Economic Review March 2011

The Hike in International Oil Prices and its Implications on Lesotho's Economy

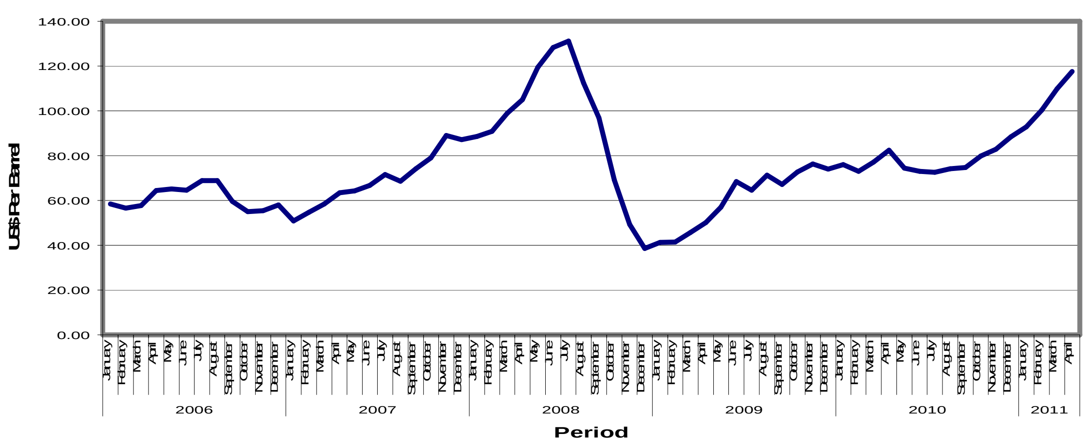
Lesotho sets its eyes on Social and Economic Transformation: The Role of National Strategic Development Plan ………....

Introduction

Crude oil prices have increased sharply over the past few months. The Organization of the Petroleum Exporting Countries (OPEC) Reference Basket rose for the sixth month to an average of $110 per barrel in March 2011, an increase of $9.55 per barrel from the previous month. At the beginning of April, prices moved considerably higher, reaching up to $120 per barrel. On the one hand, the surge in crude oil prices presents benefits for oil exporters in the form of, amongst others, strengthened external and fiscal positions. On the other hand, this is not good news for oil importing countries like Lesotho, whose import bills are likely to rise and a number of other negative effects are likely to be experienced as a result of the hike in oil prices.

The adverse effects of the rise in the price of oil arise mainly from the uses of oil products in, amongst other things, transportation, home cooking and heating, industrial production and electric power generation. Thus this article analyses the likely economic impact of the recent increases in oil prices on Lesotho's economy. This will be preceded by an analysis of the factors that are likely to have contributed to this price hike.

FIGURE 1: THE AVERAGE PRICE OF CRUDE OIL



Factors Behind the Hike in International Oil Prices

The price of crude oil is influenced by a number of factors. Demand and supply forces are expected to play a significant role in crude oil price changes. The price of crude oil should increase (decrease) if demand for the fossil fuel exceeds (falls below) supply. Fluctuations in demand and supply can arise due to political, natural and economic factors. In recent times, the use of commodities like crude oil to hedge against risk has been observed to have a significant impact on their prices. Nonetheless, the role that these factors play and the intensity of their impact change over time. Therefore it is important to have a clear understanding of the specific factors that contributed to the upsurge in the price of crude oil since February 2011.

According to OPEC's Monthly Oil Market Report for April 2011, oil prices began rising in February, at the start of supply disruptions in Libya. The unrest in Libya reduced its output considerably. It is estimated that Libya produces just under 2.0 per cent of the world's total oil supply. Moreover, 80.0 per cent of its total oil output is said to be consumed by its domestic market. The blame for the upsurge in oil prices is also placed on the post election violence in Nigeria. Nevertheless, other OPEC members increased their production to fill the gap created by supply disruptions in Libya. OPEC's Monthly Oil Market Report for April 2011 indicates that during this period, demand for OPEC crude oil was below production, indicating sufficient supply in the market. What one can deduce from this is that the current high oil prices are not reflective of the impact of the forces of demand and supply and the production disruptions are not entirely to blame for the high prices.

Investors' speculative behaviour is believed to be the major driver of the rise in the price of crude oil since February to April 2011. The argument here is that when investors hear of possible disruptions to production, traders in the futures markets start to believe that oil prices will rise. Consequently, they buy oil futures before production disruptions actually take place and hence before the price rises, with the intention to sell them at a profit when the price actually rises. This is called arbitrage, that is, attempting to profit by exploiting price differences of identical or similar financial instruments, on different markets or in different forms. This behaviour ensures a close link between futures and spot prices. Attempts have been undertaken to provide empirical evidence to this argument. For example, Möbert (2009) found that a much larger increase in the turnover of long positions in futures markets than of short positions is accompanied by price rises, with econometric tests confirming causality to run from the futures positions to crude oil prices.

The depreciation of the US dollar against other currencies is expected to have also contributed to the increase in the price of oil. As the US dollar weakened, investors switched from US dollar denominated investment holdings to oil futures and other commodities like gold.

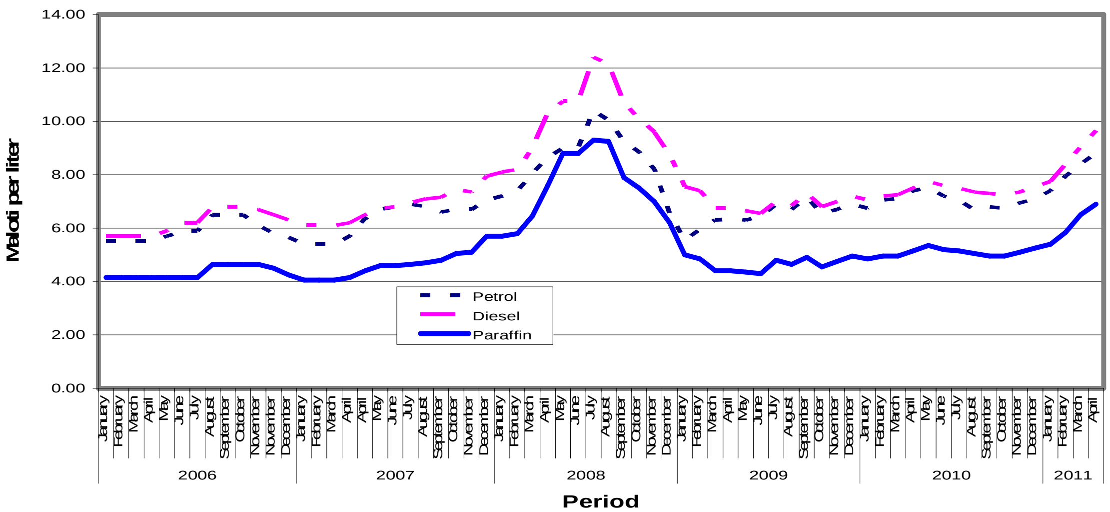
The triple catastrophe in Japan, of the earthquake, tsunami and nuclear problems are expected to have reduced Japan's use of oil. Being one of the major oil importers in the world, the fall in demand for oil by Japan was followed by a decline in the price of crude. But the price fall could not be sustained as investors continued to invest in commodities' futures markets.

Implications for Lesotho's Economy

The surge in the price of oil presents a number of challenges for countries like Lesotho, which rely on oil imports. Lesotho does not have an oil refinery, therefore, it imports refined petroleum products from South Africa.

The most direct and immediate effect of the rise in crude oil prices is the resultant increase in the pump prices of petroleum products, that is, petrol, diesel, paraffin and gas. As can be seen in figure 2 below, the prices of these products have risen quite significantly since February 2011, when the price of crude oil started on an upward trend. This filtered through into inflation and the liquid fuels inflation of 8.6, 11.0 and 17.7 per cent were registered in January, February and March 2011, respectively. This indicates that petrol, diesel and paraffin made a significant contribution to domestic inflation, which stood at 3.2, 3.3 and 3.6 per cent in January, February and March, respectively.

Figure 2: Pump Prices of Petroleum Products



The upsurge in international oil prices is likely to result in an increase in the prices of other goods and services and hence in inflation in South Africa. This will lead to an increase in Lesotho's imported inflation. This is more so because of Lesotho's heavy reliance on imports from South Africa coupled with the fixed exchange rate regime whereby the local currency, loti, is pegged one to one to the South African Rand.

High prices of petroleum products have a number of effects both at the micro and macroeconomic levels. It means that more of consumers' income is being used to pay for these oil products than it was the case before the price increase. This has even more serious implications on the poor majority of the population, who rely on paraffin for cooking and heating homes. To make things worse this price hike is happening at the start of winter when the demand for paraffin for heating purposes is high.

The increase in the prices of diesel and petrol will squeeze the profit margins of public transport operators in Lesotho. This is more so because this price hike will not be immediately followed by an upward revision of taxi and bus fares as these are regulated by Government and it usually takes very long for fares to be reviewed. Nonetheless, in the medium to long term, government could effect the upward revision of fares, which would have a negative effect on the budgets of commuters.

The high fuel prices will result in the increase in transportation costs which could, in turn, lead to the rise in the prices of other goods and services. Through this channel the increase in the price of crude oil will indirectly contribute to the rise in the general cost of living.

Oil is a vital input in the production of a wide range of products. Looking at the structure of the economy of Lesotho, the manufacturing and mining sub-sectors, which are the main drivers of the economy, rely heavily on the use of oil. High oil prices increase the cost of inputs in these sub-sectors. The manufacturing sector in Lesotho is struggling to recover from the effects of the global economic recession and is also being negatively affected by the appreciation of the local currency against the US dollar. The slow recovery of consumer demand in the United States (US) leaves limited room for the domestic manufacturing sub-sector to pass the cost increase emanating from high oil prices to consumers of textiles and clothing in the US. Consequently, labour and capital may have to be reallocated, which could result in firms scaling down and or completely closing operations and workers being laid-off. The agricultural sector, which is also struggling to meet Lesotho's food requirements and ensure food security, will also be adversely affected as the rise in the prices of petrol and diesel will lead to the rise in the costs of ploughing and planting.

The balance of payments (BOP) position for Lesotho has been deteriorating due to, *inta alia*, the decline in exports, migrant mineworkers' remittances and SACU revenue, associated with the global economic recession and the current slow global economic recovery. Rising crude oil prices may exert more negative pressure on the BOP position as it is likely to increase the national import bill. The likely deterioration of the manufacturing and mining sub-sectors, in response to the increase in the costs of production may also worsen the BOP position. Further pressure is likely to come from more retrenchments of Basotho mineworkers in South Africa (SA). The high oil prices may lead to the increase in the costs of production in the SA mining industry. The mining companies could respond by laying-off some workers because it might be difficult to pass the cost increases on to consumers, given the slow pace of recovery of the global economy and aggregate demand.

The Government of Lesotho is already faced with serious challenges emanating from the decline in SACU revenue. This situation could be exacerbated further by the surge in oil prices. The likely oil-induced slowdown in the performance of the economy, resulting from the possible deterioration of the domestic manufacturing and mining sub-sectors as well as migrant mineworkers' remittances, could lead to shrinkage of the tax revenue pool.

Conclusion

Crude oil prices have recently been on an upward trajectory mainly due to speculation in oil markets. Lesotho, being an oil importing economy and a net importer of goods and services, is highly susceptible to the negative effects of this shock. Prices of petroleum products in the country have already risen in response to this development, thus increasing the costs of cooking and heating homes as well as transportation costs in the economy and contributing to the rise in inflation. The high oil prices also increase the costs of production for the manufacturing, mining and agricultural sub-sectors. This could result in the loss of jobs, further deterioration in Lesotho's BOP position and government revenue.

2. Financial Sector Reforms Continue in Lesotho: The Financial Institution Bill is Submitted to Parliament.

The Financial Institutions Bill is proposed to repeal the Financial Institutions Act (FIA) 1999 ………

Introduction

Lesotho's Minister of Finance and Development Planning has tabled the Financial Institutions Bill, 2010 before Parliament. The main objective behind this Bill is to strengthen supervision and regulation of the financial sector in Lesotho and it will repeal the Financial Institutions Act (FIA) 1999, which is currently being used. The Act will possibly be cited as the Financial Institutions Act 2011, and shall come into operation on the date of its publication in the Gazette.

In 1999, the Lesotho Parliament enacted the FIA 1999, which entrusts the Commissioner of Financial Institutions, the Central Bank of Lesotho (CBL), with the mandate to provide a framework for and execute supervision and regulation of bank financial institutions (BFIs) in Lesotho. However, with the evolution of the financial sector and the change in the structure of the economy of Lesotho, the legal authority that the CBL derives from the FIA 1999 has become inadequate.

Thus the financial institutions Bill 2010 is intended to strengthen supervision and regulation of the financial sector by giving the CBL the adequate legal authority and mandate to regulate and supervise nonbank financial institutions (NBFIs) in addition to the BFIs. The Government of Lesotho has also had to deal with illegal and fraudulent companies that essentially entice the general public to lend them money by giving out extra-ordinarily high returns. Thus the FIB 2010 also incorporates new sections to deal with unlawful business practices in Lesotho's financial sector.

It is against this background that this article assesses the significance of strong prudential regulation and supervision of the financial system and gives an overview of the rationale for financial sector reform in Lesotho, particularly the rationale behind the new financial institutions Bill. The improvements that are proposed by the new Bill are also discussed, after which the article is concluded.

The Importance of Prudential Regulation and Supervision of the Financial Sector

The financial sector is the major channel through which borrowing and lending takes place in an economy. A weakly regulated or supervised financial sector can increase a country's vulnerability to banking and financial crisis by resulting in excessive risk taking by financial institutions. Financial sector reforms aimed at strengthening financial sector regulation and supervision can help ensure that financial institutions take adequate steps to manage risks that are inherent in their business, thus ensuring that the financial system is strong enough to meet its financial obligations and satisfy the needs of customers.

Appropriate financial sector policies can also help to establish deep and liquid domestic capital markets, which can handle reversals in capital flows and reduce vulnerability to contagion. Astrong financial sector can also reduce the need for excessive external borrowing, which more often than not, is expensive due to exchange rate fluctuations. Appropriate financial sector policies can facilitate modernisation of the financial sector and diversification of financial services. This is particularly a problem in developing countries where the range of financial services is limited and products that are high in demand are not available.

Financial sector policies should be reformed to also promote establishment of a well functioning formal financial system to curb the growth of the informal financial system, which is difficult very to manage and regulate. Where the informal financial sector already exists, the regulatory system should cover both formal and informal markets, with clear lines of responsibility for supervision and regulation. It should also impart sufficient powers to the relevant authorities to investigate and to swiftly and firmly take the necessary legal action against criminality in the sector. This could prevent the emergence and growth of pyramid schemes and enhance confidence in the stability of the financial system.

Rationale for the New Financial Institutions Bill

The FIA 1999 repealed and replaced the FIA 1973 with the objective of strengthening supervision and regulation of financial institutions in Lesotho. It was meant to establish a clear and consistent framework for supervising the financial sector. It gave the CBL, as the Commissioner of financial institutions, the operational independence to respond quickly and decisively to problems and issues confronting the financial sector. However, with time and with new developments, the FIA 1999 has become inadequate. Its main limitations include the following:

- It does not apply to all financial institutions but only to institutions that perform banking business or credit business, which are basically banking financial institutions.
- It does not give the Commissioner of financial institutions sufficient powers to take appropriate measures against unlawful and fraudulent practices in the financial sector and protect depositors, investors and the general public from being swindled by the perpetrators.
- The severity of penalties that it stipulates, which were formulated in 1999, no longer match the offences, they are less prohibitive.
- The global financial crisis has revealed a number of areas for improving financial sector regulation, particularly on corporate governance and these are not captured in the FIA 1999 as it was developed before the global financial crisis hit.

These weak points of the FIA 1999 have been observed to be inhibitive to the growth of the financial sector in Lesotho as it restrains the establishment of other financial institutions, other than banking institutions in Lesotho. In addition, it leaves investors and the public vulnerable to unlawful financial schemes such as Ponzi schemes.

The New Financial Institution Bill of 2010

The proposed new financial institutions Bill is intended to repeal the FIA 1999, with the objective of eliminating the shortcomings inherent in this Act. Therefore, the main objectives of the Bill include the following:

- To cover both banking and non-banking financial institutions. As such, it will encourage growth of the sector by allowing for establishment of a wider variety of different types of financial institutions in Lesotho. In addition, it will give the Commissioner of financial institutions the legal authority to supervise and regulate the entire financial sector.
- To protect investors and the general public from being defrauded by fraudsters, by granting the Commissioner of financial institutions adequate authority and mandate to take appropriate measures against illegal and fraudulent practices in the financial sector. In addition, it will grant the Commissioner more powers to inspect businesses, investigate unlawful practices where they are suspected, and where necessary to give orders for repayment to investors.
- To empower the Commissioner sufficiently to act decisively and speedily against persons and or business entities rendering financial services without license, including conducting investigations to cause timely disposal of assets that have been acquired unlawfully, and to ensure compensation in favour of investors and members of the public against whom the illegal conduct would have been carried out.
- To revise penalties upwards to match the committed offence, so that they carry the desired deterrence against perpetrators.
- To strengthen corporate governance structures in domestic financial institutions as a necessary condition for preventing financial crisis, by strengthening conditions for appointment of auditors for financial institutions, improving the requirements for composition of audit committee structures and appointment of directors and principal officers of financial institutions as well as on the scope of responsibility of the boards of directors of financial institutions.

Conclusion

As indicated above, reform of the financial sector, with a view to improve prudential regulation and supervision of the financial system is necessary for establishing a strong financial system that can take appropriate measures to manage financial risk, thus minimising the probability of experiencing banking and financial crises. The proposed new financial institutions Bill is intended to strengthen Lesotho's financial system in this regard by broadening regulation and supervision to cover all financial institutions. In addition, it is intended to minimise, if not completely prevent unlawful and fraudulent behaviour in the financial sector.

TABLE 1: SELECTED MONETARY AND FINANCIAL INDICATORS

	2011		
	Dec	**Jan**	**Feb**
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	10.33	10.33	10.50
1.2 Prime Lending rate in RSA	9.00	9.00	9.00
1.3 Savings Deposit Rate	1.09	1.09	1.21
1.4 Interest rate Margin(1.1 – 1.3)	9.24	9.24	9.29
1.5 Treasury Bill Yield (91-day)	5.51	5.45	5.43
3. Spot Loti/US$ Exchange Rate (Monthly Average)	7.192	6.915	6.738
4. Inflation Rate (Annual Percentage Changes)	3.3	3.6	4.1
5. External Sector (Million Maloti)	**2010**		
	QII	**QIII**	**QIV**
5.1 Current Account Balance	-891.37	-680.49	-547.75
5.2 Capital and Financial Account Balance	332.15	328.46	253.29
5.3 Reserves Assets	928.04	342.90	109.75

Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho.

TABLE 2: SELECTED ECONOMIC INDICATORS

	2007	2008	2009	2010*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	1.7	5.1	2.4	2.5
1.2 Gross National Product – GNI	1.7	11.4	1.6	-6.3
1.3 Per capita –GNI	1.6	11.3	1.6	-6.5
2. Sectoral Growth Rates				
2.1 Agriculture	-25.2	27.5	-4.2	0.8
2.2 Manufacturing	1.1	3.6	-1.3	0.5
2.3 Construction	5.1	6.5	11.0	8.2
2.4 Services	3.2	3.1	3.6	2.0
3. External Sector – Percent of GNI				
3.1 Imports of Goods	79.6	80.8	74.7	74.0
3.2 Current Account	12.6	10.3	-0.7	14.7
3.3 Capital and Financial Account	1.6	1.1	3.4	6.7
3.4 Official Reserves (Months of Imports)	7.7	8.4	6.8	6.0
4. Government Budget Balance (Percent of GDP)	8.0	5.9	-1.4	-2.7

* Preliminary estimates