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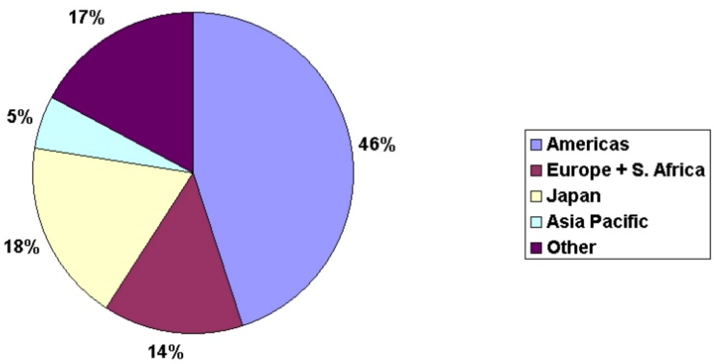
Overview

Global demand for diamonds is expected to fall, mainly because of the slowdown in the United States economy. De Beers has forecast that its sales in 2001 will be US$4.8 billion, compared with US$5.7 billion in 2000. The Botswana Government has started a campaign to counter the effects of publicity about "conflict diamonds". On the positive side, De Beers' stocks of rough diamonds are currently low. Botswana is also partially protected by De Beers' stock holding strategy, and by the Government's accumulated financial surpluses. Two international credit rating agencies have given Botswana the best ratings in Africa, several notches above those of South Africa. Although the Botswana Government does not need to borrow, the ratings should reduce the cost of foreign borrowing by the private sector, should improve the investment climate, and should provide an additional incentive for maintaining sound economic policies. Various indicators suggest that although real growth of non-mining GDP has declined, it continues to be positive, at between 4% and 5% per annum. There has been a *real* appreciation of the Pula against the rand of about 6% since the beginning of 2000. This will make it slightly more difficult for producers in Botswana to compete in the Botswana and South African markets with South African producers. Growth in formal sector employment in the second half the 1990s has resulted in the unemployment rate falling by four percentage points, to 15.8%. Most of this can be attributed to public sector employment growth, but private sector employment recovered in the second half of the 1990s.

Prospects for diamond sales

The slowdown in economic growth in the United States could have a negative effect on the growth of Botswana's diamond exports. The US economy is expected to grow by only 1.4% in 2001, compared with more than 4% last year. This is significant, because nearly half of diamond jewellery is sold in the United States. Japan is another major market for diamonds, and the Japanese economy is also struggling.

Chart 1. Global sales of diamong jewellery, 2000



Source: Mazal U'Bracha, quoting Tacy Ltd

These concerns are reinforced by the current weakness of the US stock market. The demand for diamond jewellery is thought to be quite strongly associated with the performance of stock markets. Demand for larger gems, which generates a disproportionate share of revenue from diamond producers, is especially sensitive to the value of rich buyers' other assets. Doubtless for these reasons, De Beers recent Annual Report forecasts that its 2001 sales would be only $4.8 billion. This compares with last year's record sales of $5.7 billion.

A further threat to diamond exports comes from the international campaign against "conflict diamonds". These are diamonds controlled by rebel groups in Angola, Congo and Sierra Leone. They are used to buy arms and thus to prolong civil wars. This campaign has raised the possibility of a consumer boycott of gem diamonds. It is particularly frustrating for Botswana, in that conflict diamonds account for only an estimated 4% of global output.

The Botswana Government has started a campaign to counter this bad publicity, most recently by inviting a delegation from the US Congress to Botswana. The Botswana Government's campaign is intended to show the world that Botswana diamonds do not finance conflict, but on the contrary are fundamental in financing social and economic development.

Fortunately, there are some positive factors. The "sightholders" who buy from De Beers in London were reported in March to be complaining about a shortage of supplies, and De Beers announced a 23% decline in diamond stocks in its latest annual report. Clearly, from Botswana's point of view, it is preferable to enter a period of reduced demand at a time when stocks of rough diamonds are low.

Another positive factor is that Botswana is protected by De Beers' strategy for managing the diamond market. The initial strategy for coping with fluctuations in demand is to absorb them through changes in De Beers' diamond stocks. It is only when this mechanism is insufficient that Botswana is forced to stockpile part of diamond production. This happened over an extended period in the 1980s, and for a much shorter period in 1998. If some output has to be stockpiled, reducing foreign exchange earnings and government revenue, the Botswana Government has large accumulated financial surpluses. In the short run, therefore, government spending can be maintained during a decline in mineral revenues (as it was in 1998).

Sovereign credit rating

Sovereign credit ratings are independent indicators of the creditworthiness of a country. Governments generally seek credit ratings to improve their own access (and the access of other foreign borrowers domiciled within their borders) to international capital markets, at lower interest rates than would otherwise be available.

The Botswana government decided recently to obtain a sovereign credit rating from two of the leading international credit rating agencies, in order to boost the country's international profile.

The result has been more than satisfactory. Botswana has been awarded a rating of A2 for foreign currency debt and A1 for pula denominated securities by Moody's investor service, which places the country in the middle and top range, respectively. Standard and Poors assigned its single A and A+ for long-term foreign currency borrowing and long-term local currency borrowing, respectively. Both agencies consider that their ratings for Botswana are likely to remain stable. Botswana's ratings are the highest in Africa, and several notches above those of South Africa.

The country's immediate benefit from a good rating will probably not be through improved and cheaper access for the Botswana Government to international capital markets. The Government is not at present under pressure to borrow money internationally. The budget has been consistently in surplus for many years. As a result, the Government has about two years' spending on deposit at the Bank of Botswana, and the equivalent of nearly three years imports in the foreign exchange reserves.

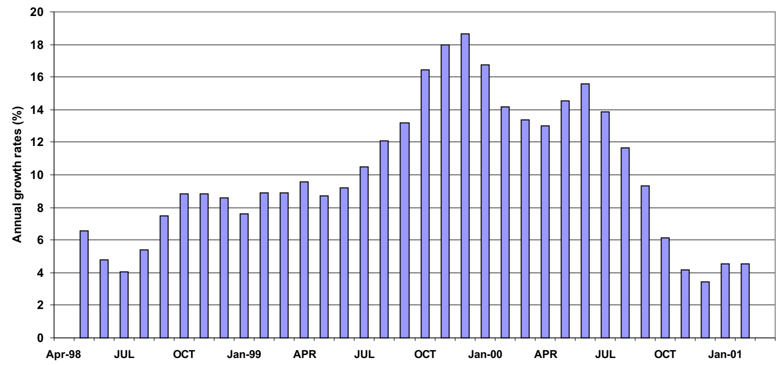
A more likely immediate benefit of the new credit ratings is that individual companies and parastatals within Botswana should find it easier and cheaper to borrow internationally. Most companies get some form of credit when they import, and this borrowing should become cheaper. The risk premium for those providing finance to Botswana should be reduced, and those extending credit to Botswana will be saved the expense of making their own risk assessment. The benefits should therefore apply to a wide range of trade finance, as well as to bond issues and bank finance. An additional benefit is that Botswana securities will become eligible to be held by some international fund managers, although this effect will be limited for the time being because of the small size of Botswana's financial markets.

Botswana's sovereign credit rating will be reviewed next year, and annually thereafter. Another benefit of getting sovereign credit ratings, therefore, is that they should help to "lock in" sound economic policy. If the credit rating agencies decide in future that the Government's economic management has become less sound, they will review Botswana's rating. This will provide a further incentive for the Government to persevere with sound economic policies, in order to avoid a public downgrading of the country's credit rating.

Indicators of GDP growth: electricity sales

Growth in non-mining GDP slowed from the 7.8% recorded in 1998/99, to a relatively modest 5.7% in 1999/2000. The important question is whether the growth rate of non-mining GDP will fall further. Alternatively, it could level off at an acceptable positive rate, or even rebound.

Chart 2. Electricity consumption: quarterly moving averages



Source: Botswana Power Corporation

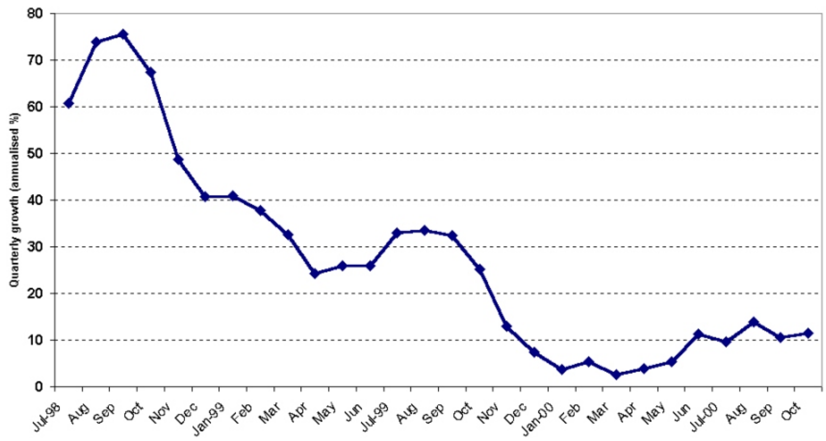
Electricity sales provide one up-to-date indicator of economic activity. They support the view that non-mining GDP has slowed down. From Chart 2, it can be seen that electricity consumption (shown in volume terms, and therefore unaffected by inflation) reached a peak 18% annual growth rate in late 1999. After that, there was a steeply falling trend in the growth rate. Growth seems, however, to have levelled off at around 4 - 5% in recent months (Nov-Feb 2001). This appears to be consistent with a slowdown in non-mining GDP growth, but with it continuing to be positive in real terms.

Indicators of GDP growth: credit and government spending

Another up-to-date indicator of the level of economic activity is commercial bank lending. Until about two and a half years ago, commercial bank lending to both the business and household sectors was growing at more than 50% per annum, *in real terms.* There was then a sharp decline in these rates of growth, with growth at less than 5% in early 2000. Since then, however, growth has picked up again. It was running consistently at more than 10% per annum in real terms, from the middle of last year until the latest month for which statistics are currently available (October 2000). This also suggests that the rate of growth of GDP has not continued to fall, but has stabilised at positive levels.

The rate of growth in government spending has also declined. Annual growth in real terms has steadied at between 4% and 5% per annum in the last two budget years, compared with between 12% and 16% in the previous two years. Government spending seems likely to grow at similar rates in the current budget year, despite the budget forecast of a real rate of growth of 12%. Such a high rate derives from the 37% increase in development spending announced in the budget speech last February. This is unlikely, because of limited implementation capacity. Further real growth of government spending at around 5%, if actually achieved, would also be

Chart 3. Growth of commercial bank lending



Source: Bank of Botswana

consistent with lower but positive real growth of non-mining GDP.

It seems likely that changes in the real growth rate of government spending, commercial bank credit and electricity sales are consistently in the same direction as changes in the rate of growth of GDP. Confidence in these indicators increases when all three tell roughly the same story. Unfortunately, it is not possible to say *how rapidly* GDP will continue to expand by using these indicators. It seems likely, though, that GDP growth is currently running at something like 5% per annum, given that government spending growth had already slowed last year and non-mining GDP grew at between 5% in 6% in the year to June 2000.

It is disappointing that GDP growth has slowed, but it was necessary to reduce the rate of growth of government spending from previous unsustainable levels. In future, higher GDP growth rates will require accelerated growth in the private sector, and therefore increased levels of domestic and foreign investment.

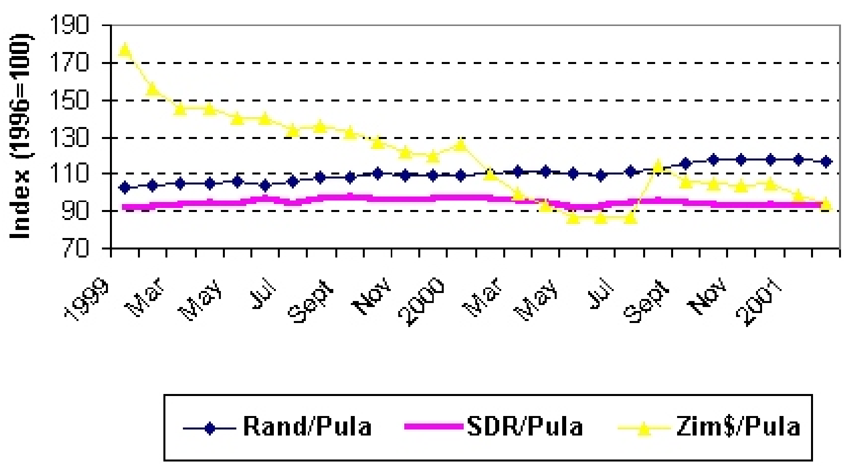
Real exchange rates

Exchange rate policy in Botswana becomes more difficult when the South African rand is unstable against the US dollar. Botswana cannot have stable exchange rates against both currencies when they move significantly against each other. This has happened several times in recent years, and it happened again in 2000. Since the end of 1999, the cost of one US dollar has increased from R6.16 to around R8.00, or by about 30%. Over the same period, the Pula has *appreciated* by more than 7% against the rand, but has *depreciated* by about 11% against the SDR (and by nearly 18% against a strong US$).

It is the bilateral *real* exchange rate against the rand which really matters. It reflects changes in the nominal Pula/rand exchange rate, adjusted for the difference in inflation in the two countries. If the Pula were to appreciate in nominal terms against the rand without there being a lower rate of inflation in Botswana than in South Africa, then goods produced in South Africa would become cheaper in Pula terms. This would make it more difficult for producers in Botswana to compete with South African producers, in both the Botswana and South African markets.

The bilateral real exchange rate against the rand matters because South Africa

Chart 4. Real Exchange Rate indices (1999-2001)



Source: Bank of Botswana

is by far the most important of Botswana's trading partners for manufactured goods, and tradable services. Some 80% of imports come from South Africa, and South Africa is the most important market for manufactured exports. Because of this, the bilateral real exchange rate against the rand has a major impact on the ability of Botswana producers to compete with South African producers.

Pula appreciation of 7% against the rand has not yet resulted in a significant reduction in Botswana's inflation. It has been much the same as in South Africa. As a result, the Pula appreciated *in real terms* by 6.2% against the rand in 2000, in addition to a more modest 1.4% in the previous year. Goods and services produced in Botswana have become more expensive relative to those produced in South Africa, as a result of this combination of the Pula rising against the rand and similar rates of inflation in Botswana and South Africa. This real appreciation of the Pula makes it slightly more difficult for Botswana to export to South Africa, and to compete with imports from South Africa.

In contrast, the real exchange rate against the SDR (a weighted average of the US$, the Euro, the Yen and the British pound) has remained stable. The Pula has depreciated in nominal terms against the SDR, following the rand, but this has been roughly offset by higher inflation in Botswana than in the major industrialised countries. Recent real exchange rate movements have not, therefore, been significant for Botswana's traditional exports (diamonds, beef and copper-nickel). In the case of diamond production, it is so profitable that it is not affected by nominal and real exchange rate movements against the US$ (the currency in which diamonds are priced and sold).

Against the Zimbabwe dollar, the Pula has *depreciated* sharply in real terms, by 12.2% last year and a massive 32.5% the previous year. Although the Zimbabwe dollar has fallen in nominal terms against the Pula, this has not been nearly enough to offset the very high rates of inflation in Zimbabwe (currently reported at more than 70%). This real depreciation, of the Pula against the Zimbabwe dollar, means that Botswana producers have become more competitive in comparison with Zimbabwe producers, in both the Botswana and Zimbabwe markets. However, it is unlikely that there will be an increase in exports to Zimbabwe, because of the collapse of demand and the shortage of foreign exchange in Zimbabwe.

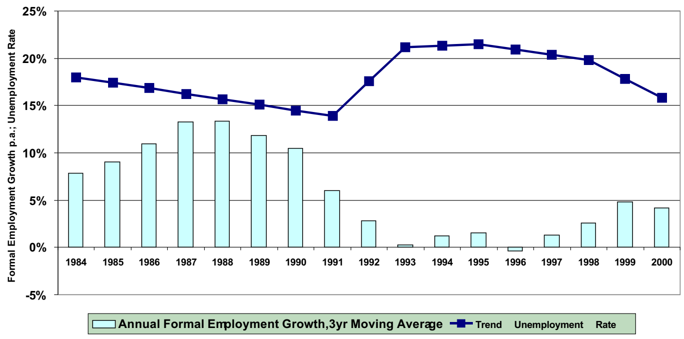
Employment growth and unemployment

There is a strong correlation between growth in formal sector employment and changes in the rate of unemployment, as shown in Chart 5. In the early 1990s, formal sector employment growth fell sharply, resulting in a 7 percentage point increase in the unemployment rate. In 1993-95, modest growth of formal sector employment (1.3% p.a.) was just enough to prevent the rate of unemployment from rising. Since 1996, formal sector employment growth has begun to accelerate again. A 4.2% p.a. average rate of increase for 1998-2000 has resulted in the unemployment rate falling by four percentage points (to 15.8%). Unfortunately, public sector employment accounted for this improvement. It grew steadily throughout the 1990s (at an average 4.3% per annum). Private sector and parastatal employment fell in the first half of the 1990s. It then recovered quite well, but only regained its 1991 level at the end of the decade.

The labour force (those working, and the unemployed actively looking for work, but not discouraged workers) actually decreased during the first half of the 1990s. Part of the decrease was because of growing enrolments in secondary schools. Another reason was that the sluggish economy, along with drought and weak agricultural performance, led many people to withdraw from the labour force (thereby becoming discouraged workers).

Even a 15.8% unemployment rate is too high, since the lack of jobs and job-related incomes are the major causes of poverty in Botswana. Unemployment also contributes to income inequality, crime, ill-health, intergenerational transmission of poverty, alienation from society, loss of self-esteem and feelings of powerlessness. Increased foreign and domestic investment, preferably in the private sector, would reduce unemployment further.

Chart 5 Growth of Formal Sector Employment and the Unemployment rate, 1984-2000



Source: CSO

ECONOMIC FACTS AND FORECASTS

Quarterly

(end of period)	Q2	Q3	Q4	2000 Q1	Q2	Q3	Q4	2001 Q1
Interest rates (%)								
BOBC (3 month)	11.58	11.65	11.98	12.43	12.49	12.49	12.71	12.68
Prime	14.75	14.81	14.81	15.25	15.25	15.25	15.75	15.75
Inflation (%)	7.2	9.1	8.4	7.8	8.9	8.2	8.7	7.5
Rand-Pula	1.30	1.32	1.33	1.35	1.35	1.38	1.41	1.42
Pula-US$	4.63	4.53	4.63	4.85	5.12	5.27	5.36	5.62
BSE index	1033	1417	1399	1471	1435	1475	1453	1733

Annual

		1994	1995	1996	1997	1998	1999	2000	2001
Growth (%)									
GDP (real)	d	2.5	6.6	7.1	8.3	4.2	7.7	3.5 e	4.0 f
Non-mineral GDP (real)	d	4.8	4.9	7.8	7.7	8.9	5.7	5.0 e	5.0 f
Exports (nominal)	b	18.4	19.0	23.1	39.6	-15.4	40.8	12.0 e	- 7.7 f
Imports (nominal)	b	2.7	20.4	8.3	43.8	18.8	3.7	15.1 e	11.1 f
Govt. spending (nominal)	c	-4.6	21.5	17.3	21.6	22.4	15.0	15.0 e	12.0 f
Govt. revenues (nominal)	c	-16.5	22.2	35.3	12.0	-7.3	55.0	8.6 e	0.0 f
Domestic (bank) credit	b	18.2	-3.7	1.1	5.6	56.1	55.9	25.0 e	18.0 f
Interest rates (%)									
BOBC (3 month)	a	11.9	12.0	12.2	11.4	10.7	12.0	12.7	12.3 f
Prime	a	14.5	14.5	14.5	14.0	14.0	14.8	15.8	15.3 f
Inflation (average, %)	b	10.6	10.5	10.1	8.9	6.5	7.8	8.6	7.0 f
Rand-Pula	a	1.30	1.29	1.28	1.28	1.32	1.33	1.41	1.43 f
Pula-US$	a	2.72	2.82	3.64	3.81	4.46	4.63	5.36	5.65 f
BSE index	a	313	333	352	709	947	1399	1453	1800 f
Balance of Payments (Pm)									
Exports (diamonds)	b	3727	3994	5272	7675	6061	9706	11000 e	9700 f
Exports (other goods)	B	1304	1994	2100	2620	2647	2522	2700 e	2950 f
Imports (goods, cif)	b	4408	5306	5729	8256	9804	10164	11700 e	13000 f
Current account balance	b	568	831	1643	2634	860	2859	2630 e	250 f
Foreign Reserves									
Pula m	a	11961	13249	19076	21619	26485	28852	33900 e	35550 f
US$ m	a	4402	4695	5234	5675	5941	6229	6300 e	6350 f
Govt. spending (Pm)	c	4277	5195	6092	7406	9065	10356	11730 e	13150 f
Govt. revenue (Pm)	c	4473	5464	7395	8281	7678	11968	13000 e	13000 f
Budget surplus/(deficit) (Pm)	c	196	269	1303	875	-1387	1611	1270 e	550 f
Govt. balances at BOB (Pm)	a	6705	6460	11664	15634	19212	20199	24000 e	25300 f

Notes: *a end of period; b calendar year; c financial year (starts April); 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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