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THE STRENGTHENING OF THE LOTI AGAINST MAJOR CURRENCIES: IMPLICATIONS FOR GROWTH AND EMPLOYMENT IN LESOTHO

The strengthening of the Rand against the major global currencies pose a huge challenge to already weak textiles and clothing sector.......

Introduction

The exchange rate plays an important role in the management of macroeconomic policy in any country. However, Lesotho through its membership in the Common Monetary Area (CMA) has surrendered its exchange rate policy arm of its monetary policy. The CMA links South Africa, Lesotho, Namibia and Swaziland into a monetary union, wherein, the Lesotho's currency, the Loti, and the Swaziland's currency, the Lilangeni and Namibian Dollar are pegged one-to-one with the Rand. The Rand is therefore legal tender in all CMA countries. Moreover, the exchange rate policy setting in Lesotho is exogenous and mirrors movements of the Rand exchange rate.

The main benefits of the CMA arrangement for Lesotho are: low inflation environment inherited from SA, which is conducive for macroeconomic stability; investor confidence in the economy and the attraction of foreign direct investment; elimination of transaction costs and foreign exchange rate risks. Therefore, this article intends to discuss the theoretical and empirical economic fundamentals that affect movements in exchange rates, recent movements of the Rand exchange rate, reasons behind such trends and policy response, and the resultant implications for economic growth and employment.

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Theoretical and Empirical Evidence of Factors Affecting the Rand

Theoretically, changes in exchange rates are broadly driven by the law of one price, the relative productivity growth rate and the interest rate or Fisher effect. The law of one price states that, in the absence of trade frictions, competitive arbitrage makes the same good to sell for the same price (when expresses in a common currency) across countries. The intuition is that the changes in exchange rates reflect the relative variations of inflation or purchasing power between currencies. On the other hand, the fisher or interest rate effect asserts that the exchange rate should change in the opposite direction to the difference in interest rates between two countries. These assertions assume free movement of capital and competitive markets.

On the basis of theoretical motivations discussed above, the following are factors that have empirically been found to influence real exchange rate movements of the Rand;

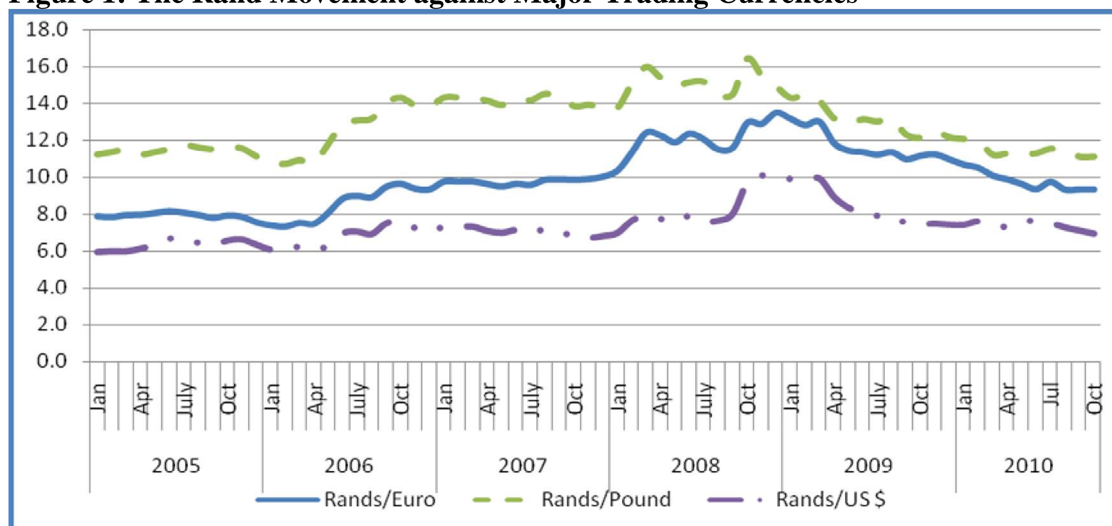
- prices of minerals that SA Produces, particularly gold and platinum,

- the real interest rate differential vis-à-vis South Africa's main trading partners,
- the inflation differential vis-à-vis SA main trading partners,
- variations in the terms of trade for SA and the stock of foreign currency reserves,
- variations in economic growth, relative technological or productivity progress vis-à-vis SA's main trading partners,
- the level and composition of government expenditure and the stock of foreign debt.
- international capital flows and the stance of commercial and trade policy.

Trends in Exchange Rate Movements

The Loti has been steadily appreciating against the US Dollar, the Euro and Pound sterling since December 2008 as shown on Figure 1 below. At its weakest point, it reached the low of 10.70 to the US Dollar, 13.50 to the Euro and 16.40 to the Pound. In the last three months, the Rand continued to gain more strength, appreciating by 7.7, 4.1 and 3.8 per cent against the US Dollar, the Euro and the Pound, respectively. On the last day of October 2010, the Rand closed at 6.95 to the Dollar, 9.77 to the Euro and 11.30 to the Pound.

Figure 1: The Rand Movement against Major Trading Currencies



Source: *Central Bank*

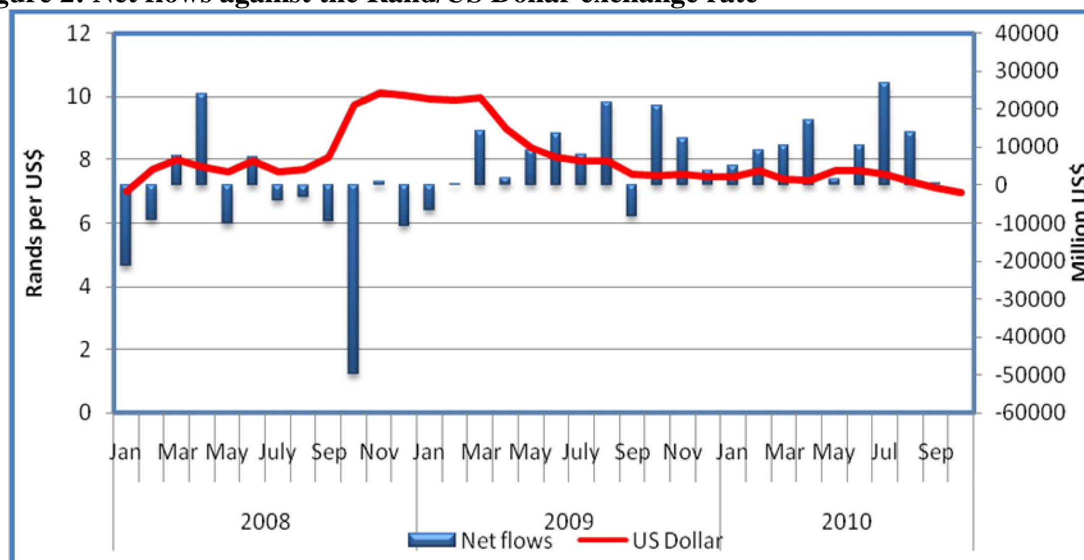
The observed strength of the currency can be attributable to a confluence of factors listed above, but this cycle is particularly marred by a chain of events that sparked a lot of controversy around the world. It all started with the financial crisis and the resultant credit crunch and global economic recession. In an effort to reverse the situation, developed countries responded with strong monetary policy easing. The Fed and the Bank of England reduced short-term interest rates to nearly zero, that is, 0.25 in the US and 0.50 in England. Economic recovery was still not satisfactory but because interest rates would not go any lower, they were left with no option but to pump money into their economies directly. The Fed purchased more than a trillion Dollars' worth of treasury and US-backed mortgage and corporate securities. With high unemployment, low inflation (even fears of deflation) and the slow pace of economic recovery still persisting, there is a feeling that further support is needed. Therefore, the Federal Open Market Committee (FOMC) is contemplating on buying additional US$600 billion worth of securities.

The excess money supply, as a result of loose monetary policy, finds its way into emerging economies. Broadly speaking, there are three reasons behind the influx of capital into

emerging markets. First, interest rates are relatively higher in emerging markets and second, large economic growth differentials between advanced and emerging economies make market equities much more attractive in emerging market economies. Last, risk averse US banks have been reluctant to lend to domestic consumers due to persistent problems in labour and housing markets. Figure 2 below, presents net flows into SA and the Rand-Dollar exchange rate.

There are essentially two issues that have sparked tension in the exchange rate market. First, the unhappiness with the level of the Chinese Yuan exchange rate. This is more evident in the US, to an extent that Congress is getting closer to passing a bill that would enable imposition of tariffs on imports that are unfairly helped by the undervalued Yuan. The second issue relates to the unhappiness in many emerging countries over currency strength caused by easy monetary conditions in advanced economies.

Figure 2: Net flows against the Rand/US Dollar exchange rate



Source: *Central Bank*

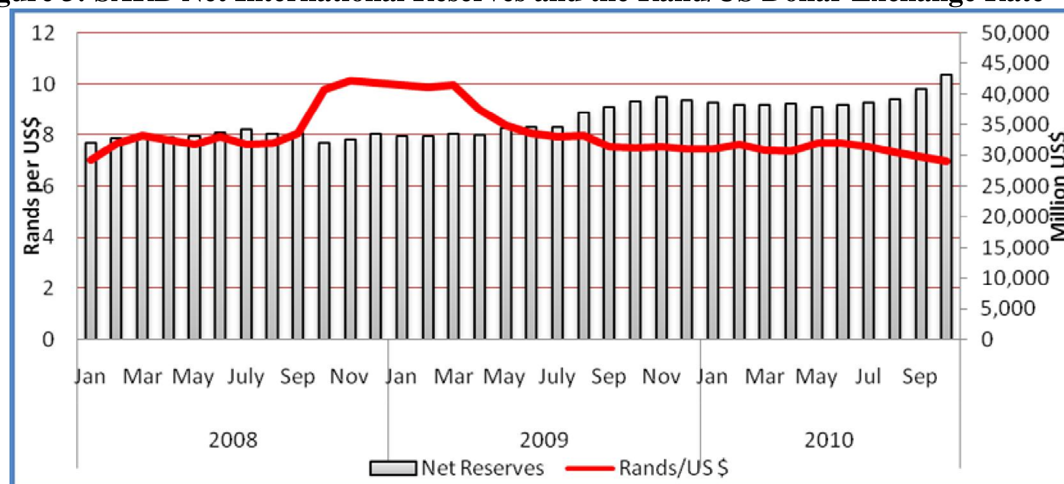
As shown on the figure 2 above, SA has received about US$131.7 million net foreign exchange inflows since October 2009 to September 2010. As a result, the Rand appreciated, leading to fears of erosion of the SA export market's competitiveness. Furthermore, the strong commodity prices may also be behind the strong Rand. South Africa is one of the major producers of gold and platinum in the world. The price of Gold continued to increase in the first three quarters of 2010 in both US Dollar and Maloti terms. In the third quarter of 2010, the average price of gold rose by 2.6 per cent to the high of US$ 1 227.8.

Policy Response to the Exchange Rate Appreciation

In an attempt to weaken their currencies, some countries were more modest in their response, while others opted for extreme measures. One of the first policy tools adopted by the South African Reserve Bank (SARB) and other countries was aimed at curbing the foreign exchange inflows through accumulating of foreign exchange reserves. Figure 3 below shows the reserve bank's net reserve position and the Rand-Dollar movements. It is apparent that the reserve bank has been accumulating reserves at a higher rate since August 2009. Despite this massive accumulation, the Rand has maintained an upward trend. This may

suggest that the rapid accumulation of reserves has had only a limited effect on curbing exchange rate appreciation, particularly in the medium term as asserted by Mohanty and Turner, 2006.

Figure 3: SARB Net International Reserves and the Rand/US Dollar Exchange Rate



***Source:** SARB*

With the accumulation of reserves being less effective, some countries then responded unilaterally to introduce strict tax measures and others altered exchange controls in order to counter foreign exchange inflows. Minister of Finance SA, pronounced SA's stance in his Medium Term Budget Policy Statement (MTBPS). He asserted that international cooperation is needed to achieve a more stable international financial environment. However, he responded also by proposing several adjustments to SA's financial and foreign exchange regulatory arrangements. He supports the continuation foreign exchange reserves accumulation and sterilization of inflows associated with foreign direct investment.

The removal of unnecessary exchange controls and offshore investment limits on individuals should be amended to encourage diversification of portfolios. These reforms are also aimed at removing barriers to international expansion from a domestic base. Furthermore, the prudential framework for foreign investment will be reviewed to support portfolio realignment and offshore diversification. He went further to say that these measures will be carefully monitored and further steps to moderate the impact of capital flows on the South African economy would be considered, drawing on both international experience and assessment of the likely local impact.

Implications for Lesotho's Economy

There are a number of both positive and negative implications of the recent strengthening of the Loti against major trading currencies. On the negative side, the strong Loti continues to put pressure on export oriented producers, particularly the ailing textiles and clothing industries and the diamond mining sector. It does so by eroding the price competitiveness against other producers in the world and reducing revenue in Loti denominated terms against the same cost structure. Domestic exporters already face fierce price competition particularly from Asian countries. These export industries are some of the most important economic growth drivers and contribute a lot to employment. The appreciation of the Rand may therefore dampen economic growth and employment.

However, the recent strengthening of the Rand is good news for inflation. The rebound in international oil and food prices has been

offset, to some extent, by the stronger Rand. In Dollar terms, brent crude oil, maize and wheat prices have been increasing sharply. However, the prices in Rand terms have been more modest. As a result, inflation is currently just above the lower band of the target and the repo rate is on 6.0, per cent.

A large portion of the Lesotho's debt stock is denominated in foreign currency, the appreciation of the Loti, therefore, reduces the Dollar denominated external debt stock because as Loti appreciates, fewer Maluti are needed to pay off the debt. This also presents a window of opportunity to pay off some of the higher interest loans.

Conclusion

Lesotho is both an export led economy and imports almost everything from abroad hence an overly strong or weak loti poses negative effects on the economy. The level of exchange rate that strike balance is not known. Also, SA is a small player in the global exchange rate market, as such the value of the rand will always be determined offshore and there is little that the local authorities can do. For Lesotho, the current exchange rate arrangement remains pivotal as an exchange rate and monetary policy.

INTERNATIONAL MONETARY FUND'S WORLD ECONOMIC OUTLOOK, OCTOBER 2010: RECOVERY, RISKS AND REBALANCING

Despite massive economic interventions and policy stimulus during the recent global financial crisis and the resultant economic downturn, the recovery is tepid and fragile with downside risks to the outlook, necessitating balance between policy responses in both advanced and developing economies……….

Background

The International Monetary Fund (IMF) released World Economic Outlook (WEO) October, 2010 titled "Recovery, Risk and Rebalancing". The report is a vital instrument for IMF's global surveillance of economic activities and is released twice a year in May and October. The report's main structure includes analysis and projections of global, regional as well as major countries' economic developments. The current report highlights that the pace of economic recovery is slow, putting into perspective major issues pertaining to the major risks to the strong, balanced and sustained recovery.

This article intends to capture recent global economic developments and their impact on the economy of Lesotho. It will also highlight the major and current risks to state of economic recovery, putting into light the rebalancing mechanisms that are to be deployed for the balanced and sustained recovery.

Recent Global Economic Developments

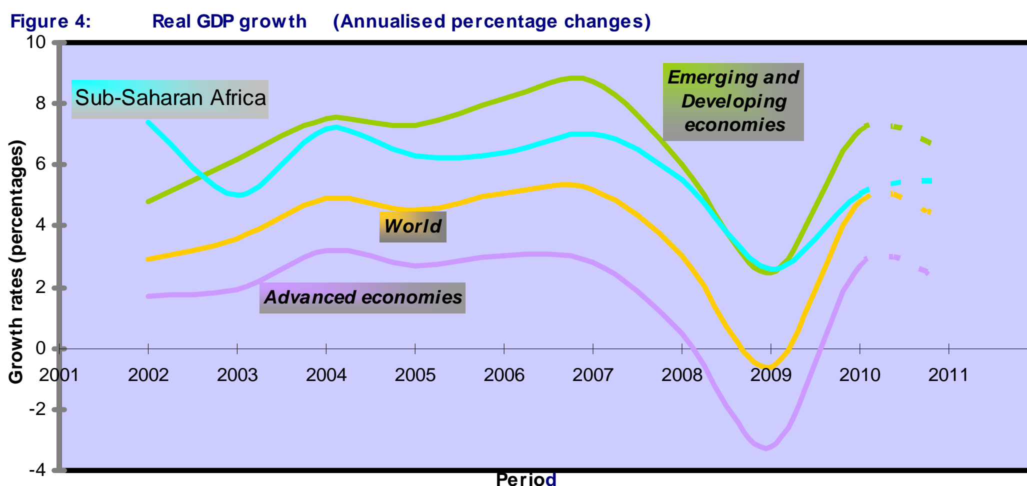
The global economy and volume of world trade continued to grow rapidly and strongly from 2002 until the advent of the global financial crisis in 2007. The world economic activity grew from 2.9 per cent in 2002 to 5.3 per cent in 2007 while the volume of world trade increased by 3.5 per cent in 2002 to 7.4 per cent in 2007. This bright performance in the run up to the crisis may be reflecting a strong and prudential global monetary and fiscal policy measures.

Nonetheless, the financial crisis and the resultant global economic downturn turned the situation around. In 2007, global real GDP slowed to 2.8 per cent compared to the 5.3 per cent registered in 2007. It declined further in 2009 by 0.6 and is projected to recover to 4.8 and 4.2 per cent in 2010 and 2011, respectively. World trade also declined by 2.9 per cent in 2008 compared with a 7.4 per cent growth realised in 2007. It plummeted by further 11 per cent in 2009.

These called for monetary authorities and governments around the world to respond and the monetary and fiscal policies implemented helped to prop up the economy. Currently, the global economy is on its recovery path, albeit, at varying speed and protracted pace. Figure 4 below shows the current global economic developments.

The United States

The US embarked on unparalleled macroeconomic policy measures and emergency stabilisation measures to keep apace in the era of global economic meltdown. Consequently, the US economy is on a recovery path, albeit, at a moderate rate of expansion.



Source: *WEO, October 2010*

The US Gross Domestic Product (GDP) grew at an annualized rated of 2.0 per cent in the third quarter of 2010 from a 3.7 per cent rates realised in the first quarter. Although personal consumption expenditure continues to grow, the rate is sluggish. Personal consumption, which accounts for 70.0 per cent of US GDP, rose by 2.6 per cent in the third quarter of 2010 compared with 2.2 per cent recorded in the second quarter. It remains weak because of high unemployment rate, tighter credit conditions and deteriorating household net worth.

The US economic prospects are tilted towards a continued slow recovery. In 2009, US GDP declined by 2.6 per cent but it is projected to recover by 2.6 per cent in 2010 and forecast to increase at a slower rate of 2.3 per cent in 2011. The unemployment rate is expected to remain high in the near-term as uncertainty continues to cloud the global economic recovery. In the environment of low demand, as is the case currently, inflation is expected to be moderately low.

Nonetheless, risks to the outlook remain very lofty. Of great concern is the spiralling government debt that has heightened the vulnerability of the economy to the volatile financial market sentiment. Furthermore, a continued decline in consumer price inflation and weak labour market conditions, coupled with relatively low consumption demand are threatening the advent of deflation. Finally, residential and commercial real estates markets are still fragile posing danger to US household budgets.

The Euro Area

The Euro area is also recovering, driven mainly by the resurgence of the global economy. Nonetheless, the recovery path has not been without challenges. The weak recovery in the region was necessitated by the sovereign debt crisis that emanated from

Greece and weak labour market conditions with stubbornly high unemployment rates in Spain and Ireland. After dipping into recession in the fourth quarter of 2009, Euro area began growing moderately at the rate of 0.2 per cent in the first quarter of 2010 to 0.4 per cent in the third quarter. However, it has moderated somewhat in the third quarter compared with a growth of 1.0 per cent realised in the second quarter of 2010.

The main challenge to the strong growth in the region was the sovereign debt crisis that emanated from Greece. The crisis became internationally contagious derailing financial system and the global economic recovery. The recovery in the zone is regaining strength even though it is uneven and moderate. Real GDP growth rate for the area is projected at 1.7 per cent in 2010 and 1.6 per cent in 2011. Moderate recovery is looming in Germany mainly due to weak growth that is expected amongst its trading partners. In France, moderate growth is also expected as private consumption is pounded by rising unemployment and the withdrawal of stimulus measures. In the peripheral economies of the euro area, such as Greece, Portugal, Ireland and Spain, fiscal imbalances are expected to constrain growth.

Nonetheless, risks to the outlook in the region remain noticeable. Potential spillages of the debt crisis across the member countries, particularly peripheral ones, remain very outstanding. The banking system in the area hinges highly on government support, making them vulnerable to the real economy, sovereign shocks and funding strains.

Developing Asia

Asia, in particular, China and India, are leading the global economic recovery. The sustained and balanced growth in Asia is mainly due to strong macroeconomic fundamentals at the beginning of the crisis and proactive stimulus package that led to resilient domestic demand during the crisis. Industrial production and retail sales have been strong in China propelling the strong growth in the region. The region is projected to growth robustly by about 7.9 per cent in 2010 and 6.7 per cent in 2011. However, activity is expected to moderate in the second half of 2010 as policy stimulus and tightening wind down.

Despite the robust and sustained growth in the region, there are still some downside risks. First, the slow recovery in the US and the Euro area and anticipated slowdown in China, as well as anticipated financial shocks from abroad could derail the pace of economic recovery in the region. Second, the yen appreciation and worsening deflation in Japan will have a drag on the region's sustained and balanced growth, further worsening the current global economic imbalances.

Sub-Saharan Africa (SSA)

SSA is orchestrating with the general global recovery. The SSA slowed down briefly in 2009 reflecting strong and prudential macroeconomic management prior to the crisis. Output is expected to grow by 5.0 per cent in 2010 before strengthening to 5.5 per cent in 2011.This outlook is expected to be supported by strong recovery in exports and commodity prices as well a robust domestic demand in a handful of economies in the region. Particularly noteworthy is the fact that South Africa has benefited from continuing robust demand in Asia and the recovery in demand for manufactured products from Euro area. Moreover, the monetary policy measures undertaken by the South African Reserve Bank last year are having a noticeable impact on domestic demand.

Nonetheless, the main risk to the positive outlook is the weak global economic recovery. Furthermore, continued weaknesses and the measures to cut back on budget deficits in advanced countries are likely to

derail aid flows and private capital financial flows into the region.

Rebalancing for a Strong and Sustained Recovery

During the global financial crisis, policy intervention measures were deployed. As a result of these interventions, especially fiscal policy, national debt and external position of various economies worsened, thus is magnifying the global economic imbalances that were already in place. The growth performances of emerging and a handful of developing countries are improving, while for the advanced world, the growth has been deteriorating even before being aggravated by the crisis, culminating into large flows of private capital into emerging market economies. This further created a loop of imbalances and other macroeconomic ailments like currency appreciation and current account deficits.

In order to resolve these issues, proactive policy measures should be put in place. First, policies need to accelerate the rebalancing of demand from public to private sources in advanced economies and from economies with external deficits to those with external surpluses. Second, the financial sector should be repaired and reformed, supervision and regulation should be strengthened in order to function optimally in terms of credit extension.

Third, monetary policy should remain mostly accommodative in many economies given muted inflation and the expected fiscal consolidation. Given that policy rates in many advanced economies are near-zero, quantitative easing is likely to be more effective given disrepair in financial markets and generally elevated volatility. Finally, structural reforms are needed to support the global demand rebalancing. For example, financial sector repair as earlier mentioned (to facilitate access to credit by SMEs) are essential to raise employment.

Challenges for Economic Recovery in Lesotho

Amid the general economic recovery, Lesotho cannot be a stand alone. After contracting by 2.6 per cent in 2009 from 5.1 per cent realised in 2008, Lesotho is poised to rebound by 5.6 per cent in 2010 and moderate to 3.8 per cent in 2011 according to IMF. The major drivers behind the 2009 contraction were Lesotho's exports of diamond and textiles as the global economic recession intensified, suppressing demand in the US and Euro area, major exports destinations.

Nonetheless, the recent broad based economic recovery spells good news for the economy. First, given that the US economy is recovering, albeit, at a slower pace, Lesotho's textile and clothing industry may pick up, with exports expanding and employment rising. Nevertheless, full recovery of the manufacturing sector in Lesotho is threatened by risks that are hampering speedy US economic recovery as highlighted above.

Second, strong but moderate economic growth in the Euro area and the rise in global commodity prices are expected to bode well for the economic prospects of Lesotho. Lesotho exports a bulk of its diamonds to the Euro area and the recent improvements in the prices of rough diamonds coupled with the general but moderate economic recovery may boost diamond exports. Nonetheless, if the financial markets volatility, which is now elevated by the Greek-induced sovereign debt crisis, does not stabilise, Lesotho is likely to lose from the imminent financial contagion, export earnings from diamond sales may fall.

Moreover, the South African economy, from which Lesotho imports more than 70.0 per cent of consumables and large portion of financial services, is also recovering, but the demand is still low. This means that Lesotho will continue to enjoy the environment of sustained price stability.