Economic Review January 2009

The Global Economic Downturn: Economic Implications for Lesotho

The global economy is currently facing a deepening crisis, with a downturn in advanced economies now spreading to emerging economies and the rest of the World. What are the economic implications for Lesotho?

Introduction

The global economic downturn emanated from the global financial markets' crisis which began in 2006 among sub-prime mortgages in the United States and spread to European markets as well as the rest of the World. Notwithstanding the wide range of policy responses, financial strain remains severe, prompting recession in the real economy – the second round effect of the financial crisis.

The continuation of financial meltdown has prompted many households and businesses to revise their budgets downwards, reducing demand for consumer and capital goods across the globe. This has resulted in many businesses, globally, scaling down their production activities and reducing their labour force in an endeavour to match with deteriorating global demand. This is despite the governments' efforts in trying to dispel the crisis.

This report, therefore, intends to highlight the current global economic developments as well as their implications for the economy of Lesotho.

INSIDE

The current global economic developments

According to the International Monetary Fund (IMF), global economic growth is projected to plummet from 3.4 per cent recorded in 2008 to 0.5 per cent in the year 2009. Figure 1 below shows Gross Domestic Product (GDP) growth for world; advanced, emerging and developing economies.

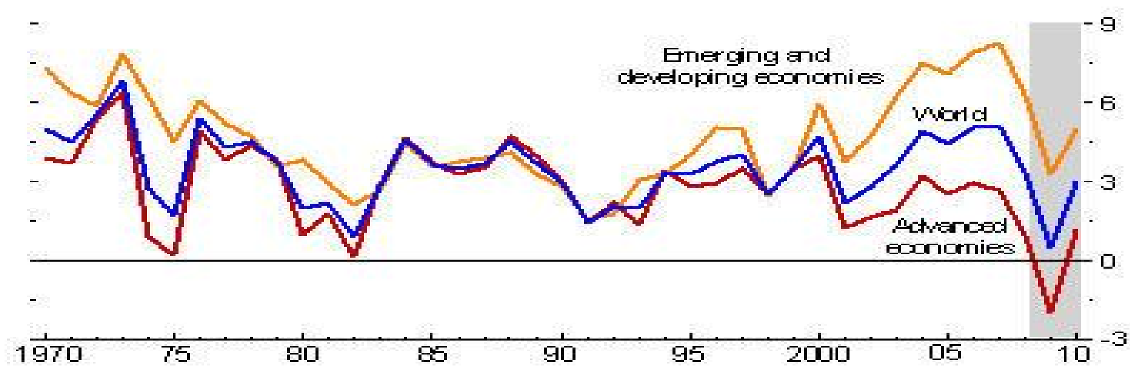
The World economic activities, including trade shrunk during the last quarter of the year 2008. This has resulted in high levels of unemployment in many advanced economies as well as other emerging economies; rising above the normal unemployment level (particularly in the US recording unemployment rate of above 7.0 per cent).

Advanced economies are projected to contract by 2 per cent in 2009, while emerging markets and developing economies are projected to slowdown from 6.3 per cent in 2008 to 3.3 per cent in 2009. This is mainly attributed to a fall in exports demand, lower commodity prices and much tighter external financing constraints. However, it is expected that growth within these regions will start recovering in early 2010 with the implementation of comprehensive fiscal and monetary stimulus aimed at supporting a gradual normalisation of financial markets.

For Sub-Saharan African (SSA) economies, growth is projected to slowdown from 5.4 per cent in 2008 to 3.5 per cent in 2009. This will be the first time in more than 45 years that the region has experienced five consecutive growth rates of at least 5 per cent per year. Robust growth in this region has been supported by strong international trade with high commodity prices, capital inflows and substantial investment. However, with advanced economies experiencing economic slowdown, with declining trade and commodity prices, growth within the region remains doubtful.

Economic growth in South Africa, SSA's largest economy, is projected to slow down from 5.1 per cent in 2007 to 2.5 per cent in 2009 mainly due to the decline in commodity prices (platinum, coal, gold, manganese, iron ore and ferrochrome – SA's exports commodities) and depreciation of SA currency against currencies of its major trading partners due to global slowdown.

Figure 1. GDP Growth
(Percent change)



Source: IMF staff estimates.

External shocks to the economy of Lesotho

Lesotho has become increasingly integrated into the global economy in recent years, with a rapid increase in trade and higher degree of openness. Although Lesotho benefits from this move, joining the world market also exposes it to external shocks. This presents a challenge of appropriate policy responses that the country should implement in order to reduce its vulnerability to such shocks.

Terms of trade[1] fluctuations (commodity price changes), variations in interest rate differentials, as well as fluctuations in global economic growth (world demand) are the three main external shocks widely articulated in economic theory.

Changes in a country's terms of trade have a significant effect on economic growth. Improvements in terms of trade increases real purchasing power on imported capital goods (equipments). This has a potential to boost domestic investment, productivity and economic growth. On the other hand, deterioration in terms of trade reduces export earnings accruing to domestic exporters. This will translate into a fall in exports and hence domestic productivity and economic growth.

A second source of adverse external shock is the variations in interest rates differentials. Lower domestic rates relative to the rest of the world encourage financial and capital outflows, translating into capital and financial account deficits and hence balance of payment deficits. This has a potential to exert a downwards pressure on the country's holdings of foreign reserves, thus presenting a challenge to monetary authorities. On the contrary, higher domestic interest rates relative to the rest of the world discourages financial and capital outflow while attracting funds from the rest of the world. This will translate into improvements in capital and financial account, balance of payments and accumulation of foreign reserves.

A third variable is the evolution of world demand, also identified as global recession effects. A decline in foreign demand will obviously reduce the volume of exports, and this in turn will worsen current account balances and therefore economic growth. This will also translate into unemployment in the export sub-sector. In addition, global recession has a potential to reduce funds flowing into the domestic economy.

Economic implications of global economic downturn for Lesotho

A number of economic implications of the current global slow down on Lesotho's economy can be traced.

- *Decline in manufactured exports (Textiles and clothing) to US*. The US has been the largest importer of Lesotho's manufacturing exports, mainly textiles and clothing since the inception of African Growth and Opportunity Act (AGOA) since 2000.

[1] Terms of trade is the ratio of the index of exports prices to the index of imports prices. It measures domestic purchasing power vis-à-vis the rest of the world.

As a result, the manufacturing sub-sector has been an important contributor of employment and hence economic growth in Lesotho. However, due to recession in the US, there has been a significant decline in aggregate demand for imports including clothing and textiles by US consumers. As a result, manufacturing sub-sector in Lesotho was forced to scale down their operations and hence laying off significant number of workers. In January, it was reported that China Garment Manufacturers (CGM) has retrenched about 1,000 workers while other firms were planning to scale down their production and lay off part of their labour force. Consequently, the purchasing power of the retrenched workers dropped, translating into the overall decrease in domestic demand. This is likely to worsen poverty situation in the country.

- *Decline in Diamond exports to European markets with declining commodity prices*. The economy of Lesotho has recently diversified its export base by offering diamond mining licences. Although the sector is still in its embryonic stage it has had significant impact on growth and investment in the country. In addition, the sector provides royalties and dividends to the Government of Lesotho. Due to weak commodity markets (particularly European diamond markets), mining industries were forced to scale down their operations and the exports of diamonds. This translates into more job losses (unemployment), decline in diamond royalties to the government as well as deterioration in the balance of payment position (BOP). Therefore, exerting downward pressure on the country's level of foreign reserves, and presenting a challenge to monetary authorities.

- *Decline in Southern African Customs Union (SACU)*. Lesotho is a member of SACU together with South Africa, Botswana, Namibia and Swaziland. Currently, SACU revenue is the main source of Government of Lesotho's (GoL's) revenue (accounting for about 60 per cent of the total revenue) and the most important source of the country's foreign reserves. It is noteworthy that this large amount of customs revenue was mainly on account of growth in imports into the region supported by relatively strong growth performance. However, the expected decline in output is likely to drag with it imports of goods and hence less customs duty collected. South Africa, the larger member of SACU, has significantly revised GDP growth forecasts for 2009. It is projected to decline from 3.1 per cent in 2008 to 2.5 per cent in 2009. The fall in the SACU revenue pool poses serious challenges for fiscal authorities in Lesotho. The challenge is amplified by the fact that the gap cannot be filled by foreign sources as there is the global scarcity of funds.

In addition, Basotho migrant labour working in SA mining industries constitutes the main source of flow of remittances to the country; The role played by migrant remittances to Lesotho's economy cannot be overemphasised. They provide livelihoods to a significant number of households mainly in the rural areas. The global slowdown has manifested itself in the decline in the prices of commodities such as gold and platinum. There are already indications that if the decline in the prices is sustained a number of mines in South Africa will close the marginal shaft thereby reducing labour significantly. This will lower remittances to Lesotho and increase unemployment and poverty.

▪ *Decline in Foreign Direct Investment (FDI) and Official Donor Assistance (ODA).* Due to tighter budget (and liquidity needs) and increased risk aversion in advanced economies, both FDI and ODA are likely to decline significantly. FDI is very critical for long-term economic development in the country, as the source of new technology, skill formation and infrastructure development. On the other hand, ODA are vital in financing development projects mostly in agriculture, health, road infrastructure and education, and provision of safety-net for many vulnerable groups (Orphans etc) in the society. However, with the current situation, FDI and ODA are likely to decline, presenting a huge challenge for Government to raise funds. It is likely that the current financial crisis may reverse some of the gains already achieved towards attaining the Millennium Development Goals.

Conclusions

Lesotho is likely to be negatively affected by the current global economic downturn and may evaporate some of the gains achieved in poverty reduction. Hence it is important that the Government consider some measures aimed at providing a cushion for a modest impact. This includes priority spending on long-term capital projects which have potential to create jobs and the improvement of the business environment to revive private sector confidence.

2. The Government of Lesotho Refunds Income Taxpayers: Implications for Lesotho's Economy

Following the passing of the Income Tax Amendment Act of 2008 by the Parliament of Lesotho, the Government has announced that about 48 000 taxpayers would be refunded pay-as-you-earn. The refund is estimated over M100 million. The overpayment resulted from the delay in passing the Act after the income tax changes were announced in the budget speech, early in 2008. The amended income tax law increases the tax credit by 28.6 per cent to M4 500 and the tax threshold by 6.6 per cent to M37 378. In addition, the lower tax rate is reduced from 25 per cent to 22 per cent.

The tax refund has a number of implications for the economy of Lesotho. First, the refund occurs at the time when the economy of

Lesotho is on a downturn in line with the global economic developments. Governments around the world are designing different forms of fiscal stimulus packages to assist their economies to avert the unfolding recessionary conditions and the refunds will serve that purpose for Lesotho. The refunds are estimated at M100 million which is equivalent to 0.7 per cent of GDP. The impact is likely to be larger as the refunds are coupled with the permanent reduction of income tax.

Second, the manufacturing sub-sector which is important to the economy of Lesotho as it provides employment to about 48000 Basotho, mainly women, is expected to contract in 2008 and 2009, leading to job losses. Thus the refunds are likely to support consumption expenditure for a significant number of households at this time of stress.

Third, the injection is likely to support the performance of sub-sectors such as retail wholesale and repair, communications, transport and storage and catering which tend to follow the performance of the manufacturing sector.

In conclusion, the tax refund has come at the time when the economy needs some form of a stimulus to curb the negative implications of the unfolding global recession. Thus the refund coupled with the tax reduction is likely to support some sectors during this period of stress.

It is important that the Government implement other strategies of intervention to ensure that the economy of Lesotho minimizes the negative impact of the current global recession.

3. Monetary Policy Operations Report for January 2009

According to the Central bank of Lesotho (CBL) Act 2000, the Bank's primary objective is to achieve and maintain price stability. This is done through maintenance of adequate level of Net International Reserves (NIR) to ensure that the parity between the Loti and the South African Rand is maintained. The Bank, therefore, undertakes Monetary Policy Open Market Operations (OMO) through which it seeks to influences Treasury bills rate. This will therefore affect the level of foreign reserves through changes in the interest rate differential between Lesotho and South Africa (SA). The parity between the loti and rand allows Lesotho to benefit from relatively low inflation in South Africa.

The report present economic and operational issues surrounding the monetary policy operations conducted during the review period to assess the success of the operations.

Table 1 below shows the amount auctioned and discount rates that prevailed during each auction. During the review period, the market responded relatively well to the 91-day treasury bills auction held on the 28th January 2009 compared with the previous auction of 14th January 2009. The auction attracted 6 bidders who submitted 15 bids compared with 4 bidders with 9 bids. Lesotho's 91-day Treasury bills rate remained steady at around 10 per cent, and lower than their South African counterpart. Due to the current global downturn, both rates declined during the review period, with SA rates declining by a larger margin as depicted in figure 2 below.

Table 1: Treasury Bills Auctions

Type of Security	Auction Date	Maturity Date	Auction Amount (Million Maloti)	Amount Issued (Million Maloti)	Discount Rate (%)	RSA Discount Rate (%)
91-day	***14-Jan-09***	15-Apr-09	M17.6	M17.6	10.03%	10.77%
182-day		15-Jul-09	M13.2	M13.2	10.37%	9.7%
273-day		15-Oct-09	M6.6	M6.6	10.48%	8.91%
364-day		13-Jan-09	M6.6	M0.201	10.12%	8.12%
91-day	***28-Jan-09***	29-Apr-09	M10.5	M10.5	10.01%	10.52%
182-day		29-Jul-09	M9.0	M9.0	10.35%	9.034%
273-day		28-Oct-09	M6.0	M6.0	10.46%	8.66%
364-day		27-Jan-09	M4.5	M0.407	9.85%	7.98%
Total for reporting period			M67.4	M63.508	-	-

The margin of interest rate differential between Lesotho's 91-day Treasury bills rate and SA counterpart declined to 51 basis points on the 28th January from 74 basis points on the 14th January. This implies that there was a minimal incentive for undesirable cross border transfers of funds between the two countries. Hence, Monetary Policy operations undertaken during the review month were successful in attaining their desired objectives of financial stability by maintaining the target NIR level.

Figure 2: Measuring the Success of Monetary Policy Objectives: Performances of Lesotho 91-day T-bills vs RSA 91-day T-bills

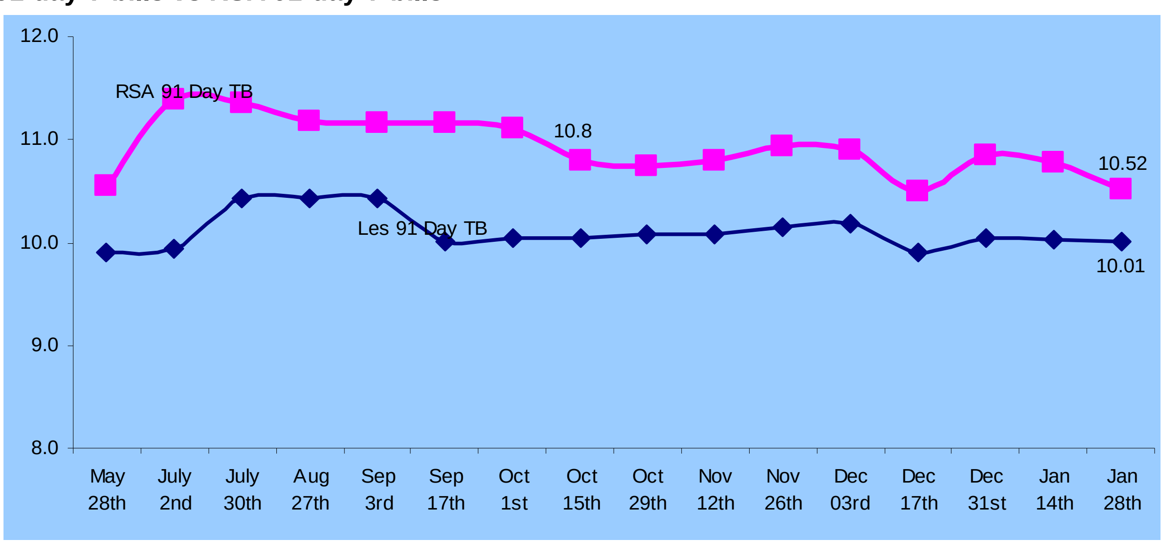


Table 2: Selected Monetary and Financial Indicators

	2008		2009
	Nov	Dec	January
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	*16.58*	*16.58*	*16.00**
1.2 Prime Lending rate in RSA	*15.50*	*15.00*	*15.00*
1.3 Savings Deposit Rate	*5.28*	*5.28*	*4.61**
1.4 Interest rate Margin(1.1 – 1.3)	*11.30*	*11.30*	*11.39*
1.5 Treasury Bill Yield (91-day)	*10.15*	*10.05*	*10.67*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*4549.19*	*4880.99*	*5494.34*
2.2 Net Claims on Government by the Banking System	*-4501.97*	*-3972.70*	*-4606.27*
2.3 Net Foreign Assets – Banking System	*11283.17*	*11172.63*	*12408.45*
2.4 CBL Net Foreign Assets	*8,871.97*	*8,251.57*	*8949.13*
2.5 Domestic Credit	*-2948.45*	*-2465.73*	*-3090.42*
2.6 Reserve Money	*706.85*	*580.32*	*613.76*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	***10.1095***	***10.0203***	***9.9250***
4. Inflation Rate (Annual Percentage Changes)	***11.8***	***10.6***	***10.7***
5. External Sector (Million Maloti)	***2008***		
	QII	***QIII***	***QIV+***
5.1 Current Account Balance	*824.12*	*346.40*	*412.57*
5.2 Capital and Financial Account Balance	*117.74*	*1083.26*	*-184.20*
5.3 Reserves Assets	*-165.33*	*-704.65*	*-558.82*

+Preliminary Estimates.

**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 3: Selected Economic Indicators

	2005	2006	2007	2008+
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	*0.7*	*8.1*	*5.1*	*3.4*
1.2 Gross National Product – GNI	*-1.9*	*12.0*	*3.0*	*5.0*
1.3 Per capita –GNI	*-1.9*	*12.0*	*2.2*	*4.2*
2. Sectoral Growth Rates				
2.1 Agriculture	*-12.4*	*14.9*	*-8.6*	*1.8*
2.2 Manufacturing	*-10.2*	*6.0*	*9.9*	*-4.5*
2.3 Construction	*5.4*	*3.5*	*6.9*	*7.7*
2.4 Services	*2.8*	*6.5*	*3.1*	*2.4*
3. External Sector – Percent of GNI				
3.1 Imports of Goods	*83.5*	*77.6*	*82.0*	*86.8*
3.2 Current Account	*-5.8*	*3.4*	*9.8*	*9.5*
3.3 Capital and Financial Account	*3.7*	*0.7*	*5.5*	*5.1*
3.4 Official Reserves (Months of Imports)	*5.5*	*6.7*	*7.6*	*7.4*
4. Government Budget Balance (Percent of GDP)	*5.0*	*11.6*	*7.5*	*-1.0*

+Preliminary Estimates