econsult REVIEW

first quarter january - march 2013

COMPILED BY KEITH JEFFERIS & THABELO NEMAORANI

SUMMARY & OVERVIEW

Economic data provides mixed picture of the economy

Economic data released in the first quarter of 2013 provides a somewhat mixed picture of the economy. The overall economic growth rate for 2012 came out at 3.7%, significantly below the 6.1% recorded in 2011. The slowdown was mainly driven by an 8.1% contraction of the mining sector, due in turn to lower output at Debswana. Several other sectors, including manufacturing, government, construction, water and electricity also showed slower growth in 2012 than 2011, while services sectors generally did better. Despite the slowdown, the non-mining private sector still grew at a healthy rate of 7.5% in 2012.

Several indicators show resilience in the domestic economy, which is perhaps surprising given the slowdown in government activity and public sector pay restraint. The growth of bank credit to households remained high, at 28% in the year to January 2013. Property (mortgage) lending was the fastest growing component of household credit. Despite this growth and concerns about household over-indebtedness, arrears on lending to households declined. The BSE also had a good first quarter, with the DCI up by almost 12%, outperforming Emerging Market peers.

Inflation remained on the high side, rising from 7.4% in January to 7.6% in March. It is nevertheless expected to start declining from mid-year onwards, driven by changes to the exchange rate mechanism (with a reduced rate of downward crawl) and benign international inflationary pressures.

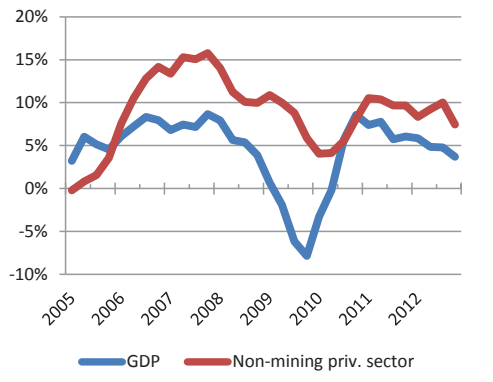
Nevertheless, higher oil prices driven by the depreciation of the pula against the dollar remain a risk. Exchange rates have been volatile, driven by rand weakness, with the pula reaching a 3-year high against the rand and a 3-year low against the US dollar.

Export and balance of payments performance has been less encouraging. Diamond exports in 2012 – excluding aggregation – were down 25% in US dollar terms. The market remains weak, and in the first quarter of 2013 diamond sales through the DTC were 8.5% down on the same period in 2012. Although prices remain good, this is at the expense of restricted supply, and as the global "swing" producer, Debswana bears the brunt of this. The balance of trade remains in deficit, and this is in turn feeding through to lower foreign exchange reserves. Although the reserves remain at a comfortable level, the downward trend is of concern and would become unsustainable – in the context of a fixed exchange rate – if it continues.

in this issue ...

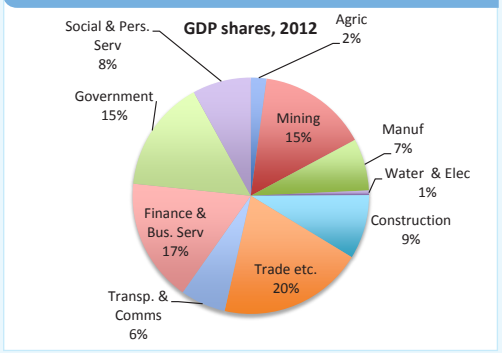
KEY VARIABLES

Annual GDP growth



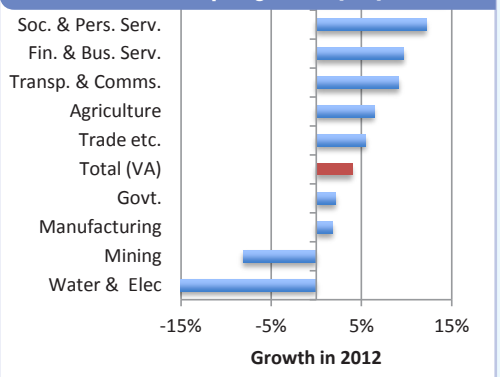
Overall GDP growth fell to 3.7% in 2012, down from 6.1% in 2011. This was mainly due to an 8.1% contraction in mining, due to lower diamond production. The non-mining private sector also slowed, but nevertheless grew at a still healthy rate of 7.5%.

GDP shares, 2012



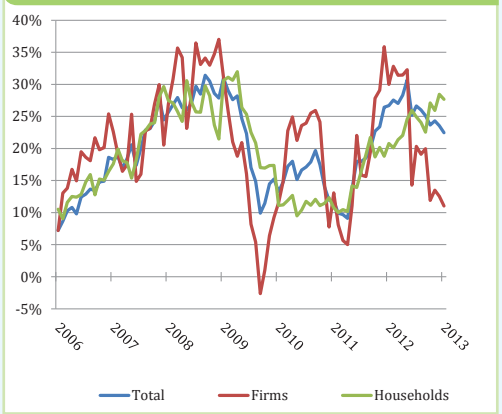
One of the consequences of continued negative growth of mining is that the sector's share of GDP has been declining. In 2012, in constant (2006) prices, mining was no longer the largest sector of the economy, but only the fourther largest, after trade, finance & business services and government. The picture is somewhat different when measured in current prices, which takes account of price changes. Then mining is still the largest sector, but with a much reduced share of 21% of value added.

Sectoral output growth (VA)



The fastest growing sectors in 2012 were construction and various service sectors. Several sectors, however, grew at a slower rate in 2012 than in 2011, notably mining, water & electricity, manufacturing, government, trade and construction.

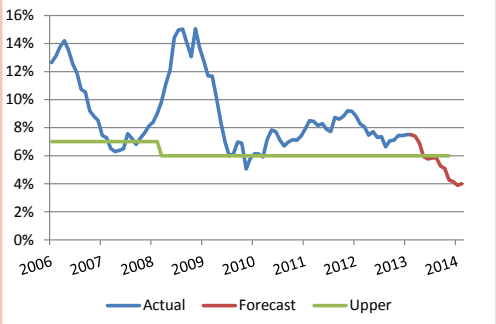
Annual credit growth



Annualised credit growth for the year to January 2013 stood at 22%, compared to 27% in January 2012. The overall slowdown in credit growth is driven by slower growth of credit to firms, down to 11% for the year to January. Perhaps surprisingly, credit growth to households remained very high, particularly property (mortgage) lending.

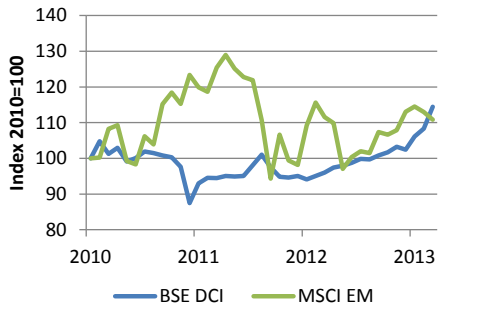
KEY VARIABLES

Inflation and forecast



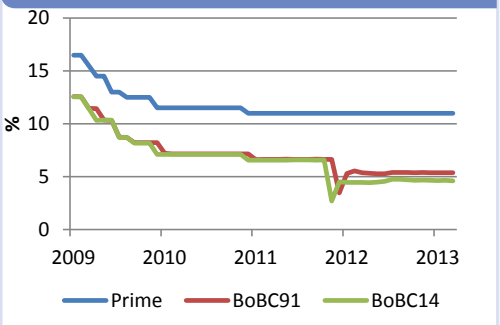
Inflation rose slightly from 7.4% in January to 7.5% in February and 7.6% in March, in contrast to expectations of a slight decline. The main driver appears to be an unexpectedly large increase in food prices. Nevertheless, we expect inflation to decline from Q2 onwards and to reach the upper end of the BoB's target range (6%) around mid-year

Stock markets



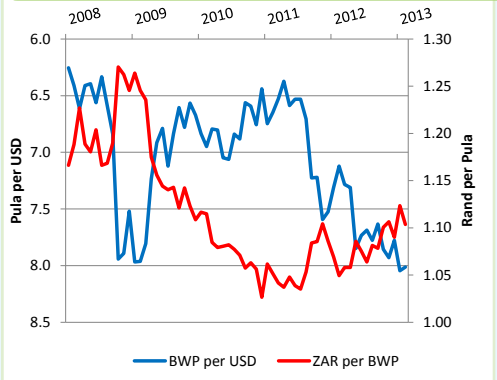
The BSE domestic board remained bullish as the DCI has continued its upward trajectory towards pre-crisis levels. Performance by Sefalana, Letshego and Choppies, during Q1, inspired the DCI to go up 11.7%. Inversely, the MSCI Emerging Markets Index contracted by 1.9% during the quarter, an indication that the BSE is performing better than its peers.

Interest rates



The first quarter of 2013 saw no discernible changes in interest rates. Bank of Botswana's recently (February 2013) released Monetary Policy Statement outlined that owing to the projected downward trajectory of Inflation the Bank rate will remain unchanged at 9.5%. By extension the Prime rate will also be maintained at 11.5%.

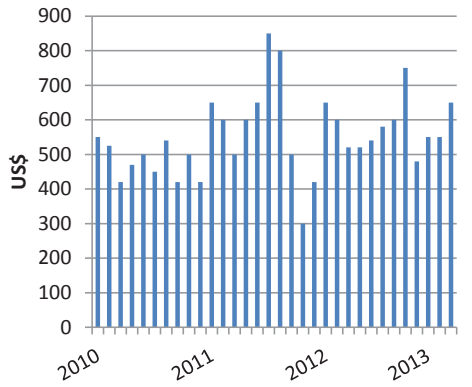
Exchange rates



In recent months the pula has appreciated significantly against the ZAR, reaching its highest level since late 2009. At the same time it has depreciated against the USD, to the lowest level since 2009. The driver has been ZAR weakness, with changes to the rate of crawl having a minor impact (the pula is around 1.5% stronger against all currencies than it would have been without any changes).

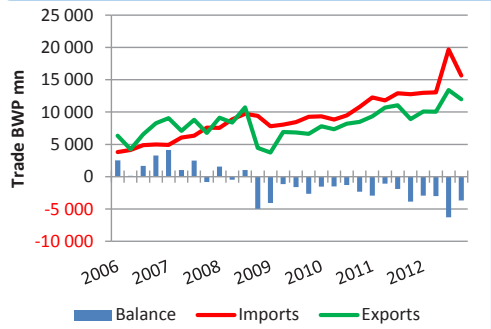
KEY VARIABLES

DTC diamond sales



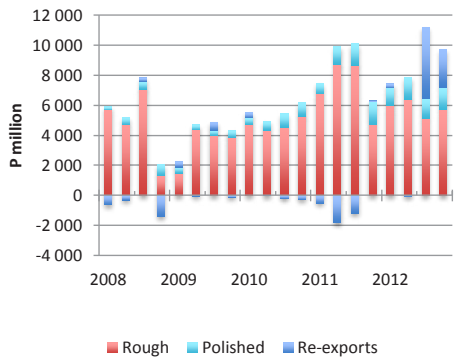
There have been three DTC sights in the first quarter of 2013 (including diamonds from Botswana, Namibia, South Africa and Canada). These saw rough diamond sales estimated at US$ 1,750 million. These reflect a combination of relatively high diamond prices and restricted supply (due to lower production). Debswana - the swing producer of diamonds internationally - produced 20.6 million carats in 2012. This is far below its full capacity of over 30 million carats. Concerns remain about rough prices being out of line with final demand for polished diamonds.

Trade



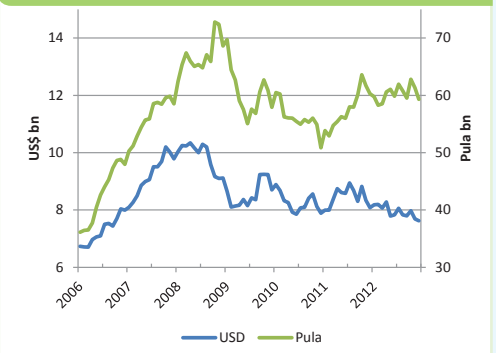
In 2012, imports stood at P61.3 bn versus exports of P45.5 bn, leaving a cumulative deficit of P15.9 bn. Despite the sharp contraction of international trade in Q4, imports and exports grew by 23% and 14% respectively in 2012. This is due partly to soaring oil prices and increased diamond imports. Diamonds remain the important commodity in Botswana's trade as they are a major component of both imports (for aggregation and polishing) and exports.

Diamond exports



Interpreting data on diamond exports has been complicated by the start of aggregation and different approaches used by Statistics Botswana and the BoB. However, 2012 was not a particularly good year for diamond exports, in line with reduced production, with total exports of Botswana rough and polished (i.e. excluding aggregation) down 25% in US dollar terms and 15% in Pula terms. The additional exports of diamonds through aggregation boosted the overall total, but this was of course offset by increased imports.

Foreign exchange reserves



Foreign exchange reserves have been weak during 2012 and ended the year substantially lower, down 5.5% in both US dollar and SDR terms, and reached the lowest level since 2006. Although not an immediate problem, the rate of decline will be unsustainable if it continues, and will require macroeconomic adjustment if there is no turnaround in international trade performance. Import cover is now down to 13 months (from a peak of 39 months in 2001).

Sources: Statistics Botswana, Bank of Botswana, Rappaport Diamond Report, MCSI, Econsult

NEWS HIGHLIGHTS

18 January	BTC reduces internet prices	The Botswana Telecommunications Corporations (BTC) has slashed internet prices for retail consumers by up to 46 percent due to reduced costs of international bandwidth and modems. According to a statement from BTC, the prices of dedicated internet to its business customers have been reduced by up to 46 percent depending on capacity and contract duration. Retail ADSL Broadband connection service - direct sales to businesses and residential customers - has been reduced by up to 27 percent.
18 January	Debswana to unlock 70m tonne resource	Debswana is studying the mineralisation of a 70 million tonne tailings dump at Letlhakane Mine, which it plans to tap into and gain the flexible production demanded by prevailing market conditions. The tailings dumps represent the residue of ore processed at the mine over the decades and with modern technology, more diamonds are recoverable from the years of lower efficiency production methods and equipment.
21 January	LEA gears up for Leather Park	The Local Enterprise Authority (LEA) has revealed that the Leather Park, which promises to revive the leather industry, is destined for Lobatse. The anticipated Leather Park will cover effluent infrastructure, training centre and shells for investors in wet blue, re-tanning and finished leather plants.
24 January	BMC resumes live cattle exports to Zimbabwe	The Botswana Meat Commission (BMC) is to restart selling live cattle from some parts of Foot and Mouth prone areas of Ngamiland for slaughter in Zimbabwe.
25 January	BPC seals fresh power deal with SA	The Botswana Power Corporation (BPC) has secured a new three-year contract for the supply of 100 megawatts of electricity from Eskom of South Africa, following the expiry last December of a previous deal.
1 February	The Immigration Point-Based System pass mark reduced	The Ministry of Labour and Home Affairs informed the Public that effective 01 February 2013, a revised Point Based System (PBS) will be implemented. The PBS pass mark has been reduced from 75% to 60% for fresh applications. This pass mark will apply to both new investors and new employees applying for Work and Residence Permits in Botswana. A lower pass mark will be applied to renewals. The revisions are intended to make it easier for foreign investors and foreign skilled workers to get permits to live and work in Botswana.
4 February	Botswana realises lower than expected Budget Deficit	The budget outturn shows that Botswana has a realised lower than expected Budget deficit for the year 2011/12 at P181 million instead of the revised estimate of P3.76 billion. This is consistent with the Government's intention to have balanced budget in the year 2012/13. Consequently, the revised estimates of the 2012/13 Budget balance show a surplus of P835 million.
21 February	President Khama wants fewer Chinese to get State contracts	The President of Botswana expressed sentiments that the Government has had bad experiences with Chinese construction contractors. Consequently, the Government will be particularly very careful when awarding construction future contracts to companies originating from China.
6 March	Botswana cannot afford to take water risks shortages	Peter Shepherd, Partner and Principal Hydrologist at SPK Consulting, asserted that Botswana cannot not afford to take any risks when it comes to water management in new mining projects. "There are essentially three water-related problems facing most big projects, namely too little water, excess water and water which is too dirty for consumption or use. The challenge for Botswana is that, as a particularly dry country, there is little margin for error when it comes to water management," says Shepherd.

NEWS HIGHLIGHTS

12 March	Africa told to view China as a Competitor	Nigeria's Central Bank Governor has urged African countries to look at China as a competitor as much as a partner. He asserted that China is capable of the same exploitative manuveors employed by old colonial powers.
14 March	Botswana advised to turn to Power generation not coal exports	J.F. Maposa, of Frost and Sullivan Mining, reportedly advised Botswana's coal mining industry to seek investment that will drive expansion in energy generation as opposed to exporting its vast coal resource. He asserted that the excess power capacity can be exported to markets such as Zimbabwe, Namibia, Zambia, Mozambique and South Africa, over the medium- to long-term. Investment into expanding Botswana's power generation sector will come as a welcome relief to the Southern African region where economic growth and quality of life has been hindered by the current power supply shortages.
19 March	Electricity tariffs to go up	Botswana Power Corporation announced that power tariffs will be adjusted upwards by 7% to 20%, effective 1st April 2013. A statement from the Ministry of Minerals, Energy and Water Resources stated that the increment has been structured in a way that it will reduce its impact on low-usage households and small-scale businesses.
19 March	SADC experiences another year of food shortage	The current dry spell is most likely to affect food production in the SADC region again this year. The recent AGROMET report observed that rainfall between February 12 and March 4, 2013, has been below normal in Botswana, Mozambique, Namibia, South Africa and Zimbabwe. Therefore harvest is most likely to be lower than normal hence leading to food shortages. This may in turn lead to the escalating of the already high food prices in the region.
21 March	Lucara recovers 239.2 carat Diamond in Botswana	Lucara Diamond Corporation has recovered a 239.2 carat diamond, as well as a 124 carat and a 71.1 carat stone at its Karowe mine, in Botswana. The 239.2 carat stone is believed to be one the biggest ever recovered from the Orapa Kimberlite.
27 March	Magang expresses concern over poor quality graduates	David Magang, a former Cabinet Minister, has asserted that some employers are shunning graduates from local tertiary education institutions saying they are not properly trained. He reportedly said critics stress that the graduates are poorly trained thus some employers by-pass them in favour of foreigners. He added that the graduates have very poor work ethic and low productivity.
27 March	India, China eager for Botswana coal	The CEO of Botswana Chamber of Mines, Charles Siwawa, indicated that buyers in India and China have expressed strong interest in securing thermal coal supplies from Botswana as the two Asian nations look for sources of energy to support their fast growing economies.

MACROECONOMIC DATA

Key Economic Data

	unit	2009	2010	2011	2012	2012 Q3	2012 Q4	2013 Q1
Annual Economic Growth								
GDP	*%*	-7.8	8.6	6.1	3.7	4.8	3.7	
Mining	*%*	-46.2	22.7	-2.4	-8.1	-12.4	-8.1	
Non-mining private sector	*%*	5.9	8.1	9.7	7.5	10.0	7.5	
GDP current prices	*P mn*	72,316	93,390	104,573	109,799	27,220	28,497	
GDP 2006 prices	*P mn*	61,282	66,549	70,591	73,201	18,221	18,945	
Money & Prices								
Inflation	*%*	6.9	7.2	9.2	7.4	7.1	7.4	7.6
Prime lending rate	*%*	11.5	11.0	11.0	11.0	11.0	11.0	11.0
BoBC 14-day	*%*	7.1	6.6	4.5	4.6	4.7	4.6	4.6
Trade & Balance of Payments								
Exports - total goods	*P mn*	24,136	31,817	40,007	45,495	13,397	11,968	
Exports - diamonds	*P mn*	15,231	21,780	30,248	36,143	11,169	9,748	
Imports - total goods	*P mn*	33,574	38,475	49,737	61,349	19,678	15,636	
Balance of visible trade	*P mn*	-9,438	-6,657	-9,730	-15,854	-6,281	-3,668	
Balance of payments	*P mn*	-4,563	-6,511	3,430	-862	1,489	-978	
Foreign Exchange								
Exchange rate USD per BWP	*end*	6.671	6.439	7.524	7.776	7.634	7.776	8.264
Exchange rate ZAR per BWP	*end*	1.109	1.027	1.086	1.090	1.078	1.090	1.121
FX reserves	*$ mn*	8,704	7,886	8,082	*7,400*	7,794	7,400	
FX reserves	*P mn*	57,908	50,847	60,271	*57,700*	59,541	57,700	
Financial Sector								
Deposits in banks	*P mn*	37,617	40,423	43,505	47,216	47,939	47,216	
Bank credit	*P mn*	19,765	22,122	27,968	34,555	32,598	34,555	
BSE index		7,241.9	6,412.9	6,970.9	7,510.2	7,389.3	7,510.2	
Business Indicators								
Diamond production	*'000 cts*	17,733	22,018	22,901	20,619	4,384	5,537	
Copper-nickel production	*tonnes*	53,425	48,890	31,780	17,620	1,424	4,551	
Business confidence index		47%	56%	54%	47%	47%	-	
No. of companies formed		11,008	11,738	12,253	15,475	3,972	4,134	
Crude oil (Brent)	*$/bar*	77.91	93.23	108.09	110.80	111.36	110.80	
Employment (formal)								
Government		128,592	130,709	130,196	-			
Parastatals		15,179	16,749	16,992	-			
Private sector		182,984	186,234	187,986	-			
Total		326,755	333,692	335,174	-			

Govt Budget		2010/11	2011/12	2012/13 Revised	2013/14 Budget
Revenues	*P mn*	31,909	38,486	41,911	44,022
	% GDP	32.0%	33.7%	33.9%	-
Spending	*P mn*	38,417	38,667	41,076	43,242
	% GDP	39.0%	34.3%	33.5%	-
Balance	*P mn*	-6,508	-181	835	779
	% GDP	-6.6%	-0.2%	0.7%	-
	% GDP	25.2%	25.3%	23.5%	-
Govt deposits at BoB	*P mn*	19,387	20,553	-	-
GDP	*P mn*	98,613	112,699	122,500	-

Sources: Bank of Botswana; MFDP; Statistics Botswana; Registrar of Companies; Econsult

How much should government be saving?

Botswana has long been known for "fiscal prudence", as part of a more general record of responsible macro-economic management of an economy driven by the rapid growth of mining revenues. This record involves the accumulation of substantial financial surpluses, which are manifested in the Pula Fund – part of the foreign exchange reserves held on the Bank of Botswana's balance sheet – and its counterpart, the Government Investment Account (GIA), which holds the proceeds of government's accumulated budget surpluses and net borrowing. In this short article we discuss the question of what is the objective of accumulating these financial surpluses, and whether the fiscal strategy being followed by the Government is likely to achieve these objectives.

These two funds – the Pula Fund and the GIA – sit on opposite sides of the BoB's balance sheet. Both represent important financial buffers or cushions. The Pula Fund represents a source of foreign currency that can be drawn upon in the event of balance of payments deficits, for instance if exports fall significantly for some reason. The GIA represents government's savings account, which can be drawn upon in the event of fiscal (budget) deficits.

The Pula Fund can be though of as a kind of Sovereign Wealth Fund (SWF), whereby a country deliberately puts aside savings to meet prudential economic needs, and typically invests those savings with a long-term perspective – e.g. with the aim of generating significant investment returns. The considerations that would apply to short-term funds, such as conventional foreign exchange reserves, are less important – for instance, SWF investment policies do not typically need to be particularly concerned about liquidity.

SWFs are becoming increasingly common around the world – 49 countries have them according to the Sovereign Wealth Fund Institute - and are particularly used by countries that are heavily dependent upon mineral production and exports. Some of the earliest SWFs were established by the Gulf oil exporters, such as Kuwait and Abu Dhabi. More recent SWFs have been established by Chile (a major copper exporter), Norway (oil) and Timor-Leste (oil). The Norwegian fund is now one of the largest investment funds in the world, with assets of $675 billion – equivalent to around 135% of Norway's GDP.

Although many countries have SWFs, they do not all pursue the same objective. Broadly speaking, there are two possible objectives of a SWF – stabilisation and savings. Stabilisation is particularly important for a mining economy. As is well known, mineral commodity markets are volatile, with prices and/or sales volumes vulnerable to considerable fluctuations from year to year. This affects both a country's export earnings and its government's revenues, given that in many cases taxes on the mining sector are a significant source of government revenues. It is important to have a stabilisation "buffer", because without this a country would have to undertake adjustment measures when mineral revenues fall – to cut imports or government spending in line with reduced earnings. The counterpart to this can be excessive expansion of government spending or imports when mineral revenues are high. In both cases, the result is volatility and economic instability. The stabilisation buffer enables imports and government spending to continue when revenues temporarily decline, through incurring deficits and running down reserves, and then generating surpluses and accumulating savings in good times.

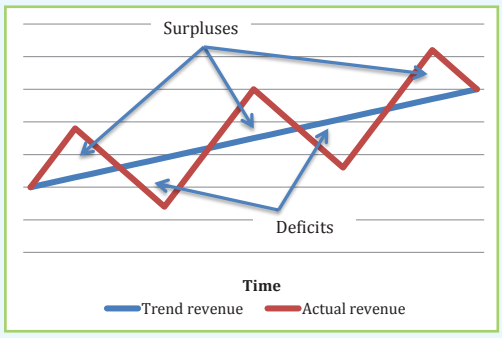


Figure 1: Volatility of mineral revenues

How large would such a fund have to be? There is no hard and fast rule, as it depends on the importance of mineral earnings in a country's balance of payments and fiscal budget, and the likely volatility of earnings from that mineral, as well as a country's unused borrowing capacity and the degree of insurance it desires. By way of illustration, however, the Government of Botswana ran budget deficits for three years during the global financial crisis (2008/9 to 2010/11), and these deficits totalled 25% of GDP – this gives a possible indication of the size that a stabilisation fund would need to be.

However, many SWFs go beyond this and are designed to protect a country not just against short-term fluctuations in income but against the long-term depletion of mineral reserves. The second common objective of a SWF is that of savings, or more particularly to provide a "Future Generations Fund". Minerals by definition represent a depleting, exhaustible asset, and at some point they will run out. Current generations benefit from the proceeds of selling those minerals, but future generations will not, if the minerals are exhausted. Furthermore an economy may experience a severe shock as minerals are depleted, for instance by losing its primary source of export earnings or government revenues. Hence the intention is that assets in the SWF would accumulate to a level whereby the income earned on those assets would provide long-term revenue that would continue even when the minerals are deleted. Hence this is a savings fund and not just a stabilisation fund. This is, therefore, a multigenerational approach, whereby minerals are converted to financial assets that will generate income for future generations, and will support future budgets by providing investment income to replace mineral income.

This requires a much larger fund, whereby the income generated by the fund flows into the budget, but the capital is preserved. This is the model used by Norway and Timor-Leste, which have accumulated SWFs of 135% and 280% of GDP respectively.

So, which of these purposes does Botswana's SWF serve? In answering this question, it is first necessary to point out that the relevant fund for fiscal purposes is the GIA, and not the Pula Fund. Contrary to many peoples' beliefs, the Pula Fund does not belong to the government. Government only has a claim on part of the Pula Fund, and the extent of that claim is determined by the size of the GIA.

The purpose of Botswana's fund has perhaps changed over time. For much of the 1980s and 1990s the government ran budget surpluses year after year, and accumulated financial assets that amounted to a high proportion of GDP – the government's share of the Pula Fund peaked at 89% of GDP in 1998. The revenues generated by these savings were an important source of income – BoB payments to government accounted for between 10% and 20% of all fiscal revenues between 1986 and 1999. These actions point to surpluses being accumulated as a long-term savings fund – in other words a fully-fledged Sovereign Wealth Fund.

More recently, however, the situation seems to have changed. According to NDP 10, the objective is now to balance the budget over the economic cycle – i.e. deficits incurred in some years should be matched by surpluses in others. It appears that the objective is no longer to steadily accumulate financial assets to provide a financial resource that will significantly benefit future generations.

The impact of the change can be seen in the sharp decline in the value of government's accumulated savings. As noted above, this peaked at 89% of GDP in 1998, but by 2011 it had fallen to only 20% of GDP. The change is even more striking on a net basis – once net debt is deducted from the value of government's share of the pula fund, the value of government's accumulated net savings is close to zero – only 2.6% of GDP in 2011.

Figure 2: Government Financial Assets

There are two main reasons for this decline. First, the decision to establish and finance the BPOPF in 2001. This required a transfer of funds from government to finance the accumulated pension liabilities of public officers as they were transferred from government to the new, independent pension fund. The second was the cost of financing the budget deficits incurred during the global financial crisis, which again depleted government's accumulated savings.

An analysis carried out by the IMF in 2008 concluded that in order to provide a future income of just over 6% of GDP through to 2050, as a replacement for mineral revenues, government would have to accumulate savings equivalent to 90% of GDP by 2023.

So, the current situation is that the financial assets accumulated by government are insufficient to fulfil the inter-generational savings objective that SWFs in mineral economies are often designed to achieve. It is also arguably the case that they are too small to provide an effective stabilisation function – and furthermore, government's accumulated financial assets are effectively funded by borrowing rather than by savings.

What can or should be done to address this situation? In some respects it seems unsatisfactory that after forty years of mineral-led growth, virtually none of the fiscal revenues derived from mining have been saved in the form of financial assets. Between 1983/4 and 2011/12, the government received an estimated P334bn (at 2010 prices) in mineral revenues, but had saved only P3bn of this in financial assets – net of debt - by the end of 2011. Of course, some of the revenues have been invested well, in human capital and economic and social infrastructure. But it would seem prudent to have at least retained a significant portion of this income in the form of financial assets, for a "rainy day" if not for coming generations.

What is needed, at the very least, is some public debate on what the purpose of the Pula Fund and government's savings should be. Are they simply for budget and balance of payments stabilisation purposes, or are they intended to accumulate financial assets to be bequeathed to the future? Do we need rules about what proportion of mineral revenues is saved in financial assets rather than spent (there are no such rules at present)? If stabilisation is the intention, then there is a need for budget surpluses in the coming years to rebuild financial balances. If the objective is saving for the future, then even larger and more prolonged surpluses will be necessary.

PO Box 45016, Gaborone, Botswana

tel [+267] 390 0575
fax [+267] 390 0585

email keith@econsult.co.bw
thabelo@econsult.co.bw
www.econsult.co.bw