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PERSISTENT OIL PRICE INCREASES: PROSPECTS FOR THE ECONOMY OF LESOTHO

The persistent oil price increases, pose threats in oil dependent products and global economic recession. This paper discusses how increase in oil, and petroleum products prices impact on Lesotho's economy and implications for policy intervention….

Background

Prices of Petroleum products in Lesotho rose twice during the month of August 2005 in response to the persistent oil price increase. This is expected to spill over on the prices of domestic goods and services, as transportation costs soar. The increased demand for oil by China and other Emerging Markets, due to structural changes such as increases in demand for transport, the remaining part resulting from electricity shortages in China created demand/supply imbalances which reflected robust global activity, an apparent shift which could be transitory. The Least Developed Countries (LDCs) are likely to suffer most as they do not have reserves to hedge against the ultimate crude oil price increase. The rural and urban communities in Lesotho will be affected. The rural community mostly use paraffin for cooking and lighting, diesel for agricultural activities, while the urbanites use all petroleum products. However, the rural communities will be the hardest hit because prices of petroleum products are usually highest in rural areas.

Therefore, persistently rising oil prices would likely put a brake on the recovery of the global economy, and have negative spill-over effects on Lesotho's economy. The high dependence on fuel renders many economies such as Lesotho vulnerable to any oil price shock. This article provides a review of recent developments in the international oil markets, traces their possible implications for Lesotho, and suggests a policy intervention.

Recent Developments in the Oil Markets

The global oil prices reached the record high of US$70 a barrel in August 2005, compared with the average of US$29 in August 2002. According to the International Monetary Fund (IMF), every US $ 5 price increase per barrel of oil may cause a global economic slowdown estimated at 0.3 per cent. This analysis reflects the influence of oil prices on global economic performance. The adverse impact of the oil price increases will be highest in petroleum importing countries.

The Organisation for Petroleum Exporting Countries (OPEC) purported that prices of oil emanated mainly from non-economic developments such as the political turmoil in Iraq, terrorism, and hurricanes in the Caribbean Gulf. It has nonetheless been noted that, at the current level, the international oil price is likely to continue impacting negatively on the global economy for the remaining part of 2005.

China's oil imports grew by 31 per cent in 2003 due to unreliable energy supply after abandoning coal as their main input in electricity production. The decision to adopt petroleum as alternative to coal was influenced by the negative impact coal had on the environment.

However, the oil exporting countries stand to gain considerably from persistent oil price increases as was the case in the late 1970's. They are likely to realise increased foreign reserves as the prices of oil rise.

This may also result in improvement in their balance of payments positions.

The effects of the oil price increases on Lesotho's Economy

The hike in oil prices may have several negative effects on the Lesotho economy. First, though dependent on commodities produced in South Africa, the country is likely to experience increased imported inflation directly through importation of petroleum products. South African inflation was recorded at 4.8 per cent at the end of August 2005, compared with 3.5 per cent as of June 2005, against Lesotho's 2.9 per cent. Though, the index of petroleum products is negligible in Lesotho, petroleum products are mainly used in the rural areas where majority of the poor live. As such the oil prices, coupled with mineworkers' retrenchment may exacerbate the poverty incidence prevailing in the rural areas. The consumers may experience the impact of higher imported inflation, since consumer basket consists mainly of imported commodities from South Africa. Another possibility is the increase in price which will reduce commodity demand and impact on business profit margins. Petroleum prices cause increases in other prices, especially transport, on which people depend. This may cause trade unions to negotiate higher wage adjustments, and further fuel inflation.

Second, since Government indirectly subsidises petroleum products through oil levy this is not likely to be sustained if the prices keep on rising because the fund may dry out. In that case, Government may, on one hand, have to make a virement and compromise other activities by the percentage increase of oil prices. On the other hand, if no virement is made, there may be a jump in the price level to market prices, which may be felt more by the transport operators. This can even result in some companies closing down because demand for their products may fall significantly.

Third, Commuter fares are determined and regulated by Government and are mostly not responsive to changes in the oil prices. However, if the latter scenario is effected, commuter operators may once again be hit hard by reduction in their profit margins and the ultimate solution may be to leave the industry. Furthermore, the reduction in profit margins may lead to some workers being laid-off and thus aggravate the already high unemployment rate in the country. Alternatively, prices may be revised upwards to absorb the rise in oil prices. Consequently, the impact of the shock may be felt more than if the fares had been increasing in line with gradual oil price increases overtime. In addition, the labour force, which comprises mostly of the urbanites, will be affected because they depend entirely on commuter transport to and fro their workplaces.

Last, the agricultural industry seems to be gaining momentum in terms of mechanisation. As a result, the sector may be affected mostly since the lowlands residents depend on mechanised agricultural implements for productivity. This will exacerbate the situation as the sector continues to be negatively affected by persistent drought and it will undermine Government efforts of supplying subsidised tractors to support the sector in order to realise food security. And finally, the government expenditure resulting from increased spending on petroleum products will rise and worsen budget deficit.

Policy Interventions

Consequently, both the internal and external imbalances are looming. In an effort to curb the problem, Government is likely to increase transfers and subsidies (direct and indirect), and exert pressure on budgetary operations, which may result in budget deficit. As petroleum products are procured in foreign currency, the import bill is likely to increase in response to higher prices. As such, due to price inelasticity

of petroleum products the volume would remain unchanged. As a result, trade position will be negatively affected. Therefore, the current account imbalance will be realised if the prices keep rising. The possible response will be to revise the petroleum levy to contain the declines in Government revenue. However, looking at the already overstretched revenue base, Government is not likely to alter taxes, but rather reduce expenditure on other items as a result of their anticipated virement.

In addition, increased Government spending, while revenues remain constant will broaden the current account deficit largely by raising the merchandise trade deficit. The relationship between fiscal policy and the balance of payment is discussed within the context of regime of fixed exchange rates. A more expansionary fiscal policy puts incipient upward pressure on domestic interest rates. The Monetary policy faces a big challenge to fight the anticipated inflation. Interest rates movements are expected to take direction that will not hamper investment climate, while maintaining price stability.

Table 1. Monetary and Financial Indicators+

	May	June	July
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	11.83	11.63	11.50
1.2 Prime Lending rate in RSA	10.50	10.50	10.50
1.3 Savings Deposit Rate	1.00	2.00	2.00
1.4 Interest rate Margin(1.1 – 1.3)	10.83	9.63	9.50
1.5 Treasury Bill Yield (91-day)	7.16	6.93	7.08
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2392.26	2320.91	2456.06
2.2 Net Claims on Government by the Banking System	-1009.02	-817.22	-1140.70
2.3 Net Foreign Assets – Banking System	4428.37	4151.03	4565.89
2.4 CBL Net Foreign Assets	3191.39	3000.88	3343.90
2.5 Domestic Credit	-355.5	-159.89	-562.98
2.6 Reserve Money	327.4	358.14	382.99
3. Spot Loti/US$ Exchange Rate (monthly average)	6.356	6.6970	6.6038
4. Inflation (year-on-year percentage change)	3.5	3.1	3.3
5. External Sector (Million Maloti)	**2004**	**2005**	
	Q4	**Q1**	**Q11**
5.1 Current Account Balance	-116.5	22.3	22.3
5.2 Capital and Financial Account Balance	225.6	-	-39.3

		39.3	
5.3 Reserves Assets	-1.2	- 199.8	-199.8

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities.

Table 2. Selected Economic Indicators

	2001	**2002**	**2003**	**2004***
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	3.2	3.5	3.3	3.4
1.2 Gross Domestic Product Excluding LHWP	3.5	2.9	3.1	3.3
1.3 Gross National Product – GNI	0.2	1.6	6.3	3.6
1.4 Per capita –GNI	-2.1	-0.2	4.0	2.4
2. Sectoral Growth Rates				
2.1 Agriculture	0.5	-4.2	-1.8	0.5
2.2 Manufacturing	7.9	6.9	5.2	5.0
2.3 Construction	1.4	6.9	4.3	4.0
2.4 Services	2.2	2.2	4.4	3.9
3. External Sector – Percent of GNI Excluding LHWP				
3.1 Imports of Goods	75.3	93.9	79.4	73.0
3.2 Current Account	-2.9	-11.6	-5.7	-0.8
3.3 Official Reserves (Months of Imports)	11.7	6.2	5.8	5.8
4. Government Budget Balance (Percent of GDP)	0.3	-5.5	-1.9	7.7

* Preliminary estimates