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BIDPA Briefing

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Overview

The main economic news over the past quarter is that of some recovery in the international diamond market, with increasing international sales and a slight easing of stockpiling requirements. Despite this improvement, global diamond sales remain well below those achieved in 1995-97, but at least it appears that the market has reversed last year’s downward trend. This will help both the balance of payments and the government budget. The Botswana economy continues to benefit from much higher growth rates than most others in the region, and the main short term economic danger remains that of overheating rather than the sluggish growth that is a problem elsewhere. Credit expansion is still too fast, and interest rates have inevitably risen as a result, while the latest inflation data shows that upward pressure on inflation remains.

Economic Review

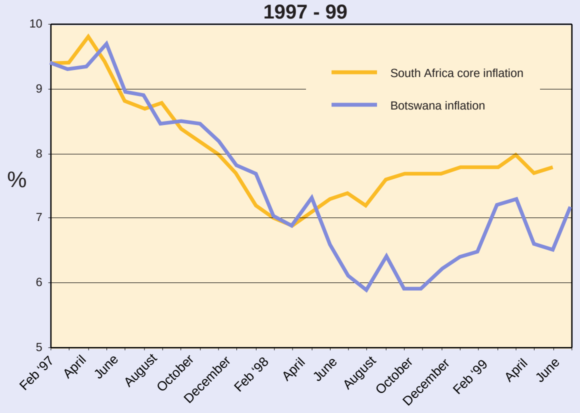
Economic growth

The economy continues to grow rapidly, with the non-mining sector probably growing faster than last year, at 8-9%. Mining sector growth will be much lower, perhaps even zero, given that the poor state of the international diamond market provides little scope for expansion, but at least diamond production has held steady despite the fall in diamond export revenue. However, it is non-mining growth that is more important for employment and economic diversification, and at present it is the non-mining sector of the economy (including government) that is leading the way. Although the statistical year (July 1998-June 1999) has just finished, GDP and growth figures will not be available for another six months or so. However, in a welcome development, the Central Statistics Office has announced that it will shortly begin reporting quarterly GDP figures, which will help the task of monitoring economic developments.

Inflation resumes upward trend

The latest inflation figures show that inflationary pressures remain. Inflation rose to 7.2% in June, after falling to 6.5% in May (see Fig.1). This marks a resumption of the steady upward trend that has been generally apparent since the low of 5.9% in October 1998. Nevertheless it is perhaps surprising that inflation in Botswana has not risen more rapidly as would be expected in conditions of rapid economic growth.

Fig.1: Botswana Inflation, and South African Core Inflation 1997 - 99



As always, consumers in Botswana have been protected to some extent by the openness of the economy and the availability of foreign exchange. This means that a large part of the increase in consumer demand can be met by imports. Furthermore, because most imports come from South Africa, there is minimal delay in making available the increased supply of imports to meet increased consumer demand.

A further factor restraining prices in Botswana is that inflation in South Africa has been declining. Consumer price inflation was running at 9% in December 1998, but had fallen to 7.7% on an annual basis by April 1999. However, South African “core” inflation, which excludes mortgage interest payments and some foodstuffs and is thought to be more representative of underlying inflationary pressures, has not shown a similar decline.

Although South African inflation does have an influence in Botswana, that influence may not be as strong as it once was, as dependency on imports has been steadily declining. The ratio of imports to GDP has fallen over the last 20 years from nearly 70%, to between 35% and 40%. Nevertheless, imported inflation remains significant, and South Africa is the most significant source as it continues to supply about 70% of all imports. We expect that during the rest of 1999, Botswana inflation will gradually rise to converge on the SA core inflation rate of 7.5-8%.

Excessive growth of commercial bank credit

The resumption of rapid growth in

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the economy has, after a considerable time lag, been accompanied by rapid growth in bank credit. As noted in the BIDPA Briefing for the first quarter of 1999, the real value of commercial bank lending actually fell during the early years of the boom. It only began to increase in real terms in 1998, and since then has been increasing very fast indeed. Lending to some economic sectors of the economy has doubled or tripled (in nominal terms).

By far the largest increase in lending was to parastatals, which increased from P70 million to P309 million over the 12 months to February 1999 (the latest month for which statistics are available). This was primarily due to lending to Water Utilities for the North-South Water Carrier Project, and accounted for about half of the total increase in commercial bank lending to the business sector in that twelve months.

The increase in bank lending to parastatals, along with the earlier floating of bonds by BTC and BDC, is a welcome outcome of an earlier shift in public-sector financial policy. Access to government lending through the Public Debt Service Fund has been sharply restricted, and the more profitable parastatals are now expected to borrow from financial markets. Partly because of this, and partly because of the repayment of past loans, outstanding loans from the PDSF and related funds fell from a peak of P 2.7 billion in March 1996, to P2.3 billion in March 1998.

The growth of commercial bank lending to the whole business sector has grown more slowly than lending to parastatals, but even so the annual rate of growth to February 1999 was 57% (47% in real terms).

Lending to households, which is believed to be mostly for the purchase of cars and other consumer durables, also continued to rise rapidly. It seems likely that the 25% wage increase for government workers in mid-1998, and the wage increases in other sectors of the economy which followed, were used by most people to increase their borrowing, rather than to repay past debts or to pay cash for new purchases.

In contrast to the explosion of commercial bank lending, total lending by the parastatal Non-Bank Financial Institutions (BDC, BBS, BSB, NDB) did not increase in 1998. Their total lending is P0.9 billion, about a third of commercial bank lending, and had increased by approximately 50% in the previous two years. The lack of growth in their lending in 1998 provided a significant offset to the very high rate of growth of commercial bank lending.

Interest rates edge higher

In response to the booming economic conditions, the Bank of Botswana has edged interest rates upwards. Bank Rate was 12.5% at the end of 1998, and had been increased to 13.25% by June 1999. Other rates have followed. For example the commercial banks' prime lending rate has increased from 14% to 14.75% over the same period; and the rate of return on three months Bank of Botswana Certificates has increased from 10.7% to 11.6%. These increases in interest rates may have contributed to the holding of inflation to levels slightly below those of the end of last year, although there seemed to be no significant slowing down of the growth of commercial bank lending.

Mining Sector Review

Recovery in Diamond Market

The first half of 1999 has seen better than expected performance in the international diamond market, with first half diamond sales by De Beers' Central Selling Organisation (CSO) up 44% compared to the same period in 1998. This has helped Botswana, along with other producers, as sales quotas have been raised from 75% to 80% of rated production capacity. Partly as a result of this market recovery, Botswana's diamond exports in the first three months of 1999 showed a marked improvement over last quarter of 1998.

Although this is good news, the international recovery is still patchy. Sales of diamond jewellery are increasing in Europe and the USA, but still falling in Japan, the second biggest retail market after America. Elsewhere in Asia, there are reports that the worst is over, and sales actually increased in South Korea by 8% in the first quarter. However, sales are still well below the level they attained before the Far Eastern crisis caused a sharp drop in the CSO's sales.

Medium term prospects for the international market for diamonds are now more optimistic than they were six months ago. De Beers has been forcing a reduction in stocks held at diamond cutting centres, to the point where there is now excess demand from cutters for rough diamonds. Secondly, it is believed that Russia has now sold most of its stockpile, because sales from stockpile have ceased. Thirdly, supply from Angola has fallen sharply due to renewed civil war. Fourthly, De Beers is hoping for an increase in sales of diamond jewellery to commemorate the millennium (although this of course will be a once-and-for-all increase of sales, and not therefore sustainable). Early indications are that this marketing programme has started off well. Fifthly, Botswana's sales through De Beers should increase when the expansion at Orapa starts production.

Should demand recover to its previous levels and more, there will in due course be an opportunity for Debswana to sell off its stockpile, as it did in 1987 after the period of reduced sales in the previous six years. Assuming that 20-25% of previous annual sales of US $1.8-2.0 billion a year has not been sold, a stockpile accumulated over a period of 15 or 16 months would be worth around US$500 million (P2.3 billion) (assuming of course that it can eventually be sold at these prices).

On the other hand, new and

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unexpected negative factors may occur; and the stockpiles of Debswana, other produces who sell to De Beers, and of the CSO itself, will overhang the market and prevent any significant increase in diamond prices until these have been significantly reduced.

The recovery in diamond sales during 1999 will have positive impacts on the government budget and the balance of payments. Raising diamond sales from 75% to 80% of output would increase exports by nearly $100m (P450m). However, a larger increase in export earnings – whether through higher diamond prices, an even larger increase in sales, or further exchange rate depreciation – would be necessary for the government to achieve the 22% rise in mineral revenues projected in the 1999 Budget.

Soda Ash: possible new investment at Sua Pan

The soda ash mine at Sua Pan has had a difficult time, including going bankrupt, and needing to be re-financed, followed by severe flooding which closed down the mine shortly after it had reopened under a new name (Botswana Ash). The mine is currently just profitable, making a very modest profit of P2 million last year and paying a dividend. It also has significant cash reserves, which may be used to finance a new investment that is under consideration.

The investment would be in a plant to produce "snow white" soda ash. The company currently produces grey soda ash, which is perfectly acceptable for the making of glass, and most other industrial uses. However, a new processing plant would be needed to produce whiter soda ash for use in the production of detergent.

Soda ash for this purpose has to be as white as possible (as the advertisements say, whiter than white). It is estimated that there is a potential regional market for 70 000 tonnes of snow white ash, which is roughly equivalent to the current unused capacity in the processing plant. The new plant would be for further processing; and investment would also be required to extend the well fields. If this investment were to go ahead, it would among other things provide additional business for Botswana Railways.

However, the viability of the proposed investment would depend to a considerable extent on the reaction of American producers of snow white soda ash. Their reaction to the original soda ash investment was to embark on a vicious campaign of price-cutting, in order to retain their share of the South African market. The marketing of soda ash from the existing plant has now settled down, with Botswana's output supplying grey ash to the Johannesburg market, and American producers supplying white ash, and grey ash to the market around Durban. If Botswana were to attack the American producers' market for white ash, it might set off another price war.

Government's financial support for BCL

The copper-nickel mine at Selebi-Phikwe has had financial problems since it was first operational. The original smelter blew up, its costly replacement was not able to supply sulphuric acid to a user in South Africa as contracted, and extra expenditure was required to deal with the resulting pollution at Selebi-Phikwe. Worst of all, base metal prices fell in the mid-1970s, and have never since remained high enough for the mine to make significant profits. For many years, the original contract between the foreign shareholders and the Botswana government protected Botswana from meeting the mine's losses. However, at present it is necessary for the Botswana government to provide a subsidy in order to keep the mine open, and to prevent the loss of 5 000 jobs.

There is, however, some misunderstanding about this subsidy. The current period of government support for BCL only began in January 1998. All previous support has been repaid, at the commercial banks' prime lending rate plus three percentage points. In the current phase, the government support was P92 million in the calendar year 1998. Although government support was P10 million in each of the months from January to April in the current year, it was zero in May, and may also turn out to be zero in June. If support in the remainder of the year is P10 million each month, as currently predicted, then the 1999 subsidy would be only slightly more than the subsidy in 1998.

The mine has also been receiving support from the European Union's Sysmin fund, part of the Lome agreement, which governs aid and trade between the European Union and the ACP (Africa, Caribbean and Pacific) countries. Sysmin was set up to protect developing countries from fluctuations in mineral prices on world markets. It provides concessional loans when mineral export prices fall, and repayments are put into a fund to finance diversification and alternative jobs in the mining locality. Some industrial investments have been funded in this way in Selebi-Phikwe. This arrangement will end in mid-2000. However, BCL management is hopeful of the success of an application to the European Union for another source of funding to replace the Sysmin support, which has been running at between P9 million and P10 million a month.

For the future, there are some reasons to be moderately optimistic, despite the deep financial problems of BCL. The company is coming towards the end of a period of major capital spending, which will enable the mining of higher grade ores. These will have a 25% higher nickel content, with a lower (perhaps only 10%) increase in recurrent costs. Secondly, the current level of nickel

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prices (approximately $2.50/lb) is well below the level which would be necessary to satisfy estimates of the growth of global demand over the next ten years (currently estimated at about $3.50/lb). Moreover, the current nickel price renders as much as half of global nickel production unprofitable, which may result in mine closures, a reduction of supply, and a higher nickel price.

Past hopeful predictions have frequently proved not to be correct; and even if nickel prices do rise eventually, the timing is uncertain so that subsidy may have to continue at present levels for an unknown number of years if the mine is to stay open. Nevertheless, there would appear to be some prospect that the nickel price will be higher than at present in at least some of the years before the end of the mine's life, currently estimated as 2011. Any increase in the nickel price would reduce the cost to the government of keeping the mine open, and might even mean that no subsidy at all is necessary in some years.

ECONOMIC FACTS AND FORECASTS

Quarterly

(end of period)	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1999 Q1	1999 Q2	1999 Q3
Interest rates (%)							
BOBC (3 month)	10.26	10.21	10.46	10.66	11.55	11.60	11.80 *f*
Prime	13.31	13.25	14.00	14.00	14.25	14.75	15.00 *f*
Inflation (%)	6.9	6.1	5.9	6.4	7.2	7.2	7.5 *f*
Rand-Pula	1.29	1.36	1.30	1.32	1.33	1.30	1.33 *f*
Pula-US$	3.90	4.33	4.48	4.46	4.67	4.63	4.75 *f*
BSE index	811	949	954	947	990	1033	-

Annual

		1993	1994	1995	1996	1997	1998	1999
Growth (%)								
GDP (real)	*d*	4.2	2.7	6.6	7.2	8.3	*5.6 e*	-
Non-mineral GDP (real)	*d*	3.5	4.8	5.0	7.9	7.7	*8.5 e*	-
Exports (nominal)	*b*	15.3	18.4	19.7	40.7	27.8	-12.5 *p*	18 *f*
Imports (nominal)	*b*	9.2	2.7	20.4	8.2	43.9	28.6 *p*	17 *f*
Govt. spending (nominal)	*c*	11.8	-4.6	21.5	17.3	21.6	31.5 *p*	15 *f*
Govt. revenues (nominal)	*c*	14.3	-16.5	22.2	35.3	12.0	-0.1 *p*	24 *f*
Domestic (bank) credit	*b*	11.8	18.2	-3.7	1.2	5.6	56.1	25 *f*
Interest rates (%)								
BOBC (3 month)	*a*	13.5	11.9	12.0	12.2	11.4	10.7	11.8 *f*
Prime	*a*	15.0	14.0	14.5	14.5	14.0	14.0	15.0 *f*
Inflation (average, %)		14.4	10.6	10.5	10.1	8.9	6.5	7.0 *f*
Rand-Pula	*a*	1.32	1.30	1.29	1.28	1.28	1.32	1.36 *f*
Pula-US$	*a*	2.56	2.72	2.82	3.64	3.81	4.46	4.80 *f*
BSE index	*a*	279	313	333	352	709	947	-
Balance of Payments (Pm)								
Exports (diamonds)	*b*	3340	3727	3994	5272	7654	6243 *p*	7700 *f*
Exports (other goods)		841	1304	1994	2100	2454	2765 *p*	3000 *f*
Imports (goods, cif)	*b*	4290	4406	5305	5743	8256	10388 *e*	12100 *f*
Current account balance	*b*	1220	642	937	2108	3059	-375 *p*	-375 *f*
Foreign Reserves								
Pula m	*a*	10509	11961	13249	19076	21619	26347	28000 *f*
US$ m	*a*	4097	4402	4695	5234	5675	5960	5900 *f*
Govt. spending (Pm)	*c*	4481	4277	5195	6092	7406	9736 *p*	11200 *f*
Govt. revenue (Pm)	*c*	5359	4473	5464	7395	8281	8271 *p*	10300 *f*
Budget surplus/(deficit) (Pm)	*c*	878	196	269	1303	875	-1465 *p*	-900 *f*
Govt. balances at BOB	*a*	5598	6705	6460	7204	15634	19212	19500 *f*

Notes: *a end of period; b calendar year; c financial year (starts March); d statistical year (starts July)*
e BIDPA estimate; f BIDPA forecast; p preliminary data
Details of assumptions underlying the forecasts can be obtained from BIDPA.

Sources: *CSO, Bank of Botswana, BIDPA*

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