Economic Review **February 2007**

Diamonds Mining in Lesotho: Implications and Challenges

Following the opening of two diamond mines in Lesotho, the mining sub-sector is set to play a crucial role in the Lesotho economic growth process. However, there are a number of challenges that face the country for this growth to reduce poverty……….

Introduction

Recent empirical literature on the relationship between natural resource abundance and economic growth has raised concerns on the validity of the economic theory proposition that natural abundant economies have better prospects for economic growth and hence poverty reduction compared with resource poor countries. Resource based economies are defined as those in which natural resources account for more than 10 per cent of Gross Domestic Product (GDP) and 40 per cent of exports.

Empirical findings show that in general natural resource abundant countries' have not performed better than resource poor countries. However, there have been some exceptions such as the case of Botswana. A number of reasons have been advanced for these empirical findings. First, natural resources induce dependence on the single commodity increasing the country's vulnerability to external shocks as prices of these commodities are determined internationally and tend to be volatile.

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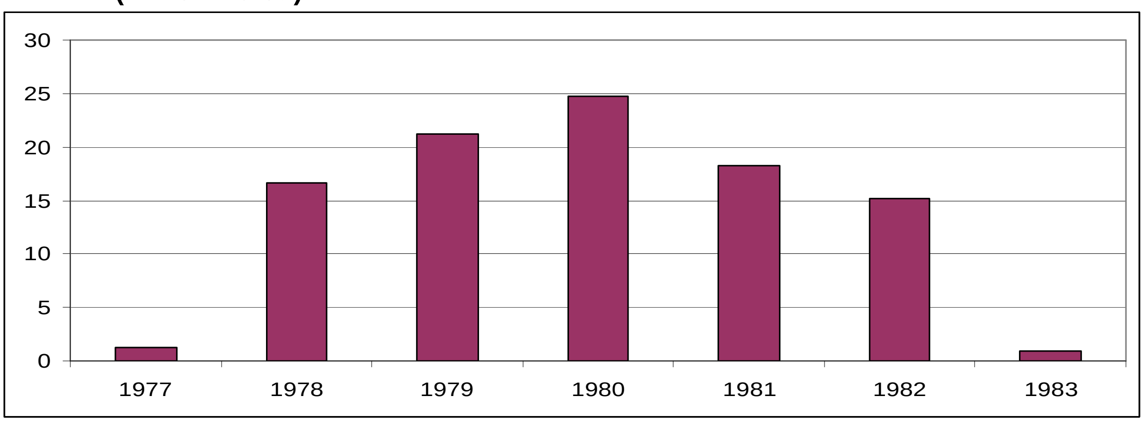
Secondly, prospective rents from the mining of natural resources have potential to motivate stakeholders to seek private enrichment to the detriment of socio-economic development. Thirdly, the increased inflow of export earnings increases a country's real exchange rate. This reduces export competitiveness while, at the same time, rendering imports cheaper than domestically produced goods. A phenomenon known as Dutch disease.

Historical Background of Mining in Lesotho

Diamond mining is not a new phenomenon in Lesotho as it dates back to the late 1970s when the Letseng la terai diamond mine was opened by De beers (PTY) LTD. Although the mine contributed significantly to economic growth, it was closed only after six years due to non-profitability. Figure 1 below shows data on Lesotho diamond exports during the period 1977-1983. Mining production reached its peak in 1980 exporting diamonds to the value of M24.7 million. Subsequent to the closure of the mine, mining operations in the country continued in small operations, mainly in the form of individual Basotho diggers. There are other resources being mined in Lesotho including sandstone, granite and sand. The production of these resources has been minimal and has not comprised a significant portion of exports. A major constraint for exporting these resources especially sandstone is its substantial weights which affects its price and hence competitiveness.

Figure 1: Diamond Exports
(Million Maloti)



Source: Lundahl, Patterson and McCarthy (2003)

Implications on the Lesotho Economy

The coming into operation of the two diamond mines, Lets'eng and Liqhobong diamond mines has enhanced prospects for Lesotho's economic growth. Domestic output has increased, partly driven by the extraction of diamonds. Data on diamond production indicates that production rose by 83.7 per cent and 103.8 per cent in 2005 and 2006 respectively. In 2006, diamond production was estimated at 97 047 carats. The mining and quarrying sub-sector accounted for 7.0 per cent of GDP during the same period. The sub-sector is expected to continue to grow as mines move to their sustainable levels of production. Table 1 below shows the performance of the mining and quarrying sub-sector for the period 1996-2006. Furthermore, two more mines are expected to be opened in the medium- term. Since the mines are situated in the rural areas, they are likely to attract Government investment in infrastructure such as roads, electricity and water into the areas. The mining companies have employed a number of Basotho. The employment opportunities have been for the rural unskilled population and different cadres at professional level which includes engineering, accounting, legal advisers,

Table 1: Performance of Mining and Quarrying

Year	Output (Million Maloti)	Real Growth (Per cent)
1996	2.9	-9.7
1997	3.6	16.7
1998	3.9	-25.7
1999	4.8	3.8
2000	7.6	18.5
2001	9.1	6.2
2002	10.0	2.9
2003	11.7	5.7
2004	174.7	1955.1
2005	425.9	139.2
2006*	632.0	40.0

Source: Bureau of Statistics
*CBL Projection

administration and general services. If the activities are sustained, this could encourage Basotho students to specialise in mining related fields. Therefore, mining activities are likely to enhance the welfare of the nearby rural communities and hence contribute towards poverty reduction.

In addition, the exports of diamonds have boosted Lesotho exports and the balance of payments (BOP) position. This has provided the country with foreign exchange which is necessary to sustain imports by the private sector. Export earnings are repatriated back into Lesotho to finance viable projects through the banking system. The Government is also entitled to diamond royalties and dividends from the mines. The current royalty rate is 8 per cent. This development signals an important step towards diversifying away from customs revenue which is expected to begin to decline in line with the tariff reductions brought about by free trade agreements and World Trade Organisation (WTO) obligations.

Challenges in the Face of Resource-based Growth

There are a number of challenges that face Lesotho in light of the resurgence of the diamond mining industry. First, the government has to develop measures to ensure that the expected growth due to mining activities contributes towards poverty reduction. Thus it is important that mining activities are integrated into the Poverty Reduction Strategy (PRS). Second, the Government has to ensure that mining companies undertake their social responsibilities particularly to the areas and communities that they are operating in. This would ensure that the welfare of the communities is uplifted. In addition, mining companies must adhere to international environmental standards. Third, it is important that skills development and transfer occurs in the mining sub - sector. This can be done in two ways; a clear rollout plan for Basotho to fill all positions in the sector may encourage students into mining-related fields. It is only when there is enough expertise in the area that supporting industries may emerge. Last, if the mining sub - sector grows to significant levels, Lesotho would be vulnerable to external shocks due to sharp declines in the commodity prices. Thus, it is important that the stabilisation fund is established to cushion the economy against such an eventuality.

Conclusions

There is evidence that Lesotho may be heading for the resource-based growth in few years. The integration of activities in the mining sector into PRS would ensure that this growth is transformed towards the poor. Furthermore, the emergence of significant mining activity provides an anchor for diversification of the Lesotho economy.

2. South African Budget Speech: Some Implications and Lessons for Lesotho

South Africa's budget for 2007 poses implications and valuable lessons for Lesotho…

The Minister of Finance in South Africa (SA) presented the 2007/08 budget before Parliament on 21st February 2007. SA is expected to register a budget surplus equivalent to 0.6 per cent of GDP in 2007/08 compared to the 2006/07 outturn of 0.3 per cent of GDP. The anticipated budget surplus is mainly due to excess growth of tax revenue. The SA government intends to use the surplus to consolidate its savings. A healthy government financial position is important towards mitigation of shocks which is common in most developing countries. The budget is expected to facilitate economic growth equivalent to an average of 5.1 per cent during the period 2007-2009 compared with 4.9 per cent registered in 2006. The strong economic performance in SA could have positive implications for the economy of Lesotho. First, this could imply a stronger demand for Lesotho exports destined to that country. About 27.1 per cent of Lesotho exports is destined to SA. Second, this could boost the region's competitiveness to foreign investors and firms targeting South African market to establish in Lesotho.

The budget projects inflation, at an average of 5.3 per cent in 2007/08 against that of 4.6 per cent observed in 2006/07. Thus, CPIX is expected to be within the South African Reserve Bank (SARB) target band of 3 to 6 per cent over the medium term. This implies that inflation in Lesotho will also remain on a single digit during the same period. Continued low inflation bodes well for both investors and consumers' decision making processes.

The budget further announced relaxation of exchange controls in line with the continued gradual approach on liberalisation of exchange controls which has taken place for a number of years. It is believed that further relaxation of exchange control would allow South African firms to diversify their investments through domestic and international channels. The Minister lowered the current shareholding threshold for foreign direct investment (FDI) outside Africa from 50 per cent to 25 per cent in order to enhance South African companies to engage in strategic international partnerships. In addition, the Customer Foreign Currency (CFC) accounts were simplified to allow a single CFC account for trade and services payments and expanding the range of permissible transactions. Lesotho also allows its exporters to open CFCs in order to manage the exchange rate risks.

Lessons from the South African Budget

A number of lessons can be drawn from the South African budget for 2007. The South African Revenue Services (SARS) continued to out-perform the set revenue targets. During the fiscal year 2006/07, SARS collected an amount equivalent to R476.0 billion. This was in excess of the previous budget by R29 billion. The exceptional performance is attributable to a number of measures implemented by SARS, such as cutting compliance costs, enhance services, and improve tax and customs administration. Thus there are important lessons to LRA in enhancing their effectiveness in revenue collection.

SA and Lesotho are concerned about enhancing educational programme. The Minister budgeted R8.1 billion for the next three years to hire additional teachers coupled with improvement in the remuneration levels of teachers. The budget indicated that R700 million is set aside for bursaries for teachers to encourage young people to train as teachers and to pursue carriers in public schooling system. The 2007/08 budget also put aside R2.2 billion to support universities to meet their objectives of increasing enrolment and producing more graduates on science, engineering and technology. The Lesotho budget also afforded high priority to the education sub-sector and increased its budget in 2005/06. The continuation of the Free Primary Education (FPF) programme, provision of loan bursaries for tertiary education and partial introduction of basic education are set to continue to play an important role in Lesotho.

The 2007/08 budget also put emphasis on the development of infrastructure. A significant allocation was made towards the development of public transport, national electrification, water and sanitation and 2010 soccer world cup stadiums. This is in harmony with Lesotho's PRS and the Medium Term Expenditure Framework (MTEF) which identifies infrastructural development as a vehicle towards poverty reduction. As for the 2010 soccer world cup, it is important that Lesotho positions itself such that she can reap some positive leakages from SA hosting such an event.

3. Monetary Policy Operations Report for February 2007

During the review period, monetary policy operations undertaken were successful in attaining their desired objectives. The primary objective of monetary policy is to achieve price stability. This is done through maintenance of adequate level of Net International Reserves (NIR). The adequate level of reserves ensures that the parity between the Loti and the Rand is maintained. The Central Bank of Lesotho Monetary Policy Committee (MPC) sets the quarterly target for NIR. The target for January to March 2007 is $400-$450 million.

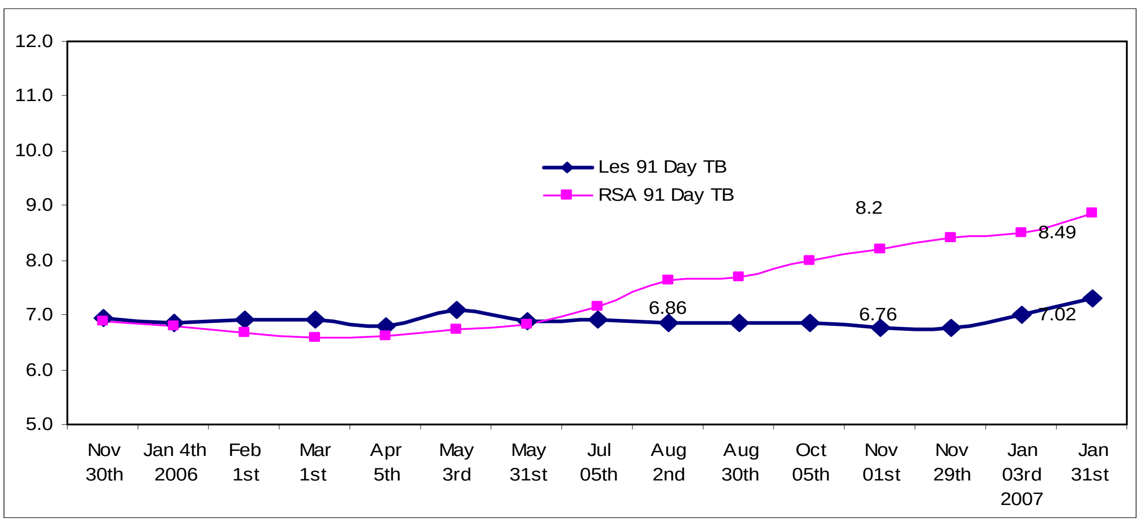
CBL uses Open Monetary Operations (OMO) to achieve the stated monetary policy objectives. Table 2 shows amounts auctioned and discount rates that prevailed for each of the auctions. The February auction was fully subscribed and as a result, the whole auction amount to the tune of M170.0 million was issued. The level of competitiveness in the market, as estimated by the number of participants in an auction, declined during the recent auction. In February, there were 8 bidders who submitted 27 bids for the auction and all bidders became partially successful.

Table 2: Treasury Bills Auctions

Type of Security	Auction Date	Auction Amount (million)	Amount Issued (million)	Discount Rate
91-day TBs	01 Nov 2006	M170.0	M170.0	6.76%
182-day TBs	08 Nov 2006	M50.0	M16.5	7.00%
91-day TBs	29 Nov 2006	M170.0	M170.0	6.76%
91-day TBs	03 Jan 2007	M160.0	M160.0	7.02%
182-day TBs	09 Jan 2007	M50.0	M50.0	7.30%
91-day TBs	31 Jan 2007	M170.0	M170.0	7.30%

During the month under review, the Lesotho 91-day treasury bill remained below that of its SA counterpart rate. It is noteworthy that the margin between the two rates is beginning to narrow. In February, the Lesotho 91 day treasury bill increased by 28 basis points to 7.30 per cent. The counterpart South African rate continued to rise from 8.49 per cent in January 2006 to 8.87 per cent in February 2007. Although the Lesotho rate increased the margin continued to widen. It widened from 147 basis points to 157 basis points at the end of the review period.

Figure 2: Measuring the Success of Monetary Policy Objectives



4. Inflation Developments in December 2006

Increases in food prices slowed down in December

The rate of inflation as measured by changes in the Consumer Price Index (CPI) slowed down to 6.4 per cent in December 2006 due to the observed decline in the international price of crude oil during the fourth quarter of 2006. International oil prices have been the major driver of inflation in the region.

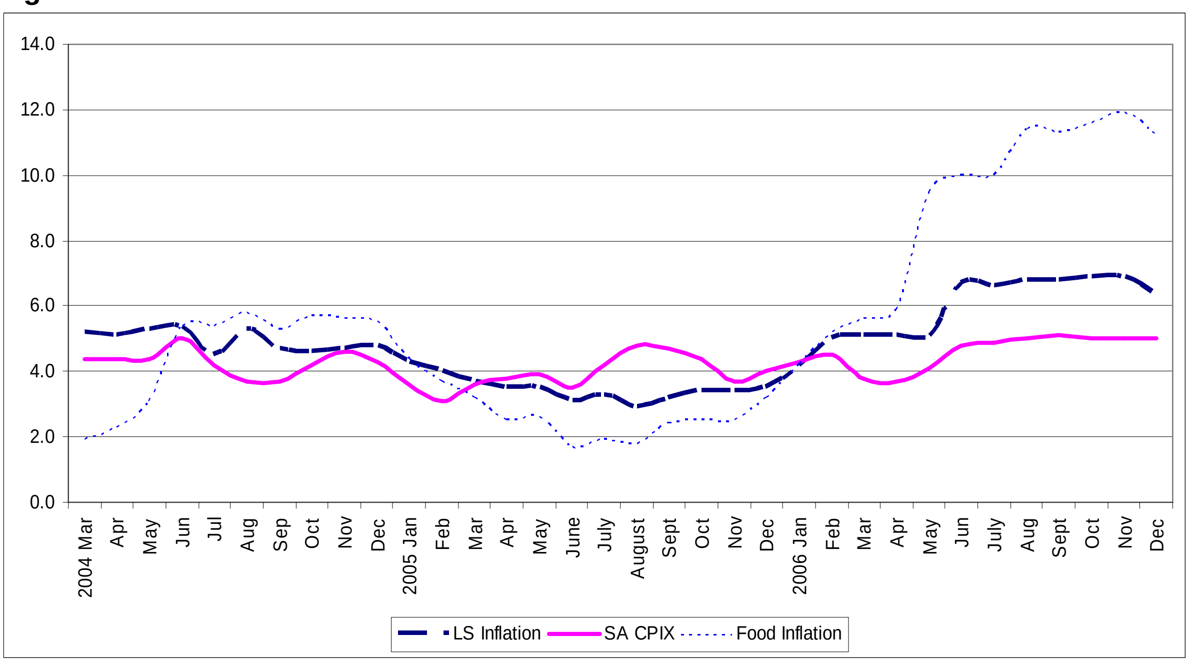
The food and non alcoholic beverages category which in terms of weight constitutes about 39.3 per cent of the CPI slowed down from a rate of 11.9 per cent in November to 11.2 per cent in December 2006. Other categories of the CPI showed some decline during the month.

As shown in Figure 3, inflation in Lesotho remained in line with those in South Africa as the bulk of Lesotho's inflation is imported from South Africa. Inflation rate in South Africa measured by changes in the CPI excluding interest rates on mortgage bonds (CPIX) remained at 5.0 per cent in December. The same rate has been registered in the past two months.

Table 3: Inflation
(Annualised Percentage Changes; April 1997=100)

	Weights	Nov-06	Dec-06
All items	100.0	6.9	6.4
Food and non alcoholic beverages	39.3	11.9	11.2
Alcoholic beravages and Tobacco	6.4	5.6	5.5
Clothing and footwear	15.6	0.5	0.4
Housing, electricity gas and other fuels	3.7	7.8	7.5
Furniture, households equipment & routine maintanence of house	17.0	3.4	2.9
Health	1.4	0.3	0.1
Transport	7.8	3.9	3.7
Communication	0.1	3.4	3.4
Leisure,entertainment & culture	1.2	-0.6	-0.6
Education	3.2	0.9	0.9
Restaurants and Hotels	0.4	15.2	15.0
Miscellaneous goods & services	3.2	3.2	2.5

Figure 3: Annual Inflation



5. Selected Monetary and Financial Indicators+

	2006		2007
	Nov	**Dec**	**Jan**
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	12.69	13.50	13.58
1.2 Prime Lending rate in RSA	12.00	12.00	12.50
1.3 Savings Deposit Rate	1.84	2.68	2.68
1.4 Interest rate Margin(1.1 – 1.3)	10.85	10.82	9.90
1.5 Treasury Bill Yield (91-day)	7.16	7.05	7.30
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2532.40	3505.80	3476.78
2.2 Net Claims on Government by the Banking System	-1751.00	1498.76	2062.88
2.3 Net Foreign Assets – Banking System	6376.99	6149.69	6815.00
2.4 CBL Net Foreign Assets	4460.29	4377.24	4950.54
2.5 Domestic Credit	-839.21	-576.82	-1060.21
2.6 Reserve Money	465.51	490.92	409.89
3. Spot Loti/US$ Exchange Rate (Monthly Average)	7.2400	6.9930	6.0958
4. Inflation Rate (Annual Percentage Changes)	6.9	6.4	6.0
5. External Sector (Million Maloti)		**2006**	
	QII	**QIII**	**QIV**
5.1 Current Account Balance	256.41	151.78	18.88
5.2 Capital and Financial Account Balance	-154.91	-23.94	-81.15
5.3 Reserves Assets	-442.82	-641.50	-32.81

+Indicators at the end of period. 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.

6. Selected Economic Indicators

	2003	2004	2005	2006*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	2.7	4.0	2.9	6.2
1.2 Gross National Product – GNI	6.0	6.1	4.0	7.1
1.3 Per capita –GNI	3.7	3.9	1.9	5.8
2. Sectoral Growth Rates(Percent)				
2.1 Agriculture	0.3	13.5	20.0	13.5
2.2 Manufacturing	5.7	2.1	-8.0	1.2
2.3 Construction	-4.9	-4.4	2.5	2.8
2.4 Services	6.1	2.6	4.0	5.1
3. External Sector – Percent of GNI				
3.1 Imports of Goods	86.4	86.3	78.7	80.2
3.2 Current Account	-10.5	-4.7	-5.5	0.3
3.3 Capital and Financial Account	-0.7	0.1	-2.6	-0.9
3.4 Official Reserves (Months of Imports)	5.6	5.2	5.7	6.7
4. Government Budget Balance (Percent of GDP)	-0.4	6.9	5.3	11.3

* Preliminary estimates