Economic Review May 2011

European and US Debt Crises: Causes, Policy Responses and Implications for Lesotho's Economy……….

Introduction

Issues around debt crisis have recently been making news headlines at the global arena as the sovereign debt levels of some of the world economies have increased sharply, putting them at the risk of defaulting. Generally, an economy is said to be in a debt crisis when its government has defaulted on its debt. None of the countries that are currently in debt crisis have defaulted. However, they have very high government debt and their bond yield spreads in government securities have risen and consequently their sovereign credit ratings have been downgraded. A country in a debt crisis could, as a result, experience a sudden stop of foreign capital inflows due to eminent loss of investor confidence on the economy.

The ongoing debt crisis started with the collapse of the banking system in Iceland in 2008 and spread to some European countries including Greece, Ireland and Portugal in 2009. At the beginning of the latter half of 2011, news about the US debt crisis also erupted. This article is intended to provide an overview of the causes of these crises and policy responses thereon. In addition, the implications of these debt crises for the economy of Lesotho are highlighted.

The Causes of the European and US Debt Crises

These debt problems are attributable to pro-cyclical fiscal policy during the period preceding the financial crisis. The affected countries had been running large and unsustainable fiscal deficits for a number of years, financed mainly through borrowing. These deficits are said to have resulted from unsustainable welfare spending and uncompetitive factor markets. The Greek government is said to have used deficit spending to 'artificially' increase the living standards of the population as the deficit financed the unemployment social benefits, increased salaries of public employees and pensioners' earnings and hence served to sustain an uncompetitive labour market.

The global financial crisis that started in 2007 led to deterioration of government budgets. Some governments bailed out financial institutions that became insolvent following the burst of the housing bubbles in their economies. For example, before the financial crisis, the banking sector in Ireland had expanded substantially and earned immense profits through credit expansion and implicit government backing. The expansion of credit led to a housing bubble that fuelled the collapse of banks in 2007. In 2008, the Irish government guaranteed all bank liabilities and injected a lot of funds into its banking system. Iceland's entire international banking system collapsed in 2008 as a result of the global financial crisis. However, it has emerged less affected by the sovereign debt crisis because its government did not bail out the banking sector.

In addition, as the financial crisis translated into a global recession, expansionary fiscal policy was used to stimulate economic recovery. Governments in various economies of the world reduced taxes and increased spending to stimulate aggregate demand and take their economies out of the recession. This led to deterioration of fiscal budgets as government revenues had fallen as a result of the recession and led to further accumulation of debt.

The Greek government ran large fiscal deficits for several years. The financial crisis that began in 2007 and later on culminated into an economic recession exacerbated the situation. It hit Greece's largest economic contributors, tourism and shipping very hard, leading to declines in government revenue, which fell by 15.0 per cent in 2009. Portugal also faced the same challenges though its public debt levels are significantly lower than Greece's and its banking sector is comparatively more stable than that of Ireland.

In the case of the US, Standard and Poor's and Moody's credit rating services issued warnings that the US economy could be downgraded because of large fiscal deficits and increasing debt. The federal fiscal position deteriorated in the early 2000s from surpluses of the late 1990s, mainly reflecting expenditure increases related to the response to terrorist attacks, while revenue fell as a result of, amongst other things, the tax rate reductions implemented under the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. Together these two Acts reduced individual income tax rates, increased the child tax credit, phased out the estate tax, raised deductions for joint filers, increased benefits for pensions and individual retirement accounts, created additional benefits for education and also reduced business taxes. The US federal deficit widened sharply during the recession as a result of the automatic stabilizers and stimulus packages that were implemented to support the economy and the financial sector rescue measures including bail outs that were meant to revive market confidence. Finally in August 2011, Standard and Poor's credit rating agency lowered the US's long-term rating from 'AAA' to 'AA+', prompted by, amongst other things, the rising public debt burden.

The case of Ireland is different in that its economy was doing very well prior to 2008, supported by the growing banking sector and property market. At the beginning of the global financial crisis in 2007, Ireland's fiscal position was in surplus and general government debt was only 25.0 per cent of GDP.

Table 1: Selected Economic Indicators (In per cent of GDP, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011*
Ireland						
Fiscal Balance	2.9	0.1	-7.3	-14.3	-32.4	-10.6
Current Account Balance	-3.6	-5.3	-5.6	-3.0	-0.7	0.5
Public Sector Debt	24.8	25.0	44.4	65.6	96.2	111.1
Public Sector Debt-to-Revenue Ratio	68.5	69.9	129.2	194.1	278.8	318.6
Greece						
Fiscal Balance	-6.1	-6.7	-9.8	-15.5	-10.4	-7.6
Current Account Balance	-11.2	-14.4	-14.7	-11.0	-10.4	-8.2
Public Sector Debt	106.0	105.0	111.0	127.0	143.0	153.0
Public Sector Debt-to-Revenue Ratio	271.8	262.5	277.9	340.5	365.5	404.7
Portugal						
Fiscal Balance	-3.9	-2.6	-2.7	-10.1	-9.1	-5.9
Current Account Balance	-10.1	-9.9	-12.6	-10.9	-9.9	-9.9
Public Sector Debt	64.7	68.3	71.6	83.0	93.0	106.4
Public Sector Debt-to-Revenue Ratio	152.6	165.9	174.1	209.0	223.9	254.8
Unites States						
Fiscal Balance	-1.9	-1.2	-3.2	-11.4	-9.6	-9.3
Current Account Balance	-6.0	-5.1	-4.7	-2.7	-3.2	-3.2
Public Sector Debt	61.0	62.2	71.2	84.2	93.2	99.0
Public Sector Debt-to-Revenue Ratio	180.47	184.02	218.4	273.38	302.6	318.33

Source: IMF staff reports, various issues.

** IMF projections*

The Irish banking sector came under severe pressure in 2008 due to the global financial crisis and its high exposure to the Irish property market. These resulted in a substantial erosion of confidence and, in turn, to a loss of deposits and market funding. In an attempt to strengthen the banking sector and resuscitate confidence, government injected substantial capital and provided guarantees. Nonetheless, market pressure continued to pose challenges to large roll-over needs, thus threatening solvency of the banking system and putting more pressure on government's finances. The recession exacerbated the impact of the banking sector crisis on the fiscal position.

Policy Responses to the Debt Woes by the Affected Economies

The debt difficulties could have devastating effects on the highly indebted European economies and the US. To protect these economies, their governments, with the assistance of the European Union (EU) and the International Monetary Fund (IMF) are taking measures to lessen the impact and to try to restore debt levels to sustainable paths.

EU member countries have put together a rescue package to the tune of €110 billion to help prevent Greece from defaulting and avoid contagion to other European countries. This assistance came with conditionalities including that Greece had to implement austerity measures to contain the high level of debt. The austerity measures, aimed at reducing government expenditure and increasing revenue, were not well received by the people of Greece, who, in response, engaged in violent protests. The austerity measures include (i) reduction of public employment by attrition, reductions in contract employment and involuntary redundancies as well as public sector wage reductions; (ii) closure, merger and/or privatization of some public entities and agencies; (iii) streamlining and better targeting of social benefits; (iv) elimination of tax exemptions and scaling back on preferential tax regimes; (v) strengthening enforcement of tax laws.

In addition, the EU is providing financial assistance to its member countries through the European Financial Stability Facility (EFSF) to maintain financial stability in times of crisis. In July 2011, the leaders of the euro area countries agreed to provide additional financing amounting to €109 billion as a second bailout to Greece under the EFSF. In addition, the financing terms for Greece under the EFSF were improved by extending the maturity of current and future loans from 7.5 years to a minimum of 15 years and reducing the interest rate on them from 5.5 per cent to 3.5 per cent going forward. The improved loan terms would also be extended to Ireland and Portugal, which also have programs with the EU and the IMF.

Portugal also implemented some austerity measures to cut fiscal spending and increase revenue. Some of the policies implemented by the Portuguese government include, pay cut for senior public sector staff and politicians and increases on various types of taxes including Value Added Tax (VAT), income and profits taxes, amongst others. In addition, Portugal requested financial assistance from the IMF to the tune of $26 billion under the Extended Fund Facility (EFF) to cover its external financing gap arising from its external debt profile and gradual adjustment of the current account deficit. The IMF assistance would cover two-thirds of the financing gap while the balance would be covered by the EU.

Ireland also implemented a number of consolidation measures to contain the fiscal deficit and reduce government debt. Policies for raising more revenue included, inta alia, lowering personal income tax bands, reducing pension tax relief, other pension related deductions as well as introduction of a property tax. Government expenditure would be cut by reducing expenditure on social protection and reducing public service employment, public service pensions and capital expenditure. To address the major source of Ireland's fiscal difficulties, government injected a lot of capital into the banking system and provided it with guarantees. Nevertheless, the banking sector still faces severe vulnerabilities and measures are being taken to downsize, recapitalise and reorganize it. There came a time when banks could not raise funds any more and government bonds were no longer attractive to investors. The Irish government then approached the IMF and the EU for financial assistance, which was granted at the beginning of 2011.

In the US, the debt ceiling, which is the statutory limit of the amount of indebtedness that the US government can have, was raised from $14.3 trillion to $16.4 trillion. This reduced uncertainty in the markets and boosted US fiscal credibility. It prevented the US government from defaulting on its debt repayments and also gave it space to avoid abrupt fiscal adjustment and severe economic disruption. In addition, the US government will take measures to cut the federal budget deficit by around $2.5 trillion over the next decade.

Implications for Lesotho's Economy

Fiscal consolidation measures that are being implemented by debt-crisis-hit European countries and the US will reduce aggregate demand and hence economic growth at a time when expansionary fiscal policy should play a significant role in moving these economies towards full recovery from the global economic recession. The positive effects of fiscal stimuli which these economies implemented to ignite recovery are fading and no more stimulus packages are possible under the prevailing circumstances. In the short to medium term, this could derail economic recovery and/or get these economies back into recession.

The possible economic slowdown in the US and highly indebted European economies presents negative implications for Lesotho. The US is the major destination for Lesotho's exports of clothing and textiles, which were negatively affected by the global recession and have up to now, not started to show any signs of recovery. The possible economic slowdown in the US imply that it could take much longer for Lesotho's exports of textiles and clothing to recover to pre global recession levels, especially given the high unemployment and subdued personal consumption in the US. It could also put additional negative pressure on employment in the textiles and clothing manufacturing sector in Lesotho.

The European market is the major destination for Lesotho's exports of rough diamonds. However, rough diamonds from Lesotho are mainly exported to Belgium and not to any of the debt-crisis-hit economies. In addition, developments during the recent global recession have indicated that commodities, specifically minerals like gold and diamonds, tend to flourish during crises because of their use as *safe havens*.

However, the financial assistance that these economies are receiving from the EU and the IMF should help mitigate the negative economic impact of the debt crisis and give these economies room to adjust smoothly and avoid severe economic disruption. In addition, in the medium to long term, these countries could benefit from fiscal consolidation and economic reform measures that could strengthen their fiscal positions and economic growth.

2. Analysis of the Ease of Doing Business in Lesotho: Making a Difference for Entrepreneurs.

Lesotho slipped by 8 points to 138 in 2011 from last year's World Bank ranking of doing business despite some business reforms that have taken place recently………..

Background

The vibrant business environment enabled by non-restrictive regulations plays a central role in promoting entrepreneurship and national competitiveness, which are conducive for rapid and sustainable growth. It is in this regard that the World Bank (WB) annually publishes the Doing Business Reports (DBRs) which use quantitative indicators on regulations to rank countries according to the ease of doing business. The DBRs generally investigate regulations promoting and constraining business activity.

This article reviews Lesotho's performance in doing business and compares her with other Southern African Customs Union (SACU) members. It highlights economic reforms instituted in the last three years and analyses the implications of Lesotho's business climate on its economy.

A Review of Doing Business in Lesotho

The DBR's aggregate ranking on the ease or otherwise of doing business is based on indicators that measure and benchmark regulations affecting nine processes in the life cycle of a business. The nine processes are starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. A country's performance on each of the nine processes determines its overall position at the global level.

At the aggregate level, Lesotho's doing business ranking has deteriorated after 2007. It was in position 116 in 2006 and improved to position 114 in 2007. Nonetheless, it slid to positions 130 and 138 in 2010 and 2011, respectively. At this level Lesotho has performed badly compared to other SACU member states (South Africa (SA), Botswana, Namibia and Swaziland). It is important to mention that SA, Namibia and Botswana are among the top 70 good performers in terms of ease of doing business in 2011 at the global level.

We now assess Lesotho's performance on each of the nine areas. The first process is that of staring a business. The starting a business indicator describes the bureaucratic procedure and legal hurdles faced by an investor or entrepreneur when registering a new business. To start a business in Lesotho, there are 7 procedures involved, namely: company name search, hiring a legal practitioner, obtaining a land lease, inspection for health safety, applying for operation licence and tax registration, opening a bank account and filing a workman's compensation with an insurance firm. There are also 40 days to legally start a business and 12.0 per cent of per capita income for minimum required capital to start a business. These sub-indicators remained unchanged from last year. Nonetheless, the cost of starting a business, as a percentage of per capita income, improved slightly by one percentage point to 26.0 per cent in 2011. In 2009, a one-stop shop for business registration was opened and it simplified the processes for starting a business. This reduced the time required to start a business by 1 month.

With regard to processes and procedures involved in building a warehouse the number of procedures and time taken to obtain the construction permit are 15 procedures and 601 days, and they have remained unchanged since 2010. In addition, it takes about 270 days to connect to electrical power services with a cost of M14, 000. Moreover, 180 days are taken to request and obtain a lease from the Ministry of Home Affairs and to obtain telecommunications connections. The cost for the lease is M1, 200 and M500 is for telecommunications connection.

Formal property rights are fundamental to entrepreneurship and investment growth and also promote access to credit for entrepreneurs. In this area, Lesotho's performance deteriorated by 4 points from 142 in 2010 to 145 in 2011. The decline in this indicator, despite land reform in 2010, shows that other economies surveyed among the 183 countries improved property registration relatively faster than Lesotho. The number of procedures, time in days and the cost required to register the property have all remained unchanged from 6 procedures, 101 days and 8.0 per cent of the total property value, respectively.

The indicator on getting credit measures the efficacy of collateral and bankruptcy law in facilitating lending and credit information registries. In this area, Lesotho is in position 128 having lost 3 ranks from 2010. All other SACU members outperformed Lesotho in this category. Nonetheless, the Financial Institutions Bill 2011 is expected to improve access to credit in the country by providing a framework for the establishment of a credit bureau. In addition, the 2010 Land Bill facilitates access to and extension of credit as it enables the use of land as collateral.

The area on protecting investors deals with protection of shareholders' against the misuse of their assets by directors for their personal gain. It specifically takes into account the laws that regulate the extent of directors' powers in the asset portfolio of the investors. Lesotho lost 1 rank for this indicator in 2011 from rank 146 in 2010. The strength of investor protection index remained unchanged at 3.7 out of 10 from 2008 to 2011. The index measures the extent of disclosure, ability of minority shareholders to sue directors for damages and access by shareholders to documents and other evidence for trial.

Tax systems and polices affect the level and rate of entrepreneurship, infrastructure and services which, in turn, promote economic growth. The indicator on paying taxes takes into account taxes and obligatory contributions that a medium-sized firm must pay as well as measures of administrative burden in paying taxes. Lesotho has made several reforms in this area. For example, the tax burden on companies was reduced by simplifying the tax structure and rates in 2008. In terms of paying taxes, Lesotho is position 64 and has outperformed Namibia at position 99.

Open borders for trade and removing barriers to trade boost firms' competitiveness, and hence economic growth. Lesotho improved by 4 ranks to 140 in 2011 from 144 in 2010 in this area. On the one hand, it takes 6 and 8 documents to export and import, respectively. The time to export has been reduced by 13 days to one month in 2011 while to import, it takes 35 days in 2011 compared with 49 days in 2010. On the other hand, the cost of exporting one container has increased by US$131 from 2010 to US$1680 in 2011, while the cost of importing has declined from US$1715 in 2010 to US$1610 in 2011. Comparatively, Lesotho ties with Botswana in the number of documents used in exporting while it performs better than other SACU economies. It costs lesser for Lesotho to import than any other SACU member. However, only SA, among SACU members, is cheaper in terms of export cost than Lesotho.

Efficient court functions are fundamental for smooth enforcement of contracts. Under the enforcing contracts indicator, Lesotho's rank remained at 116 from 2010 to 2011. The sub-indicators show that the number of procedures, the time in days and cost taken to enforce contracts as percentage of claim remained at 41 procedures, 785 days and 19.5 per cent of claim from 2008 to 2011, respectively. For the time taken to enforce contracts and for trial and judgement it takes about 560 days. The attorney cost as percentage of claim is 9.9 per cent.

Lesotho's performance on processes involved in closing a business improved by 4 points from position 73 in 2010 to 69 in 2011, mainly as a result of the increase in the recovery rate (measured as cents on the dollar recouped by creditors through the bankruptcy, insolvency or debt enforcement proceedings). There was no change in time and cost of closing a business as a percentage of estate. They remained at 2.6 years and 8.0 per cent of estate from 2008 to 2011, respectively.

Implications for Lesotho's Economy

Even though Lesotho was outperformed by other SACU member countries at the aggregate level, she did better than some of them in some of the nine processes. Lesotho performed better than all other SACU members for the indicator, trading across borders. It also performed better than Swaziland on starting a business, registering property and enforcing contracts. She also performed better than Namibia on paying taxes and South Africa in closing a business.

Lesotho's good performance on trading across borders could have a positive effect on the manufacturing subsector, which is one of the largest contributors to economic growth in Lesotho. The favourable number of documents required and time taken to ship cargo across borders and port clearance could stimulate increased manufacturing activity. This could contribute to more employment of Basotho, increasing export earnings and contributing to economic growth.

The slow implementations of policies that are expected to facilitate and support business activity remain the largest problem in Lesotho. Currently, Central Bank of Lesotho is in the process of coming up with a law for the establishment of a credit bureau. The absence of the credit bureau does not bode well for growth of the business sector as it hinders credit extension. This is because of lack of information about creditworthiness of individuals. The relatively poor performance of Lesotho in terms of access to credit indicator makes it harder for entrepreneurship to emerge and thrive. This has serious implications on economic growth and welfare of the majority of aspiring business people.

In addition, the deterioration of the country's performance in the ease of doing business relative to fast reforming economies makes Lesotho less competitive globally. For example, if Lesotho's performance continues to deteriorate and that of its competitors such as China and India improves, Lesotho is likely to lose export revenues. The slow pace of regulatory reform and deterioration in investment climate in Lesotho hamper the growth of Small and Medium Enterprises (SMMEs). Lesotho's financial sector is relatively underdeveloped, with the banking system dominated by three SA –owned banks and one post bank, which is owned by the government. These banks provide little finance to SMMEs but limit their extension of credit to established businesses with which they have long standing financial relationships. The functioning of the Credit Bureau when it does become operational will alleviate this problem as it will provide information for assessing credit worthiness of enterprises.