Economic Review **September 2009**

INTERNATIONAL MONETARY FUND WORLD ECONOMIC OUTLOOK OCTOBER 2009: SUSTAINING THE RECOVERY

The International Monetary Fund (IMF) World Economic Outlook (WEO) October 2009 argues that following one of the deepest global recessions in recent years, there are clear indications that economic growth has turned positive mainly due to strong macroeconomic policies intervention. The key challenge is the restoration of the health of the financial sector and scaling down the intervention while maintaining the recovery……..

BACKGROUND

The International Monetary Fund (IMF) released the World Economic Outlook (WEO) in October 2009 titled "sustaining the recovery". The WEO is part of the IMF global economic developments surveillance, it contains analysis and projections. The outlook is released twice a year in April and October. The October 2009 theme tries to put into perspective the key challenges facing the global economy in order to sustain the modest positive economic growth being observed in a number of regions. While still modest, it is clear that the recovery of the global economy has started.

The October 2009 edition of the WEO is released at the opportune time for most developing countries including Lesotho. A number of developing countries were affected by the second round effects of the financial crisis through their trade relationship with the developed countries. Thus the lagged effect is now having the full impact. The policymakers have to implement macroeconomic policies that would curb the recession from eroding some of the gains achieved towards the Millennium Development Goals. The WEO is an important input to ensure that implemented policies assist developing economies ride on the observed modest recovery.

WORLD ECONOMIC DEVELOPMENTS

From 2004 to the beginning of the current global recession, global economic growth was much more rapid, and the global economy enjoyed the highest growth since the oil price surges of the 1970s. At that time, output volatility was also very low as a result of the general improvement in the conduct of monetary and fiscal policy. Nevertheless, occurrence of recessions was not completely ruled out, nor did this good performance mean that the business cycle had died. New risks and challenges could still arise in the global economic system and turn things around.

Indeed a new challenge arose in the form of the subprime mortgage crisis and caught the world unprepared and led to the deepest downturn of the global economy in 50 years. According to the WEO, the global economy has started to follow an inverted Newtonian logic as the crisis is eventually subsiding. It has estimated that economic activity at the global level has increased by 3.0 per cent in the second quarter of 2009 compared with a contraction of 6.5 per cent in the first quarter and a much stronger growth is expected in the final half of the year. Different world economies are contributing differently to the global recovery, in line with the differences in the extent to which they have been affected by the global financial crisis and the recession.

Table 1: World Economic Outlook Projections (Annual Percent Change)

	2007	2008	2009	2010
World Output	5.2	3.0	-1.1	3.1
Advanced Economies	2.7	0.6	-3.4	1.3
United States	2.1	0.4	-2.7	1.5
Euro Area	2.7	0.7	-4.2	0.3
Emerging market and developing	8.3	6.0	1.7	5.1
Africa	6.3	5.2	1.7	4.0
Sub-Sahara	7.0	5.5	1.3	4.1
Central and Eastern Europe	5.5	3.0	-5.0	1.8
Commonwealth of Independent States	8.6	5.5	-6.7	2.1
Developing Asia	10.6	7.6	6.2	7.3
Middle East	6.2	5.4	2.0	4.2
Western Hemisphere	5.7	4.2	-2.5	2.9
Consumer Prices				
Advanced Economies	2.2	3.4	0.1	1.1
Other Emerging market and developing	6.4	9.3	5.5	4.9
Imports				
Advanced Economies	4.7	0.5	-13.7	1.2
Other Emerging market and developing	13.8	9.4	-9.5	4.6
Exports				
Advanced Economies	6.3	1.9	-13.6	2.0
Other Emerging market and developing	9.8	4.6	-7.2	3.6

SOURCE*:* IMF World Economic Outlook October 2009: *Sustaining the Recovery*

THE UNITED STATES

According to the WEO the US economy started emitting signs of stabilization in the second quarter of 2009 as evidenced by a moderation in the rate of GDP contraction. GDP is estimated to have declined by a seasonally adjusted annual rate of 1.0 per cent in the second quarter compared with a fall of 6.4 per cent in the first quarter. This improvement is mainly a reflection of the effects of the monetary, financial and fiscal policy responses to the crisis, which have led to the increase in government spending as well as the stabilization in consumer spending, housing and financial markets. Personal consumption expenditure declined further in the second quarter of 2009 albeit at a lower rate compared to the previous quarters. In addition, conditions in the housing and financial markets have improved as evidenced by improved interbank spreads and the rally in equity markets as well as the tightening up of corporate bond and mortgage spreads. Nevertheless, some negative forces still remain. Exports continue to fall and contribute negatively to growth as global demand remains sluggish. Imports and business investment remain subdued, while the saving rate continues to pick-up.

The WEO projected positive growth for the second half of the year, which would result in a lower contraction of 2.75 per cent for 2009. Indeed the US Department of Commerce's Bureau of Economic Analysis has estimated that real GDP rose at an annual rate of 3.5 per cent in the third quarter of 2009 following a string of declines in the previous four quarters.

The most encouraging aspect of this growth is the recovery in consumer spending, which rose by 3.4 per cent. The most significant contributor to the increase in consumer spending was spending on new cars and trucks, which should have been boosted by purchases under the Consumer Assistance to Recycle and Save Act of 2009 (Cash for Clunkers Program), under which tax credit was provided to encourage consumers to trade in older and less fuel efficient vehicles for new and better ones. Residential fixed investment and government spending also contributed positively to growth during the quarter. The US$8 000.00 tax credit for first time home buyers may have played a significant role in boosting residential fixed investment.

There are some downside risks to the positive outlook and the third quarter expansion. Unemployment is rising and is expected to continue to increase for some time. In addition, households are in the process of deleveraging, reducing their debt and increasing savings and this could continue for a prolonged period given the high household debt in the US. These two factors do not augur well for the rebound of consumption expenditure. Corporate and commercial property defaults are continuing and this could slow down the improvement in financial conditions.

THE EURO-ZONE

The global financial crisis and recession resulted in output declines in the Euro area. Major impact came from the decline in domestic demand, particularly investment, as well as from the slump in trade within and outside the region. Sudden reversals of real estate price booms led to considerable decline in activity in a number of countries.

The WEO is foreseeing recovery at the snail's pace for the Euro zone. While some countries in the region, specifically, France and Germany, experienced positive growth rates in the second quarter of 2009, others continued to register negative growth. Consequently, the WEO is projecting a contraction of 0.7 per cent for the Euro area in 2009, which is similar to hat recorded in 2008.

Speedy recovery in the Euro zone is hampered by the continued negative pressures from the housing markets. In addition, the largely bank-based financial sector was severely affected by the crisis and will take time to become fully operational and carry out their role of financial intermediation. Credit conditions have not loosened up and continue to constrain private investment. Unemployment is also rising and putting pressure on consumption.

EMERGING ASIA

Asia was hit very hard by the financial crisis and the recession, through both trade and financial linkages to the US and other European economies. This led to abrupt declines in exports and production, while capital also flew out of Asia. Nevertheless, Asia appears to be leading the recovery. This is attributable to the timely and substantial fiscal stimulus package, which is said to have been larger than the G-20 average. Asia's relatively robust fiscal position at the onset of the crisis facilitated implementation of much stronger discretionary support than in other economies.

While the signs of economic turnaround are said to have emerged in many countries during the second half of 2009, the WEO indicates that Asia's recovery started in the first half of the year and it appears to be strengthening over time. Asia realized a growth rate of 2.5 per cent in the second quarter while declines were recorded in other regions of the world. Asia's recovery is led by China and India which, according to the WEO, are expected to register real growth rates of 8.5 per cent and 5.4 per cent, respectively in 2009.

A number of factors have supported the rebound in Asia. Expansionary fiscal and monetary policies moderated the decline in domestic demand. The fiscal stimulus packages in Japan and Korea were aimed at bolstering consumption of durables. In China the target was to upgrade infrastructure and to retool factories. Interest rates cuts in a number of Asian economies and the relaxation of credit ceilings in China enabled credit growth and boosted domestic demand. The decline in total exports by the region was moderated, to a large extent, by strong demand in China, which boosted exports in the region, especially, in Indonesia and Korea.

However, there are threats to the remarkable picture painted above. A strong rebound in external demand has not been seen as yet and this is hampering a more robust recovery of Asia's exports to pre-crisis levels. In addition, the labor markets in the region still remain weak, thus exerting some negative pressure on consumption.

AFRICA

Africa did not escape unaffected by the global financial and economic crisis. The first African countries to feel the pinch of the crisis were those with more developed financial sectors and higher levels of integration into global financial markets. The collapse of global trade also had devastating effects on exporters of oil, manufactured goods and minerals. The WEO has estimated that Africa's real GDP growth will decelerate to 1.75 per cent in 2009 compared with 5.2 per cent in the previous year. The largest economy in the region is expected to register a negative real growth rate of 2.2 per cent in 2009.

The WEO pointed out that African economies have been resilient during the recession. While the external shocks emanating from the recession were severe and quite devastating, African economies did not perform as bad as one would have expected based on past experience. This is mainly attributable to the use of counter-cyclical fiscal and monetary policies, which helped to moderate the decline in domestic demand. More prudent fiscal policies in the region, prior to the crisis, appear to have provided some room for policy intervention so that a number of African countries were able to allow automatic stabilizers to operate while others implemented countercyclical policies. Consequently, Africa's fiscal position would deteriorate. Africa as a region is projected to realize a fiscal deficit of 1.75 per cent of GDP in 2009 compared with a surplus of 4.75 per cent in 2009.

Speedy recovery by African economies is largely dependent on stronger and sustained global recovery, which would strengthen the recovery in commodity and financial markets and, it turn, improve export receipts and capital inflows from other regions of the world.

HOW SUSTAINABLE IS THE RECOVERY?

The observed global economic recovery appears to be driven mainly by fiscal and monetary policy interventions implemented by policymakers throughout the world. This was the best option under the circumstances, and it seems to be yielding the expected results. Nevertheless, the response by other economic players, including households and the private sector remains subdued. This is raising concerns regarding sustainability of the recovery. The main issue is how long can the fiscal stimulus packages be sustained and to what extent can the already high fiscal deficits be allowed to surge?

This is a critical issue because premature withdrawal of the fiscal stimulus packages could reverse the recovery achieved so far. In addition, large fiscal deficits could possibly result in rapid increase in debt, which could threaten debt sustainability, especially taking into account the fact that many countries (particularly advanced economies) had high debt levels prior to the crisis. Thus government intervention cannot go on indefinitely but its place will have to be taken over by private demand.

The increasing unemployment in the US and Euro area rule out the possibility of a speedy recovery of household consumption in these parts of the world. Private investment also remains constrained by the still tight credit conditions. This leaves Asian economies, which have more fiscal space and have been running current account surpluses, to increase their demand further and help sustain the global recovery. In fact, as mentioned above, domestic demand remains relatively strong in Asia.

With regard to monetary policy, it appears that advanced economies have some space for maintaining the current accommodative stance for longer period. This is because inflation is very low and there is highly limited upward pressure on prices as unemployment is rising and credit extension will take long to recover, since financial markets and households are expected to take considerably long to repair their balance sheets.
The situation is different for emerging economies, they may have to start tightening monetary policy sooner than advanced economies. Recent developments have increased prospects for some upward pressure on prices. While inflation remains low in emerging economies, economic activity has started to recover relatively strongly and unemployment is expected to start falling soon. In addition, asset prices have increased substantially as a result of low interest rates and have increased chances of new asset price bubbles.

IMPLICATIONS FOR LESOTHO'S ECONOMY

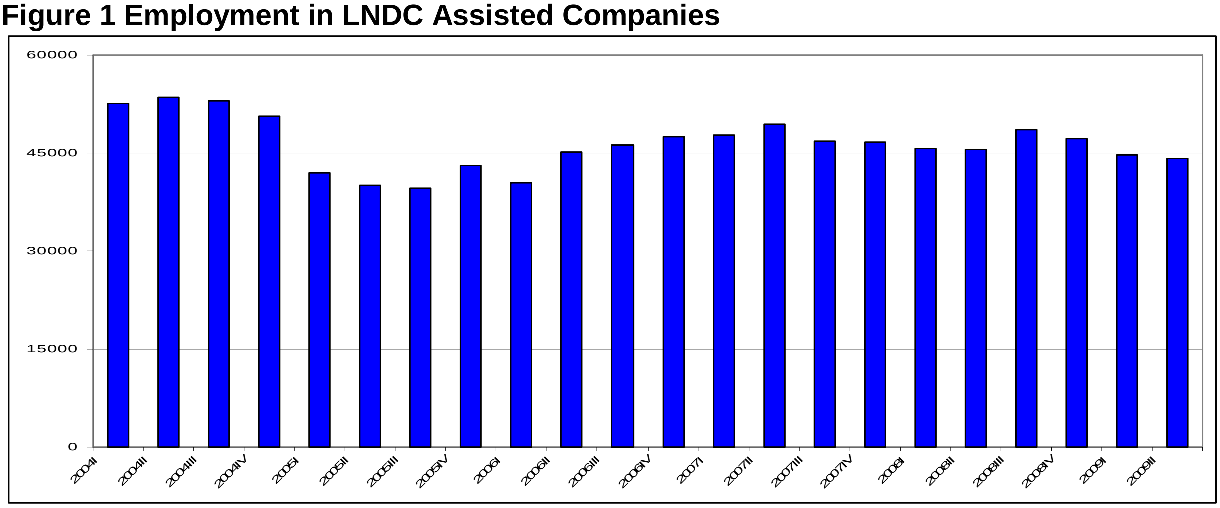
The global economic recovery is a welcome development to economies of the world, including Lesotho because, if sustained, it could curb the devastating direct and second round effects of the financial crisis. Nevertheless, the recovery has just started and it appears that so far only government spending has increased as a result of the interventions by the Governments in various countries. Household consumption and employment remain subdued, in the US and the Euro zone. As a result a number of economic challenges still remain for Lesotho, mostly emanating from the trade relationship between Lesotho and the US as well as the Euro zone.

Since the inception of African Growth and Opportunity Act (AGOA) in 2000, the bulk of Lesotho-based manufacturing sector's products, mainly textiles and clothing, have been exported to the US. This resulted in a significant increase in employment in the manufacturing sub-sector and improved contribution of the sub-sector to economic growth. As aggregate demand in the US fell, on account of the recession, demand for Lesotho's exports of textiles and clothing to US retailers also fell. Consequently, Lesotho-based manufacturers started receiving very low orders from their customers in the US. As a result, the manufacturing sub-sector had to scale down operations and hence laid-off a considerable number of workers. Figure 1 below shows the employment levels in LNDC assisted companies during the period 2004QI to 2009QII. The number employed declined from 48,621 in the third quarter of 2008 to 44,689 in the second quarter of 2009. If the trend is not reversed soon, this is likely to impact negatively on the Government's efforts to alleviate poverty in the country. Performance of the sector is expected to remain subdued until households have resumed their expenditure, at least, to pre-crisis levels. This is important for recovery as well as for further expansion of the sub-sector.

The diamond mining sector, which has had a significant contribution on economic growth and investment in recent years, was adversely affected. This changed at the onset of the recession, when the international price of diamonds fell in response to low demand. This resulted in a decline in Lesotho's exports of diamonds. The price of diamonds rebounded along with the prices of other commodities in the first half of this year on account of the increase in financial investment in commodity assets. The prices of commodities are expected to remain high for sometime, supported by the recovery in consumer demand in developing and emerging economies, especially Asian. The mining sector in Lesotho has already started to respond to these positive developments. Exports of diamonds rose by 85.0 per cent in the second quarter of 2009. In addition, the mining production index improved substantially by more than 200 percentage points during the same period.

Lesotho is a member of the Southern African Customs Union (SACU) with Botswana, Namibia, Swaziland and South Africa. SACU revenue is the main source of revenue for the Government of Lesotho. The recession has reduced production and employment and hence domestic demand in many economies of the world including SACU countries. As a consequence, these countries are experiencing declines in imports of goods and services and hence revenues from import duties. The most significant contribution to the SACU revenue pool, estimated at 98 per cent in 2006/07 comes from SA. As mentioned earlier the SA economy is projected to record a contraction this year. In addition, imports of goods are continuing on a downward trend with a monthly decline of 1.7 per cent registered in September. This implies a considerable decline in SA's transfers to the revenue pool and hence shares to member states. Lesotho will be the most severely affected as it obtains more than 50.0 per cent of the national revenue from SACU.

Figure 1 Employment in LNDC Assisted Companies



3. Monetary Policy Operations Report for September 2009

One of the main objectives of the Central Bank of Lesotho (CBL) is to maintain price stability, which is achieved through the maintenance of adequate level of Net International Reserves (NIR). The adequate level of NIR ensures that the parity between local currency, the Loti and the South African Rand is maintained. The CBL's Monetary Policy Committee (MPC) set the NIR target range of US$500-US$550 million during the period under review. The CBL employs the Open Market Operations (OMO) as a monetary policy tool in order to achieve the stated objective. The open sale and purchase of treasury bills goes a long way to protect the currency peg.

The report presents economic and operational issues surrounding the monetary policy operations conducted during the review period to assess the success of the operations.

Table 1 below shows that the entire amounts of treasury bills (M100 million) announced during the auctions conducted on September 02, 16 and 30, respectively, were ultimately issued. During the review period, the market showed an improvement in the 91-day treasury bills auction held on the 30th September, 2009 compared with the previous auctions on September 02 and 16, 2009. Competitiveness of the 91-day Treasury Bills auction, measured by the number of bids received, improved marginally during the review period. The number of bids received during the auction conducted on September 30 remained unchanged at 10 and 6, respectively, but the number of successful bids increased marginally from 4 to 5 compared with 16 September, 2009.

Lesotho's 91-day Treasury bills rate (discount rate) remained below its South African counterpart by 6 basis points, on September 30, 2009. The margin of interest rate differential between Lesotho's 91-day Treasury bills rate and SA counterpart narrowed significantly to 6 basis points on September 30, 2009 compared with 10 basis points on September 16, 2009. This implies that there was a minimal incentive for undesirable cross border transfers of funds between the two countries. Therefore, the Monetary Policy operations undertaken during the review month were successful in attaining their desired objectives of price stability by maintaining the target NIR level.

Table 1: Treasury Bills Auctions

Type of Security	Auction Date	Maturity Date	Auction Amount (Million Maloti)	Amount Issued (Million Maloti)	Discount Rate (%)	RSA Discount Rate (%)
91-day	***02-Sept-09***	02-Dec-09	M12.0	M12.0	6.86%	6.98%
182-day		03-Feb-10	M12.0	M12.0	7.20%	7.05%
273-day		02-June-10	M8.0	M8.0	8.04%	7.05%
364-day		01-Sept-10	M8.0	M8.0	7.93%	7.01%
91-day	***16-Sept-09***	16-Dec-09	M6.0	M6.0	6.86%	6.96%
182-day		17-Feb-10	M6.0	M6.0	7.19%	7.08%
273-day		16-June-10	M4.0	M4.0	8.04%	7.03%
364-day		15-Sept-10	M4.0	M4.0	7.90%	6.99%
91-day	**30-Sept-09**	30-Dec-09	M12.0	M12.0	6.84%	6.90%
182-day		03-Mar-10	M12.0	M12.0	7.18%	7.04%
273-day		30-June-10	M8.0	M8.0	8.03%	7.05%
364-day		29-Sept-10	M8.0	M8.0	7.90%	7.04%
Total for reporting			**M100**	**M100**		

Figure 1: Measuring the Success of Monetary Policy Objectives: Performances of Lesotho 91-day T-bills vs RSA 91-day T-bills