Economic Review July 2009

## The Strengthening of the Loti Exchange Rate: Implications for the Economy of Lesotho

*The sustained appreciation of the Loti exchange rate against major global currencies poses a significant challenge to the textiles and clothing sub-sector which is already under pressure from the global economic slowdown…….*

### Background

The exchange rate plays an important role in the management of macroeconomic policy in any country. However, for various reasons, countries do surrender their power to influence exchange rate. Lesotho is one such country which has forfeited the exchange rate policy due to its membership in the Common Monetary Area (CMA) with South Africa, Namibia and Swaziland. Thus the exchange rate of the Loti against major currencies is exogenous to macroeconomic policymaking in Lesotho as it mirrors movements of the South African rand. Since the beginning of the year, the Loti has strengthened significantly against major currencies.

This article intends to discuss the implications of the recent appreciation of the local currency against major currencies, particularly, at this time when Lesotho's economy is slowing down due to the global economic recession.

**INSIDE**

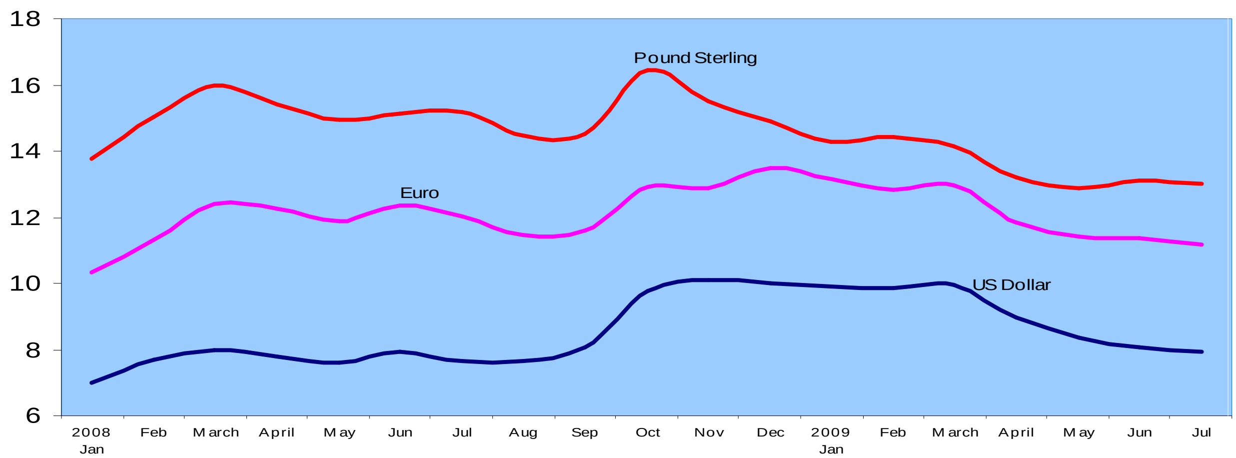


### Recent Exchange Rate Movements

The Loti exchange rate has shown some strength during the first half of 2009. As shown in Figure 1 below, the Loti against the US dollar appreciated from 10.0 at the end of 2008 to 7.9 at the end of July 2009. Measured against the Euro and the British pound, the Loti appreciated by 16.9 per cent and 12.7 per cent, respectively. A similar movement was also observed against the SDR (SDR is a unit of account for the International Monetary Fund -

defined in terms of a basket of major currencies used in international trade and finance). The observed strength of the currency can be attributable to a confluence of several factors. First, the US dollar has been depreciating due to the weakening economy as the financial crisis and the economic recession intensified. Second, the Loti has benefited from the relative strength of the commodity markets, which normally strengthen the South African rand given its status as a major exporter of commodities. The price of gold has remained relatively high, averaging US$860.53 per ounce during the first half of the year. South Africa is one of the leading exporters of gold. Finally, as the financial crisis unfolded, most developed countries were fast to reduce their interest rates compared to those in the CMA region which only started reducing interest rates in December 2008. This reluctance to reduce rates led to relatively higher returns on the South African financial markets.

**Figure 1: The Rand Exchange Rate Movement against Major Trading Currencies.**




**Source: Central Bank of Lesotho**

## Implications for Lesotho's Economy

A number of both positive and negative implications of the recent strengthening of Loti against major trading currencies can be traced. On the positive side, appreciation reduces inflationary pressures as imports become cheap. This is important in the case of Lesotho because the bulk of inputs to the domestic production units are imported from SA. At least three-quarters of imports of Lesotho emanate from its neighbour. Inflation rates in both South Africa and Lesotho have been on the increase in 2008 due to the impact of an upsurge in food and fuel prices. Appreciation can also dampen the effects of the current rise in oil prices, thus helping to preserve the purchasing power of the loti. The appreciation of the loti can further facilitate economic growth because it has created room for reduction of interest rates in CMA region, a move that could boost credit for consumption and investment, thus increasing economic activity. Moreover, appreciation of the currency eases the Central Bank's challenge of managing Lesotho's foreign currency reserves. It allows the Bank to maximise returns by holding more of its investible foreign assets in the form of rand investments, which normally attract higher returns than other currency markets. The Bank tends to forgo higher returns by holding less rand investments during times when the currency is depreciating. Third, a large portion of the country'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 vis-à-vis the currencies on which the foreign debt is denominated, fewer Maluti are needed to buy a dollar. It also reduces the Loti cost of servicing the debt, presenting an opportunity to pay off some of the higher interest commercial loans.

On the negative side, the effect of Loti appreciation on economic growth can be through reducing the loti value of exports. This reduces revenue and profit and has already resulted in retrenchment of workers in the textile subsector. The economy is highly reliant on exports of textiles and clothing accessories to the United States (US). Thus the appreciation of the local currency erodes the price competitiveness of the exports into the US market. The negative impact on the Lesotho's economy is likely to be worsened by the prevailing recessionary conditions in the US. The newly revived mining industry which exports diamonds to the euro area, could also suffer because of the appreciation of loti. Furthermore, the domestic tourism sector is likely to take a knock as tourists find it expensive to visit South Africa and the region. The tourism sector in Lesotho is still young, therefore, appreciation of the currency will affect it negatively.

### Conclusion

Although the recent strengthening of the Loti against major currencies is beneficial for domestic inflation and interest rates developments, it is important that the local exporting firms remain price competitive. The strong Loti does not bode well with the performance of the textiles and clothing sector, the leading domestic employer in Lesotho; and the recovery of domestic mining industry.

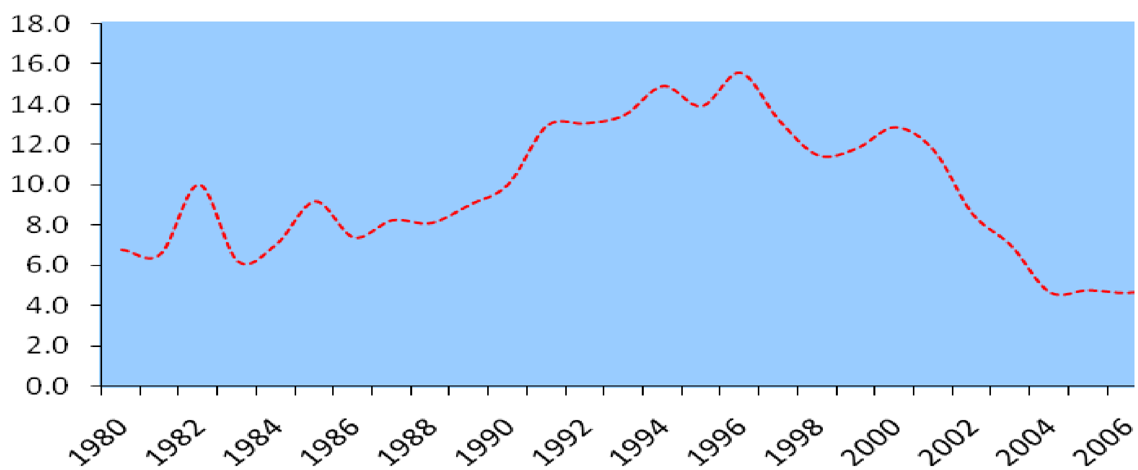
## 2. Outlook of the Construction Sector in Lesotho: Some Implications for the Economy

*The construction sector is expected to recover strongly on the back of several major construction activities scheduled for the coming years ………*

### Introduction

The construction sector is expected to resurge after slowing down in the early 2000's. In the 1990's, the construction sector emerged as the mainstay of the economy of Lesotho, largely driven by the advent of Phase I of the Lesotho Highlands Water Project (LHWP). In terms of its contribution to Gross Domestic Product (GDP), the sector was in the lead till mid-1990's. It reached a peak of 15.6 per cent of GDP in 1996 (see Figure 2). However, following the completion of the project, this sector went into a relapse. Nonetheless, the sector seems to be on a rebound as evidenced by several construction activities in the pipeline, *inter alia*, the commencement of the second phase of the LHWP which would involve construction of the Polihali Dam in Mokhotlong District and the taking-off of the long awaited Millennium Challenge Account (MCA) projects. These construction activities come at the opportune time, when two key sectors (manufacturing and mining sectors) are facing a number of challenges posed by amongst others, the current financial turmoil. The objective of this article, therefore, is to discuss developments in the construction sector and to provide implications for the economy of Lesotho.

**Figure 2: Construction Sector as a Percentage of GDP (1980-2008)**



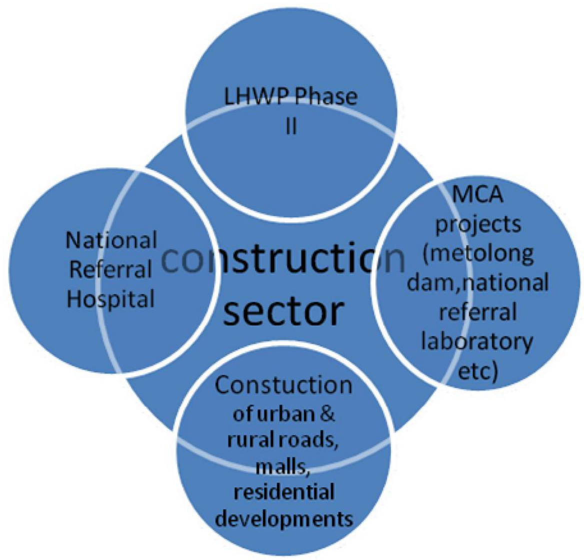

Data Source: Bureau of Statistics

**An Outline of Construction Projects in the Pipeline**

There are several construction related projects which are expected to give thrust to the construction sector. Major projects in the construction sector include the phase 2 of the LHWP, MCA projects and construction of the National Referral Hospital. The second phase of the Lesotho Highlands Water Project (LHWP) is a M7.3 billion project between the Governments of Lesotho and South Africa. This project follows construction of Phase I of the LHWP which involved construction of the Katse and Mohale Dams, while Phase II would involve construction of the 165-m-high, 2.2-billion-cubic-metres reservoir Polihali Dam, in the Mokhotlong District. The project would ensure continuing water supply to the Gauteng province especially the industrial sites. The project is expected to get off the ground in 2011 and would be completed by 2017. This project is expected to be financed partly by funds sourced from the capital markets in the country.

As mentioned above, other construction projects would be those under the MCA. There are several projects under the MCA such as the construction of the Metolong Dam, which will supply water to Maseru, and the neighbouring towns (Mazenod, Roma and Morija). According to the budget speech for 2009/10, the Metolong project would kick-start in late 2009 and it is expected to cost M3.0 billion. There are also construction activities such as the building of the National Referral Laboratory and students' dormitories at the National Health Training College which will also contribute positively to the construction sector. Further, the construction of the National Referral Hospital, whose cost is estimated at M1.0 billion, and construction of both rural and urban roads to the tune of M873 million (Budget Speech 2009/10) would also propel construction activity.

**Figure 3: The Expected Pillars of Construction Activity**



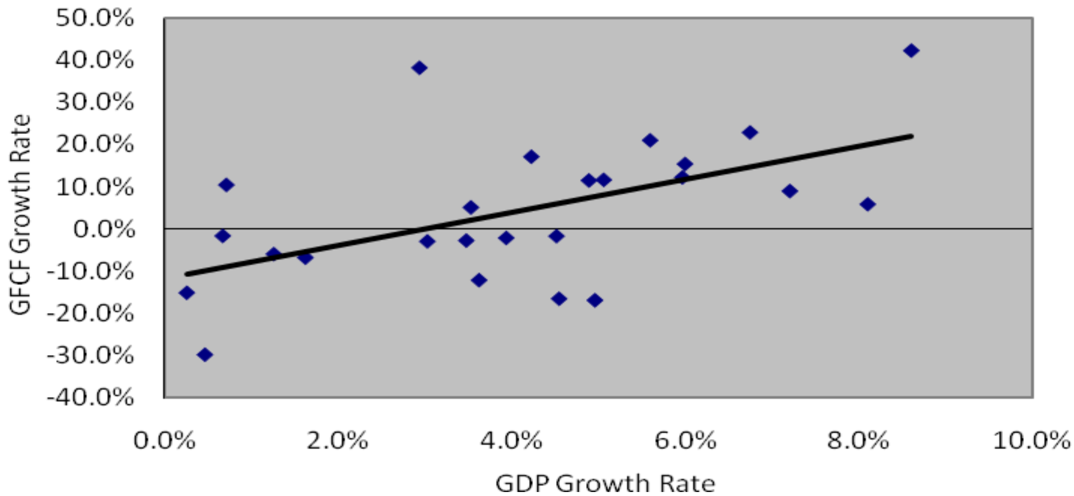

**Implications for the economy of Lesotho**

There are many channels through which these construction activities will impact positively on the economy of Lesotho, at both the micro and macroeconomic levels. First, given the performance of the manufacturing and mining sectors, whose performance depends mainly on consumer demand from outside the country, a recovery in the construction sector will ensure that economic growth is sustained. The positive impact of expenditure on construction activities (dams, roads, hotels and restaurants) derives from economic theory.

Economic theory contends that there is a long-run relationship between capital investment and economic growth. It argues that capital investment increases the marginal product of capital and hence impacts positively on growth of output. Capital accumulation provides workers with better equipment and increases productivity of labour. Thus both output per worker and total output increase. Lesotho's historical data shows a positive relationship between capital investment and economic growth, particularly during the implementation of the LHWP, which involved huge investment in the construction of roads and dams infrastructure (Figure 3). Figure 4 below shows the positive relationship between the growth in GDP and Gross Fixed Capital Formation (GFCF) in Lesotho. It can be seen that during episodes of high growth in GFCF, GDP also picked up.

Further, some theories argue that there is complementarity between government investment and private investment. It is argued that government capital investment leads to private investment. Construction of dams and roads would trigger private investment and employment (skilled and semi-skilled) creation in sectors such as tourism, retail, wholesale and repairs and agriculture. Furthermore, at the macro level these projects will inject a lot of foreign reserves into the economy which will, in turn, boost Lesotho's holding of international reserves and therefore improve its balance of payments. On the fiscal side, these construction activities will generate revenue as economic activity increases. The expansion of LHWP implies increased water royalties as more water would be delivered to SA.

**Figure 4: Relationship between GDP Growth Rate and GFCF Growth Rate**




## 3. Monetary Policy Operations Report for July 2009

The Central Bank of Lesotho's (CBL) main objective is to maintain price stability within the economy. This can be achieved through maintaining adequate level of Net International Reserves (NIR). The adequate level of NIR ensures that the parity between the Loti and the Rand is maintained. The CBL's Monetary Policy Committee set the NIR target range of US$500-US$550.0 million for the review period.

The main objective was achieved through the use of Open Market Operations (OMO). Table 1 below indicates the amount auctioned and discount rates that prevailed for each of the auctions, comparable with their South African (SA) counterparts during the review month. The number of participants in an auction measures the level of competitiveness in the treasury bills' market.

In July, three auctions were undertaken for the 91-day treasury bills and registered participants of 3 bidders who submitted 10 bids on the 1st July. The second auction recorded 4 bidders who submitted 10 bids on the 15th July and third auction saw participants of 7 bidders who submitted 10 bids. The auctions were oversubscribed by more than M20 million in each of the auctions during the review month.

**Table 1: Treasury Bills Auctions**

| Type of Security | Auction Date | Maturity Date | Action Amount (Million Maloti) | Amount Issued (Million Maloti) | Discount Rate (%) | RSA Discount Rate (%) |
|---|---|---|---|---|---|---|
| **91-day** | 01-July-09 | 30- Sep-09 | M10.5 | M10.5 | 6.79% | 7.38% |
| **182-day** | | 30-Dec-09 | M10.5 | M10.5 | 7.17% | 7.32% |
| **273-day** | | 31-Mar-10 | M7.0 | M7.0 | 8.00% | 7.48% |
| **364-day** | | 30-Jun-10 | M7.0 | M7.0 | 7.87% | 7.27% |
| **91-day** | 15-July-09 | 14-Oct-09 | M12.0 | M12.0 | 6.80% | 7.36% |
| **182-day** | | 13-Jan-10 | M12.0 | M12.0 | 7.16% | 7.35% |
| **273-day** | | 14-Apr-10 | M8.0 | M8.0 | 8.00% | 7.44% |
| **364-day** | | 14-Jul-10 | M8.0 | M8.0 | 7.92% | 6.35% |
| **91-day** | 29-July-09 | 28-Oct-09 | M15.0 | M15.0 | 6.80% | 7.43% |
| **182-day** | | 27-Jan-10 | M15.0 | M15.0 | 7.16% | 7.46% |
| **273-day** | | 28-Apr-10 | M10.0 | M10.0 | 8.00% | 7.43% |
| **364-day** | | 28-Jul-10 | M10.0 | M10.0 | 7.92% | 7.29% |
| **Total for reporting period** | | | **M125.0** | **M125.0** | **-** | **-** |

The Lesotho 91-day Treasury bill rate remained steady at 6.80 per cent in July 2009 and it was below that of its SA counterpart. However, other domestic discount rates remained above SA counterpart rates during the review month. The discount rate margin between Lesotho and SA remained within the guideline limit of -2 and +2. The Monetary Policy Operations undertaken in the review period were successful in attaining their desired objectives of Price stability and the target NIR level.

**Figure 5: Measuring the Success of Monetary Policy Objectives: Performance of Lesotho 91-Day T-Bills vs RSA T-Bills**

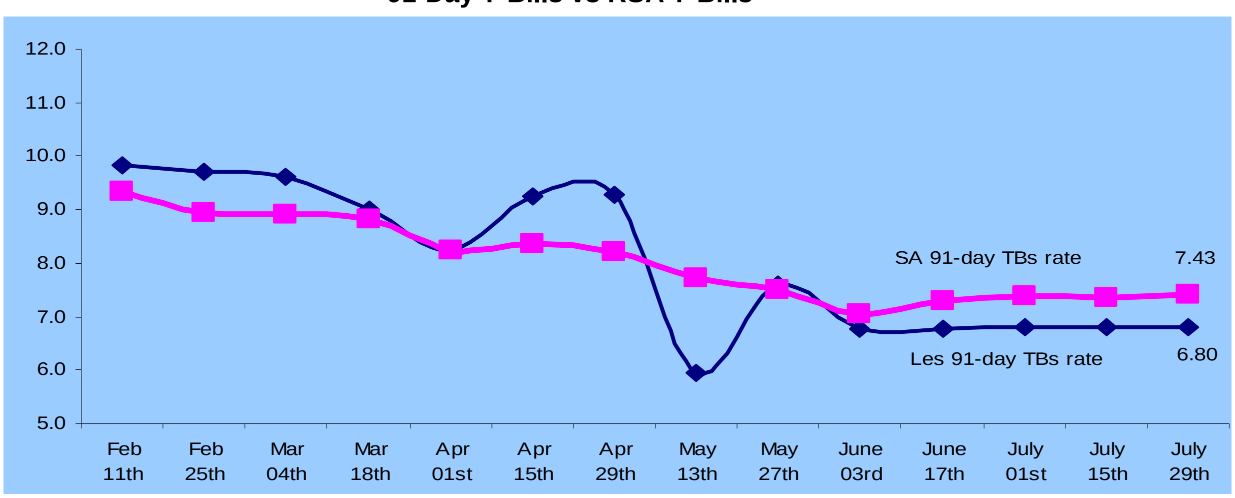


**Table 2: Selected Monetary and Financial Indicators**

| | 2009 | | |
|---|---|---|---|
| | **March** | **April** | **May** |
| ***1. Interest rates (Percent Per Annum)*** | | | |
| *1.1 Prime Lending rate* | 14.50 | 13.83 | 12.83 |
| *1.2 Prime Lending rate in RSA* | 13.00 | 13.00 | 11.00 |
| *1.3 Savings Deposit Rate* | 3.64 | 2.69 | 2.70 |
| *1.4 Interest rate Margin( 1.1 – 1.3)* | 10.86 | 11.14 | 10.13 |
| *1.5 Treasury Bill Yield (91-day)* | 9.00 | 9.27 | 7.60 |
| ***2. Monetary Indicators (Million Maloti)*** | | | |
| *2.1 Broad Money (M2)* | 5629.10 | 5492.77 | 5568.95 |
| *2.2 Net Claims on Government by the Banking System* | -3622.69 | -4781.42 | -4518.60 |
| *2.3 Net Foreign Assets – Banking System* | 11520.93 | 11982.90 | 11632.16 |
| *2.4 CBL Net Foreign Assets* | 8921.95 | 9484.41 | 9100.79 |
| *2.5 Domestic Credit* | -2166.56 | -3301.85 | -2990.37 |
| *2.6 Reserve Money* | 749.96 | 664.22 | 681.37 |
| | | | |
| ***-3. Spot Loti/US$ Exchange Rate (Monthly Average)*** | 9.921 | 8.988 | 8.374 |
| | | | |
| ***4. Inflation Rate (Annual Percentage Changes)*** | 10.1 | 9.5 | 8.9 |
| ***5. External Sector (Million Maloti)*** | **2008** | | **2009** |
| | **QIII** | **QIV** | **QI** |
| *5.1 Current Account Balance* | 269.04 | 330.59 | 322.98 |
| *5.2 Capital and Financial Account Balance* | 1079.61 | -184.20 | 132.85 |
| *5.3 Reserves Assets* | -704.65 | -558.82 | 67.28 |

*+Preliminary Estimates.*

**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 3: Selected Economic Indicators**

| | **2005** | **2006** | **2007** | **2008+** |
|---|---|---|---|---|
| ***1. Output Growth( Percent)*** | | | | |
| *1.1 Gross Domestic Product – GDP* | 0.7 | 8.1 | 5.1 | 3.4 |
| *1.2 Gross National Product – GNI* | -1.9 | 12.0 | 3.0 | 5.0 |
| *1.3 Per capita –GNI* | -1.9 | 12.0 | 2.2 | 4.2 |
| | | | | |
| ***2. Sectoral Growth Rates*** | | | | |
| *2.1 Agriculture* | -12.4 | 14.9 | -8.6 | 1.8 |
| *2.2 Manufacturing* | -10.2 | 6.0 | 9.9 | -4.5 |
| *2.3 Construction* | 5.4 | 3.5 | 6.9 | 7.7 |
| *2.4 Services* | 2.8 | 6.5 | 3.1 | 2.4 |
| | | | | |
| ***3. External Sector – Percent of GNI*** | | | | |
| *3.1 Imports of Goods* | 83.5 | 77.6 | 82.0 | 86.8 |
| *3.2 Current Account* | -5.8 | 3.4 | 9.8 | 9.5 |
| *3.3 Capital and Financial Account* | 3.7 | 0.7 | 5.5 | 5.1 |
| *3.4 Official Reserves (Months of Imports)* | 5.5 | 6.7 | 7.6 | 7.4 |
| | | | | |
| ***4. Government Budget Balance (Percent of GDP)*** | 5.0 | 11.6 | 7.5 | -1.0 |

***+Preliminary Estimates***