Economic Review December 2008

The Global Fiscal Stimulus: Will it work for Lesotho?

The International Monetary Fund (IMF), together with her partners, has called for fiscal stimulus as a means to avert the potential recession. How can Lesotho respond to mitigate the effects of the current financial crisis?

Introduction

The global financial crisis began in mid 2007 when investors lost confidence in the value of securitised mortgages in the United States. This resulted in a liquidity crisis that prompted a substantial injection of capital into financial markets by the United States Federal Reserve, Bank of England and the European Central Bank. This credit crunch was attributed to a rise in credit risk between July 2007 and October 2008.

In September 2008, the crisis deepened, as stock markets world-wide crashed and entered a period of high volatility. This led to a number of financial institutions realising significant losses.

However, it must be acknowledged that the extent to which the crisis has affected the Southern African region, so far, does not compare with the rest of the world. This was partly on account of the conservative approach that the banks in the region have adopted over the years, as well as relatively stringent exchange controls. Of the four big banks operating in the region, only one was slightly affected, mainly due to the merger it has with one of the British banks. Otherwise, the crisis appears to be well muted in the entire region.

INSIDE

The Second Round Effect

One would have expected that since the crisis did not adversely affect the financial sector in Southern Africa, then second round effects would be minimal, if any at all. But the region appears to have been affected significantly by second round effects. The economic structure of the least developed countries, as well as that of the emerging markets, dictates that these countries are affected by the developments in the markets of developed countries. For instance, it is established that Lesotho's exports of clothing and textiles is largely dependent on the level of economic activity in the US markets. This seems to hold for the whole region's exports, regardless of the level of development.

As a result of the impact of financial crisis on the US economy and her peers, demand for regional products has plummeted. This has forced manufacturing industry, especially the export sector, to retrench workers. Consequently, the purchasing power of the retrenched workers has dropped, leading to the overall decrease in domestic demand. This process manifests itself through cyclical effect, resulting in the overall slowdown in production. This slowdown has potential to develop into a recession, if not adequately addressed by the policy makers. The domino effects of recession need not be overemphasised. For small economies like Lesotho where the majority already live on handouts, the impact can be severe.

The crisis has also affected the region through depreciation of regional currencies against currencies of their major trading partners. This has potential to cause inflation. However, the decline in world oil prices due to crisis-driven fall in demand could dampen the adverse effects of exchange rate depreciation on regional prices. The IMF has urged countries to stimulate their economies in the face of a bigger than expected turmoil in the global economy. Accordingly, the IMF has revised world economic growth forecast downwards by 75 per cent to 2.2 per cent for 2009. The argument was that the advanced economies' output would contract significantly, while that of the emerging markets would slow down.

The World's Response

Economists all over the world have made diverse predictions over the apparent economic slowdown. Some fear that this, if not attended to urgently, has potential to match the recession experienced in the 1930s. The world leaders have taken different policy actions to avert the situation. The Fund advocated for global actions to support financial markets and provide further fiscal stimulus and monetary easing to limit the decline in growth.

The US and some members of the European Union have provided a number of bailout packages to stimulate their financial sectors' performances. Those were accompanied by accommodating fiscal and monetary policy actions. It was earlier mentioned that the Federal Reserve lowered the interest rates to almost zero (0.25 percent), in an effort to stimulate credit mobilisation. The following are some of the suggested prescriptions:

- to repair the financial system by recapitalising banks and isolating bad assets;
- to use monetary policy to increase demand; and

- to limit the decline in demand and output through fiscal stimulus

.The Fund encourages the use of reversible fiscal measures, formulated within a robust medium-term fiscal framework. These measures can either be in the form of increases in spending, or tax cuts depending on resource constraints. It is argued that investment spending has a direct effect on demand than spending on wages, because it has a positive supply side effects, and it can easily be reversed.

Relevant Policy Actions for Lesotho

Like her peers, Lesotho faces a serious challenge to avert the situation. Lesotho's membership in Common Monetary Union (CMA) and the Southern African Customs Union (SACU) limits her policy options. The CMA membership has ceded the use of monetary policy to respond to any shock. Likewise, SACU membership also restricts the use of fiscal policy. There is also a serious limit on tax cuts since SACU members have resolved to unify their tax policies and laws.

It must be highlighted that Lesotho's main source of revenue is SACU, with a share of over 50 per cent. Furthermore, Southern African Development Community (SADC) has put in place the benchmarks for macroeconomic convergence. The two benchmarks relevant to fiscal policy are; a fiscal deficit range of 3 to 5 per cent of GDP, and debt to GDP ratio of not more than 60 per cent.

This means the country has leverage on increasing spending. It is imperative at this stage to determine the items whose spending can easily be reversed with minimum market distortions. As mentioned earlier, investment spending would be desirable to use as a fiscal stimulus. This has potential to lubricate private sector demand and achieve growth within a short period. For Lesotho, boosting the economy could mean a more aggressive stance on capital expenditure. The capital budget was under spent in the recent years due to limited capacity to implement projects. However, it is important to identify specific sectors of the economy whose response to stimulus is high and desirable. This implies that social spending may not qualify for fiscal stimulus.

Conclusions

The article has demonstrated that indeed stimulus package should be based on a set of policies. However, it is observed that Lesotho has a limited scope on policies. Therefore, authorities should rather identify relevant sectors that have potential to respond quickly to policy actions. Moreover, government's response should be biased in favour of investment spending. This is easy to reverse, has potential to boost economy, can realise positive returns and lay a base for higher future economic activities.

2. The Assessment of Social Spending

Background

The role of Government in the economy is provision of stability, mainly through spending and tax changes. It can affect structure of aggregate demand and in the process, change the level of prices and employment. Government interventions encompass a wide range of regulatory, fiscal, indemnification, and legal actions that modify the rights and responsibilities of various parties in society. Interventions can increase or decrease costs to particular groups, effectively acting either as a subsidy or as a tax. Some of these interventions increase social welfare, while others could worsen societal imbalances. Besides spending on provision of social services, significant portion of Governments' budgets is directed towards subsidies and transfers. But where does this money go to? That is the puzzle the article tries to resolve.

In economics, a subsidy is a form of financial assistance paid to a business or economic sector. A subsidy can be used to support businesses that might otherwise fail, or to encourage activities that would otherwise not take place. It can also be used to stimulate demand, and or facilitate affordability of some basic commodities. A subsidy that increases production will tend to result in a lower price, while a subsidy that increases demand will tend to result in an increase in price in the short run. Both cases result in a new economic equilibrium.

It is, however, important to note that not all goods experience the same consequences; some categories of goods may suffer less from this effect. For instance, the total costs of subsidies remain constant for public goods regardless of the number of consumers, and depending on the form of the subsidy.

The recipient of the subsidy may need to be distinguished from the beneficiary of the subsidy, and this analysis will depend on elasticity of supply and demand as well as other factors. For example, a subsidy for consumption of milk by consumers may appear to benefit consumers (or some subset of consumers, such as low-income households); but if supply of milk is constrained, the result is high demand relative to supply, therefore, prices rise. Under the circumstances, the milk producer benefits while the consumer derives no net gain, as the higher price of milk offsets the subsidy. The net effect and identification of winners and losers is rarely straightforward, but subsidies generally result in a transfer of wealth from one group to another.

Subsidy may also be used to refer to government actions which limit competition or raise the prices at which producers could sell their products, for example, by means of tariff protection.

Evaluation of subsidies in Lesotho

Government of Lesotho, like other governments, provides subsidies to different segments of the populace. She employs a number of interventions discussed above to cushion her citizens against economic hardships, while maintaining economic stability. The interventions are in the form of spending and tax changes. Government applies the interventions to different sectors of the economy.

Specific interventions can be traced from the time Lesotho gained independence, whose focus was mainly on improving productivity. Those were combined with others that intended to facilitate access to basic food stuff, in which beneficiaries earned them by providing labour at different community projects. The social sector remained government priority, with education and health the largest recipients of the subsidy. Government implemented indirect education related interventions, until the fiscal year 1999/2000 when Free Primary Education (FPE) was introduced. The first cohort of FPE graduates will be sitting for the junior certificate examinations at the end of the year 2009. Free primary health care was also introduced in 2007/08 in response to the apparent limited affordability of health care products. The other direct subsidy was effected last fiscal year (2007/08) when Government subsidised selected basic commodities to cushion people against the effects of draught that was experienced during that period.

However, upon realisation that in some cases the benefits did not equate to the cost incurred, government undertook structural reforms. Privatisation programme was the first to be introduced in 1995 to minimise government expenditure. Petroleum fund was established to facilitate departure from the era of controlled fuel prices. These initiatives have reduced government expenditure significantly.

Market Response

It is worth noting that Lesotho periodically protects domestic agricultural products by restricting imports of products that are produced locally. This normally benefits producers more than the consumers. Prices of the same protected sectors increase due to supply/demand imbalances. For example, prices of poultry products and vegetables often increase when the intervention is in effect to take advantage of the market conditions. However, consumers have not derived any gains from this.

This could prove to have negative effects on local production if local producers do not seem to be expanding but rather enjoy the effects of subsidies. Besides this form of intervention, government often provides subsidies on agricultural inputs. This is another intervention that is not achieving the intended purpose. Productivity does not seem to reflect the injected subsidy.

The Impact on Government Budgetary Operations

This section presents the share of budget that is allocated to subsidies and transfers. The article employs economic classification, which derives from Government Finance Statistics manual of 1986. It is shown that as a percentage of total recurrent budget, subsidies and transfers averaged 26.7 per cent over the period 2003/04 to 2007/08. They have also been growing at an average of 24.3 per cent over the same five-year period. This implies that about 70 per cent of recurrent budget is distributed among the rest of other economic clusters. These figures demonstrate that a significant portion of the budget is reserved for unrequited transfers. It should be highlighted that autonomous institutions are some of the beneficiaries of this share, while one third forms part of pensions and gratuities.

Table 1: Subsidies and Transfers

	2003/04	2004/05	2005/06	2006/07	2007/08
Percentage of Recurrent Spending	21.7%	26.2%	27.5%	28.9%	29.1%
Growth rate	23.9%	21.2%	29.2%	27.7%	19.3%

Conclusion and Recommendations

It is acknowledged that subsidies and transfers are good gestures of governments to citizens. It is also demonstrated that subsidies improve social wellbeing, though some sectors fail to realise positive results. Therefore, it is important to establish suitability of any intervention before funds are committed, otherwise the results may not be desirable. This is reflected by the rising amount allocated to subsidies. The subsidy may end up in the wrong hands and increase market imbalances.

Government of Lesotho has implemented a number of “safety nets-related programmes”. Some of them achieved their goals, but they were implemented on a small scale, while others saw people’s welfare deteriorating upon termination. For instance, community projects and programmes have potential to improve welfare, if well targeted. Participants are those who are in need of any type of remuneration on offer. Programmes, such as, food-for-work were able to separate the needy from the rest of the residents in terms of distribution of food parcels. Those programmes improve productivity, or access to other areas, and hence unlock the villages for investments.

- It is, therefore, recommended that a need assessment study be conducted before any intervention is implemented.
- Information can be extracted from “the Household budget survey and or Health and Demographic survey” to facilitate proper planning to achieve the targeted intervention. With this information, government can separate assistance to farmers in their different clusters, and implement the pro-poor programmes with minimum free rider problems. This will facilitate specialisation, and improve productivity at a minimum cost.

- Government should consider establishing, or using privatisation proceeds to provide revolving funds to stimulate private sector growth. But potential economic drivers need to be identified first to make it effective.
- Government should also consider replicating food-for-work programmes. This will separate the needy from those who could only join as free riders.

.

Table 2: Selected Monetary and Financial Indicators

	2008		
	Sept	**Oct**	**Nov**
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	16.58	16.58	16.58
1.2 Prime Lending rate in RSA	15.50	15.50	15.50
1.3 Savings Deposit Rate	5.28	5.28	5.28
1.4 Interest rate Margin(1.1 – 1.3)	11.30	11.30	11.30
1.5 Treasury Bill Yield (91-day)	10.01	10.1	10.15
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	4378.56	4626.84	4549.19
2.2 Net Claims on Government by the Banking System	-3939.21	-4718.45	-4501.97
2.3 Net Foreign Assets – Banking System	9891.51	11575.76	11283.17
2.4 CBL Net Foreign Assets	7766.18	9,149.65	8,871.97
2.5 Domestic Credit	-2404.32	-3118.36	-2948.45
2.6 Reserve Money	723.49	684.14	706.85
3. Spot Loti/US$ Exchange Rate (Monthly Average)	**8.0599**	**9.7423**	**10.1095**
4. Inflation Rate (Annual Percentage Changes)	**12.1**	**12.0**	**11.8**
5. External Sector (Million Maloti)	**2008**		
	QI	**QII**	**QIII**
5.1 Current Account Balance	507.48	824.12	278.92
5.2 Capital and Financial Account Balance	330.96	117.74	1083.26
5.3 Reserves Assets	-774.19	-165.33	-704.65

+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	5.1
1.2 Gross National Product – GNI	7.9	5.5	3.1	4.9
1.3 Per capita –GNI	7.9	5.5	3.1	4.0
2. Sectoral Growth Rates				
2.1 Agriculture	-1.9	-1.7	1.7	-39.3
2.2 Manufacturing	2.1	-8.6	10.5	11.0
2.3 Construction	-4.4	-3.4	0.6	3.5
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	9.5
3.3 Capital and Financial Account	5.8	3.6	0.7	8.2
3.4 Official Reserves (Months of Imports)	5.2	5.5	6.7	7.6
4. Government Budget Balance (Percent of GDP)	5.7	4.8	11.8	5.3