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AN OIL CRISIS LOOMS: PROSPECTS FOR THE ECONOMY OF LESOTHO

The rising oil prices, increasing oil demand while supplies dwindle, and international apprehension due to terrorism all form a recipe for inflation and global economic slowdown. Hence, the question of the future of Lesotho within the industrial civilisation paradigm gains importance…

Background

At the recent Monetary Policy Meeting (MPC) that was held on the 14th of October this year, the South African Reserve Bank (SARB) did not change the repo rate. This decision was based on, among other things, the fact that the strong performance of the rand has shielded the economy from the international oil price shock. Hence the short run impact of the rising oil price has been, to some extent, absorbed. However, although the SARB could be optimistic, should the oil crisis be sustained, the CPIX could breach the 6% upper limit of the inflation target over time. The result would erode consumer expenditure on goods and services, and force companies to tighten their hiring strategies, and occasionally would exert pressure on interest rates. This oil crisis is looming on the horizon as oil supplies keep increasingly dwindling on one hand, and the global oil demand keeps rising on the other.

Therefore, persistently rising oil prices would likely put a brake on the recovery of the global economy. The high dependence on fuel renders many economies vulnerable to any oil price shock. This article provides a review of recent developments in the international oil markets as well as traces their possible implications for Lesotho

Recent Developments in the Oil Markets

The global oil prices have risen above 50 US dollars a barrel recently. According to the International Monetary Fund (IMF), every 5 US dollar a barrel increase in oil price may cause a global economic slowdown estimated at 0.3 per cent. This situation could bring dire consequences on the developing world, especially African countries whose gains from non-fuel commodities would be offset by losses from high oil prices.

The Organisation for Petroleum Exporting Countries (OPEC), which was formed in 1960, purported that prices of oil are rising due to non-economic fundamentals such as political turmoil in the Arab countries, and the mayhem of terrorism. Conversely, some theorists propounded that historical evidence points to the fact that oil price cycles have always responded to changes in demand for and supply of oil. The extreme sensitivity of prices to supply shortage have historically reflected an interplay of market forces which cause wide price swings in times of a shortage or glut. Thus oil price surge is a repercussion of market disequilibrium, in case demand exceeds supply.

When putting this oil crisis into perspective, the outlook for the global economy appears to have three stripes. As a starting point, the severity of the oil crisis depends on the energy-intensity of the non-fuel sub-sectoral modes of production. Due to the inter-linkages among these sectors surging oil prices may spark off a non-fuel price crisis as well, particularly in the absence of lack of, or no energy-input substitutes in production. Also, the continuously rising demand for oil in countries such as the US, India, and China underpin the persistence of the oil crisis. Moreover, quantity supplied manipulation by OPEC

indicated either the fact that the spare capacity is limited among OPEC members, or that these cartel is exerting pressure in pursuit of feel good national goals of its members.

On the non-fuel asset market arena, there is a continuing lack of volatility in equity and bond markets across the globe. This scenario has hit negatively on hedge fund's profitability, and then prompted many funds to invest in commodities and oil. This in turn, fuelled higher oil prices. Countries that export oil enjoy windfall gains from higher international oil prices. For example it has boosted economic growth in Arab oil producers resulting in healthy fiscal and current account positions. These high prices have gone a long way in supporting the equity markets in the region because energy stocks tend to lead the way. This positive outlook for oil exporters has caused some economists to reason that the net effect of the crisis on the global economy may be minimised as some countries have gained while others have lost. It is therefore imperative to examine how the mountain kingdom would likely fare during this critical time.

The effects of an oil crisis on Lesotho

The age of global industrialisation and its dependence on fuel has caused high degree of vulnerability to oil shocks for almost all economies. Lesotho could not be immune to this problem because of its dependence on transportation, increased reliance on mechanised agricultural production methods, and manufacturing. Evidently, soaring fuel prices threaten the performance of various sectors in the economy, due to the linkages that exist between these sectors. Ultimately, both the producer and the consumer would be adversely affected by an oil price hike.

The oil price channel can influence macroeconomic behaviour through several channels. First, the income would be transferred from oil-importing, such as Lesotho, to oil-exporting countries. Second, this income transfer would reduce global oil demand. Third, the higher prices reduce the purchasing power of money and worsen public welfare. Fourth, workers and producers may resist the declines in their real wages and profit margin, thereby exerting upward pressure on unit labour costs and the prices of finished goods, and services. Fifth, should the wage spiral persist, high fuel prices may gain a greater potential for a pass-through into core inflation, thus inducing monetary policy tightening.

Since Lesotho satisfies the energy needs by importing 100 per cent of oil from abroad, this underscores the extent to which the impact of the shock will be on the economy. The oil driven inflation could eat into people's disposable income, pensions, and savings. This would worsen people's standard of living, because it would hike transport costs, and narrow the profits margins of companies that offer flying services. As a result, air travel could become expensive and discourage the much needed tourists from visiting the country. Under this scenario more and more people would likely lose their jobs and further exacerbate the poverty problem.

Imports of oil are estimated to have cost the Lesotho M398.4 million in 2003-an equivalent of 9.3 percent of GDP. The completion of the construction activities associated with Phase1B of the Lesotho Highlands Water Project (LHDA) went a long way in reducing the level of oil imports. Nonetheless, the country remains heavily reliant on imports to meet its oil demands. Assuming that production activities are currently and will continue to be, undertaken efficiently, a 10 percent increase in the price of oil -persistent for a year, would have a negative impact on GDP, heat up the economy and exacerbate the unemployment problem. According to table 1 below, an increase to this tune would hike oil cost to M438.2 million - an equivalent of 9.9 percent of GDP. Put simply, the country would have to spend 0.6 percent more of GDP to import the same quantity of oil. The same hike is likely to fuel inflation by 0.1 percent

using 2003 estimates.

Table 1: Impact Analysis of the Oil Crisis

The Impact of a 10% Oil price hike on:	***2004***
GDP	-0.60%
CPI	0.09%

Despite the welfare erosive impact of the oil crisis, the outlook for Lesotho is not entirely bleak and hopeless. This is true because the crisis is compelling many economies to explore possibilities of oil-import substitutes. For example, South Africa's coal based syn-fuel industry could be increased significantly through the medium of Sasol. The low-grade coal resources available for this purpose are large, and technology has greatly improved over the years. Thus sustained rise in international oil prices would potentially furnish new opportunities for South Africa as it faces the challenge of increasing self-sufficiency in the respect of oil supplies. This may have positive spill-over effects on the Lesotho economy because as the coal mining industries increase production, more miners would have to be employed and many of these are from Lesotho. This would in turn increase mine worker remittances and improve the country's foreign currency earnings. In view of the foregoing, how can monetary authorities respond to this challenge?

A Monetary policy Response

In order to face the challenge policy must be timed properly. The reaction of policy makers to the impending crisis should be cautious due to the uncertainties involved. The uncertainty about the extent to which oil prices may come down in the future, as well as uncertainty about the effects of higher oil prices on core inflation, put up a strong case for monetary authorities to either delay or moderate their response to the run-up in prices until the macroeconomic effects of the price shock are more apparent. This is because sometimes the shocks may be very temporary or the risk of a pass-through into core inflation may be low.

In Lesotho, the monetary policy maker- the Central Bank of Lesotho (CBL) – has a dual mandate, namely; to stabilise prices and to maximise sustainable employment. This two-fold mandate implies that CBL's response to the oil price increases should focus on these two objectives. It is recommended that it would be best to accept some temporary rise in both inflation and unemployment in tandem with the underlying mandated objectives, such that a balance could be struck. This balance is necessary because first, if policy were to try to avoid any rise in unemployment, the initial oil price shock might be passed through to continuing inflation and second, if policy were to try to avoid any rise in inflation, the movement in unemployment would be substantial. Hence, a good policy stance should lie between the two extremes, and should be properly timed instead of being spontaneous.

Conclusion

The CBL, among other functions, has been mandated to maintain price stability in the economy. Hence, the soaring prices of oil present a great challenge for the Bank, and it may over the long run over heat the economy. Anecdotal evidence, points to the detrimental effects that higher oil prices could cause to the real economy due to the crucial role played by oil in both the production and consumption arms of the economy. The network of linkages between various sectors of the economy may facilitate a pass-through

of the price increase into the economy's core inflation. The main competing objectives of the monetary authorities, namely, high employment and price level stability pose a great challenge, and call for a policy balance between the two ends. This problem is sure to further be amplified by the oil price shock, thus should not to taken as a grain of salt.

This report is benefited by International Energy Agency (IEA) report on "the analysis of the impact of high oil prices on the global economy" and www.imf.org

Table 1. Monetary and Financial Indicators*

	Jul	Aug	Sep
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	12.5	12.42	12.17
1.2 Prime Lending rate in RSA	11.5	11.00	11.00
1.3 Savings Deposit Rate	2.31	1.49	1.35
1.4 Interest rate Margin (1.1 – 1.3)	10.19	10.93	10.82
1.5 Treasury Bill Yield (91-day)	9.27	8.91	8.27
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2424.2	2448.60	2474.3
2.2 Net Claims on Government by the Banking System	-552.4	-650.28	-572.91
2.3 Net Foreign Assets – Banking System	4031.3	3973.33	3959.95
2.4 CBL Net Foreign Assets	2911.5	2877.35	2806.54
2.5 Domestic Credit	60.58	17.87	76.53
2.6 Reserve Money	356.4	330.51	349.04
3. Spot Loti/US$ Exchange Rate (monthly average)	6.2050	6.6793	6.4433
	2003	**2004**	
	Q4	Q1	Q2
4.1 Current Account Balance	-299.8	-193.2	-161.64
4.2 Capital and Financial Account Balance	320.0	-23.5	181.73
4.3 Reserve Assets	-156.6	257.5	-251.39

Table 2. Selected Economic Indicators

	2000	2001	2002	2003
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	1.3	3.2	3.5	3.3
1.2 Gross Domestic Product Excluding LHWP	0.0	3.5	3.3	3.2
1.3 Gross National Product – GNP	-3.2	0.2	1.6	6.3
1.4 Per capita –GNP	-5.2	-1.9	-0.4	4.1
2. Sectoral Growth Rates				
2.1 Agriculture	2.8	0.5	-4.2	-1.9
2.2 Manufacturing	4.4	7.8	6.9	5.2
2.3 Construction	9.7	1.4	6.9	4.3
2.4 Services	-0.9	2.2	2.2	4.4
3. External Sector – Percent of GNP Excluding LHWP				
3.1 Imports of Goods	64.4	68.2	82.8	74.5
3.2 Current Account	-21.3	-17.4	-24.5	-21.1
3.3 Official Reserves (Months of Imports)	8.9	11.7	6.4	5.5
4. Government Budget Balance (Percent of GNP)	-4.9	-1.0	-2.7	-2.5

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* **These indicators refer to the end of period. Prime lending and savings deposit 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.**