Economic Review December 2007

THE ECONOMIC IMPACT OF THE SURGE IN CRUDE OIL PRICES

The price of crude oil continue to surge, posing threat on oil importing economies such as Lesotho………

Introduction

International oil prices have been on the increase in recent months as evidenced by *Figure 1* below. In December 2007, the price of crude oil reached an average of $87.13 per barrel. During the same month, it reached a maximum of $90.92 per barrel. Oil is one of the world's most valuable commodities mainly due to the important role it plays in most economies. It is used as liquid fuel for transportation. In developing economies such as Lesotho, oil products are also used mainly for heating and cooking.

Therefore, the rise in the price of crude oil as well as the probability of even further increases in the future have been of key interest to both policymakers and academics alike due to the adverse effect high oil prices have on oil importing economies. The aim of this paper is to assess or gauge the likely economic impact of the persistent rise in crude oil prices on the Lesotho economy.

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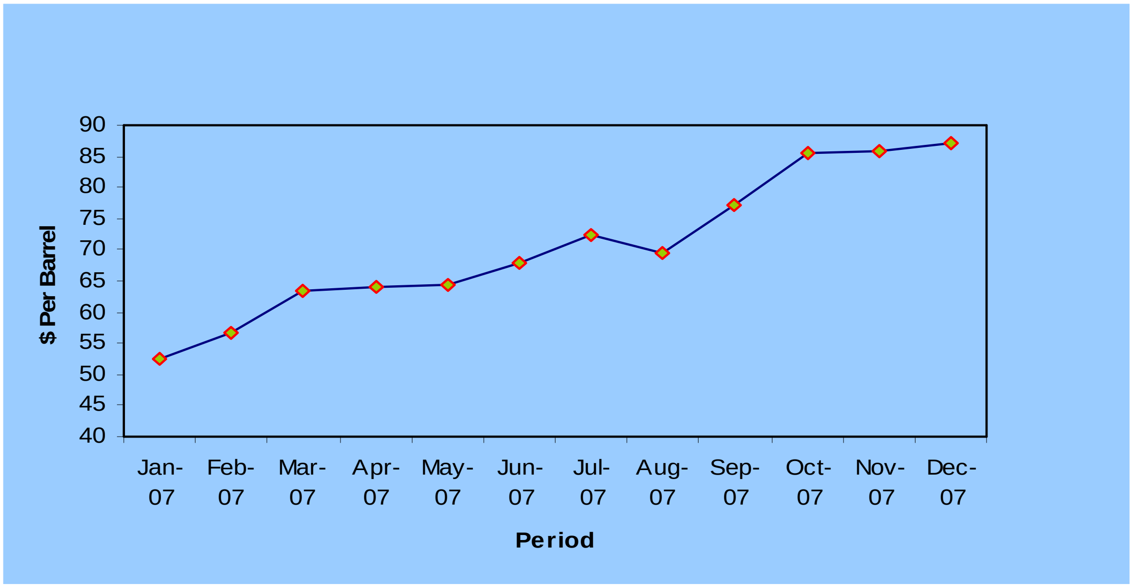
Determinants of the Price of Crude Oil

The key determinant of crude oil prices is the conventional demand and supply factors in the international market. The demand for oil is determined chiefly by the rate of global economic growth as well as energy-related technological developments. Thus, in the present scenario, buoyant economic growth in emerging market economies such as China have had quite a significant impact on the world demand for oil and hence the rise in the price level .

Figure 1: Average Oil Prices



On the supply side, control of production by Organisation of Petroleum Exporting Countries (OPEC) and temporary supply disruptions due to political factors or natural disasters exert upward pressure on oil prices. Specifically, recent tension between the United States and Iran has fuelled prices. The weakening of the US dollar has also compounded the situation.

However, in the long-term, supply depends on the rates of extraction, depletion and new discoveries. Expectations and speculation about future demand and supply also play a prominent role in determining crude oil prices.

Effects of Oil Price Increase on the Lesotho Economy

The rise in the price of oil has several effects at both micro and macroeconomic levels. The Lesotho economy is highly vulnerable to changes (specifically an increase) in the price of crude oil because of the structure of the Lesotho economy. The manufacturing and mining sub-sectors, the major drivers of Lesotho's economy, would be adversely affected by the increase in the price level since they are heavily reliant on oil usage. There might also be adverse effects on the agricultural sub-sector as the rise in the price of crude oil raises costs of ploughing and planting.

The increase in the price of crude oil implies that the prices in Lesotho's trading partners such as South Africa (SA) would also be on the rise and more so given that most of Lesotho's trading partners are also net oil importers. This implies that import prices would increase and hence prices in the domestic economy. Most importantly there are likely to be second-round effects which might have the potential to extend the price effect beyond the initial once-off increase. The resulting increase in consumer prices could lead to a loss in real wages, influencing workers to bargain for higher wages. Increased labour costs would be passed on to consumers, leading to wage-price spiral. Thus, the increase in crude oil price could complicate the conduct of monetary policy.

Further, monetary policy authorities in the region are responding to this by hiking interest rates so as to curb inflationary pressures. As a consequence of these tighter monetary policy decisions, credit extension to the domestic private sector might fall, and leading to a decline in aggregate consumption and investment and hence economic growth.

The most immediate effect of the rise in oil prices is an increase in liquid fuel prices for transport. Hence, this will have adverse effects on taxi operators in Lesotho as this will squeeze their profit margins. In the medium to long-term Government could respond to this by revising taxi fares upwards, affecting commuters negatively. In addition, an increase in the prices of paraffin used for cooking and lighting would exert immense pressure on the budgets of poor households.

Rising oil prices might have negative implications on the balance of payments (BOP).The current account balance (CAB) of the BOP might worsen due to a higher import bill (due to low price elasticity of demand for oil in the short term). The export sub-sector performance might also deteriorate as costs of production rise. Further, foreign investment could be affected if investors cut down investment in the domestic economy.

The increase in the price of oil might have negative effects on the South African mining industry where the majority of Basotho mineworkers are employed. The increase in the price of oil might lead to an increase in the costs of production in the mining industry. As a remedial measure, the mining companies could mitigate this by laying-off some workers. The laying-off of mineworkers would also translate into a decline in remittances which constitutes an important source of foreign reserves in Lesotho.

The fiscal side might also face immense challenges. The revenue side might be affected as the tax pool shrinks in line with the oil-induced slowdown in the performance of the economy. Further, Government debt repayments would rise along with the rise in interest rates regionally, in sum, oil importing countries vulnerability to high oil prices is worsened by their limited ability to switch to alternative sources of energy.

Conclusions

Crude oil prices have recently been on the increase mainly due to both demand and supply factors. On the demand side, robust demand by emerging market economies such as China and the Middle East have contributed to the recent price increase. On the supply side, there are several factors that have put up-ward pressure on prices *inter alia* the geo-political concerns about growing tensions in the Middle East. Therefore, Lesotho being an oil importing economy remains highly vulnerable to changes in the price as the transportation system in Lesotho is heavily reliant on liquid fuels. There is an expectation that there are likely to be supply shortages in the future and therefore Lesotho has to device some strategies that would mitigate this situation such as accumulating some oil reserve.

This paper benefited from:
1. Wakeford J.J (2006) " The impact of oil price shocks on the South African macroeconomy: History and prospects" Presented at the South African Reserve Bank Conference 2006, pp.95-115

Lesotho Signs a loan agreement to strengthen telecommunications infrastructure

Introduction

The Government of Lesotho is in the process of expanding telecommunications infrastructure throughout the country. This involves expansion of national telecommunications network to parts of the country which do not have access to telecommunications services. To this effect, the Government of Lesotho signed a soft loan agreement worth M228 million with the Government of China.

The role of telecommunications in economic growth

Modern theories on economic growth posit that factors such as ICT are important ingredients in the growth process. ICT infrastructure includes internet, voice and data transmission and broadcasting network. Telecommunications can affect economic growth through a number of channels. First, telecommunication increase productivity in the economy. This is through enabling timely and more efficient exchange of information. The reduction in transaction and transportation costs facilitates international trade and allows countries to expand their markets. Second, expenditure on consumption of communications services has grown in significance in final consumption expenditure in most countries.

Third, investment in telecommunication infrastructure has a direct link to gross domestic product and employment. Building towers and cabling require skilled labour. Last, availability of an efficient telecommunications system could trigger new investments into developed areas. With Sub-Saharan Africa in particular, the poor economic performance is believed to be due to among other things low investments in electricity and telecommunication infrastructure.

Advancement in ICT is one of the factors that investors take into consideration when assessing whether an economy presents any business opportunities for them.

Recent trends in economic growth across different regions bear testimony to the role of ICT in economic growth. Although there has been considerable growth over the past few years, Sub-Saharan African countries have remained behind other regions. The IMF World Economic Outlook for October 2007 shows that world output has increased from an average of US$ 26,246 billion, measured at market exchange rates in the period 1989-98 to an estimated US$ 40,909 billion in 1999-2008. This enormous growth has nevertheless been enjoyed disproportionately by different regions of the globe. Generally, western countries, the Asian tigers and emerging markets like China and India have developed at a faster pace than Sub-Saharan Africa and other least developed countries.

Telecommunications Sector in Lesotho

The telecommunications sector has been developing rapidly in recent years. Table 1 presents the number of licensed telecommunications service providers since 2000. During the period, significant growth was registered in mobile network, sound broadcasters, internet service providers, telebureaus, two way radios and customer premises equipment providers.

In addition, telecommunications development indicators show that the performance of the sector has been improving steadily over time. The Lesotho Telecommunications Authority (LTA) Annual Report for 2006/07 indicates that there has been an improvement in access to telecommunications services in Lesotho. One of the measures of access to telecommunication services is teledensity. Teledensity is defined as the total number of subscribers of both the fixed and mobile telephone operators per every 100 people. It rose from a modest 1.0 per cent in 2000 to 23.0 per cent in 2007. This improvement is attributable to an increase in the number of public pay phones, fixed line connections and Base Transceiver Stations (BTS).

Table 1: Number of licensed Telecommunications Service Providers

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Fixed line network	1	1	1	1	1	1	1
Mobile network	1	1	2	2	2	2	2
Data Communications	-	1	1	1	1	1	1
Electronic Messaging Services	-	-	-	-	-	1	1
Television Broadcasters	2	2	2	2	2	2	2
Sound Broadcasters	6	6	7	7	8	9	10
ISPs	3	3	3	4	5	6	6
Customer Premises Equipment Providers	10	17	8	11	11	12	13
Telebureaus	112	465	628	1213	2605	2543	3081
Two-way radios	-	-	-	8	14	16	20

LTA Annual Report2006/2007

Table 2 shows the 2003 Lesotho charges in comparison to those of SACU. A three-minute local phone call in Lesotho amounted to 22 US cents and was the most expensive among SACU countries. The cost of international calls was also very high. Although the cost of a phone call to the US in Lesotho was lower than in Swaziland, Botswana and Namibia, it was almost three times higher that in South Africa. Nevertheless, the cost of a cellular call was competitive even though it was a bit higher than in South Africa. At 26 US cents, the cost of a three minutes off-peak cellular local call in Lesotho was cheaper than the average for Sub-Sahara Africa (42), low income countries (40), lower middle income countries (44) and upper middle income countries (54).

Table 2: Affordability - Cost of a Call for the Year 2003

Country	Cost of Local Phone call(US cents/3 minutes)	Cost of Phone call to the US (US cents/3 minutes	Cost of Cellular Local call (US cents/3 minutes)
Botswana	2	364	33
Lesotho	22	231	26
Namibia	4	428	30
South Africa*	15	58	25
Swaziland	5	242	34

*South Africa is for 2002

Conclusion

The improvement of telecommunications system in Lesotho is a significant move towards attaining sustainable economic growth and development. The majority of schools in Lesotho are in areas with limited telecommunications infrastructure and as a result they do not have internet facilities. Thus the loan would allow students throughout the country to have access to internet connection. Furthermore, the trade in Lesotho particularly the small medium enterprises would be enhanced as entrepreneurs discover opportunities available in the internet. For sustained economic benefits to be realised, the country must encourage Basotho to acquire human capital skills in information communication technology such that they can manage the process.

3. Monetary Policy Operations for December 2007

Central Bank of Lesotho employs monetary policy as a vital instrument to achieve price stability using open market operations (OMO). This enables the Bank to maintain money market rates that are in line with the South African counterpart rates, and realise the ideal level of Net International Reserves (NIR) to defend the parity between the local currency, Loti, and the South African Rand.

During the auction in December, an amount of M150.0 million worth of securities was announced for auction in 91-day treasury bills. The amounts auctioned and discount rates that prevailed for each of the auctions are presented in Table 3. The auction was over-subscribed and as a result the whole amount was ultimately issued. The main objective of the auction was to absorb the excess liquidity which mainly arose from the maturing securities from a previous corresponding November auction.

Table 3: Treasury Bill Auctions

Type of Security	Auction Date	Maturity Date	Auction Amount (million)	Amount Issued (million)	Discount Rate
91-day TBs 182-day TBs	29 Aug 2007 05 Sep 2007	30 Nov 2007 07 Mar 2007	M160.0 M20.0	M160.0 M20.0	8.12% 8.90%
91-day TBs	03 Oct 2007	04 Jan 2007	M160.0	M160.0	8.32%
91-day TBs 182-day TBs	31 Oct 2007 07 Nov 2007	01 Feb 2008 07 Mar 2007	M160.0 M30.0	M160.0 M30.0	8.90% 8.72%
91-day TBs	28 Nov 2007	29 Feb 2008	M150.0	M150.0	8.82%

The success of monetary policy operations is judged amongst other things, by the behaviour of the margin of interest rates between Lesotho and South Africa (a neighbour and largest CMA member). A large treasury bill rate differential, say greater than 2 percentage points, would lead to undesirable transfers of funds which would bring unnecessary interest costs to Government if in favour of Lesotho, or a run-down of external reserves.

The Lesotho 91-day treasury bill rate still remained below its SA counterpart rate despite the fact that it continued to increase in December. The Lesotho 91-day treasury bill rate fell by 8 basis points to 8.82 percent. The counterpart SA rate also increased from its previous level of 9.94 per cent in October to 9.96 per cent in December. Consequently, the margin between the two rates increased from 51 basis points to 114 basis points at the end of the review period, as depicted in Figure 2 below. The level of net international reserves remained above the CBL target of US$450-500 million. Thus the monetary policy operations were deemed successful in achieving the desired level of external reserves.

Figure 2: Measuring the Success of Monetary Policy Objectives

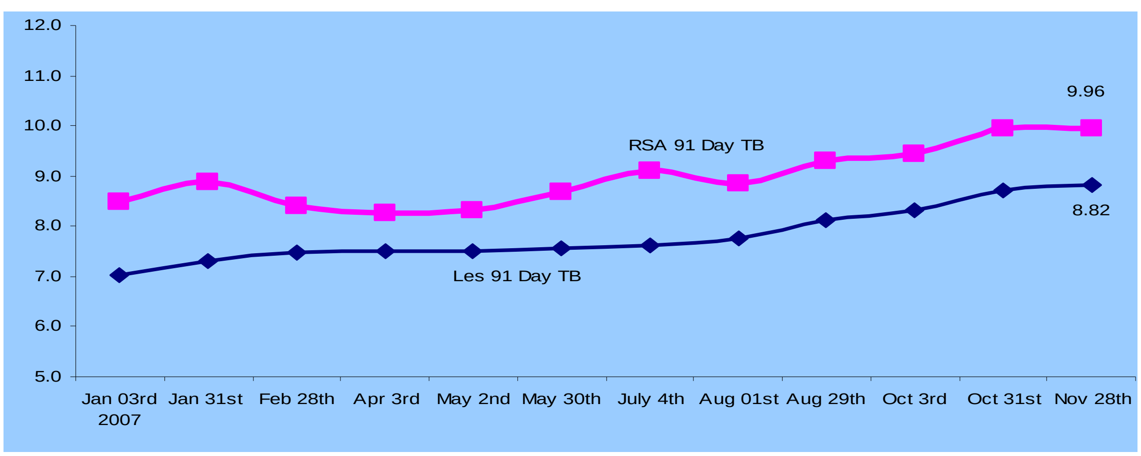


Table 4: Selected Monetary and Financial Indicators

	2007		
	September	October	November
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	14.17	14.50	14.50
1.2 Prime Lending rate in RSA	13.50	14.00	14.00
1.3 Savings Deposit Rate	4.05	4.08	4.67
1.4 Interest rate Margin(1.1 – 1.3)	10.12	10.42	9.83
1.5 Treasury Bill Yield (91-day)	8.12	8.32	8.74
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	3766.12	3869.05	4134.15
2.2 Net Claims on Government by the Banking System	-3100.09	-3873.83	-3324.32
2.3 Net Foreign Assets – Banking System	7939.53	8702.39	8377.64
2.4 CBL Net Foreign Assets	6063.39	6725.60	6424.21
2.5 Domestic Credit	-1909.39	-2676.81	-1882.05
2.6 Reserve Money	508.999	496.755	716.06
3. Spot Loti/US$ Exchange Rate (Monthly Average)	**7.1083**	**6.7831**	**6.7224**
4. Inflation Rate (Annual Percentage Changes)	**8.6**	**8.7**	**9.3**
5. External Sector (Million Maloti)	2007		
	QI	QII	QIII
5.1 Current Account Balance	716.63	62.68	465.67
5.2 Capital and Financial Account Balance	278.94	390.49	245.40
5.3 Reserves Assets	-1023.89	143.38	-870.86

+These indicators refer to 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

Table 5: Selected Economic Indicators

	2004	2005	2006	2007+
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	4.2	2.9	7.2	4.9
1.2 Gross National Product – GNI	7.9	5.5	3.1	3.6
1.3 Per capita –GNI	7.9	5.5	3.1	3.6
2. Sectoral Growth Rates				
2.1 Agriculture	-1.9	-1.7	1.7	-22.5
2.2 Manufacturing	2.1	-8.6	10.5	11.0
2.3 Construction	-4.4	-3.4	0.6	2.5
2.4 Services	2.1	4.1	6.6	6.3
3. External Sector – Percent of GNI				
3.1 Imports of Goods	86.3	83.1	80.1	86.5
3.2 Current Account	-4.7	-5.7	3.5	8.6
3.3 Capital and Financial Account	5.8	3.6	-1.2	5.9
3.4 Official Reserves (Months of Imports)	5.2	5.5	6.7	7.2
4. Government Budget Balance (Percent of GDP)	5.7	4.8	12.6	4.8

** Preliminary estimates*
+CBL Projections