Economic Review July 2012

The Role of Diamond Mining Sector in Lesotho's Economy

The mining sector is increasingly becoming a significant player in Lesotho's economic performance ………

Background

The diamond mining industry has been in existence in Lesotho since the late 1950s. Prospecting rights were granted over Kao and Liqhobong pipes in 1959 but immediately after Lesotho's independence from colonial rule, these mines ceased operations on account of dissatisfactory diamond production results. In 1961, artisanal diamond mining by licenced Basotho diggers started at Lets'eng-la-Terai, Kolo, Nqechane and Hololo. However, in 1968 the process of prospecting on Lets'eng diamond pipe commenced. Again, the results proved futile in the 1970s and thus the mine ceased operations again. Nonetheless, the reopening of the diamond mines in Lesotho about a decade ago has brought benefits worthy of mention. The diamond mining industry's contribution to Lesotho's economic growth has increased from virtually zero in 2000 to around 4.0 per cent in 2010/11.

The purpose of this article is to present the structure of the diamond sector in Lesotho. It also highlights the recent developments in the sector and its impact on Lesotho's economy.

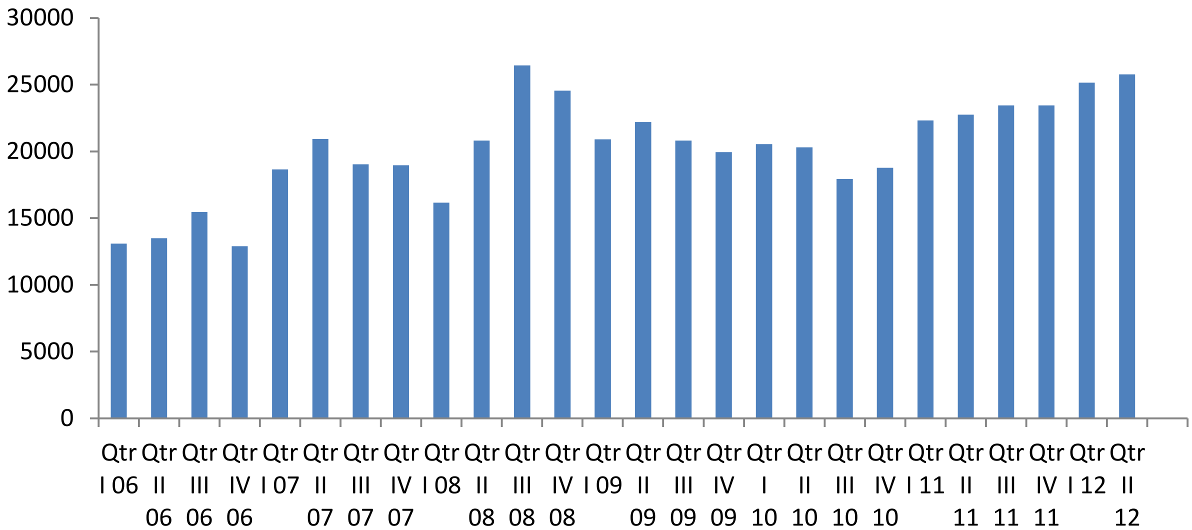
The Structure of the Diamond Industry in Lesotho

The diamond sector comprises five major mines, namely Lets'eng, Liqhobong, Kao, Kolo and Mothae. These are operating as foreign direct investment companies with majority shareholding of up to 70.0 per cent by foreign companies. The Government of Lesotho through the Ministry of Natural Resources is responsible for authorizing exploration and extraction, issuing mining leases to companies as well as regulating the industry. The regulatory framework for the mining industry includes the following laws: the Mines and Minerals Act of 2005, the Mine Safety Act of 1981, the Precious Stones Order of 1970 as amended and the Explosives Proclamation of 1958 as amended.

Recent Developments in Lesotho's Diamond Sector

Diamond production in Lesotho has increased significantly since the reopening of the mines a decade ago. As depicted in figure 1 below, the weighted diamond production index? has risen from 13 089 carats in the first quarter of 2006 to 27 724 carats in the second quarter of 2012. However, diamond production fluctuated a lot between the two periods. For example, it went on a downward trend from the third quarter of 2007 to reach a trough in the first quarter of 2008. Thereafter it rose to reach a peak in the third quarter of 2008. This was in line with the general increase in commodity prices at the global level during this time. Diamond production then went on a declining trend up to the third quarter of 2010 as some mining companies in Lesotho closed down operations in response to low global demand that led to plummeting of prices associated with the global recession. It has, since then, been on an upward trend, reflecting the recovery of global demand hence the price, which led to the resumption of mining operations by the mines that had closed down in 2008.

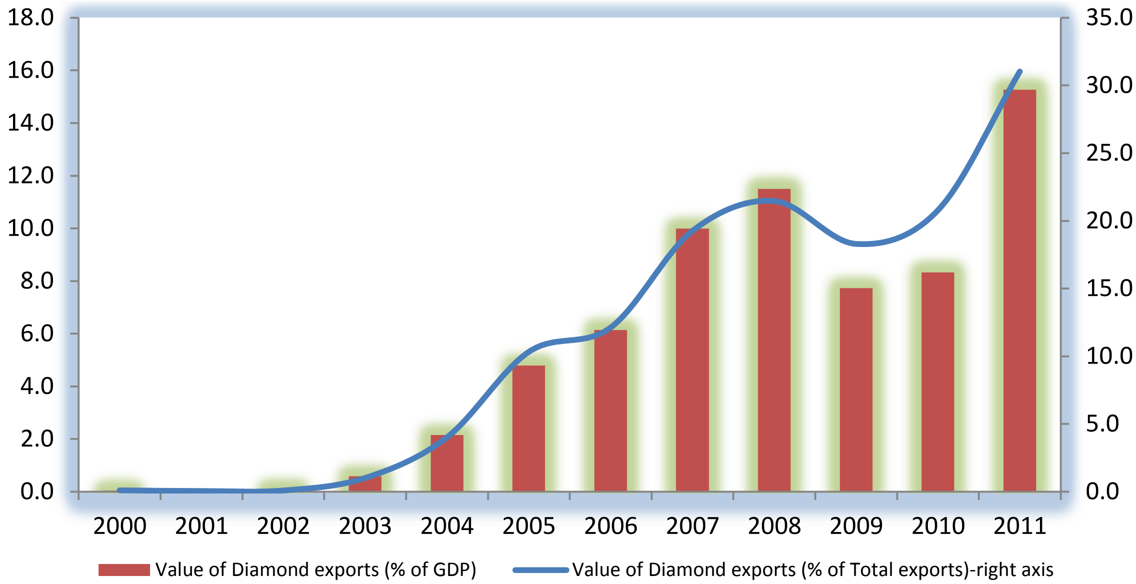
Figure 1: Weighted Diamond Production (thousand carats)



Source: Department of Mines and Geology and CBL

The increase in diamond production was in line with the increase in the value of diamonds exports (figure 2 below). Diamond exports as percentage of total exports and gross domestic product (GDP) increased from virtually zero in 2002. The value of diamond exports as a percentage of total exports increased from 0.1 per cent in 2002 to 31.0 per cent in 2011. Nonetheless, it dropped to 18.3 per cent in 2009 as a result of the global financial crisis and recession. It slightly increased to 20.8 per cent in 2010 as the global economy showed some signs of recovery. As shown in figure 2 below, the value of diamond exports as percentage of GDP followed the same trend as the ratio of diamond exports to total exports (figure 2 below). The ratio of diamond exports to GDP increased from zero in 2001 to 15.2 per cent in 2011.

Figure 2: The Value of Diamond Exports (% of total exports and GDP)



Source: CBL

The Economic Impact of the Diamond Sector on Lesotho's Economy.

The diamond sector has made a commendable contribution to Lesotho's economy, especially since 2004. The growth of the sector has contributed to the increase in the mining and quarrying sub-sector's share in GDP from 0.9 per cent in 2004 to around 4.5 per cent in 2011.

The diamond mining industry has also been pivotal in increasing Lesotho's exports earnings hence Lesotho's gross foreign reserves since the reopening of the mines a decade ago. Lesotho is operating a fixed exchange rate regime under which the local currency is pegged at par to the South African rand. To maintain the peg, Lesotho needs to at all times maintain a sufficient level of foreign exchange reserves. The industry has and continues to make a significant contribution to Lesotho's capacity to maintain the peg.

Despite the capital-intensive nature of the mining industry, it has contributed to employment in the country hence has shaken the roots of poverty in some parts of the country as household incomes increased for those employed in the mining industry. As of 2010, the number of people employed by Lesotho's diamond mining companies with active licences was around 1,300, with Lets'eng Diamonds (Pty) Ltd as the largest employer followed by Kao diamond mine. By the end of 2012 the sector employed about 2,000 workers which translate to 0.3 per cent of total employment. The sector is expected to absorb additional 1,000 workers in 2016/2017 as some of the mines expand production capacity and new plants are activated.

The diamond mining industry also plays an important role in boosting government revenues through various channels such as the corporate tax and royalties. The company tax and royalties increased significantly from the financial year

2003/2004, which coincided with the coming into operation of mines as well as the formation of the Lesotho Revenue Authority. However, the company tax and royalties declined in 2009 and 2010 due to the negative effects of the global financial crisis on the diamond mining industry.

Trends in International Commodity Prices from January to July 2012 and Their Implications for Lesotho's Economy.

Commodity prices generally increased with the exception of precious metals and stones………..

Introduction

According to theory and empirical findings, the movements in commodity prices are determined by changes in the demand for and in the supply of such commodities. Commodity specific factors may alter the demand for and/or the supply of specific commodities, thus affecting their price. Sometimes the prices of different commodities simultaneously move in the same direction, reflecting a response to a common factor that drives commodity-wide movements in the prices during that particular period. There is a general observation that oscillations in economic activity and in the outlook on economic growth are the major determinants of the short-term fluctuations in commodity prices. Nonetheless, causality may sometimes go the other way, that is, supply disruptions may cause a surge in commodity prices, which in turn may curtail economic activity. Sometimes the decline in supply or concerns that supply may fall or be depleted may affect the price but may not be strong enough to have any impact on activity. Speculative commodity trading also influences price movements.

Commodity prices generally increased in the first quarter of 2012 buoyed by the better than expected global growth during the same period. In addition, market confidence recovered early in 2012 in response to the European Central Bank's longer-term refinancing operations. Prices changed direction in the second quarter as leading macroeconomic indicators showed that global economic activity, hence recovery, was slowing down. The fall in commodity prices was stronger during May 2012 as the debt crisis in Europe intensified and China's growth slowed down. In July 2012, commodity prices staged a comeback with pronounced increases observed in international crude oil and food prices.

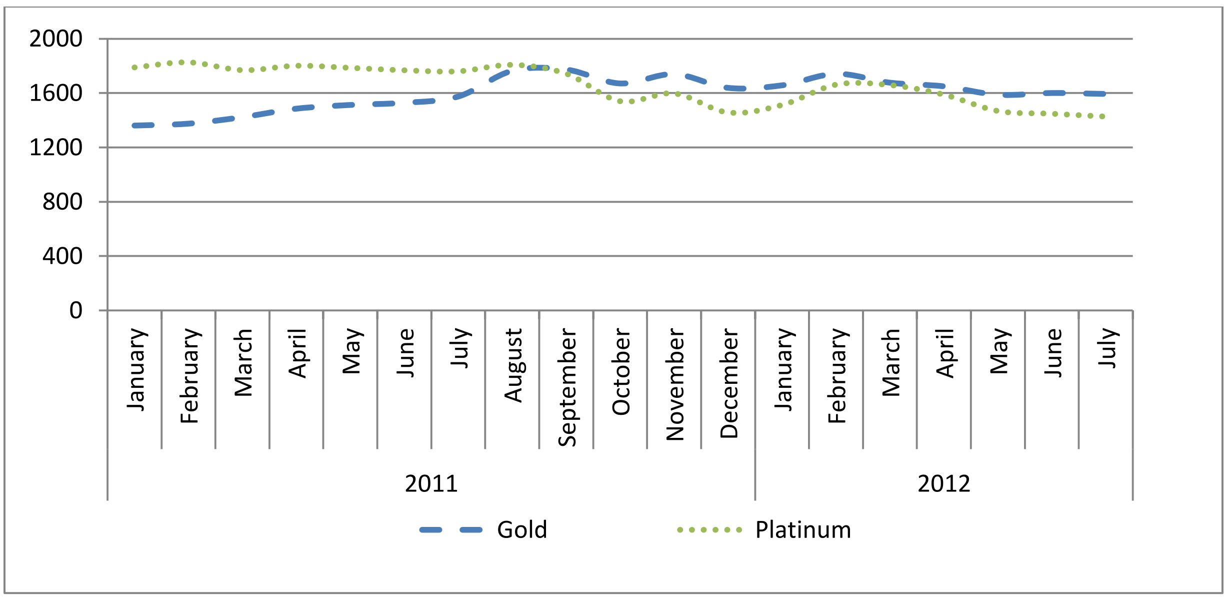
Recent Trends in Commodity Prices

Commodity prices fluctuated within a very narrow band and essentially stayed flat throughout the course of 2011. This was followed by a general increase in the first quarter of 2012. Prices for most commodities fell in the second quarter of 2012, particularly in May as the debt crisis in Europe intensified and China's economic growth slowed down.

Precious Metals and Stones

Prices of precious metals started the year 2012 on a rising trajectory. This resulted mainly from the better than expected global economic growth during this time. They reached a peak in February after which they went on a downward trend, till July 2012. The observed decline mainly reflected setbacks in global economic recovery. The leading macroeconomic indicators pointed to a synchronized slowdown in the momentum of economic activity in advanced economies. This exerted a drag on base metal consumption. In addition, China, the largest consumer of base metals at an estimated 40.0 per cent of global consumption, has been pursuing policies aimed at slowing down the economy to a more sustainable pace. This has led to a decline in China's industrial production hence its demand for base metals, contributing significantly to the decline in prices in the second quarter of 2012. China's high consumption of metals reflects substantial investment in construction, infrastructure and manufacturing, which has been behind China's rapid economic growth.

Figure 3: The International Prices of Gold and Platinum

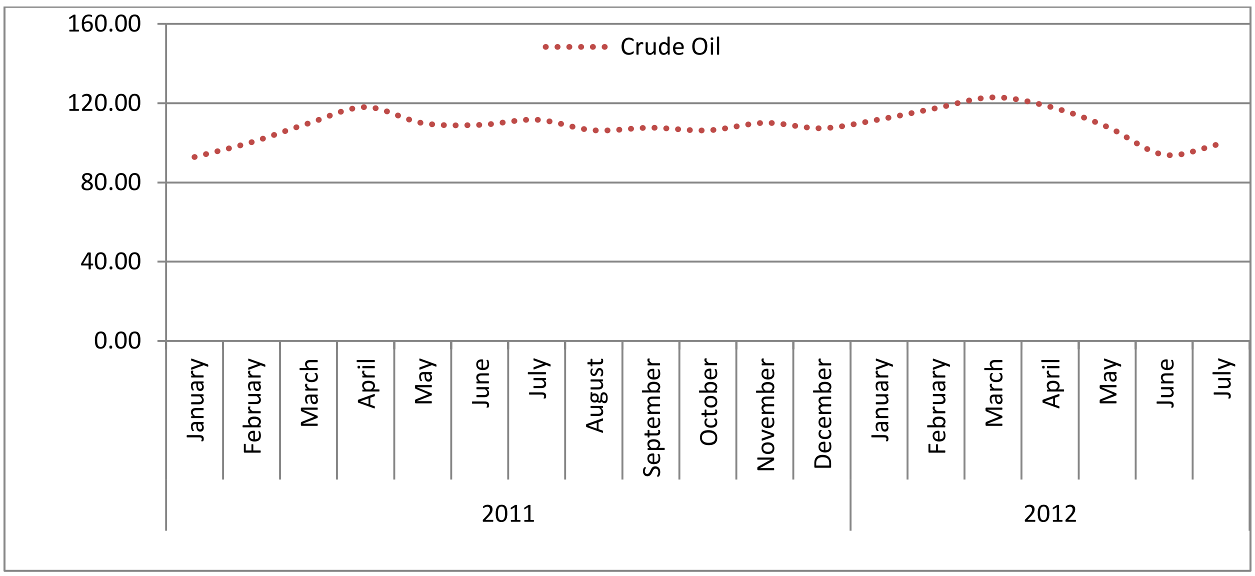


Source: Bloomberg

Crude Oil

The price of crude oil rose from US$107.36 in December 2011 to US$122.93 in March 2012, the highest monthly average since July 2008. The price increased during this time despite the slow rise in global oil demand, mainly attributable to a mild winter in the northern hemisphere. Demand by OECD countries slowed. Japan was reported to be the only OECD country that increased demand for crude oil as it expanded its power generation to compensate for earthquake and tsunami related loss of nuclear capacity. The rise in crude oil prices during the first quarter of 2012 mainly reflected developments on the supply side. Non-OPEC production fell by more than 1 million barrels per day on account of geopolitical tensions and technical problems. According to Reuters, civil unrest, adverse weather conditions and technical glitches disrupted 1.2 million barrels per day of global oil output in March 2012. The economic sanctions on Iran due to its nuclear program had already started causing a decline in oil imports from Iran by European Union (EU) countries, Japan and other nations. The price of crude oil went on a downward trend in the second quarter of 2012 in response to easing supply conditions. Even though supply disruptions were experienced in South Sudan, Syria, Yemen, and Iranian exports continued to fall as a result of sanctions, OPEC and non-OPED producers increased production. In addition, while production was on the rise, concerns about slowing demand related to the general slowdown in global economic activity and the sovereign debt crisis mounted. Prices rose in July 2012 as Sanctions on Iran took full effect, partially contributing to the moderation in OPEC production. Non-OPEC production also fell as a result of, amongst other things, the unplanned outages in Norway and those related to Hurricane Isaac in the Unites States of America (US).

Figure 4: The Price of Crude oil

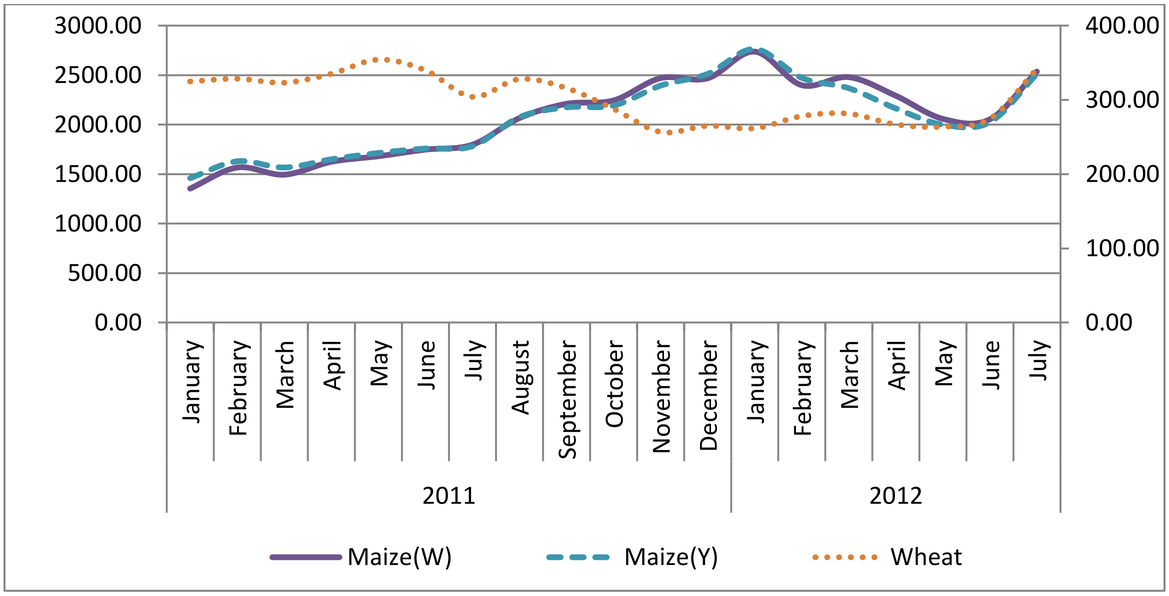


Source: Bloomberg

Food Commodities

Prices of major food crops, corn, soybeans and wheat rose sharply in June 2012 and maintained the upward trend in July 2012, fuelled by weather-related supply disruptions in several regions. South America experienced devastating drought earlier in the year and this damaged corn and soybean production in Argentina, Brazil and Paraguay. New supply concerns emerged in the middle of June 2012 as hot and dry weather hurt corn and soybean yields in the US Midwest. At the same time, estimates of wheat production were downgraded as a result of adverse weather conditions in Kazakhstan, Russia, Ukraine and China. The response by prices to supply disruptions largely reflects the low buffers. The IMF (October 2012) has indicated that global food reserves are low, particularly for soybean and corn. At the same time food demand remained relatively robust despite the slowdown in global economic activity.

Figure 5: International Prices of White (W) and Yellow (Y) Maize and Wheat



Implications for Lesotho's Economy

Crude Oil

The surge in the price of oil presents a number of challenges for countries like Lesotho, which rely on oil imports. Two ways in which it may exert inflationary pressures could be traced. The most direct and immediate effect of the rise in crude oil prices is the resultant upward revision of the pump prices of petroleum products, that is, petrol, diesel and paraffin. The rise in the prices of these products contributes to the increase in inflation. In addition, the upsurge in international oil prices is likely to result in an increase in the prices of other goods and services and hence in inflation in South Africa. This will lead to an increase in Lesotho's imported inflation. This is more so because of Lesotho's heavy reliance on imports of goods and services from South Africa (SA). The resultant high inflation means erosion of consumers' purchasing power. This has even more serious implications for the poor majority of the population, who rely on paraffin for cooking and heating homes. The increase in the prices of diesel and petrol also has the effect of squeezing the profit margins of public transport operators in Lesotho. This is more so because the hike in the prices of petrol and diesel is usually not immediately followed by an upward revision of taxi and bus fares as these are regulated by Government and it usually takes very long for fares to be reviewed. Nonetheless, in the medium to long term, government could raise the fares, which would have a negative effect on the budgets of commuters.

Oil products are a vital input in the production of a wide range of products. Looking at the structure of the economy of Lesotho, the manufacturing and mining sub-sectors, which are the main drivers of the economy, rely heavily on the use of oil. High oil prices increase the cost of inputs in these sub-sectors. The manufacturing sector in Lesotho is struggling to recover from the effects of the global economic recession and the rise in fuel prices will exacerbate its difficulties. Consequently, labour and capital may have to be reallocated, which could result in firms scaling down and or completely closing operations and workers being laid-off. The agricultural sector, which is also struggling to meet Lesotho's food requirements and ensure food security, will also be adversely affected as the rise in the prices of petrol and diesel will lead to the rise in the costs of ploughing and planting. The eminent rise in crude oil prices may increase the national import bill hence worsen the balance of payments position.

Food

The rise in international food prices is likely to filter into the domestic food prices especially because Lesotho is a net importer of food. This presents a number of implications both at the micro and macro levels. Theoretically, poorer households spend a substantial share of their incomes on food than richer ones. Lesotho is a low income country and has a high proportion of households that spend a larger portion of their income on food, which increases as food prices increase. Consequently, the escalation in food prices could worsen food insecurity and increase poverty, thus derailing progress towards achievement of the Millennium Development Goal (MDG) of poverty reduction. This is a serious concern for Lesotho this year and early in 2013 because of the poor agricultural output, which has led Government to declare Lesotho in a state of emergency. Due to the significance of food prices in the CPI basket, the rise in the domestic prices of food will contribute significantly to the increase in overall inflation. The rise in food prices is likely to push up the import bill as the value of food imports increases.

Precious Metals and Stones

The fall in commodity prices could affect Lesotho's economy in a number of ways particularly due to Lesotho's economic relationship with SA. Production volumes in the SA's mining sector contracted sharply in the first quarter of 2012 partially due to relatively weaker demand, especially from Asia. The prices of gold and platinum were relatively higher during this time compared to April to July when they fell. The fall in the prices in the latter months of the review period imply further declines in SA's mining production. This, in turn, implies further retrenchments of Basotho men by the mines in SA. The number has been declining significantly over the years as more SA men take interest in working in the mines. This presents two possible effects on Lesotho's economy. First is the increase in unemployment and its consequent poverty effects on households in Lesotho. Miner's remittances will also decline, thus worsening Lesotho's BOP position.