Economic Review January 2010

RECENT DEVELOPMENTS IN THE MANUFACTURING SUBSECTOR IN LESOTHO: PROSPECTS FOR DIVERSIFICATION OVER PRODUCTS AND MARKETS.

The global economic crisis affected the domestic manufacturing subsector adversely. Several firms recently ceased their operations and employment reached its lowest level since 2005……

Introduction

The manufacturing subsector in Lesotho comprises three broad activities, namely, manufacturing of food and beverages; textiles and clothing; and other manufacturing. Textiles and clothing manufacturing is the most important to the economy of Lesotho in terms of its large contribution to GDP and employment. The subsector has however been hit by several shocks, the biggest of which are the facing out of the multi-fiber agreement in 2004 and the current global economic crisis. However, the other manufacturing activity has registered a double digit real annual growth rate since 2006 and that has partially offset the downward trend in textiles and clothing.

Textiles and Clothing

Textiles and clothing is the largest industry with 68.8 per cent contribution to total manufacturing production, followed by food and beverages, and other manufacturing with contributions of 16.9 per cent and 14.4 per cent respectively. The subsector grew significantly between 2000 and 2004 in response to the enactment of the African Growth and Opportunity Act (AGOA). The Act offers tangible incentives for Sub Saharan Africa (SSA) in the form of Duty Free Qouta Free (DFQF) and preferential market access for imports into the US. Lesotho is one of SSA countries that made the best out of the act. Between the year 2000 and 2004, US textiles and apparel imports from Lesotho increased by 223.5 per cent, making it the biggest exporter of textile and apparel in SSA with a share of 24 per cent. Although the percentage share has been maintained, both the value and volume of textiles and apparel imports from Lesotho have declined since 2004.

The biggest decline of 17.2 per cent witnessed in 2005 was due to the expiration of the Multi-Fibre Agreement (MFA) in 2004. This system allowed for allocation of quotas and guaranteed Less Developed Countries (LDCs) like Lesotho with US market access. MFA was phased out in line with World Trade Organisation (WTO)'s requirements which advocate for a highly competitive trading environment.

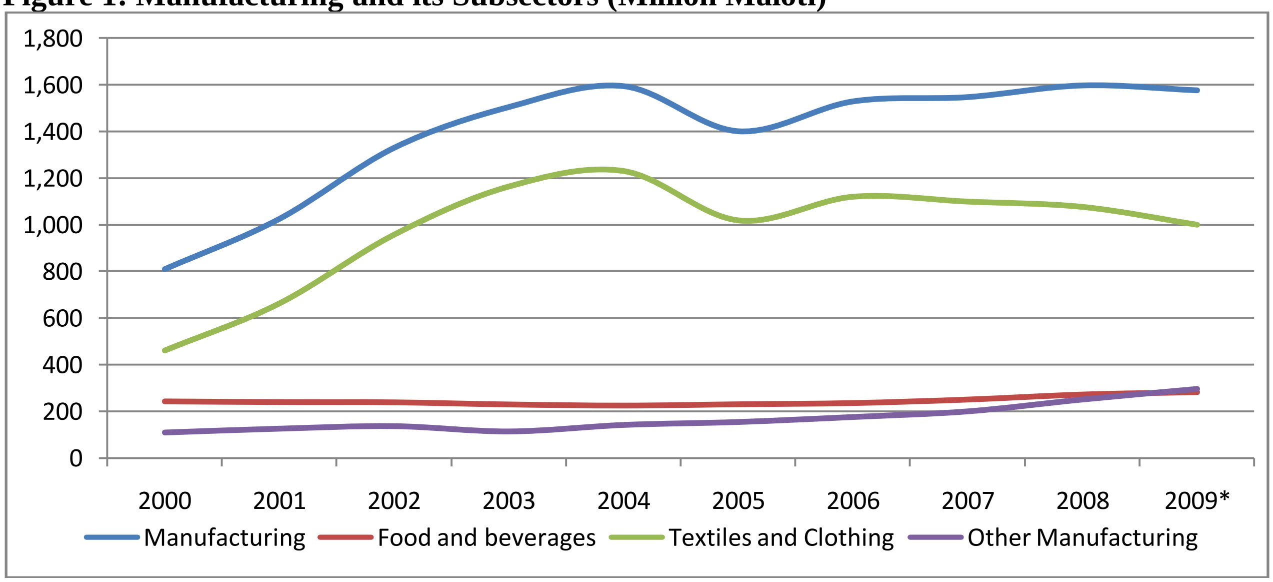
Analysts expressed concerns that AGOA's duty-free preference would not be enough to maintain US apparel orders in the face of unlimited competition from China and other Asian giants. This led to the imposition of safeguard quotas on China in November 2005 which prompted textiles and clothing to rebound by a modest 10 per cent in 2006. Since then, textiles and clothing failed to recover to its peak but remained under pressure maintaining a somewhat downward trend. In December 31, 2008, the safeguard quotas on China expired and its impact coupled with the weakening international demand resulted in a projected 7.1 per cent decline in 2009.

Furthermore, the current financial crisis, followed by the global economic downturn has exposed weaknesses in the subsector. The crisis manifested itself in a global credit crunch which resulted in collapse of the major financial institutions in the world. The financial crisis created a financial distress to the industry and the resulting global economic recession meant lower sales orders to the subsector.

Textiles and clothing industry in Lesotho is dominated by Asian owned companies and are still linked to their parent companies in Asia in terms of finances, processing of orders, sourcing of raw materials, Letters of Credit and shipping arrangements. With the advent of the credit crunch and the financial crisis, banks in East Asia tightened access to finance. As a result, a few textiles firms found themselves in financial distress.

The impact of the crisis may have been exacerbated by the 32 per cent appreciation of the Loti against the Dollar in the last three quarters of 2009. Since buyers are invoiced in Dollars and pay in Dollars, an appreciation of the Loti implies a loss in revenue against the same level of costs when denominated in Maloti.

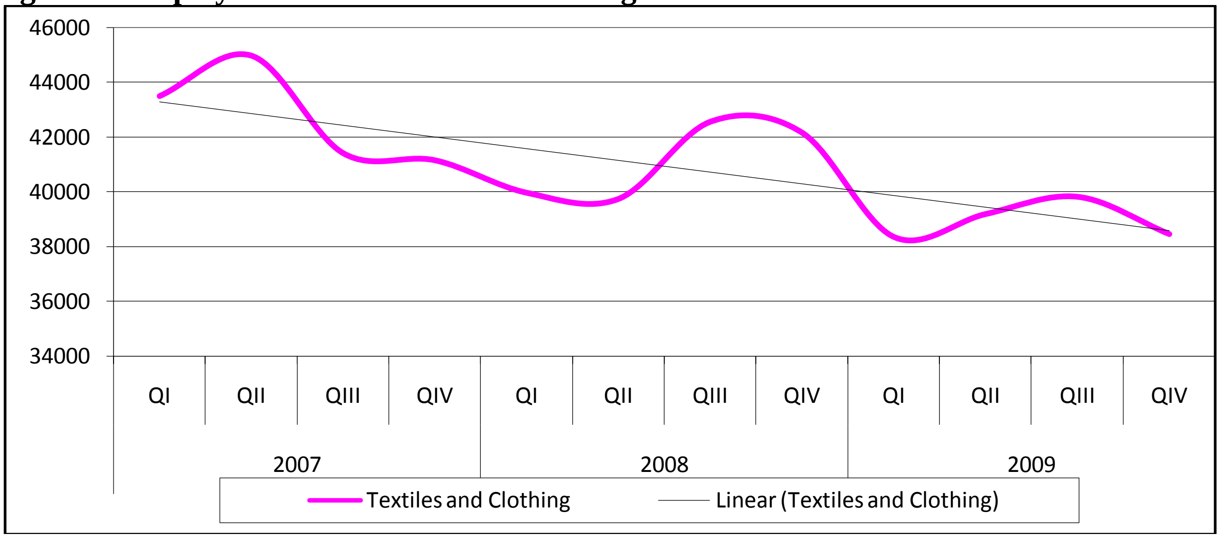
Figure 1: Manufacturing and its Subsectors (Million Maloti)



Data Source: BOS

Employment in textiles and clothing firms was volatile in the past three years but the overall picture reflects a negative linear trend as shown on Figure 2 below. The volatility may be accounted for by the seasonality in sales orders but the decline over the long-run is explained by the factors as stated above. Employment in 2009 closed the year at its lowest since 2005 at 38437. The biggest decline was mainly on textiles and apparel producing firms, whose products are destined for the US.

Figure 2: Employment in Textiles and Clothing



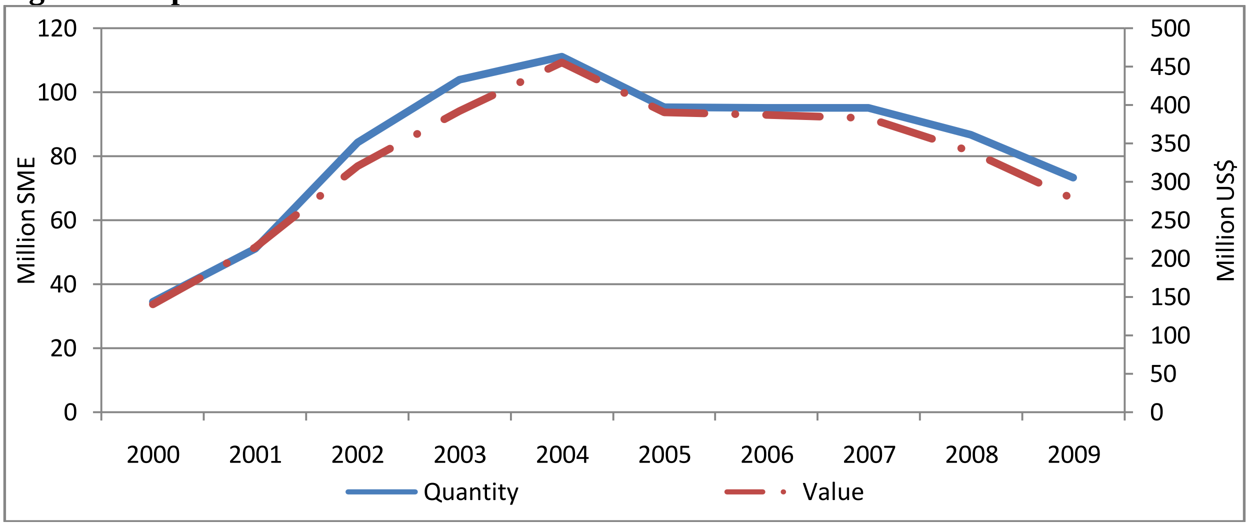
Data Source: LNDC

The second half of the year 2009 saw four firms closing shop in the textiles and clothing subsector, representing a loss of 1191 jobs. With one big company already confirmed to cease its operations at end of February 2010, an additional 2700 jobs will be lost. This will bring the total number of job losses to 3891 excluding jobs lost by other companies as a result of cutting down on operations.

Nonetheless, the closures mean more factory space created, and on a brighter side, about three firms have already occupied the empty factory shells. These new companies are, however, too small to compensate for the lost jobs. Overall, only an additional 243 jobs were created against 3891 jobs to be lost by February. A lot more jobs are expected to be created by these new companies with time as they increase their operational capacity in the medium to long-run. This does not augur well for the Government's efforts to fight against poverty and to attain high, sustainable and broad based economic growth. It is expected that employment would remain under pressure in 2010 but a slow recovery may follow thereafter in response to the global economic recovery.

Exports of textile and clothing also suffered in the recent periods. As shown on Figure 3, the U.S. imports from Lesotho were prospering from 2000 until it reached the pinnacle in 2004. After 2004, there was a steady downward trend and this negative trend is discernible in both the quantity in square meter equivalence (SME) and values in million US Dollars. This decline in exports adversely affects the external sector position by contributing to deterioration of the current account balance. This, in turn, leads to a worsening overall balance which may result in running down official reserves thereby threatening the NIR target which is a tool used in maintenance of the Rand-Loti peg.

Figure 3: Exports to the US

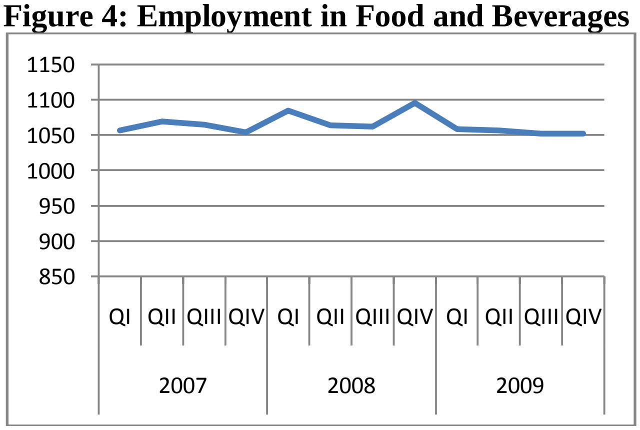


Data Source: Office of Textiles and Apparel (www.otexa.ita.doc.gov)

Food and Beverages

Food and Beverages industry comprises of manufacturing of meat, dairy, grain mill, bakery, beverages and other food products. As Figure 4 shows, food and beverages activity has been fairly flat since 2007 growing by an average of 1.9 per cent. It is the smallest activity in the manufacturing subsector both in terms of production and employment. Most of the production in the sector is meant for local consumption although a small portion is exported. This industry faces competition from South Africa and most products consumed in Lesotho are imported from South Africa.

Figure 4: Employment in Food and Beverages



Data Source: BOS

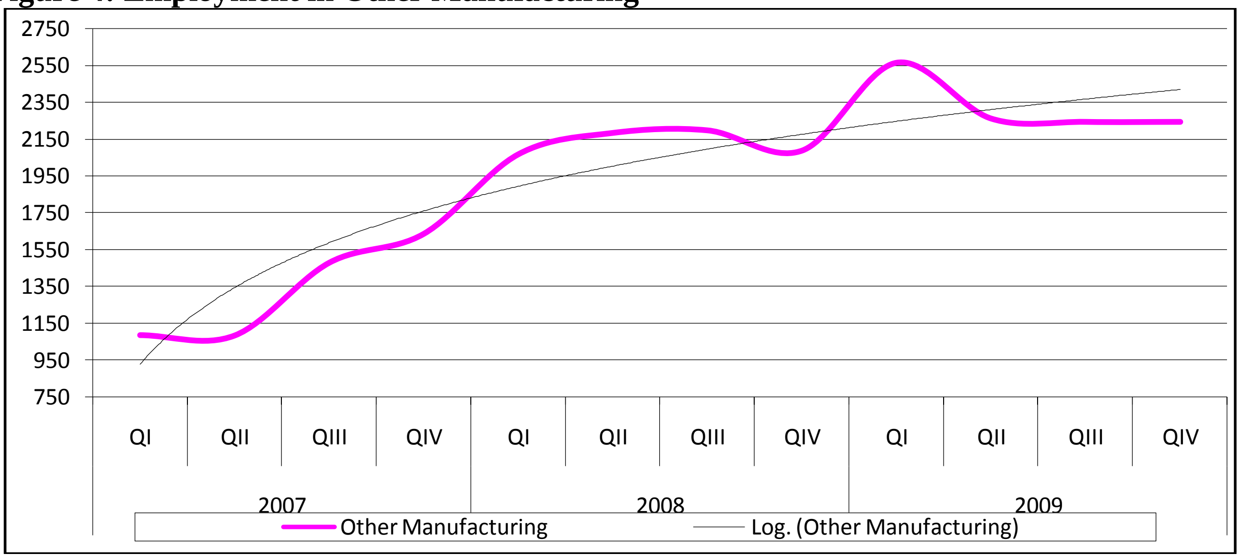
The food and beverages activity currently employs about 1052 workers and that represents about 2.4 per cent to the total employment in manufacturing, which is the least contributor. Employment in the industry was fairly flat in 2007 closing the year at 1054. However, 2008 saw employment increasing by 4.0 per cent and closing the year at the high of 1096. Employment declined in 2009 by about 4 per cent on an annual basis, closing the year at an estimated 1052 employees. This decline was driven mainly by a decline in production of food and beverage products due to the global economic recession related fall in demand.

Other Manufacturing

Other manufacturing activity involves production of pharmaceutical products, umbrellas, furniture, books and other printed matter, brooms and basketworks, energy saving bulbs, electronics and others. This industry is relatively small and most firms are still in an infantry stage. Other manufacturing activity registered a double digit growth since 2006 and is projected to have surpassed food and beverages in 2009 to become the second largest industry in the manufacturing subsector.

Other manufacturing activity is the second largest employer in the manufacturing subsector with about 2073 employees which represents a 5.5 percent share of the total manufacturing subsector. The industry has performed well in terms of employment, doubling in the previous ten years. The growth in employment has followed a logarithmic pattern as shown on Figure 4 below.

Figure 4: Employment in Other Manufacturing



Data Source: LNDC

Government Interventions

The Government has always supported the manufacturing sector, whether with tangible support like subsidies and other incentives or in negotiating concessions and other non tangible support. In response to MFA in 2005 and the loss of competitiveness thereof, the Government provided some tax incentives to the private sector, especially the export sectors. To deal with the situation and improve competiveness, the Government implemented a cut on company tax from 35 per cent to 25 per cent in April 2006. To further support manufacturing industries and to attract new investors, a 5 per cent preferential tax rate cut from 15 per cent to 10 per cent was effected at the same time. To help support the recovery in textiles and clothing industry and to encourage diversification of exports, a zero per cent company tax on income generated from exporting manufacturing goods outside of SACU was implemented.

Apart from the financial distress suffered by the textiles and clothing industry due to the financial crisis, another source of financial strain is the mismatch between cash inflows brought about by longer trade terms by buyers against shorter trade terms by raw material suppliers. In the bit to ease this financial strain and to address other problems facing exporters, the Government commissioned CBL to establish a Foreign Currency Fund (FCF) and to liberalise the current export financial scheme to accommodate both large scale and SMMEs exporters. This facility intends to reduce or eliminate the need for exporters to solicit funds from abroad. The proposed facility will take the form in which the Lesotho-based Authorised foreign exchange dealers will manage the fund (issue and track letters of credit, discount L/Cs against shipping documents, collect L/Cs from buyers etc).

The main benefit from the fund is that Lesotho will be in a position to reap full benefits of its export sector, as more value would be added domestically. Since the fund is inclusive, it may assist in the diversification process of the manufacturing sector. The financial institutions in Lesotho will also benefit from increased number of financial products.

The textiles and clothing industry faces massive exposure to exchange rate fluctuations as already alluded to above. To cushion the industry against the exchange rate fluctuations, the Government, along with other relevant parties, is in the process of establishing a stabilization fund which will hedge the risk. Another short term measure taken by Government was the bailout of one major firm in the form of acquisition of equity in the firm. Going forward, the Land Bill is expected to address the weakness of the Land Act which prohibits foreign investors from owning land in Lesotho.

Conclusion

Manufacturing subsector as a whole has been under pressure and this may continue going into the short to medium term. There are no major changes expected in food and beverages. Traditionally, concentration has relatively been on textiles and clothing but major interventions to revitalize the industry should be put in place.

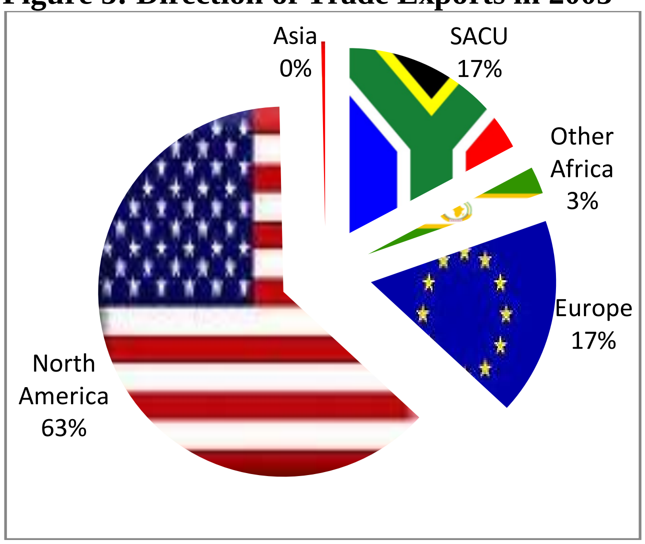
Textiles and apparel industry may have survived the past storms but it is clear that its competitiveness, going forward, may be threatened. The Government should therefore continue to support the industry and much focus should be on protection against the Asian giants. Other manufacturing has been performing well in the past and prospects are positive going forward. The question is, will the industry overcome the lack of factory shell constraint?

2. Prospects for Products and Markets Diversification of Exports in Lesotho

The structure of the export sector since AGOA has been characterized by dominance of textiles and apparel products and the US market being the main destination of the exports. The challenges faced in recent times have led to a major change in export market dynamics.

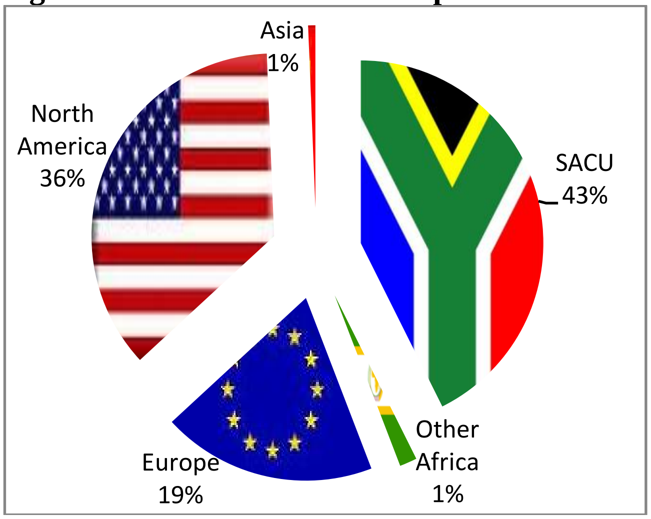
At its peak in 2005, the US market accounted for 63 per cent of the total export market in Lesotho while SACU and Europe were at 17 percent. However, in 2009 SACU is estimated to have increased to 43 per cent while the US is projected to have declined to 36 per cent of the total export market. With these recent changes, the option that the relevant authorities have is to explore other avenues in terms of diversification of markets and products.

Figure 5: Direction of Trade Exports in 2005



Data Source: CBL

Figure 6: Direction of Trade Exports in 2009



Data Source: CBL

Subsequent to the recent closures, there are three companies that occupied the vacant shells. One is in the traditional textiles and clothing production while the other two are in screen printing and printing of cigarette packaging businesses. There are two more firms which are currently in the process of registering. There is in total about 14 investors awaiting factory shells, out of which, 5 intend to expand and 9 are hot new prospects. These are companies that frequently knock on LNDC's door in request for factory shells and would start operations today if such space would be granted to them.

Apart from these investors, there are several others who have expressed some interest on investing in Lesotho. These hot prospects are expected to fill-in the empty shells and priority will be given to firms with new products (high value added products), more jobs to be created and markets other than the US. Since the factory space comes as a result of closures, priority will also depend upon different factory shells specifications by different firms.

Most of these prospective investors wish to invest in diverse sectors such as television assembly and energy-saving light bulbs which would diversify the economy away from high reliance on textiles exports. Some other vehicle assembly companies have also showed some interest in operating in Lesotho. One other important aspect about these firms to note is that, their target market is SACU, which is seen to be less volatile relative to the US. Apart from the diversification benefit that can be derived, there is also an indirect benefit in the form of agglomeration or clustering effect which can attract other firms on board.

These prospects are however constrained by financial resources to develop the minimum infrastructure platform and construction of factory shells. Even for those who want to build the shells themselves, they are constrained by the Land Act which prohibits foreigners from buying land in Lesotho. There are also not enough incentives for those investors to build factory shells on land that does not belong to them. The lack of factory shells is the most binding constraint and according to the LNDC, a number of investors had in the past moved to elsewhere in the region. This investment is estimated to cost M152.6 million and may increase employment by 3230.

Table 2: Selected Monetary and Financial Indicators

	2009		2010
	November	*December*	*January*
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	11.83	11.67	12.00
1.2 Prime Lending rate in RSA	*10.50*	*10.50*	*10.50*
1.3 Savings Deposit Rate	*2.11*	*2.05*	*2.05*
1.4 Interest rate Margin(1.1 – 1.3)	*9.72*	*9.62*	*9.95*
1.5 Treasury Bill Yield (91-day)	*6.99*	*6.94*	*6.94*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*5697.69*	*5744.69*	*5939.34*
2.2 Net Claims on Government by the Banking System	*-4348.79*	*-3996.00*	*-4663.78*
2.3 Net Foreign Assets – Banking System	*11152.62*	*10702.08*	*12162.27*
2.4 CBL Net Foreign Assets	*8166.44*	*7785.54*	*8664.40*
2.5 Domestic Credit	*-2496.74*	*-2136.21*	*-2767.70*
2.6 Reserve Money	*820.94*	*819.61*	*886.95*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	***7.5164***	***7.4632***	***7.4576***
4. Inflation Rate (Annual Percentage Changes)	***4.3***	***4.2***	***4.1***
5. External Sector (Million Maloti)			***2009***
	QII	***QIII***	***QIV+***
5.1 Current Account Balance	*339.97*	*-132.30*	*-366.04*
5.2 Capital and Financial Account Balance	*507.34*	*-501.16*	*1303.29*
5.3 Reserves Assets	*70.01*	*875.49*	*-368.78*

+Preliminary Estimates.
**Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho.*

Table 3: Selected Economic Indicators

	2006	*2007*	*2008*	*2009+*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	*6.6*	*2.3*	*4.4*	*1.9*
1.2 Gross National Product – GNI	*2.4*	*1.7*	*11.4*	*0.7*
1.3 Per capita –GNI	*2.3*	*1.6*	*11.3*	*0.7*
2. Sectoral Growth Rates				
2.1 Agriculture	*18.4*	*-14.0*	*6.3*	*1.1*
2.2 Manufacturing	*9.1*	*1.2*	*3.2*	*-1.3*
2.3 Construction	*-1.3*	*5.1*	*7.7*	*7.9*
2.4 Services	*5.7*	*2.5*	*4.0*	*2.7*
3. External Sector – Percent of GNI				
3.1 Imports of Goods	*80.5*	*87.8*	*82.8*	*78.7*
3.2 Current Account	*3.5*	*11.0*	*11.1*	*3.2*
3.3 Capital and Financial Account	*0.8*	*5.9*	*7.6*	*8.7*
3.4 Official Reserves (Months of Imports)	*1.2*	*5.0*	*8.9*	*10.4*
4. Government Budget Balance (Percent of GDP)	*42.8*	*43.1*	*43.3*	*48.1*

+Preliminary Estimates