



Effects of the Current Global Economic Slowdown: Impacts and Challenges for Government Budgetary Operations in Lesotho

The current economic slowdown is posing formidable challenges to many Governments around the world as revenue is declining when there is a need to boost expenditure to stimulate demand. The challenge is even more pronounced in Lesotho due to high dependence on external revenue.....

Introduction

Many countries around the world are experiencing major declines in government revenue as a result of the global economic crisis, which originated in the sub-prime mortgage problem that occurred in the United States (US) in 2006. The problems in the housing market filtered through into the US's financial system leading to a credit crunch that quickly affected other countries thus causing the global financial crisis and finally the slump in aggregate demand and the global recession. In particular, the US economy has declined by 6.1 per cent in the fourth quarter of 2008 and further by 6.3 in the first quarter of 2009. The Euro economy has also contracted by 1.5 per cent during the fourth quarter of 2008. There are indications that the South African economy is also heading into a recession with economic growth declining by 1.8 per cent in the last quarter of 2008.

These developments are posing a number of challenges for developing countries like Lesotho whose economies are dependent on economic activity in

developed countries. This article intends to highlight the implications of the current economic slowdown on Lesotho government budgetary operations and the challenges arising thereof.

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The Role of Fiscal Policy in Recession Episodes

The relationship between fiscal policy and economic output during recessionary periods is well articulated in economic theory. The episodes of severe recessions in a number of countries have shed more light on the effectiveness of fiscal policy in stimulating aggregate output during recessions. The size of the multipliers

arising from the increase in spending by government and the reduction in taxes continue to be an area of further empirical research. In response to the unfolding global recessionary conditions, the G20 group of countries has called on governments to reduce taxes and increase spending by an equivalence of 2 per cent of Gross Domestic Product (GDP). This is one measure targeted at stimulating aggregate demand in various economies.

Government Budgetary Operations and Output in Lesotho

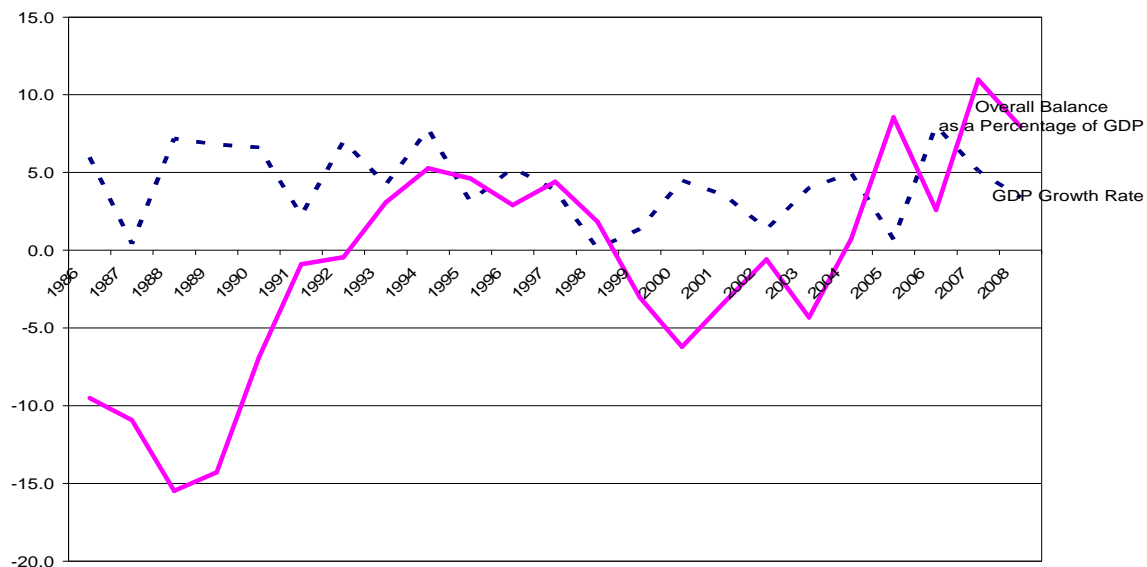
Figure 1 below shows the evolution of economic growth as measured by the real GDP and the fiscal overall balance. The data does not reflect a clear cut long-run stable relationship between these two variables. In some instances where GDP growth moderated, the

fiscal position either improved or worsened.

When comparing the five year period from 1989 to 1993 and from 1994-1998, the fiscal balance improved from an average deficit of 3.9 to a surplus of 3.8 per cent of GDP. In the following five years (1999-2003), GDP grew at an even slower average rate of 3.0 per cent while the fiscal position deteriorated to an average deficit of 3.5 per cent of GDP. This was followed by a five year period exhibiting a positive correlation between the two variables as a higher GDP growth rate of 4.4 per cent was matched by a fiscal surplus of 6.2 per cent of GDP.

The fiscal outlook as presented in the next section seems to indicate that this positive relationship will continue for some time with both economic growth and the fiscal position falling on account of the global economic downturn.

Figure 1: Real GDP Growth and Overall Balance (1980-2008) Per Cent



The Impact of the Global Economic Recession on Lesotho's Budgetary Operations

Revenue

The major impact of the recession on the fiscal position is expected to come from SACU revenue due to heavy reliance on this source of revenue by Government of Lesotho. The global recessionary conditions are hurting production and employment and, in turn, domestic demand in a number of world economies and SACU countries are no exception to this. As a consequence, these countries are experiencing declines in imports of goods and services and hence revenues from import duties. With the most significant impact are the high tariff imports. In addition, the domestic sale of excisable goods is falling, thus exerting pressure on the excise component of SACU revenue.

The most significant contribution to the SACU revenue pool, estimated at 98 per cent in 2006/07, comes from SA. Recent data on South Africa (SA) shows that imports of goods are on a downward trend. The South African Revenue Services (SARS) has reported a decline of 16.8 per cent in imports of goods between January and February 2009. Car sales, which contribute the most to excise revenue, have also plummeted, thus hurting collection of excise duties. Further negative pressure on the imports by SA is expected to come from the completion of the construction of soccer stadiums in that country. Imports by other SACU member countries are also expected to be falling.

SACU member countries' transfers to the revenue pool and hence in revenue shares received by member countries could decline. SA's transfers alone are estimated to fall by R1 billion and R1.5 billion in 2009/2010 and 2010/2011,

respectively. Lesotho and Swaziland will be affected most by this unwelcome state of affairs because they obtain up to 50 per cent of their national revenues from SACU.

Income tax, particularly company tax, is also likely to decline as a result of the global credit slump and the low aggregate demand. The impact is expected to arise from several sectors in the economy including banking, telecommunications, insurance and mining. These sectors saw increased economic activity and profitability and supported the rise in government revenue by contributing to the increase in company tax collections since 2005/06. Their profits could decline this year due to falling interest rates and demand for products, a freeze on finance and declining sales of diamonds. The textiles and clothing manufacturing firms that export outside the SACU region and which are more prone to the negative impact of the crisis, are exempt from company tax. However, poor performance by this sector is likely to have spin-off effects on the above mentioned sectors, except mining, due to the use of their services by the manufacturing sector.

The domestic mining sector is expected to perform poorly on account of low global demand that has led to considerable declines in the international price of diamonds. Lesotho's exports of diamonds fell by 65.5 per cent in the fourth quarter of 2008, which could lead to a fall in profits of mining companies and company tax contributions from this sector. In addition, two domestic mining companies suspended operations towards the end of 2008 in response to capital losses. This has reduced the company tax base from this sector, the growth of which has been curtailed further as new mines that were in the process of opening up have been

deterred by failure to obtain financing from international financial institutions as a result of the global credit problem.

The impact on personal income tax is expected to be negligible because the manufacturing sector, which has responded to the crisis by laying-off workers, employs mainly low skilled workers. The wages that these workers earn are low and hence leave them out of the tax net.

More pressure on government revenue collections is likely to come from the Value Added Tax (VAT). The domestic retail sector is expected to experience low demand for goods and services on account of losses of income by the retrenched workers as businesses cut employment.

Both the credit crunch and the low global demand are exerting negative pressure on the domestic textiles and clothing manufacturing sector. Local manufacturing firms are having difficulty accessing credit facilities from banks in Asia. This became apparent in the middle of 2008 when Government had to provide financial assistance and rescue one local firm from closing down. In addition, these firms are experiencing falling orders from Lesotho's major trading partners like the US and are as a result reducing production and exports. Exports of textiles and clothing make about 50 per cent of total exports. A number of firms in the domestic manufacturing sector have responded to the decline in orders and exports by retrenching some workers. The manufacturing sector outperformed government and became the biggest employer in the country in 2001. Its contribution to total employment is estimated at 50.0 per cent for 2008. The global crisis threatens to reverse these benefits.

In addition, the South African mining sector, which is the third largest employer of Lesotho's labour force, has been experiencing declining profits as a result of the generally low commodity prices. Consequently, more Basotho migrant mineworkers have been retrenched, resulting in seasonally adjusted annual declines of 2.1, 2.3, 2.4, and 1.4 per cent in their employment, in the four respective quarters of 2008. These lay-offs mean loss of income by the affected households, which would lead to reduced consumption of goods and services, especially high value (luxury) goods. This would, in turn, translate into lower VAT collections and hence lower contribution to total government revenue.

Expenditure

The Government has set aside a stimulus fund of M600 million for the next two fiscal years as part of fiscal policy interventions for invigorating economic growth that is under threat due to the global economic downturn. Proposals on how these funds could be utilised are centred on financing development projects in manufacturing, agriculture and tourism, which are identified as key sectors with the potential to promote faster economic growth and employment. In addition, the Government has extended a hand to help the vulnerable by increasing the old age pension by M100 per month, increasing the cost to Government by M95.2 million in the 2009/2010.

Budgetary Operations Outlook

The global recession let the Ministry of Finance and Development Planning to revise the budgetary operations outlook significantly. *Table 1* presents a summary of economic indicators extracted from the three-year Medium Term Expenditure Fiscal Framework (MTEF) 2009/2010 to 2011/2012. This

outlook appears to be in line with the implications of the recession on Lesotho's budgetary operations as discussed in the preceding section.

Government has been registering fiscal surpluses in the recent years. This is expected to change in the medium term. The MTEF could be seen as presenting

a move to countercyclical fiscal policy in the sense that the fiscal position is going into deficits to finance more expansionary stance and support the economy during the difficult times. This follows five years of fiscal surpluses during which satisfactory economic growth was realised.

Table 1: Government Budgetary Operations Outlook

| KEY FISCAL VARIABLES (in Percent of GDP) | | | | | | | |
|--|---------|---------|---------|---------|---------|---------|---------|
| | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 |
| Revenue & Grants | 51.1% | 60.7% | 58.7% | 59.2% | 62.2% | 48.5% | 53.0% |
| Total Expenditure | 46.6% | 47.4% | 47.3% | 49.9% | 64.4% | 62.4% | 61.1% |
| Overall Balance | 4.5% | 13.3% | 11.3% | 9.2% | -2.2% | -13.9% | -8.2% |
| Primary Balance | 6.8% | 16.2% | 13.7% | 10.1% | -1.2% | -13.2% | -7.6% |

Source: MTEF 2009/2010

The overall balance is expected to register an average deficit equivalent to 8.1 per cent of GDP during the outlook period. This is mainly due to a decline in total revenue from 62.2 per cent of GDP in 2009/2010 to 48.5 per cent in the following year and a slight recovery to 53.0 per cent in 2011/2012, on account of the decline in SACU and income tax revenues. It is estimated that SACU receipts by Lesotho will fall by 37.7 per cent in 2009/2010, mainly as a result of repayment to the pool of over receipt amounting to M974.5 million in 2008/09. In addition, a further decline of 11.2 per cent is expected for 2010/11 compared with 2009/10 mainly on account of the decline in imports in the region, induced by the global economic downturn. In addition, income tax revenue is projected to grow at a slower rate of 11.4 per cent per year from 2008/09 to 2011/12 compared with 25.3 per cent in 2007/08. Total expenditure is projected to grow substantially, with most of the increase arising from capital expenditure. Capital and recurrent expenditures are forecast to increase by 76.2 and 42.6 per cent, respectively in

2009/2010 and this will be followed by lower rates of increase in the subsequent years.

Challenges for Fiscal Policy

The unfolding recession poses a number of challenges for fiscal policy in Lesotho. First, government revenue is expected to decline. As already mentioned, the receipts from SACU, which accounts for over 50 per cent of the Government budget, is likely to decline thus threatening fiscal sustainability in the medium term. In addition, the likely slowdown in economic activity in Lesotho is expected to induce a decline in the domestic taxable income thereby reducing both income tax and VAT.

Second, the global slowdown is expected to have a negative impact on grants and donor funds to developing countries. This is likely to pose a major challenge for government to continue implementation of some projects particularly in health and education. Lesotho has made significant strides

towards reversal of the negative effects of HIV/AIDS pandemic and providing adequate infrastructure necessary to achieve education for all.

Third, the global economic downturn has raised the need for Government to increase expenditure to counteract the expected fall in private sector spending. In addition, the slump is occurring at the time that the Government is considering the growth strategy paper, which seeks to identify key sectors that have the potential to drive the economy of Lesotho to attain broad, sustainable and shared economic growth. Once the process is finalised, the budget processes would then be informed by these identified key sectors. The growth strategy is a step towards promoting dynamic economic growth and broadening the tax base. However, the scope of fiscal intervention may be curtailed by inadequacy of resources, especially in the medium to long term.

Last, the fiscal position is expected to deteriorate considerably into deficits over the short to medium term. Nevertheless, the fiscal surpluses realised over the recent past have put Lesotho in a relatively good position to meet the expenditure requirements. The importance of prudent spending policies to ensure long term

sustainability cannot be over-emphasised. This is especially so given the threats to SACU revenue, which will reduce total revenue flows substantially over the foreseeable future. The existing limited financial resources will have to be targeted effectively on sectors that could maximise economic growth and reduce reliance on SACU revenue by broadening the tax base.

Conclusion

The paper has shown that the global recession is posing a number of challenges for fiscal policy in Lesotho. It will cause declines in government revenue while it has also raised the need for government to increase expenditure and boost aggregate demand, leading to deterioration of the fiscal position from surpluses to deficits in the short to medium term. However, the recent fiscal surpluses have put Lesotho in a better position to cope with these challenges but long term prospects are made bleak by the expected decline in SACU revenue due to the ongoing trade liberalisation. Expenditure will have to be managed effectively to ensure that it makes an optimal contribution to economic growth, which is necessary for broadening the tax base.

2. The Unfolding Global Recession: Implications of the Recent Appreciation of the Loti against Major Currencies

Lesotho operates a fixed exchange rate regime with the local currency (the Loti) pegged at par to the South African (SA) Rand under the Common Monetary Area (CMA) agreement. Other members of the CMA are Namibia and Swaziland. The Rand circulates freely but also in parallel with national currencies within the territories of CMA countries. The

appreciation or depreciation of the loti against major currencies could have various implications for an economy. The objective of this section is to provide an analysis of the recent movements in the Loti against major currencies, in the context of the continuing global recession.

Table 2: Foreign Exchange Rates

| Currency | 2008 | | | | 2009 | | | |
|----------|-----------|------------|-------------|------------|---------|----------|---------|-----------|
| | Quarter I | Quarter II | Quarter III | Quarter IV | January | February | March | Quarter 1 |
| SDR | 12.0639 | 12.6483 | 12.3814 | 14.9852 | 15.0249 | 14.8929 | 14.7493 | 14.8890 |
| EURO | 11.3423 | 12.1539 | 11.6944 | 13.0949 | 13.1496 | 12.8043 | 12.9865 | 12.9801 |
| USD | 7.5475 | 7.7785 | 7.7850 | 9.9574 | 9.9250 | 9.8640 | 9.9469 | 9.9120 |
| POUND | 14.9317 | 15.1715 | 14.716 | 15.6179 | 14.2986 | 14.4427 | 14.1226 | 14.2879 |

The Loti weakened considerably against major currencies in the fourth quarter of 2008. It depreciated by 27.9, 12.0 and 6.1 per cent against the US Dollar, the Euro and the Pound Sterling, respectively. It maintained the downward momentum in the beginning of 2009 but gained some resilience as the first quarter of 2009 progressed. On average the loti appreciated by 0.5, 1.0, and 8.5 per cent against the US Dollar, the Euro and the Pound Sterling, respectively, in the first quarter of 2009.

A number of factors may have contributed to the strengthening of the rand during the first quarter. Many countries around the world have devised fiscal stimulus packages with the objective of mitigating the effects of the global crisis on their economies and the Group of twenty (G-20) nations have pledged to help the world economies towards recovery. These have raised speculations that the impact of the

global recession may not be as severe as initially expected, especially on emerging markets such as SA, relative to the developed world. Thus investors directed funds into investments in SA, increasing the demand for rand, relative to major currencies.

The recent appreciation of the Loti could have devastating effects on the economy of Lesotho. It could exacerbate the recent declines in exports of manufactured textiles and clothing as well as crude diamonds due to the continuing global economic downturn, by reducing their price competitiveness. This, in turn, could lead to further retrenchment of workers by the manufacturing sub-sector. On the positive side, by reducing the cost of imports denominated in major currencies, it could ease inflationary pressures and give the SA monetary policy makers room to reduce interest rates and stimulate economic recovery.

3. Monetary Policy Operations Report for March 2009

One of the main objectives of the Central Bank of Lesotho (CBL) is to maintain price stability, which is achieved through maintenance of adequate level of Net International Reserves (NIR). The adequate level of NIR ensures that the parity between the Loti and the Rand is maintained. The NIR target set by CBL's Monetary Policy Committee (MPC) remained unchanged at US\$500.0 million during the period under review.

CBL uses Open Market Operations (OMO) to achieve the stated objectives made by MPC. Table 2 below shows the amount auctioned and discount rates that prevailed for each of the auctions during the review month. The level of competitiveness in the treasury bills market is estimated by the number of participants in an auction. Therefore, during the review month, the 91-day treasury bills auction saw a participation

of 4 bidders who submitted 12 bids on the 4th March and 6 bidders who submitted 15 bids on the 18th March. All

bidders were partially successful. The number of successful bidders remained the same as in the previous month at 7.

Table 3: Treasury Bills Auctions

| Type of Security | Auction Date | Maturity Date | Action Amount (Million Maloti) | Amount Issued (Million Maloti) | Discount Rate (%) | RSA Discount Rate (%) |
|-----------------------------------|--------------|---------------|--------------------------------|--------------------------------|-------------------|-----------------------|
| 91-day | 04-Mar-09 | 04-Mar-09 | M9.1 | M9.1 | 9.63% | 8.92% |
| 182-day | | 04-Mar-09 | M7.8 | M7.8 | 9.50% | 7.88% |
| 273-day | | 04-Mar-09 | M5.2 | M5.2 | 9.30% | 7.56% |
| 364-day | | 04-Mar-09 | M3.9 | M3.9 | 9.24% | 7.33% |
| 91-day | 18-Mar-09 | 18-Mar-09 | M8.0 | M8.0 | 9.00% | 8.82% |
| 182-day | | 18-Mar-09 | M7.0 | M7.0 | 9.25% | 7.80% |
| 273-day | | 18-Mar-09 | M4.0 | M4.0 | 9.26% | 7.34% |
| 364-day | | 18-Mar-09 | M3.0 | M3.0 | 9.22% | 7.26% |
| Total for reporting period | | | M48.0 | M48.0 | - | - |

During the review month, the Lesotho 91-day treasury bills rate remained above the SA counterpart rate. The Lesotho's discount rate was 9.0 per cent while the SA counterpart treasury bills rate was 8.82 per cent on March 18. Nevertheless, the rates for the two countries moved together thus minimising the incentive for the undesirable cross border transfer of funds between the two countries. The

margin between the two rates narrowed from 0.71 on March 04 to 0.18 on March 18. However, as a result of the global economic meltdown, both rates fell by a larger margin as depicted in figure 1 below. The Monetary Policy Operations undertaken in the review period were successful in attaining their desired objective of price stability through maintenance of adequate level of NIR.

Figure 2: Measuring the Success of Monetary Policy Objectives: Performance of Lesotho 91-Day T-Bills vs RSA T-Bills

