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BIDPA Briefing

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Overview

The growth of non-mineral GDP in Botswana would slow down very sharply, if government spending growth were to be reduced from 26% to 3% as announced in the February Budget Speech. However, the slowdown in government spending may be less pronounced, resulting in GDP growth at about half the present high rate of about 9%. Recent growth has been achieved, however, partly because development spending in the first four years of NDP8 will exceed the original six-year total. News from the mining sector, especially diamonds, is good, so that the financial position remains sound. The rand has fallen sharply against the US dollar, partly because of a previous period of real appreciation. Current exchange rate policy means that the Pula has also been weak against the dollar, while rising slightly against the rand. Higher interest rates have not reduced commercial bank lending to households; the growth of lending to the business sector has declined sharply, but this may be because larger (mainly foreign-owned) businesses have switched to borrowing abroad where real costs of borrowing are now lower than in Botswana. Inflation has remained stable at about 7%; it has not apparently fallen in response to higher interest rates. The International Financial Services Centre has attracted its first applications for licensing.

Economic Developments

Government spending and GDP growth

As noted in the BIDPA Briefing on the 2000 Budget, the Government plans to reduce the rate of growth of government spending quite drastically. The budget estimates for 2000/01 show that government spending will increase by only 3%, compared with 26% in the previous year. If actually implemented, this will cause a rapid slowdown in the rate of growth of non-mineral GDP, because the growth of government spending is one of its major determinants.

The impact may not, however, be quite as drastic as the figures suggest. Firstly, the rate of growth of government spending in the budget year just finished may not be as high as 26%. The outturn seems quite likely to prove lower than the revised estimates, as happened last year. If, for the sake of argument, the outturn to March 2000 shows a rate increase of only 20% (roughly the average for the previous few years), then the rate of increase in the current budget year would be 7%, rather than 3%. Secondly, it seems unlikely that the Government will succeed in cutting the rate of growth of spending quite as drastically as proposed in the Budget Speech. It would seem more plausible, for example, to expect government spending to increase by about 10% or 12%.

If correct, these modifications of the formal estimates would reduce the cut in spending growth to about 8 or 10 percentage points, rather than the official forecast of 23 percentage points. This would make the slowdown in GDP growth less pronounced. That is the basis for the very tentative forecast in the table on page 4, that non-mineral GDP growth in 2000/01 will be about 5%, compared with the current growth rate of 8% or 9%.

Other factors affecting economic growth

There is anecdotal evidence that the construction boom is slowing down, from construction companies, from those involved in supplying them, and from others in the property sector. However, we expect that the slowdown will be less dramatic then it was at the beginning of the 1990s.

News from the mining sector is positive. Diamond sales have held up well, suggesting that 1999's sales were not just caused by a one-off millennium effect, but could continue through 2000. However, this has little impact on the non-mineral economy except through government spending of mineral revenue. The nickel price is above $4/lb, making it possible for necessary capital expenditure to be undertaken by BCL without further emergency funding; and expansion of wellfield capacity is proceeding at Sua Pan in anticipation of an increase in demand from South Africa. On the downside, some exporters will be hit by the problems in Zimbabwe, but Botswana's manufactured exports are no longer so dependent as they were in the 1980s on the Zimbabwe market. Only about 10% of non-diamond exports go to Zimbabwe. Some 55% of non-diamond exports now go to South Africa, where growth is expected to be higher in 2000 than for many years.

Overspending of NDP8

It is now certain that development spending in NDP8 will greatly exceed the planned amounts. Actual spending in the first two years, plus the revised estimates for the third year, plus the estimate for the fourth year (2000/01), amount to P12.5 billion. This is already more than the 6-year total of P11.8 billion in the Plan, with two years to go. It is no longer a question of cutting back sharply on development spending to fit in with Plan totals, as discussed in the previous BIDPA Briefing, but of it being certain that spending in the final two years of the Plan will all be additional.

With hindsight, it was always unlikely that the Government would succeed in cutting back sharply on development spending after the first two years of the Plan. While there is a case for using the accumulated government financial surpluses to sustain economic growth, overspending what was approved in the Plan (by what could be as much as 30%) sets a damaging precedent. What is needed is a debate on how far and how fast the country's financial reserves should be run down to support the growth of GDP, while slowing down the growth of government spending to a sustainable level.

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Exchange Rates

The South African rand was fairly stable against the US dollar for more than a year. The rand averaged R6.11 against the US dollar in the first half of 1999, and R6.12 in the second half, while core inflation in South Africa was about 8%. United States producer prices were unchanged in 1999. This means that the rand was appreciating in real terms, imposing a penalty on exporters and making it more difficult for South African producers to compete with imports. In these circumstances, it was probable that there would be a relatively large correction sooner or later.

It appears that such a correction has started to happen. By late April, the US dollar was trading at R6.85, a depreciation of more than 10%. There is no particular reason to think that the rand will recover its former value. Indeed, it should not do so if the rand exchange rate is not to make tradable production uncompetitive.

Part of the fall of the rand against the US dollar is because the latter has been unusually strong. The rand's weakness has also been blamed on the problems in Zimbabwe. If these problems continue they are expected to put further downward pressure on the rand. Zimbabwe has been an important regional export market for South Africa. But these are only proximate reasons for rand weakness. If it had not been dollar strength and problems in Zimbabwe, something else would sooner or later have triggered rand weakness because of its earlier real appreciation.

It is official policy not to allow the Pula to appreciate significantly against the rand. This policy is necessary in order for Botswana producers to remain competitive with South African producers. As a direct consequence of rand weakness, therefore, the Pula has also depreciated against the US dollar.

Interest rates and bank credit

On the 23 February, the Bank of Botswana increased interest rates by half a percentage point, from 14.75% to 15.25%. This compares with only 14% just over a year ago. The primary reason given for raising interest rates was the need to curb the very rapid growth of commercial bank lending, especially lending to households, and thereby to reduce the rate of inflation. On the other hand, the Bank is concerned about the high cost of business borrowing, and its effect on the economy.

In its monetary statement, the Bank states that higher interest rates in 1999 contributed to a fall in the rate of growth of lending by commercial banks. But the rate of growth of lending to *households* rose by 44% in 1999, compared with 46% in 1998. This is barely any reduction at all. The main impact, therefore, has been to increase borrowing costs. Evidence from other countries is that household borrowers do not know the effective rate of interest on their borrowing; their primary concern is whether they can afford the monthly repayments.

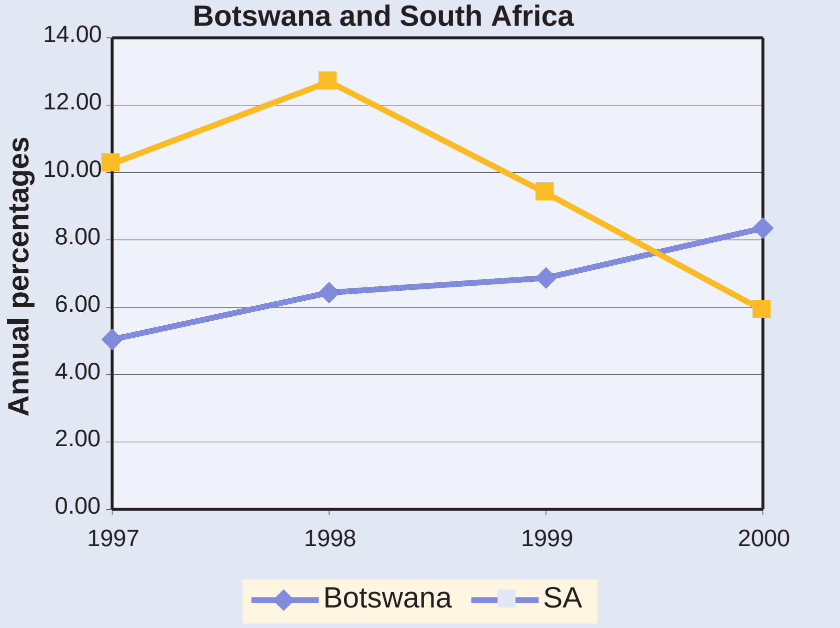
Meanwhile, the rate of growth of lending to the *business sector* fell quite substantially, from 44% to 26%. Business borrowing is probably more responsive to interest rates, because businesses are more aware of the cost of their borrowing. However, increasing the cost of borrowing in Botswana may simply encourage many businesses to borrow abroad, mainly from South Africa. Chart 1 shows that the real cost of borrowing (defined as prime rate adjusted for inflation) in Botswana has risen above the cost of borrowing in South Africa, for the first time in many years. It has therefore become rational to borrow in South Africa, where that option is available.

Inducing businesses to borrow abroad, instead of in Botswana, amounts to a form of short term capital inflow, for which Botswana has no immediate need. Only the larger businesses, and those involved in international trade, may be able to switch their borrowing to other countries. In particular, the large number of South African owned businesses in Botswana are well placed to borrow in South Africa, either from their owners or directly from South African banks. Businesses not involved in international trade, and smaller scale businesses (most of which are locally owned), are less likely to have this option.

It is therefore possible that increasing the cost of borrowing in Botswana:
- has a very limited effect on borrowing by households
- raises business costs
- has a discriminatory effect against small-scale and locally owned businesses
- does not reduce total borrowing by larger scale (and mostly foreign-owned) businesses because of their ability to switch their borrowing abroad.

Another objective of the Bank of Botswana's interest rate policy is to have real interest rates roughly comparable to those in the major industrialised countries. Recently, the real cost of borrowing in Botswana has risen above the cost of borrowing in the USA, and is several percentage points above the cost of borrowing in Britain and Japan (see Chart 2). In addition, corporate tax rates are lower in Botswana, so that claiming interest costs against tax liabilities has a smaller effect. The *after-tax* cost of borrowing in Botswana is therefore even higher in comparison with the after-tax cost of borrowing elsewhere. While the basic objective of having small but positive interest rates in real terms

Chart 1 Real cost of borrowing: Botswana and South Africa



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seems sensible, it seems perverse for Botswana to have *higher* borrowing costs than in the major industrial economies. Capital is not currently scarce in Botswana, so there is no case for making it more expensive than in other countries.

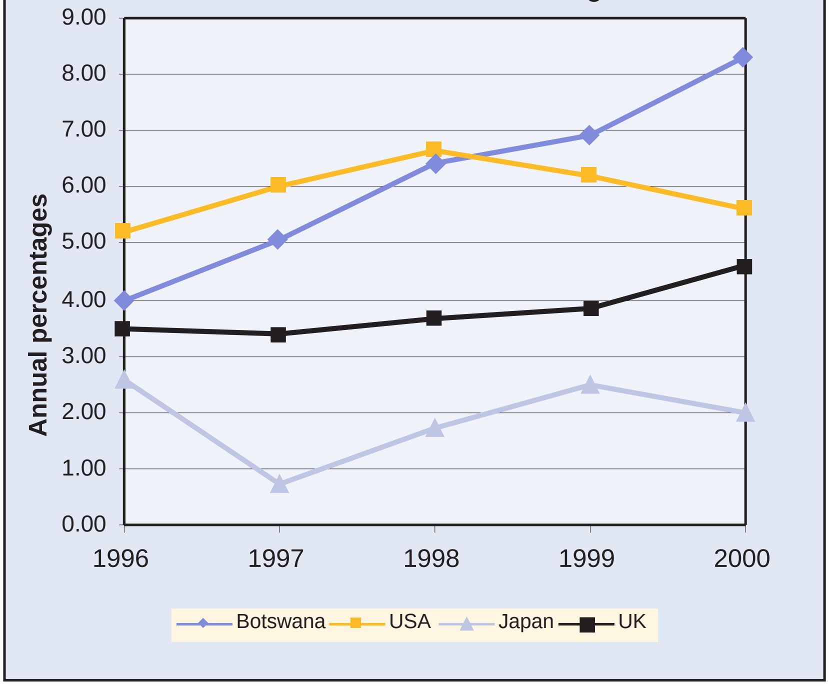


Chart 2 Real costs of borrowing

There is an additional reason to be concerned about the increased cost of borrowing in Botswana. Growth is expected to decline because of reduced government spending. Now may therefore be the wrong time to be increasing the real cost of borrowing. The impact on private sector activity may be limited, and it is unlikely that private sector spending can compensate for slower growth of government spending. But it could be a move in the wrong direction to impose higher borrowing costs in the current circumstances.

The Bank of Botswana's monetary statement also states that higher interest rates are necessary to reduce the rate of inflation. If household borrowing continues not to be affected, and if much of business borrowing can be switched abroad, it is difficult to argue that higher interest rates have much effect on inflation. This is supported by recent evidence. Charts 1 and 2 show that the real cost of borrowing increased in 1998 and 1999. Yet inflation remained at much the same level during this time (Chart 3). Recent evidence does not, therefore, support the view that higher interest rates have significantly reduced inflation, unless there are unusually long lags.

The policy of having positive real interest rates is definitely sound, so that the present level of interest rates is not seriously out of line. It does seem, though, that the cost of borrowing may be unnecessarily high, with a real cost of borrowing above 8%, and higher than in the countries used for comparison in Charts 1 and 2.

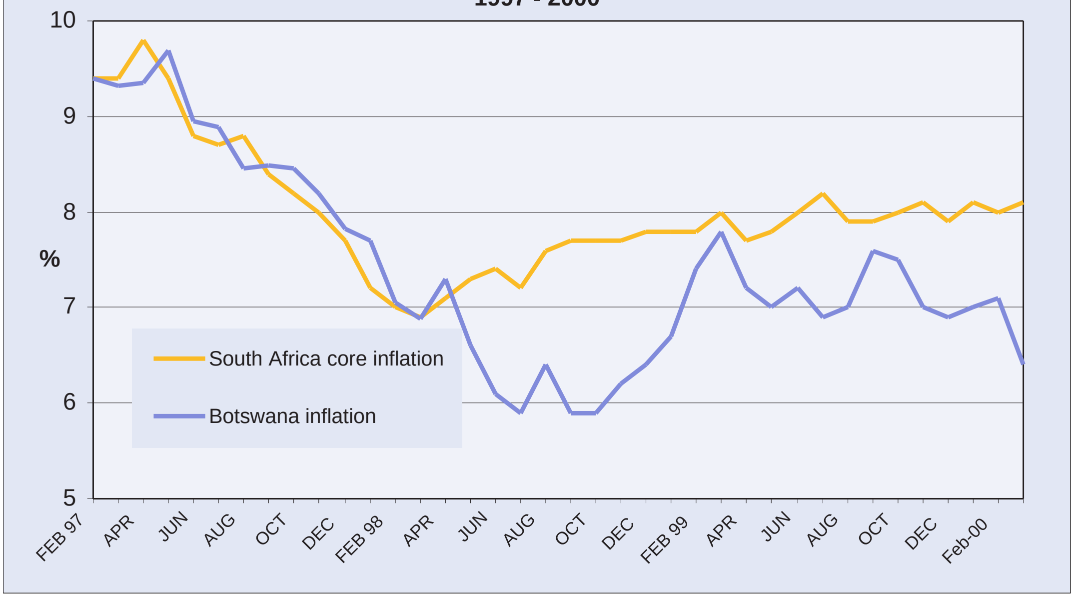
Inflation

Botswana's consumer price inflation continues to be slightly below the core inflation rate in South Africa. Core inflation is the most useful point of comparison, because it excludes changes in the cost of mortgages in South Africa. These have a negligible impact on Botswana's import costs. The annual rate of inflation in Botswana has remained fairly steady at about 7% since the middle of last year, and was at 6.4% in March. Core inflation in South Africa has been fairly steady at 8% for at least the last 12 months (see Chart 3).

There seems to be no particular reason for expecting the rate of inflation to change very much for the time being. To the extent that government expenditure gross more slowly, there will be a slowdown in the rate of growth of non-mineral GDP. This will tend to reduce inflationary pressure. However, any effect will probably be quite small because so much of inflation in Botswana is still imported from South Africa.

International Financial Services Centre (IFSC)

Most of the necessary legislation was passed during 1999. Some further legislation is required: a new Act for

Chart 3: Botswana Inflation, and South African Core Inflation 1997 - 2000


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captive insurance and reinsurance companies, and amendments to the Proceeds of Serious Crime Act. These are expected to be passed during 2000.

Some applications have already been received, although the relevant unit in BDC has not yet been active in promoting the Centre. The first application, from a merchant bank in Zimbabwe to set up its regional operations in Botswana, is awaiting a banking licence from the Bank of Botswana. Three further applications are expected to be approved, but are still at the stage of requiring additional information. One of these would involve shifting into the Centre the existing international activity of an existing Botswana bank; this would not involve any increase in employment, but would enable the bank to take advantage of the 15% corporate tax rate on that part of its operations established in the IFSC. Plans for promoting the Centre are well advanced. The brochure has been prepared, and presentations are planned for Johannesburg and Cape Town during May. Seminars will be presented to between 15 and 20 interested institutions in each city, and will be followed up by one-to-one meetings as necessary.

ECONOMIC FACTS AND FORECASTS

Quarterly

(end of period)	1998 Q2	Q3	Q4	1999 Q1	Q2	Q3	Q4	2000 Q1
Interest rates (%)								
BOBC (3 month)	10.21	10.46	10.66	11.55	11.75	11.68	12.0	12.45
Prime	13.25	14.00	14.00	14.25	14.75	14.75	14.75	15.25
Inflation (%)	6.1	5.9	6.4	7.2	7.5	7.6	6.9	6.4
Rand-Pula	1.36	1.30	1.32	1.33	1.30	1.32	1.33	1.35
Pula-US$	4.33	4.48	4.46	4.67	4.63	4.55	4.62	4.85
BSE index	949	954	947	990	1033	1417	1399	1471

Annual

		1993	1994	1995	1996	1997	1998	1999	2000
Growth (%)									
GDP (real)	*d*	4.2	2.7	6.6	7.2	8.3	4.2	9.0 *p*	7.0 *f*
Non-mineral GDP (real)	*d*	3.5	4.8	5.0	7.9	7.7	8.9	8.5 *p*	5.0 *f*
Exports (nominal)	*b*	15.3	18.4	19.7	40.7	27.8	-12.5	45 *p*	-7.6 *f*
Imports (nominal)	*b*	9.2	2.7	20.4	8.2	43.9	19.7	11 *e*	-5.7 *f*
Govt. spending (nominal)	*c*	11.8	-4.6	21.5	17.3	21.6	22.4	20 *f*	12 *f*
Govt. revenues (nominal)	*c*	14.3	-16.5	22.2	35.3	12.0	-7.3	55 *e*	-1 *f*
Domestic (bank) credit	*b*	11.8	18.2	-3.7	1.2	5.6	56.1	45	-
Interest rates (%)									
BOBC (3 month)	*a*	13.5	11.9	12.0	12.2	11.4	10.7	12.0	12.3 *f*
Prime	*a*	15.0	14.0	14.5	14.5	14.0	14.0	14.8	15.3 *f*
Inflation (average, %)		14.4	10.6	10.5	10.1	8.9	6.7	7.2	6.7 *f*
Rand-Pula	*a*	1.32	1.30	1.29	1.28	1.28	1.32	1.33	1.36 *f*
Pula-US$	*a*	2.56	2.72	2.82	3.64	3.81	4.46	4.63	4.96 *f*
BSE index	*a*	279	313	333	352	709	947	1399	-
Balance of Payments (Pm)									
Exports (diamonds)	*b*	3340	3727	3994	5272	7675	6405	10000 *f*	9400 *f*
Exports (other goods)		841	1304	1994	2100	2620	2603	3300 *e*	2600 *f*
Imports (goods, cif)	*b*	4290	4406	5305	5743	8256	9804	10890 *e*	10270 *f*
Current account balance	*b*	1220	642	937	2108	3059	860	1842 *p*	1000 *f*
Foreign Reserves									
Pula m	*a*	10509	11961	13249	19076	21619	26347	28552	31000 *f*
US$ m	*a*	4097	4402	4695	5234	5675	5960	6229	6500 *f*
Govt. spending (Pm)	*c*	4481	4277	5195	6092	7406	9065	10818 *e*	11730 *f*
Govt. revenue (Pm)	*c*	5359	4473	5464	7395	8281	7678	11922 *e*	11777 *f*
Budget surplus/(deficit) (Pm)	*c*	878	196	269	1303	875	-1387	1044 *e*	47 *f*
Govt. balances at BOB	*a*	5598	6705	6460	7204	15634	19212	20148	20000 *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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