BIDPA Briefing

3rd Quarter 1998

Overview

The global economic turmoil of recent months has so far not had a major effect on the Botswana economy. Despite tumbling stock markets around the world, and the fear of global economic recession, the Botswana economy is performing well, particularly in comparison with most other emerging markets. Many sectors of the economy are currently experiencing good growth, while inflation is low by historical standards. However, there are worrying signs on the economic horizon. In the short term, there is a danger of an overheating domestic economy under pressure from increasing government spending, booming construction activity and rising consumer borrowing and spending. Looking further ahead, however, Botswana is likely to feel the impact of a slowdown in economic growth. Even if the world economy avoids a recession, both global and regional economic growth rates are likely to be low in 1998 and 1999, and this will adversely affect Botswana's exports; diamonds look particularly vulnerable, but so do the increasingly important regional exports. The next six months are likely to see a moderate rise in inflation, and the first government budget deficit for fifteen years.

Exchange Rates

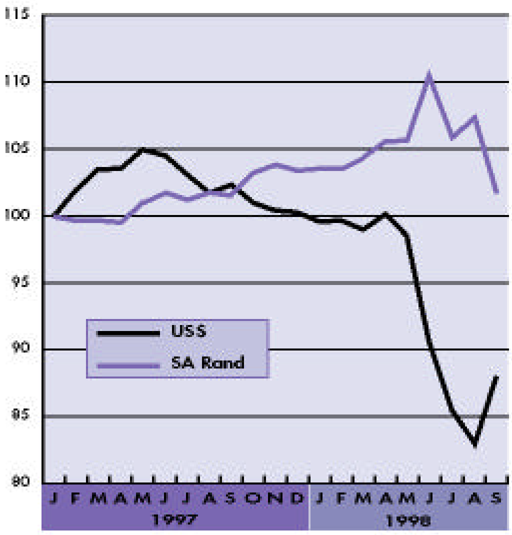
The most obvious impact of global economic developments on Botswana has been through the exchange rate. This year has seen great volatility on foreign exchange markets, and Southern Africa has not been immune to this. Major trends have included the spread of currency weakness from Asian economies to other emerging markets, especially Russia and some Latin American economies, as well as to commodity exporters such as Canada, Australia and South Africa. The latter economies have been adversely affected by weak international commodity prices, sluggish demand for exports, and the depreciation of Asian currencies which has intensified competition in export markets. South Africa has also suffered from general emerging market contagion and perceptions of higher risks associated with investing in those markets. Botswana is affected through the link between the pula and the rand, which has transmitted rand weakness against major international currencies to the pula. As a result, the pula has depreciated by 15% against the US dollar during the first nine months of 1998, although it has appreciated by 2% against the rand and by 38% against the beleaguered Zimbabwe dollar.

The pula link to the rand has been the source of continued controversy during this period of currency volatility, and is unpopular with those who have actual or perceived interests in a stronger link to the US dollar.

However, the broader national interest remains in having a currency that enables Botswana producers to be competitive against foreign producers in both the local market and export markets – as was clear from a 1998 BIDPA study on exchange rates. Given that our main competition comes from South Africa, the appropriate policy is a reasonably stable exchange rate against the rand. If the pula appreciated against the rand, Botswana's growing non-traditional exports, and strategy of economic diversification, would be threatened. A similar problem was faced by exporters to Zimbabwe back in the early 1990s, when the Zimbabwe dollar collapsed and the pula appreciated sharply against it, causing many Botswana exporters to retrench and some to close down. Exchange rate stability against the rand has helped non-traditional exports (excluding vehicles) to grow at an average rate of 15% a year over the past decade, and to become an increasingly important source of jobs.

Fig.1 shows that although the pula has been quite stable against the rand in nominal terms, Botswana's competitiveness has declined, due largely to higher inflation than in South Africa (competitiveness is measured by the real exchange rate, and a rise in the index shows a decline in competitiveness). However, Botswana firms have become more competitive in markets where trade is in US dollars, which should again help export diversification and job creation.

Fig 1: Pula real exchange rate vs South Africa and USA



Inflation

1998 has been the best year for inflation for a long time, with an average inflation rate of 6.6% for the first nine months of the year (compared with an average of 8.9% for 1997). The figure of 5.9% recorded in July and September is the lowest since February 1985, and inflation has been falling steadily since the beginning of 1996.

However, there are several indications that inflation is likely to rise over the next few months. First, there will be pressures resulting from the recent public sector pay award. While this does not directly increase inflation, wage pressures are transmitted to the private sector, and especially to parastatals, where higher costs will eventually feed through to prices. Second, South African inflation has been rising in recent months, and this will eventually feed through to Botswana.

Third, the government pay award will cause domestic spending (by civil servants) to increase, and such additional demand will also add to inflationary pressures, especially as it comes on top of the pressures already caused by a rapid increase in government spending this year even before the pay award was ann-ounced.

Finally, the depreciation of the pula and the rand against major international currencies will put some upward pressure on import prices, although this will be offset to a certain extent by the ongoing SACU tariff reduction programme, and lower international prices for many commodities.

Bank Credit

Bank credit is useful indicator of trends in nominal demand in the economy, and recent months have seen a sharp increase in its rate of growth (see fig.3). During the first six months of 1998, commercial bank lending rose at an annualised rate of 48%; this compares with an increase of only 6% during 1997. Some increase in bank lending is undoubtedly welcome, as it hardly grew at all during 1996 and 1997. Part of the recent growth in lending results from the major loan made to Water Utilities Corporation for the North-South Carrier Project, which marks a welcome move away from parastatals sourcing loans from the government.

Nevertheless, recent developments do indicate some problems. The first is the rapid growth of household credit, which is largely spent on consumption rather than investment, and does not help to expand the productive capacity of the economy.

Second, when bank credit grew rapidly in the late 1980s and early 1990s, it led to an unsustainable level of debt, bankruptcies and repossessions. Might this happen again?

One indicator of the debt burden is the ratio of bank credit to non-mineral GDP. This debt ratio is now rising again after declining for several years. During the last credit boom, this ratio for households climbed from 3% to over 8%. As bad debts mounted and new lending slowed down between 1993 and 1997, the ratio only fell back, but to 7%.

In the current round of credit growth, therefore, the debt ratio is starting from a high level, and has already reached 8% again. Unless there has been a major change in the ability of households to service debt, this indicates that there is little scope for household borrowing to rise further before another debt crisis results.

For businesses the story is different, as the problems of the mid-1990s led to a major reduction in their indebtedness, and the corporate sector is starting the latest round of credit expansion with a manageable level of debt to local banks.

Fig 2: Inflation - Botswana and South Africa

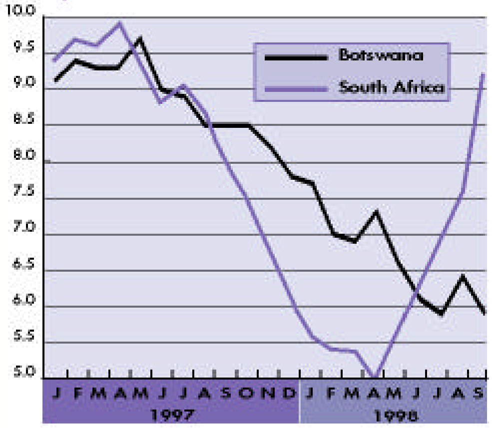


Fig 3: Growth of Bank Credit (p.a.)

International Reserves

Although import data are not yet available for the first half of the year, figures for movements in the foreign exchange reserves indicate that the overall balance of payments continues to be in surplus. The reserves increased from US$5.67 billion to US$5.84 billion during the first six months of 1998, an increase of 3%.

The increase in pula terms, from P21.6 billion to P25.2 billion, was much larger at 17%, but this largely reflects exchange rate movements and does not provide much information about the underlying balance of payments flows.

Interest Rates

While the economic turmoil has resulted in sharply increased interest rates in many developing countries, Botswana has largely avoided such pressures. Although short term rates were raised slightly in response to the August upturn in inflation to 6.4%, the 3 month BoBC rate of 10.4% still only represents a real interest rate of 4.2%. This is comparable with short-term real interest rates of 3.5-4% in the US and the UK, and much lower than South Africa's real short term rate of around 12%.

While international interest rate trends will probably be downwards for the rest of 1998, this is not yet an appropriate policy for Botswana. International reductions in interest rates will be aimed at preventing the world economy from slipping into recession, or helping countries that are already in recession (such as many Asian economies) to recover. The Botswana economy appears to be growing at a healthy rate, and, if anything, needs higher interest rates to slow down excessive demand expansion. There is already a strong fiscal stimulus, with government spending likely to increase by 20% to around P9 billion in 1998/99. Private sector credit expansion, as discussed above, is likely to provide a further boost to aggregate demand. These developments indicate a need for higher interest rates if demand is to be kept in line with the capacity of the economy to supply goods and services. However, it may be too late for this, and it could be that a tighter monetary policy now would have its effect next year when the economy is likely to be slowing down anyway.

Exports

The export picture for the first six months of 1998 has been mixed. Diamond exports, which account for around 75% of total exports, were down 16% in US dollar terms compared to the first half of 1997. Due to exchange rate changes, however, pula earnings were only 8% lower. The downturn in diamond earnings is not unexpected, and in some ways the fact that the reduction was only 16% is quite encouraging, given that De Beers' total diamond sales in the first half of 1998 were down 41% over the previous year.

Copper-nickel exports suffered an even larger decline than diamonds in the first half of 1998, down 20% in US dollar terms and 13% in pula terms compared to 1997. This is due to a decline in metals prices, following the more general fall in commodities prices; by June 1998, copper and nickel prices had fallen by more than one third from their levels a year earlier. These developments will put even more pressure on the loss-making BCL. Soda ash exports also fell, by 8% in dollar terms. On the brighter side, exports of beef (in the first half of the year) and motor vehicles (in the first quarter) showed sharp increases. Overall, exports of principal commodities were down 12% in dollar terms, and 4% in pula terms, in the first half of the year.

Outlook

While the overall economic situation is currently healthy, there are some concerns on the horizon. Rapid credit expansion will add to the inflationary pressures that are already resulting from a rise in government spending, and could lead to another round of household over-indebtedness. Higher interest rates might help, but this is a blunt weapon that also adversely affects investment. Perhaps it is time to consider regulation of consumer credit, such as minimum deposit requirements, or restrictions on the ability of employers to provide or guarantee staff loans. This is an area where government itself could set a good example, but with the new subsidy scheme for elected officials, it is doing exactly the opposite.

A further concern arises from prospects for diamond exports. Following the news that De Beers diamond sales have continued to be very weak into the third quarter, Botswana's diamond exports for the second half of 1998 are likely to show a major reduction compared to 1997. Prospects for 1999 depend very much on what happens in the world economy in general, and Japan and the USA in particular. The USA has been driving world diamond sales for the last couple of years, but this is likely to tail off as US economic growth slows, and as the end of the Wall Street boom brings about a reduction in luxury goods consumption. There will only be a recovery in the world diamond market if Japanese growth picks up, and so far there is no sign at all of that happening. It is quite possible, therefore, that a bad year for diamonds in 1998 could well be followed by another bad year in 1999.

There are also concerns about the prospects for other exports. In 1997 two-thirds of non-traditional exports (i.e. excluding diamonds, copper-nickel and beef) went to South Africa, and yet that country is now experiencing economic problems with virtually no growth now being forecast for 1998 and 1999. This will cause problems for Botswana's emerging exporters. For instance, South African car sales in September 1998 recorded a drop of 27% on the same month in 1997, which will adversely affect Hyundai.

While the current account of the balance of payments appears to be strong enough to withstand a reduction in diamond exports without moving into deficit, the same cannot be said for the government budget. Already a deficit is likely in the current (1998/99) financial year, under the combined impact of reduced mineral revenues and higher recurrent expenditure after the public sector wage award. While the projected deficit of P500 million can easily be handled from accumulated government savings balances, next year the situation may not be so favourable. The public sector pay award will add over P600m to government spending over a full year, and if this is to be accommodated without leading to mounting deficits, the growth rate of development spending may need to be curtailed. If this does happen, and comes on top of a slowdown in export activities, 1999 could well see sharply reduced economic growth in Botswana.

Briefing

Economic Facts and Forecasts

Quarterly (end of period)		1996 Q4	1997 Q4	1998 Q1	1998 Q2	1998 Q3	1998 Q4
Interest rates (%)							
BOBC (3 month)		12.23	11.40	10.26	10.21	10.46	11.60f
Prime		14.50	14.00	13.31	13.25	14.00	15.0f
Inflation (%)		8.9	7.8	6.9	6.1	5.9	7.0f
Rand-Pula		1.28	1.2	1.29	1.36	1.30	1.32f
Pula-US$		3.64	3.81	3.90	4.33	4.48	4.55f
BSE index		352	708	811	949	954	975f
Annual		**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
Growth (%)							
GDP (real)	d	4.1	3.1	7.0	6.9	5.7e	3.5f
Non-mineral GDP (real)	d	3.6	5.5	5.6	7.5	8.5e	6.0f
Exports (nominal)	b	15.3	18.4	19.7	40.7	27.8	1.0f
Imports (nominal)	b	9.2	2.7	20.4	8.2	43.9	14.0f
Govt. spending (nominal	c	11.8	-4.6	21.5	17.3	21.3	22.0f
Govt. revenues (nominal)	c	14.3	-16.5	22.2	35.3	17.1	-2.0f
Domestic (bank) credit	b	11.8	18.2	-3.7	1.2	5.6	35.0f
Interest rates (%)							
BOBC (3 month)	a	13.5	11.9	12.0	12.2	11.4	11.5f
Prime	a	15.0	14.0	14.5	14.5	14.0	15.0f
Inflation (average, %)		14.4	10.6	10.5	10.1	8.9	6.7f
Rand-Pula	a	1.32	1.30	1.29	1.28	1.28	1.32f
Pula-US$	a	2.56	2.72	2.82	3.64	3.81	4.55f
BSE index	a	279	313	333	352	709	975f
Balance of Payments (Pm)							
Exports (diamonds)	b	3350	3727	4042	5933	7994	7100f
Exports (other goods)	b	841	1237	1898	2427	2690	2900f
Imports (goods)	b	4290	4406	5305	5740	8263	9500f
Current account balance	b	1220	642	937	2108	3059	2049f
Foreign Reserves							
Pula m	a	10509	11961	13249	1907	21619	27500f
US$ m	a	4097	4402	469	5234	5675	6100f
Govt. spending (Pm)	c	4481	427	5195	6092	7389	9000f
Govt. revenue (Pm)	c	5359	4473	5464	7395	8659	8500f
Budget surplus/(deficit) (Pm)	c	878	196	269	1303	1270	-500f
Govt. balances at BOB	a	5598	6705	6460	7204	15634	1900f

Notes: a = end of period; b = calendar year; c = financial year (starts March); d = statistical year (starts July) e = BIDPA estimate; f = BIDPA forecast
Details of assumptions underlying the forecasts can be obtained from BIDPA.
Sources: CSO, Bank of Botswana, BIDPA

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