Economic Review April 2011

The International Monetary Fund's World Economic Outlook, April 2011: Tensions from the Two-Speed Recovery: Unemployment, Commodities, and Capital Flows

The economic recovery has strengthened, but unemployment is still high and other new macroeconomic risks are manufacturing in emerging market economies ………....

Introduction

The International Monetary Fund's April 2011 World Economic Outlook (WEO) indicates that the global economy is strengthening. However, the speed of recovery varies across regions and countries. Lagging behind are those economies that suffered much larger financial shocks during the crisis. Advanced economies are growing modestly. Asian developed economies are experiencing a much stronger rebound than Euro area economies that were hit hard by the global financial crisis. Emerging and developing economies are realising robust growth, with Asian developing countries in the lead, followed by sub-Saharan African countries whereas eastern European countries are just beginning to realise significant growth.

This article provides an overview of how the global economic recovery is progressing. It also provides a highlight of the implications of the economic developments surrounding the recovery, for the economy of Lesotho.

The Global Economic Recovery and Projections

According to the April 2011 WEO, the global economy is continuing on a recovery path. The world growth rate fell from 5.25 per cent in the first half of 2010 to 3.75 per cent in the second half, resulting in an average growth rate of 5.0 per cent in the year 2010. In the first half of 2010, business confidence improved after fears of a global depression receded in 2009. Consequently, businesses began to rebuild depleted inventories. This promoted a rebound in industrial production and trade during the first half of 2010. In the second half of 2010, inventory rebuilding slowed down, pulling industrial production and trade along with it. Nonetheless, the short rebound in industrial production and trade reduced excess capacity, which together with accommodative policies, and further improvements in confidence and financial conditions encouraged investment and significantly reduced the rate of job losses.

The global recovery is expected to solidify in 2011 and 2012, supported by buoyant activity in emerging and developing countries and growing confidence in advanced economies. In addition, despite the sovereign debt risks and related financial difficulties in peripheral Euro area economies, the global financial conditions are improving.

Bond prices have declined and profits have strengthened, spurred by equity price gains. Stock prices in emerging Asia, Latin America and the United States (US) have recovered and are close to pre-crisis peaks.

Downside risks to global economic growth have moderated considerably, particularly financial risks, as the financial conditions have improved markedly. The major downside risk to global growth relates to the current upsurge and the potential for further rises in oil and food prices.

The United States

The US economy is continuing to recover and is projected to grow by 2.75 per cent and 3.0 per cent in 2011 and 2012, respectively. The recovery of the US economy is being supported mainly by the gradually strengthening private final demand. After increasing gradually throughout the year, private consumption gained speed at the end of 2010. Consumer confidence is rebuilding at the back of the improvement in financial conditions. Corporate borrowing rates remain very low and tight bank lending conditions have started to ease, both for large firms and small and medium size firms.

Table 1: World Economic Outlook Projections (Annual Percentage Change)

	2009	2010	2011	2012
World Output	-0.5	5.0	4.4	4.5
Advanced Economies	-3.4	3.0	2.4	2.6
United States	-2.6	2.8	2.8	2.9
Euro Area	-4.1	1.7	1.6	1.8
Emerging and Developing Economies	2.7	7.3	6.5	6.5
Sub-Sahara	2.8	5.0	5.5	5.9
Central and Eastern Europe	-3.6	4.2	3.7	4.0
Commonwealth of Independent States	-6.4	4.6	5.0	4.7
Developing Asia	7.2	9.5	8.4	8.4
Middle East and North Africa	1.8	3.8	4.1	4.2
Imports				
Advanced Economies	-12.6	11.2	5.8	5.5
Emerging and Developing Economies	-8.3	13.5	10.2	9.4
Exports				
Advanced Economies	-12.2	12.0	6.8	5.9
Emerging Developing Economies	-7.5	14.5	8.8	8.7

Source: IMF World Economic Outlook, April 2011

The firming private demand is offsetting the waning support from the federal fiscal policy. The US Government approved a new fiscal stimulus package in December 2010. This is expected to add slightly more than 0.5 per cent to growth in 2011, although the recent agreement to cut federal spending during the 2011 fiscal year would reduce the economic support from fiscal policy. The fiscal deficit of 10.7 per cent is projected for 2011 and the general government debt is rising at a fast pace, indicating that the room for further fiscal stimulus is becoming increasingly eminent. .

The US economic recovery is being held back by sluggish recovery in both the labour and housing markets. Although the rate of unemployment has declined from a peak of 10.1 per cent to 8.8 per cent in March 2011, long-term unemployment remains high. Forecasts indicate that unemployment will remain high, falling moderately to about 7.7 per cent in 2012. According to the April 2011 WEO, the US labour market cut more than 8.5 million jobs in 2008 and 2009 and has, since then, only been able to add just below 1.5 million jobs. This is said to be just about sufficient to keep up with the increase in the working-age population but not enough to put those who lost jobs back into employment.

The housing market in the US remains depressed, thus resulting in lacklustre housing investment. There is an abundance of foreclosed homes in the US housing market and this has led to falling house prices. This is because foreclosed properties often sell at a discount and so force other sellers to lower their prices. In March 2011, house prices declined for the 57th consecutive month, by a monthly rate of 1.1 per cent. There is also a large inventory of houses for sale, which is depressing construction of residential property.

There are some downside risks to the US's economic recovery. The financial difficulties in the Euro area, where financial turbulence erupted in May 2010 and again in November 2010, could possibly tighten financial conditions and weaken demand. In addition, the upsurge in the prices of oil and other commodities could damped confidence and weaken consumer spending.

The Euro area

Moderate economic recovery in the Euro area continues despite the debt crisis that has hit the peripheral Euro area. Private domestic demand is gradually beginning to play a significant role in Euro area's recovery, though there are divergences across countries in the region. After declining by 4.1 per cent in 2009, the Euro area economy has expanded by 1.7 per cent in 2010. A growth rate of 2.5 per cent was recorded in the first quarter of 2010. According to the April 2011 WEO, the Euro area is expected to continue to recover moderately, rising by 1.7 per cent in 2011, before accelerating to 1.9 per cent in 2012. Performance of the Euro area is largely influenced by developments in the area's largest economies, Germany, France and Italy. Growth is expected to be modest in Germany and France and to remain weak in Italy mainly on account of the withdrawal of fiscal support, which will dampen domestic demand in these economies.

Downside risks to the positive outlook continue to prevail. The sovereign debt risk and related fragilities faced by the financial sectors in some countries in the region, particularly, Greece, Ireland and Portugal, pose a significant threat to financial stability and growth in the medium term. The upsurge in commodity prices could also derail recovery. Another main downside risk according to the report is the high fiscal imbalances. Plans for fiscal consolidation and support to the banking sector are underway to address the fiscal deficits and banking sector risks. Nonetheless, concrete and sustained policies need to be formulated to underpin these medium term adjustment plans.

Sub- Saharan Africa (SSA)

The SSA has also suffered adverse effects of the global financial crisis and the resultant economic slowdown. African countries with more developed financial sectors and higher levels of integration into the global financial markets were the first to feel the adverse effects of the crisis. Exporters of oil, manufactured goods and minerals also felt the blow as global trade collapsed. Nonetheless, most countries in the region weathered these negative effects well as they were able to implement countercyclical fiscal and monetary policies, which helped to moderate the decline in domestic demand. These policy interventions were made possible by prudent fiscal and other macroeconomic policies pursued prior to the crisis.

The region is recovering quite well. The growth rate of 5.0 per cent was realised in 2010, supported by strong domestic demand, the rebound in trade and commodity prices while macroeconomic policies also continued to be accommodative. The recovery is expected to remain strong, with growth rates of 5.5 per cent and 6.0 per cent projected for 2011 and 2012, respectively. However, prospects differ markedly across the region. SSA's growth is being led by low-income countries. These are forecast to grow by 6.0 per cent in 2011 as a result of commencement of oil production in newly discovered oil wells, infrastructure investment and improving agricultural production in some LIC countries. Oil exporters in the region, such as Nigeria are expected to benefit from the surge in oil prices. The buoyancy of international oil markets should assist these countries to reduce or even close their fiscal deficits and rebuild foreign exchange reserves. Contrary to most of the region, recovery in South Africa (SA), the region's biggest economy, is expected to be lacklustre, growing by 3.5 per cent in 2011. This is attributable to sluggish domestic demand as private investment is being held back by excess capacity. This growth is not sufficient to reverse the substantial job losses that occurred in the past two years, as a result of low global demand.

There are risks to SSA's economic growth prospects. First, the slowdown in Europe would hurt manufacturing exporters, such as SA, in the region. Second, the upsurge in energy prices will benefit oil exporters but raise inflation and dampen growth in the region's oil importers. The rise in food prices could also have adverse effects in the region. The surge in both fuel and food prices could have major social and fiscal costs in the LICs. Politics play an important economic role in the region. Political unrest has dampened growth in some countries in the region, an example being Côte d'Ivoire. In addition, around 17 countries in the region are scheduled to have national elections in 2011. National elections, according to experience, could lead to political turmoil, which could, in turn, hinder economic activity.

Implications for the Economy of Lesotho

The solidifying global economic recovery is a welcome development to economies of the world, including Lesotho because it could reverse the devastating effects of the financial crisis and recession. Moreover, the downside risks have moderated considerably, and global economic activity seems to be on the path to accelerate again. Nevertheless, the geographical unevenness of the pace of recovery and the slow recovery of unemployment present a number of challenges for Lesotho, mainly emanating from the trade relationship between Lesotho and the US, the Euro zone and South Africa.

Since the inception of African Growth and Opportunity Act (AGOA) in 2000, Lesotho's exports of textiles and clothing to the US have increased. The textiles and clothing manufacturing sub-sector expanded, resulting in its contribution to economic growth and employment. As aggregate demand in the US fell, on account of the recession, demand for Lesotho's exports of textiles and clothing to US retailers also fell. Consequently, Lesotho-based manufacturers started receiving very low orders from their customers in the US.

As a result of a decline in orders, the manufacturing sub-sector had to scale down operations and hence laid-off a significant number of workers. The employment levels in LNDC assisted companies, which are mostly engaged in textiles and clothing manufacturing, has declined from 48,621 in the third quarter of 2008 to 45,084 in the first quarter of 2011. Nevertheless, the rate of decline has recently moderated in response to the recovering, though still fragile, consumption demand in the US, given the sluggish US labour market. If the trend is not reversed soon, this is likely to impact negatively on the Government's efforts to alleviate poverty in Lesotho. Performance of the domestic manufacturing sub-sector is expected to remain subdued until households in the US have resumed their expenditure, at least to pre-crisis levels. This is important for recovery as well as further expansion of the sub-sector.

The upsurge in commodity prices, as a result of high international demand for commodities, is having mixed effects and implications for the economy of Lesotho. On the positive front, diamond mining production is rapidly recovering and has resumed on an increasing trend, as a result of the rebound in diamond prices. Exports of diamonds rose by 41.2 per cent in the first quarter of 2011. In addition, the mining production index increased significantly by more than 200 percentage points during the same period. This positive trend is expected to continue as two mines, Liqhobong and Kao mines, that had closed operations since the third quarter of 2008, resumed production in the first quarter of this year.

Lesotho is a member of the Southern African Customs Union (SACU) with Botswana, Namibia, Swaziland and South Africa. SACU revenue is the main source of revenue for the Government of Lesotho. The recession has reduced production and employment and hence domestic demand in many economies of the world including SACU countries. As a consequence, these countries experienced declines in imports of goods and services and hence low revenues from import duties. The most significant contribution to the SACU revenue pool, estimated at 98 per cent in 2006/07 comes from SA. As mentioned earlier, the SA economy is recovering rather slowly due to lackluster domestic demand. In addition, imports of goods are sluggish and continue to remain below pre crisis levels. This implies sluggish recovery of SA's transfers to the revenue pool and hence reduced shares to member states. Consequently, Lesotho will take time to recover from fiscal revenue loss caused by the decline in SACU revenue, which is the main source of revenue for the Government.

The Impact of Electricity Tariffs Increases on Lesotho's Economy

The current revision of electricity prices is expected to have an impact on Lesotho's economy………..

Background

Electricity plays an important role in economic growth because it is an input in the production of goods and services. It also contributes to social development through its role in health care and education. By contributing to job creation, it also assists in poverty alleviation. Given the current electricity energy imbalance in Lesotho, especially in winter periods, where demand exceeds supply, it is not surprising that electricity tariffs have been increased. Electricity prices are an important factor in the revenue structure of electricity supplying utilities like Lesotho Electricity Company (LEC). To be able to finance its operations and expand the distribution infrastructure, LEC has applied for tariff increases by 17.0 per cent and this has been approved by the Lesotho Electricity Authority (LEA), which is the electricity regulator in the country.

It is due to the centrality of electricity sub-sector in economic and social life that the Government of Lesotho has drafted the energy policy. The policy highlights the energy sector's important role in economic growth. In this regard, electricity is placed at the centre of the energy policy framework. The strategies identified for the sector under the policy include enhancement of the competitiveness of commerce and industry electricity tariffs. This is because electricity is a major source of energy in commerce and industry.

The Structure of Electricity Supply

Prior to 1998, Lesotho used to get all its electricity supply from Eskom in South Africa (SA). The situation, however, changed in 1998 when 'Muela Hydropower Plant (MHP), which is owned by Lesotho Highlands Development Authority (LHDA), came into operation as the main electricity power generator. The plant has the maximum capacity of 72 Mega watts. Since 1998 after establishment of 'Muela, some bulk of electricity has been imported from SA and recently from Electricidade de Mozambique (EdM) particularly during winter when demand for electricity energy is very high.

The electricity sector in Lesotho is dominated by LHDA, LEA and LEC. On one hand, LEA is entrusted with the responsibility of regulation and control of electricity supply in the country. On the other hand, LEC is licensed by LEA to supply, distribute and transmit electricity power throughout the country.

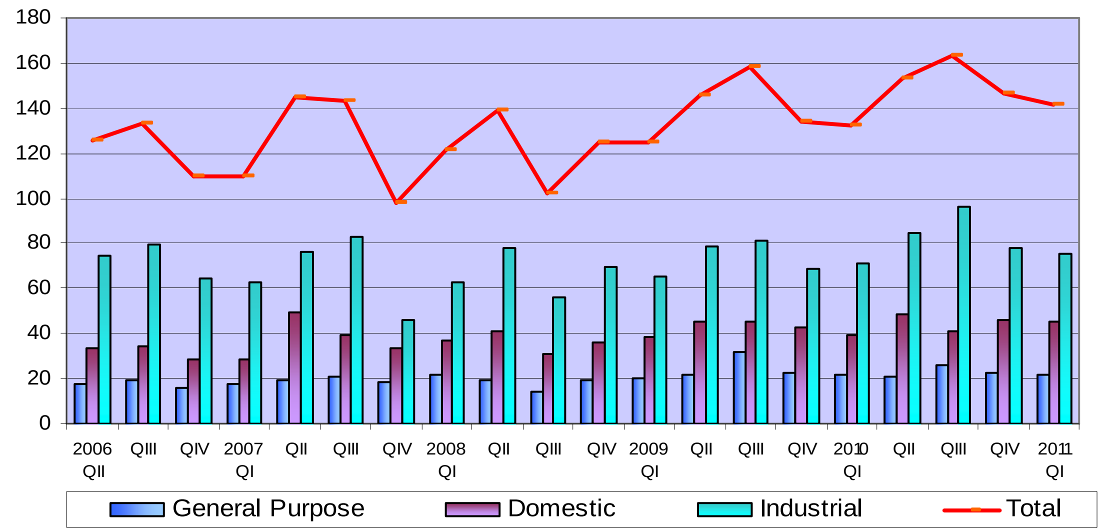
In 2010, the country's electrification rate was at 16.0 per cent. Of the 16.0 percent, 44.0 per cent was in urban areas while the rural areas constituted 6.0 per cent. The Government has targeted 25.0 per cent of electrification rate by 2015. Lesotho's electricity supply is not dependable at this rate given some technical problems at 'Muela and the level of electricity grid interconnectedness infrastructure in the country as demand expands.

The Structure of Electricity Demand

The demand for electricity in Lesotho has been growing significantly over the last few years. The demand for electricity can be best viewed in terms of electricity consumption and this has grown by 20.4 per cent from 2007 to 2010 (figure 1). As mentioned earlier, the electricity market segmentation in Lesotho consists of general purpose, domestic; and commercial and industrial. The general purpose consists of government buildings, churches, schools, among others. The industrial and commercial consists of manufacturing firms and other large companies. The largest user of electricity can be seen from figure 1 below to be the commercial and industrial sub-sectors at 54.0 per cent of total electricity consumption on average, followed by the domestic users with 23.0 per cent and lastly, the general purpose with 16.0 per cent.

Even though the demand for electricity power has increased in the past few years, the country suffers from a power supply capacity deficit (the amount by which demand for electricity exceeds its supply). This becomes acute during winter periods when there is a high demand for electricity power for warmth. For example, in 2008, the system peak demand (the highest point of consumption of electricity by customers) was 123 MW and has increased to 133 in 2009 while the total installed generation capacity is 72 MW from MHP.

Figure 1: 2006 QII - 2011QI Electricity Consumption Capacity in Lesotho



Source: LEA and LEC

During 2008 and 2009, the imported capacity from Eskom and EdM changed from capacity deficit of 42.0 per cent to 46.0 per cent, respectively. Nonetheless, the imported capacity of electricity remains variable depending on the maximum demand by customers in Lesotho. LEC has forecast that electricity demand will reach 160 MW by 2011. This means that the imported capacity will increase to 88 MW making Lesotho to be the net importer of electricity. The company has also forecast that the increase in demand will stay strong for the next fifteen years. This is expected at the back of Government's policy of higher rates of electrification.

Factors Behind the Upward Revision of Electricity Tariffs

According to the LEC reports, the main drivers of this year's tariffs increase include cost of supply of electricity, which is driven by higher cost of electricity imports from Eskom and EdM rate of return on investment, infrastructure depreciation as well as the company's increasing operating costs. Current increases in electricity tariffs are characterized by a growing demand that is marched by insufficient supply. The imbalance creates room for price adjustments, especially price increases.

Table 1 below shows trends of approved electricity tariffs from 2009 to 2011 and their percentage changes. The approved electricity tariffs were increased by 17.0 per cent on average. At this level, the tariffs are below those applied for by LEC by 12.0 percentage points for energy charges and 9.0 percentage points for maximum demand charges. Maximum demand charges are the prices of electricity power charged to customers when there is high demand and were increased by 16.0 per cent on average for all customer categories.

Implication for the Economy of Lesotho

Electricity tariffs play a crucial role in the supply and demand of electricity. As mentioned earlier, electricity is an important input in the production process of many goods and services in Lesotho. Therefore, the current tariffs hike is expected to have a negative impact on the economy.

First, the rise in electricity tariffs will alter household welfare. Nonetheless, the welfare effect will depend on electricity‘s share in the household’s budget. Consumption of electricity is much higher in high-income households and thus its expenditure. As a result, the increase in tariffs could result in reallocation in their consumption basket. Moreover, households are likely to resort to efficiency measures by cutting off non-essential consumption.

Second, the price hikes will affect households indirectly through increased inflation rate. In Lesotho, the weight of electrify cost in overall consumer price inflation is 0.5. Therefore, an increase of 17.0 per cent translates into electricity tariff-induced inflation of 0.09 per cent. The acceleration in inflation rate, in turn, reduces purchasing power of household income.

Third, the increase in tariffs poses a challenge for the industrial and commercial segments of the economy. A large portion of the commercial and industrial output uses electricity as an input. Therefore, the increased tariffs are expected to result in a rise in the costs of production in manufacturing, mining, agriculture and commerce. The increased cost structure of these subsectors is expected to further impact negatively on employment.

In the manufacturing industry, it is expected harm the competitiveness of exports, further worsening the balance of payments position. The extent of the impact will depend on the responsiveness of electricity consumption by the sector to price changes.

The rise in tariffs is also expected to affect the overall economic activity through decline in household consumption and industrial output. This poses a challenge to the tax revenue collections as the respective sector’s profits may be negatively affected. Nonetheless, the increased tariffs may boost LEC revenue capacitating it for further expansion and improvement of electricity infrastructure in the long run.