferable from an economic development perspective. While arrears on bank lending to households remains a major concern, a positive development in the first quarter of 2010 is that the arrears rate has fallen (marginally, from 7.5% to 7.1% of credit overall, and from 10.2% to 10.0% on household loans). If this trend continues, it will be an indication that credit problems in the banking sector have peaked, and that economic conditions are steadily improving.

Figure 11: Credit Growth



NB: adjusted for changes in definitions and coverage

Source: Bank of Botswana, Econsult

In other developments related to the financial sector, the Bank of Namibia has blocked the proposed takeover of Capricorn Investment Holdings (CIH), the parent company of Bank Windhoek and Bank Gaborone, by ABSA of South Africa, part of the Barclays group. This outcome is not surprising, and reflects the BoN's desire to maintain a spread of ownership in the Namibian banking system, rather than having all banks as subsidiaries of South African banking groups. The outcome is also relevant for Botswana. A successful takeover of CIH by ABSA would have resulted in either the absorption of Bank Gaborone by Barclays Botswana, or (more likely) the sale of Bank Gaborone to a third party. The way is now clear for Bank Gaborone to remain under current ownership.

A further key development in the banking sector will be the government decision regarding the proposed privatisation of the National Development Bank (NDB), which is expected in the near future. A privatisation proposal has been submitted by the Public Enterprises Evaluation and Privatisation Agency (PEEPA). While there are various possible options, a phased process whereby a strategic equity partner is brought in to restructure the bank prior to a subsequent IPO and flotation on the BSE would probably make the most sense.

Outlook

Following the recession of 2009, it is anticipated that economic growth will experience a robust recovery during 2010, with growth forecasts in the range of 6-8%. We expect mining to be the main driver of the growth recovery, while non-mining sector growth will remain sluggish as a result of reduced government spending and ongoing pressure on household incomes and balance sheets.

IMF forecasts indicate expected growth in the range of 5-6% over the next five years. More detail of the thinking behind these forecasts should be available when the IMF's 2010 Article IV report on Botswana is published, following the visit of the IMF assessment mission to Botswana in June. In a press release published at the end of the visit, the IMF made it clear that one of their main concerns related to long-term fiscal sustainability. The IMF reinforced the need to improve the management of public finances and "to do more with less". Central to this is the need to reform budget formulation and management, with greater emphasis on prioritizing spending and delivering results. This is complemented by an ongoing Public Expenditure Review being undertaken by the World Bank, which is likely to propose widespread reform and modernisation of the budgeting and National Development Planning (NDP) framework, and the adoption of a medium-term budgeting framework that is more in keeping with international best practice. Improved planning and budgeting will help to offset the negative economic impact of the inevitable slowdown in total government spending.

Similar fiscal sustainability concerns are likely to dominate the annual reviews conducted by the credit rating agencies Moody's and Standard & Poors. Botswana's credit ratings have taken a knock, with a downgrade from Standard & Poors and a negative outlook from Moody's earlier in the year, as a result of rising budget deficits. However, a strong commitment by government to undertake effective public finance reform, combined with the commitment in the 2010 Budget to achieve a balanced budget by 2012, should help to improve the ratings outlook.