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Lesotho's Economy in Perspective: A Review of Major Macroeconomic Challenges

The economy of Lesotho is faced with a number of challenges………..

Introduction

Lesotho's economy faces a number of challenges, some of which are not new while some are recent and largely reflect the impact of the global economic crisis. These problems need to be addressed for the economy to be on a sustainable growth and development path, which is necessary for employment generation and poverty reduction. This article provides an overview of major economic challenges that prevailed in Lesotho in 2011 and had an impact on Lesotho's economic performance in the same year even if they had been there before 2011.

Real Sector

Agricultural Production

Lesotho's agricultural production has deteriorated significantly over the years. This is despite several attempts by Government to revive the sector through various forms of support. The latest example is the financial assistance that was provided through the block farming initiative. Performance of the agricultural sub-sector remained subdued in 2011. The Central Bank of Lesotho estimated that value added by the sub-sector contracted by 1.8 per cent in 2011 compared with an acceleration of 10.9 per cent in 2010. The poor performance was largely at the back of the damage to crops by the heavy rains, floods and storms that were experienced during the 2010/2011 agricultural year. Farming of animals also remained lackluster during the year.

While the unsatisfactory performance of the agriculture sub-sector in 2011 could be blamed on unfavorable climatic conditions, the long standing structural problems that characterize the sub-sector cannot be overlooked. The subsistence nature of Lesotho's agriculture has failed to ensure food security and reduce poverty for the country. It has failed to promote the use of advanced and effective agricultural production technologies and practices. Some of the factors constraining agriculture production in Lesotho include, *inter alia*, high production costs and lack of capital resulting in a lot of arable land lying fallow from year to year. Lack of proper irrigation equipment and facilities have meant that crop production has been and remains vulnerable to drought. Another pertinent challenge over the years has been the inefficiency in input supply. This is characterized by delays and inadequacies in fertilizer and seeds supply by government agencies.

Lesotho's agricultural sector needs to be revived so that this sector could make a meaningful and sustainable contribution to poverty eradication and economic growth. Improved access to capital, efficient input supply, availability of irrigation facilities and other agriculture related technology and well managed water resources could result in proper utilization of the arable land. Promotion of green agriculture, which has the potential to increase food production without depleting the earth's resources or polluting the environment, could be an option for consideration. It minimizes production costs because it involves the use of location specific organic resource inputs and natural biological processes to restore and improve soil fertility. This could make food production more sustainable, improve food security and reduce poverty. Green agriculture presents an opportunity for Lesotho to commercialise agriculture and move away from subsistence farming. It involves production of organic food products, for which global demand has risen substantially in recent years, thus presenting an opportunity for Lesotho to increase its export earnings.

Manufacturing Production

Since Lesotho became eligible for trade benefits under the Africa Growth and Opportunities Act (AGOA) in 2000 and resumed to export to the US under the same in 2001, Lesotho's textiles and clothing manufacturing sub-sector has grown substantially. Nonetheless, the road has not always been smooth. The phasing out of the multi-fibre agreement in 2005 resulted in a decline in the sub-sector's contribution to gross domestic product (GDP) in 2005 and 2006. Recently, Lesotho's textiles and clothing manufacturing sub-sector has been negatively affected by the global economic crisis and the related slump in consumer demand in the United States (US). Consequently, the sub-sector registered negative growth rates from 2007 to 2009 and recovered to positive territory in 2010. Nonetheless, it has not recovered fully as it was estimated to have registered a lower growth rate of 4.4 per cent in 2011 compared with 6.4 per cent in 2010.

The bulk of the sub-sector's products are exported to the US. The slow recovery of the US economy from the recession and the associated low consumer demand resulted in a decline in orders for Lesotho's manufactured textiles and clothing by US based enterprises. Consequently, the sub-sector had to reduce production and some manufacturing firms had to close down operations in 2011. One other challenge threatening the sub-sector is increased competition for the US market from East Asian countries.

The textiles and clothing manufacturing sub-sector dominates Lesotho's manufacturing industry and makes a substantial contribution to employment and economic growth in Lesotho. Nonetheless, its sustainability and reliability are threatened by its high reliance on trade preferences and susceptibility to external shocks. The third country provision, which allows AGOA beneficiary countries to source fabric for production of apparel for export to the US from anywhere, expires in 2012. If not extended, Lesotho's manufacturers will no longer be able to source cheap fabric from Asia, hence an increase in the sub-sector's production costs. In addition, the current AGOA term expires in 2015. If it is not extended, Lesotho's exports will have to compete on an equal footing with cheaper Asian exports for the US market.

The need for export product and market diversification by Lesotho cannot be overemphasised. The high reliance on textiles and clothing and on the US market makes Lesotho highly susceptible to shocks that could negatively affect exports as has been demonstrated by the recent recession. Studies such as the "Lesotho Potential Export Diversification Study" have identified products in which Lesotho could have comparative advantage and potential additional markets for her products. Efforts should be geared towards attracting both domestic and foreign investment in such areas. Besides, the list of AGOA eligible products is long enough and diversification could help Lesotho to reap more benefits from AGOA before it expires in 2015.

The high dependency on preferential market access for the exports of textiles and clothing needs to be reduced. Lesotho should use the remaining AGOA period to strengthen her competitiveness so that her exports could compete in the global market with countries like China without preferential treatment. This could be achieved by, amongst other things, investing in human capital development to enhance labour productivity in Lesotho's textiles and clothing sector, which is said to be very low compared with more competitive countries like China and Singapore. In addition, the business environment should be improved to make it easy for both local and foreign entrepreneurs to start and operate businesses in Lesotho. Provision of the necessary infrastructure could also attract investment into Lesotho.

The Fiscal Sector

One other challenge that Lesotho experienced in 2011 was the continued low level of Southern African Customs Union (SACU) revenue, which compelled Government to undertake some fiscal consolidation measures. SACU revenue, which is the most significant source of revenue for the Government of Lesotho, comes from Lesotho's membership of SACU with Botswana, Namibia, Swaziland and South Africa (SA). Historically, this source of revenue financed more than 50.0 per cent of the national budget.

SACU member countries levy a common external tariff on imports from non-members and do not charge any duties on imports from each other. The SACU agreement provides for a common excise tariff to the customs area. Import duties are charged at the first port of entry of imports, regardless of their final country of destination within SACU. Customs and excise duties collected by each member at a particular period are sent to the pool and each financial year the common customs revenues are shared according to an agreed formula. Customs and excise duty revenues are highly volatile. They increase with strong economic performance and fall when the economy is struggling. The total amount of SACU revenue available in the pool at any particular year is highly dependent on the level of tariff duties as well as the value of excisable imports by all member countries. In addition, the share that a member gets in any particular year depends mostly on the cost of insurance and freight (c.i.f.) value of total imports by the member.

The global recessionary conditions reduced production and employment and in turn domestic demand in a number of the world economies including SACU countries. As a consequence, these countries experienced declines in imports of goods and services and in the sales of excisable goods, hence revenues from import and excise duties. The decline in the high tariff imports had the biggest impact. The most significant contribution to the SACU revenue pool, estimated at above 90 per cent, comes from SA. Imports of goods by SA fell dramatically in 2009 and 2010. In addition, car sales, which contribute the most to excise revenue, also plummeted, thus hurting collection of excise duties. Merchandise imports by other SACU member countries also fell during the same period.

The consequence of all this has been considerable declines in SACU member countries' transfers to the revenue pool, hence in revenue shares that they received. Lesotho's share fell from above 50.0 per cent of total revenue in the years before 2010/11 and 60.1 per cent of total revenue in 2009/10 fiscal year to 35.9 per cent and

36.8 per cent of total revenue in 2010/11 and 2011/12 fiscal years, respectively. This demonstrated the highly volatile nature of this type of revenue and threatened fiscal sustainability going forward.

So far government has been able to navigate the storm caused by the decline in SACU revenue mainly due to prudent fiscal policy pursued prior to the crisis and the resultant built up in foreign exchange reserves during that time. This unfortunate state of affairs also increased awareness of the need for fiscal consolidation through expenditure rationalisation and reduction. This was clearly articulated in the budget speeches for 2010/2011 and 2011/2012 fiscal years. To this end, some of the measures that were proposed included cutting expenditure on international travel, eliminating purchases of furniture, training and workshops as well as short term vehicle hire. Preliminary estimates indicated a drop in government expenditure, particularly recurrent expenditure, which was projected to fall by 6.4 per cent while capital expenditure was expected to increase by 22.8 per cent in 2011/2012. In addition to this, Government needs to come up with a long term plan on how to reduce the heavy reliance of fiscal operations on SACU revenue and to build up deposits during good times, when inflows are high, to be used as a buffer during tough times.

The Monetary Sector

On the monetary and financial sector, the main challenge relates to the high liquidity of the banking sector vis-à-vis credit extension to economic agents. On the one hand, commercial bank's liquidity, measured by the ratio of liquid assets to deposit liabilities and placements with other banks remained above 70.0 per cent in the fourth quarter of 2011. On the other hand, while credit extension has recently been on the rise, it still remains low compared to the high liquidity. The high liquidity remained despite the introduction of treasury bonds in October 2010 and the increase in tenors to 10 years from 3 and 5 years at introduction. The 10-year bond has so far not been very attractive and this could be attributable to the fact that commercial banks' liabilities are short term in nature and they opt for assets that match their liabilities. The low credit extension may be indicative of commercial banks' response to high risk factors in the country, including unavailability of information for assessing credit worthiness of borrowers. However, it is expected that the situation will improve in the short to medium term as financial sector reforms are being undertaken, including efforts to establish a credit bureau in Lesotho.

The distribution of credit is also a concern. While close to 100 per cent of credit goes to the private sector, a larger share of it goes to households as opposed to business enterprises. In the final quarter of 2011, the largest share of domestic credit, estimated at 56.3 per cent was extended to households and 43.7 per cent to business enterprises. Business enterprises play a critical role in stimulating economic growth and creating employment. Thus, a shift such that more credit is extended to business enterprises compared with households would improve long term growth prospects and ensure growth sustainability.

Conclusion

The article has provided an overview of major challenges faced by the economy of Lesotho. It has highlighted the need for the agricultural sub-sector to be revived through commercialisation and promotion of green agriculture. The issue of sustainability of the textiles and clothing manufacturing sub-sector was also discussed. The article has indicated that heavy reliance of the sub-sector on trade preferences should be reduced by strengthening its competitiveness through improvement of labour productivity, of the overall business environment and of availability of the necessary infrastructure. In addition, diversification of the type of manufactured, hence export products and markets should be seriously considered. Concerning fiscal sustainability, the article has highlighted the need for a long term plan to reduce heavy reliance of fiscal operations on SACU revenue and to develop some savings when SACU inflows are high, to be used as a buffer when inflows are low. Lastly, the need to expedite financial sector reforms to promote higher credit extension to business enterprises than to households so as to stimulate rapid economic growth and employment generation was highlighted.

Crude Oil: Demand, Supply and Prices: Implications for Lesotho's Economy

The price of crude oil is on the upswing again, maintaining the trend last seen before the 2008 global financial crisis ………..

Introduction

During the first half of 2011, the global oil market was characterized by considerable volatility in the price of oil. This moderated somewhat in the second half of 2011 with the price of crude oil, remaining above the levels realized in the first half.

Thus, this article provides an overview of recent trends in the demand for and supply of oil. It also analyses their impact on the price of crude oil. The paper also highlights the implications of the increase in crude oil prices for the economy of Lesotho.

The World Supply of and Demand for Crude Oil

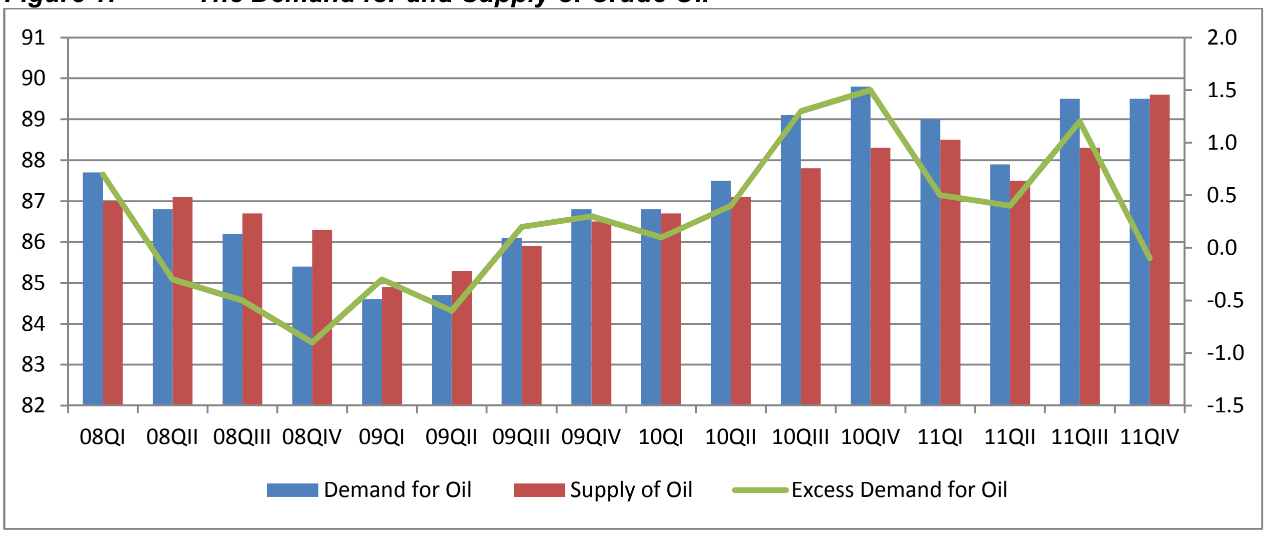
Developments in the oil market are determined by interaction of supply of and demand for crude oil, and hence its price. Majority of studies on energy and commodity prices argue that demand for crude oil is the main determinant of movements in crude oil prices. However, supply–side proponents argue that it is the supply of oil that determines its price. Since oil is an exhaustible resource, its scarcity (natural or artificial) permanently affects the price of oil. Figure 1 below shows the evolution of supply and demand for crude oil from the first quarter of 2008 to the fourth quarter of 2011.

The World Supply of Oil: On the supply side, conditions are highly dictated by production state of oil producing countries, which are largely driven by a host of geological, political and economic factors. These factors include geopolitical tensions, especially in North Africa (for example Libya, Sudan, etc.) and the Middle East (Iran, Iraq, etc.). According to the figure below, the world supply of crude oil declined from the first quarter of 2008 to the last quarter, albeit with relatively lessvolatility, after which it started to climb until the last quarter of 2010. Thereafter, it started to fluctuate between 85.0 million barrels per day and 90.0 million barrels per day. After declining by 1.0 million barrels per day in the first quarter of 2011, it rose by 2.1 million barrels per day from the second quarter to the fourth quarter of 2011. In the first quarter of 2011, the supply disruption emanating from turbulence in Libya and geopolitical tensions in the Middle East curtailed the supply of oil.

Nonetheless, towards the end of the second half of the year, oil production and hence supply increased as Libya returned to normal capacity utilization and, to a lesser extent, Saudi Arabia and United Arab Emirates (UAE) slightly increased their production quotas. According to the International Energy Agency (IEA) Oil Market report (OMR) for December 2011, the global supply of oil rose by 1.8 million barrels per day in December 2011 compared with the December 2010 supply. 80.0 per cent of this supply emanated from increased output of oil from the Organization of Petroleum Exporting Countries (OPEC).

The outlook for the supply of oil is clouded with uncertainty as looming UN sanctions over Iran's controversial nuclear energy. The EU has proposed an embargo on all purchases of Iranian oil. This leaves the supply of oil in doldrums as 2012 unfolds.

Figure 1: The Demand for and Supply of Crude Oil



Source: International Energy Agency (IEA)

The World demand for Crude Oil: The demand for crude oil plays a major role in the determination of crude oil price. As such it is important to understand what determines oil demand. According to the United States Government Accountability Office report, the *Understating Gasoline Prices*, the demand for crude oil has been increasing since 1980 from around 59.0 million barrels per day to more than 82.0 million barrels per day in 2004. This trend was largely driven by the world's largest oil consumer, the United States. Recently, the rapid growth in demand for oil by the Asian countries, notably China and India has been the main driver of the world demand for oil. China and India are rapidly industrializing and their economic growths are oil intensive.

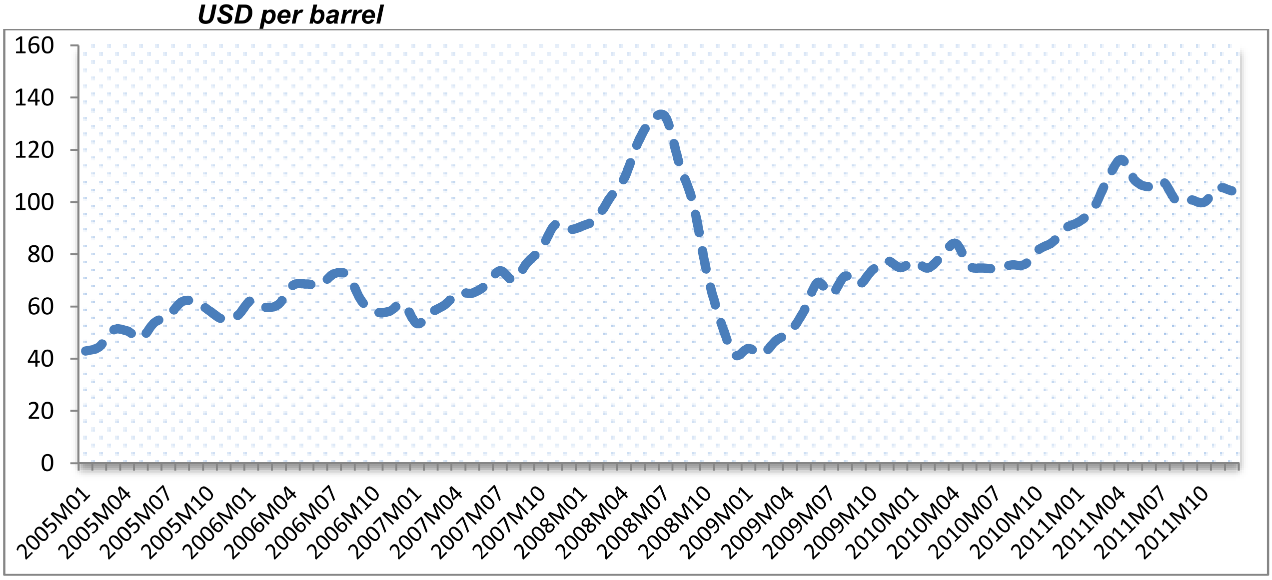
Moreover, the Organization for Economic Co-operation and Development (OECD) countries are also oil intensive in their production processes. Nonetheless, the recent financial market turbulence in Europe and the dim outlook of the global economic activity poses a threat to the oil demand. As demonstrated in figure 1 above, the demand for oil declined from around 87.5 million barrels per day in the first quarter of 2008 to less than 85.0 million barrels per day in the second quarter of 2009. However, during the third quarter of 2009, demand for oil started increasing from around 86.0 million barrels per day to around 89.5 million barrels per day in the fourth quarter of 2010. In the first half of 2011, oil demand declined but picked up in the second half of the review year.

Behind this volatile demand for crude oil were a combination of factors. These included, the deterioration in the global economic environment, driven mainly by the Eurozone financial market turbulence, high debt problems in the OECD countries, the slowdown in China and a recent spate of earthquakes in Japan. The demand-supply balance for oil declined from around 0.5 million barrels per day in the first quarter of 2008 to around -0.6 million barrels per day during the last quarter of 2008. From the first quarter of 2009 to last quarter of 2011, there was excess demand and this was in line with the persistently rising crude oil prices.

The Crude (petroleum) Oil Price Movements: 2005 January – 2011 December

The persistently increasing and volatile oil prices have sparked debate regarding its potential impact on the global economy. During the course of 2011, as mentioned earlier, crude oil prices had been on the rise albeit slightly moderated in the fourth quarter of 2011. Figure 2 below shows the monthly US dollar average spot price of crude oil over the 2005-2011 periods. Following a prolonged increase in the price of crude oil, which peaked in mid-2008, international petroleum prices fell sharply but bottomed up in early 2009. Since then, the crude oil prices have risen, with accelerating speed throughout 2010 and much of 2011.

Figure 2: ***Crude Oil Price (Average of U.K. Brent, Dubai, and West Texas Intermediate) in USD per barrel***



Source: International Monetary Fund's International Financial Statistics (IMF's IFS)

The average spot price of crude oil depicted high volatility from the first half of 2009 to July 2011. It then moderately increased with some volatility to around $110.0 per barrel in December 2011.

Against this backdrop of high volatility in crude oil price were factors that created supply-demand imbalance in the oil market. As mentioned earlier, the demand for oil emanating from Asia, especially from China and other developing countries drove the prices higher, while supply remained relatively low as a result of supply chain disruptions.

The oil price volatility seen during 2011 also emanated from concerns surrounding the global economic activity which was forecast to slow down by the IMF, due to contagion effects arising from the European debt crisis. Other emerging economies that consume huge amounts of oil, such as China, were expected to slow down in 2011, thus leading to low demand for oil. The supply side situation was characterized by control of production by some OPEC countries and supply disruptions due to Middle East unrest especially in Syria, Yemen and Iraq.

Implications for the Economy of Lesotho

The crude oil industry is central to Lesotho's economy since the transportation sector, mining industry and manufacturing sector use oil in their production processes. As a consequence, any developments in the oil market, such as fluctuations in the price of crude oil, have a bearing on the economy of Lesotho.

A sudden rise in the price of crude oil will spark an increase in the price of liquid fuels (petrol and diesel) which are used for transportation and other personal purposes. An increase in the price of petrol will squeeze the profit margins of the taxi operators forcing some out of the business. In the medium term, this may raise issues of higher taxi fares. The high taxi fares could affect the commuters negatively.

Moreover, the rise in the price of paraffin will affect the poor households negatively since most of the people in the rural towns of Maseru and other districts use it extensively for cooking, lighting and heating homes in winter. This may further squeeze their budgets forcing them to cut expenditure on some areas of their daily living because they cannot go without cooking and lighting.

The increase in the price of crude oil may also filter through the economy of Lesotho affecting its Balance of Payments (BOP) position. The impact will emanate from the import bill which may affect the current account balance negatively.

On the monetary policy front, the rise in the crude oil prices may lead to a hike in interest rates. This is because changes in crude oil prices explain- most of the variation in inflation rate in the Common Monetary Area (CMA). The tighter monetary policy stance if implemented would derail credit expansion to the private sector, leading to a decline in aggregate demand through investment and consumption.

Finally, the recent spike in the price of crude oil may derail the SA economy crippling demand and leading to slowdown in imports. This may negatively affect the South African Customs Union (SACU) revenue pool, which depends largely on the performance of SA economy. If crude oil prices are persistent the decline in the pool, means that the SACU revenue share for Lesotho will also be reduced, leading to expansion in both external sector and fiscal deficits. The combination of these deficits, known as the twin deficits may plunge the economy into long term imbalances, thereby creating further challenges in the fight against poverty.