Economic Review April 2012

Recent Global Economic Developments: Implications for Lesotho's Economy

"After suffering a major setback during 2011, global prospects are gradually strengthening again, but downside risks remain elevated ………"

Introduction

The International Monetary Fund (IMF) released the World Economic Outlook (WEO) report in April 2012, indicating that the global economic growth was picking up following a slowdown of global output and trade in the second half of 2011. The improved growth was underpinned by the slightly stronger economic activity in the US and polices adopted in the Euro area to counteract the euro crisis. Nonetheless, the WEO indicated that there remained some downside risks that may threaten the strength of the recovery. The main risks were expected to be the high oil prices and the uncertainty regarding the unfolding of the Euro area crisis.

This article provides an overview of the path of the global economy in the run up to the second quarter of 2012, highlighting the major factors driving the recovery after an interruption late in 2011 and the risks involved. The implications of the global economic developments for Lesotho's economy are also explored.

Recent Global Economic Developments and Outlook

According to the WEO, the global economy experienced a slowdown in 2011 growing by 3.9 per cent compared with 5.3 per cent in 2010. This reflected deterioration in economic activity in advanced countries as well as in emerging and developing economies. The slowdown was a result of, among others, real GDP contraction in Japan as global demand weakened and supply disruptions caused by floods in Thailand. In addition, confidence plummeted and financial stress heightened in the Euro area causing growth to contract. These negative developments overshadowed the growth acceleration in the US.

Economic activity in the emerging and developing economies was dampened by policy tightening in emerging and Latin America and geopolitical tensions in the Middle East and North Africa. The sharp slowdown and weak policy framework in emerging Europe also contributed to the weak performance. However, Sub-Saharan Africa experienced strong growth which was largely underpinned by buoyant commodity prices.

Nonetheless, economic indicators painted a more improved picture of the global growth trajectory in the first quarter of 2012. The manufacturing purchasing managers' index for both advanced and emerging economies increased in the first quarter of 2012 reflecting an improvement in manufacturing activity. The industrial production and trade indices were also strong for various Asian countries. Reconstruction activity boosted output in Japan and, confidence in banking and sovereign bonds also increased.

In terms of the outlook, the global economy was expected to grow by 3.5 per cent in 2012 compared with 4.0 per cent in 2011. This was at the back of rising uncertainty regarding the euro crisis and high global unemployment rates. The prospects of a downturn in emerging and developing economies resulted from weak investment, labour market and manufacturing production in emerging Europe, Brazil, India and China. The on-going fiscal adjustments are also expected to dampen global growth.

Table 1: World Economic Outlook estimates and projections (Annual Percentages)

	Estimates		Projections	
	2010	2011	2012	2013
World Output	5.3	3.9	3.5	4.1
Advanced Economies	3.2	1.6	1.4	2.0
United States	3.0	1.7	2.1	2.4
Euro Area	1.9	1.4	-0.3	0.9
Emerging and Developing Economies	7.5	6.2	5.7	6.0
Sub-Saharan Africa	5.3	5.1	5.4	5.3
Central and Eastern Europe	4.5	5.3	1.9	2.7
Commonwealth of Independent States	4.8	4.9	4.2	4.1
Developing Asia	9.7	7.8	7.3	7.9
Middle East and North Africa	4.9	3.5	4.2	3.7
Inflation				
Advanced Economies	7.5	2.7	1.9	1.7
Emerging and Developing Economies	6.1	7.1	6.2	5.6

Source: IMF WEO, April 2012

The Economic Developments in the US

Economic growth had gained some momentum in the US during 2011 with its output growth on an upward trajectory and some improvements in the labour market. This was mainly driven by the decline in oil prices, rebuilding of inventories and waning of Japan's earthquake impact on the US economy. This recovery followed a sluggish growth in the first half of 2011, which accelerated to 2.4 per cent in the second half of the year. Since the second half of 2011, improvements in the labour market have helped private investment to remain strong as incomes increased. Improved risk sentiment and robust profits bolstered household wealth. The labour market saw the unemployment rate dropping to 8.2 per cent in March 2012 from 8.5 per cent in December 2011. Construction activity also remained strong boosting the overall economic growth in the first half of 2012.

Credit market conditions in the US also improved in the first quarter of 2012 as banks relaxed their lending requirements, except on housing credit. Credit conditions improved as sentiment about the impact of the euro crisis on the US receded due to relatively strong policy actions that were taken to address the euro crisis and the reduced US banks' exposure to the Euro area. The US banks' vulnerabilities to turbulence in financial markets in Europe were lessened by scaling back of significant claims of US banks, money market mutual funds and insurances. .

On the economic policy front, the Federal Reserve embarked on monetary policy easing. The US maintained interest rates near zero and expressed their commitment to maintain the same rates up to mid-2014. Fiscal policy was contractionary in 2011. However, the structural primary balance was projected to improve by an extra 1.0 per cent of GDP in 2012, a relatively high rate given the slow economic recovery.

The US economic outlook demonstrated that economic activity would improve in 2012 and 2013, expanding at an annual rate of 2.0 per cent per year, mainly underpinned by strong recovery of the housing market, stronger household balance sheets and the steady improvement in the labour market. Nonetheless, some downside risks to the outlook were noted. First, if the Euro area crisis worsened and spikes in the oil price continued and housing prices tumbled, then the US growth would likely be compromised. The US fiscal cliff, which is the expiration of the Bush-era tax cuts and imposition of US government spending cuts as the US Budget Control Act of 2011 comes into effect on December 31, 2012, further poses a substantial threat to the US recovery. Moreover, in the absence of rational fiscal consolidation the US would likely see spikes in interest rates, which would to a large extent, affect growth negatively in the short-run.

Europe and Euro Area Economic Developments and Prospects

In Europe, economic activity slowed down to 0.7 per cent at the end of the second half of 2011 compared with 2.5 per cent in the first quarter of 2011. This slowdown was at the back of perceived risks concerning growth prospects, balance sheet deleveraging that was triggered by perceived risks concerning high premiums and increasing yields of the sovereign bonds. These resulted in a slump in credit to the private sector.

In the Euro area, most of the member countries performed relatively well with the exception of Greece, Ireland, and Portugal. These countries remained at the heart of the crisis. Nonetheless, Italy was severely affected by the crisis in the fourth quarter of 2011 and to a lesser extent Spain. In January 2012, sentiments about the financial markets and economic activity improved. This was manly underpinned by the receding sovereign yields spreads against the German bonds. The pick-up in the financial markets was mainly driven by the impact of the European Central Bank's Long-Term Repurchasing Operations (LTROs) which started in the middle of December 2011. The LTROs were introduced for the purpose of counteracting liquidity-related solvency risks for the Euro area banks.

Economic prospects in the Euro area pointed to a contraction of real GDP at an annual rate of 0.5 per cent in the first half of 2012, and 0.3 per cent for the whole of 2012 compared with an estimated expansion of 1.4 per cent in 2011. Growth was expected to pick up to 0.9 per cent in 2013 mainly at the back of normalising volatility of sovereign yields, and a pick-up in trade and manufacturing activity both in the Euro area and across the globe.

Nonetheless, the prospects for growth in 2013 were deemed to be clouded by downside risks. Tight credit extension that was due to deleveraging in the Euro area risked to bring about a credit growth squeeze. The possibility of renewed escalation of the Euro area crisis remained an issue that depended on whether the underlying causes of the crisis would be resolved.

Sub-Saharan Africa (SSA) Economic Developments

Regardless of a relative slowdown of the global economy in 2011, the SSA region remained resilient and grew at a rate of 5.1 per cent in 2011 compared with 5.3 per cent in 2010. This was a reflection of a number of factors. The region survived the adverse effects of the Euro area crisis as majority of the countries in the region have little or no financial ties with Europe. Exports from the region are mainly geared towards fast-growing emerging markets and less goes to Europe. In addition, the boom in commodity prices boosted investment in natural resources in the region's commodity exporters immediately after the recent global financial crisis.

Despite the region's resilience during the review period, its growth forecasts were revised downwards mainly at the back of a slowdown in South Africa (SA), which has relatively strong financial and trade linkages with the Euro area. Adverse supply shocks from Eastern and Western Africa due to drought in many countries in Western Africa Economic and Monetary Union and in Kenya are also expected to exert negative pressure on growth in the region.

Overall, the region was expected to pick up from 5.1 per cent in 2012 to 5.3 per cent in 2013 mainly supported by the production of newly discovered natural resources in several countries such as Angola and the expected recovery from drought and conflict in both Eastern and Western Africa. The main downside risks to the region's growth in the medium term were expected to emanate from the volatility in oil prices and the probable intensification of the Euro crisis.

Implications for Lesotho's Economy

The recent global economic recovery and the identified downside risks to sustained global economic growth have a number of implications for Lesotho's economy. This is because Lesotho is integrated to the global economy through trade and financial linkages, mainly with the US, Euro area (albeit indirect) and SA.

The bulk of Lesotho's exports of textiles and clothing are mainly destined for the US market and these have increased tremendously since the inception of Africa Growth and Opportunities Act (AGOA) in 2000. Nonetheless, the global financial crisis resulted in a decline in Lesotho's textiles and apparel exports in

2008-2009. The observed recovery and the expected strong economic performance of the US in 2012 and 2013 at the back of strong household balance sheets and some improvements in the labour market could strengthen Lesotho's exports of textile and clothing during the same period. The good performance of the textile sector in the country would spell good news for increased employment and economic growth. In addition, exports earnings, hence the country's international reserves would increase.

Lesotho does not have a strong direct link to the Euro area. However it is indirectly exposed to developments in the Euro area because of its strong integration with SA. The Euro area is SA's major trading partner. Consequently, low economic activity and demand in the Euro area could cause a slump in SA's exports, manufacturing activity, employment and imports. These, in turn, could filter through to Lesotho through a number of channels. The decline in SA's imports implies lower payments by SA into the Southern African Customs Union (SACU) revenue pool, hence shares to SACU member countries. This does not augur well for Lesotho due to its heavy reliance on this source of revenue. In addition, the decline in employment implies low demand by SA for Lesotho's exports.

2. Recent Trends in Foreign Direct Investment (FDI): Implications for Lesotho's Economy

While global FDI flows have grown to levels exceeding the pre-crisis levels, Africa and the least developed countries (LDCs) saw a third year of declining flows since 2009..……………….…………

Introduction

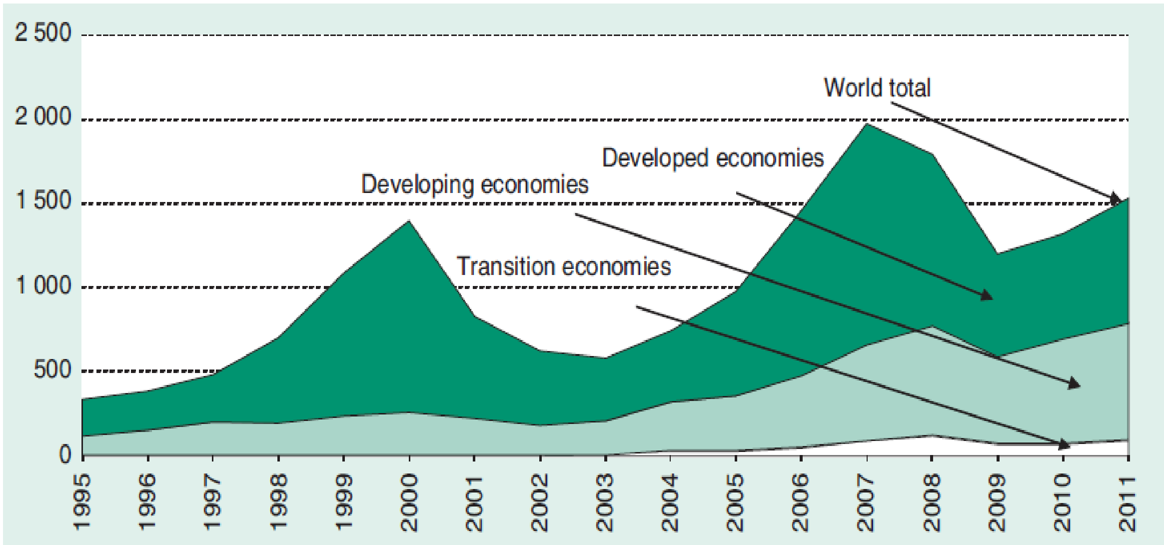
FDI plays a central role in a country's integration into the global economy and its economic growth. It plays a significant part in boosting productivity, employment, skills and technology transfer, which are important for economic growth and development. In recent years FDI flows across the globe have exceeded the pre-2008 global financial crisis level. According to the No.8 January 24, 2012 Global Investment Trends Monitor, global FDI flows increased significantly between 2010 and 2011 despite the global economic slowdown and Euro crisis. Nonetheless, FDI flows to Africa declined for three years since 2009 mainly due to the impact of the Arab uprising.

This article examines the recent trends in global FDI and Lesotho's position in FDI trends. It also highlights some economic effects of FDI on Lesotho's economy.

Recent trends in global FDI

According to the United Nations Conference on Trade and Development (UNCTAD) World Investment Report 2012, global FDI increased by 17.0 per cent despite the global financial crisis of 2008-2009, the resultant global economic crisis and the financial markets uncertainties and crises in the Euro area. The growth in FDI during this review period was mainly underpinned by relatively high economic growth in developing countries and higher profits of Transnational Corporations (TNCs).

Figure 1. FDI Inflows, Global and by Group of Economies, 1995-2011 (Billions of US Dollars)



Source: UNCTAD, based on annex table I.1 and the FDI/TNC database (www.unctad.org/fdistatistics).

The growth in FDI was observed across the three broad country categories (figure 1 above). It rose by 12.0 per cent in developing and transition economies, driven mainly by the increase in greenfield investment projects while for the developed countries, FDI rose by 21.0 per cent, largely due to an increase in cross-border mergers and acquisitions (M&As). Greenfield investment projects and M & A are components of FDI where the former involves construction of new operational facilities while the latter involves foreign investors acquiring existing assets.

While FDI inflows increased in many regions around the globe, Africa was an exception. In 2011, Africa's FDI flows fell largely on account of disinvestments from North Africa while inflows to SSA increased. An increase was also observed in FDI outflows at the global level mainly supported by growth of FDI outflows from developed countries and the transition economies while FDI outflows from developing countries fell. Outflows from Africa also fell as a result of significant declines in outflows from Egypt and Libya.

Concerning various modes of FDI, UNCTAD found that cross-border M&As rose significantly in 2011 as deals announced in 2010 came to fruition. This mode of FDI rose sharply in developed and transition economies, especially in the form of mega-deals such as extractive industry and pharmaceutical M&As. However, this mode of FDI edged down in value in developing countries reflecting faltering new deal activities as the number of announcements tumbled significantly during 2011.

According to UNCTAD, the value of greenfield investment declined for three consecutive quarters in 2011, despite the strong performance realised in the first quarter. For the whole year, greenfield investments declined by 3.0 per cent on an annual basis, with nearly 75.0 per cent of the decline occurring in developed countries. This mainly reflected the weak investor sentiment as the sovereign debt crisis in Europe intensified and the direction of the global economy became uncertain. Greenfield investment projects are registered on an announcement basis and they are highly correlated with investor sentiment, increasing when investor confidence is high and vice versa.

With respect to the prospects of FDI, UNCTAD pointed out that FDI flows would increase but at a slower rate in 2012 to around $1.6 trillion, mainly at the back of expected recovery in GDP growth in 2012 and the increase in cash holdings by the TNCs. The medium-term prospects pointed to a moderate but steady growth of FDI flows which would reach US$1.8 trillion and US$1.9 trillion in 2013 and 2014, respectively, if negative macroeconomic shocks do not materialise. The positive prospects would mainly reflect opportunities arising from industrial and corporate restructuring, especially in crisis-hit countries and as investment in the energy sector and green economy, in particular, in crisis-resilient economies rebounded.

Recent Trends in Lesotho's FDI

FDI net inflows and net stocks in Lesotho have increased significantly throughout the years, driven mainly by greenfield investment. However, FDI inflows declined by 5.0 per cent in 2011 to US$52.0 million while FDI stock grew by 4.6 per cent between 2010 and 2011. According to the figures released by UNCTAD, M&As were not contracted by Lesotho, while it attracted a large number greenfield investments which increased significantly from US$51.0 million in 2010 to US$710.0 million in 2011. The number of greenfield investments also increased from a stagnant 1 to 4 in 2011.

Table 2. FDI Trends, Type and Components by Lesotho, 2006-2011 Million of US Dollars

		2006	2007	2008	2009	2010	2011
FDI flows	**Inward**	88.5	96.6	55.6	48	54.7	52
	Outward	..	..	..	..	..	..
FDI Stock	**Inward**	629.2	734.9	933.7	1075.5	1128.7	1181.0
	Outward	2.0	2.0	2.0	2.0	2.0	2.0
Cross-border M&As	**Value**	..	..	..	..	..	..
	Number	..	..	..	..	..	..
Greenfield Investment	**Value**	..	51.0	16.0	28.0	51.0	710.0
	Number	..	1.0	1.0	1.0	1.0	4.0

Source: UNCTAD, FDI/TNC Database,
".." means not available

As indicated in table 2 above, FDI flows increased from US$88.5 million in 2006 to US$96.6 million in 2007 before declining by 42.4 per cent between 2007 and 2008. This trend continued in 2009 but at a lower rate than the preceding year to US$48.0 million before rising again to US$54.7 million in 2010.

Nonetheless, FDI stocks have been on an increasing trend since between 2006.

According to US Department of State, Lesotho's attraction of FDI had been commendable. Historically, 90.0 per cent of FDI into the country had been channelled into the manufacturing sub-sector, especially textiles and apparel for the US and SA markets. Most firms in the sector are woven and knit garments and mainly originate from Taiwan, Hong Kong and Singapore, while FDI from SA are concentrated in footwear, hotels, travel, insurance, retail, telecommunications and financial services.

Lesotho's FDI in mining sector has been revived by the reopening of the three diamond mines, namely, Lets'eng Diamonds, Liqhobong and Kao Diamond mines in 2011. In an attempt to attract more FDI in the mining sector the Government of Lesotho has put in place some incentives such as Value Added Tax (VAT) exemptions on inputs used during construction.

The FDI that Lesotho is attracting has benefited the economy substantially. FDI firms in Lesotho have been the cornerstone of employment for most Basotho, especially the textile and apparel industry. For example, in the second quarter of 2012 the number of people employed in the manufacturing sub-sector was around 44800. FDI also contributes to increased production of goods that are exported, thus resulting in an increase in export earnings. The impact of a surge in exports and earnings especially from the manufacturing sub-sector, especially after 2000 when African Growth and Opportunities Act (AGOA) was enacted has been tremendous. It also contributes directly to economic growth through the output of FDI firms and indirectly through spill over effects to sectors that provide services and utilities to the firms and retailers who benefit from increased demand by the increased number of employees. FDI is also expected to bring in new research, technology and skills and knowledge spill overs. However, this has not happened satisfactorily in Lesotho, particularly in the textiles and apparel industry as most of the managerial and supervisory positions are held by expatriates and there is still no local ownership of firms.