Economic Review August 2013

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1. Private Sector Credit Behavior in Lesotho

1.1 Introduction

Deposit-taking institutions perform an important role to source finance to the private sector for consumption and investment in Lesotho. On a one hand, they mobilizes funds from a surplus which are derived from individuals and companies' savings, while on the other hand, extend credit with interest charge to private and public sectors. Credit extension is linked to the transmission mechanism that relays changes in monetary policy which will affect demand for goods and services and the general level of economic activity.

Greater access to credit makes it easier for business enterprises to start capital projects, augment stock levels, increases personnel and to the extent that increase activities. In addition, the availability of credit makes it easier for household to spend now not in the future. However, the excessive credit extension or indebtedness could make creditors vulnerable to adverse shocks and increase risks to the financial system which may lead to financial instability as illustrated by the global financial crisis.

Lesotho experienced rapid private sector credit growth in recent years, supported by low interest rates, low inflation and positive performance of economic growth. The sector is composed of business enterprises and households which are major participants in the financial debt market.

1.2 Determinants of Credit Extension to Private Sector

As indicated earlier, there are two sub-components of private sector; business enterprises and households. Therefore, factors that contribute to changes in credit extension to private sector are as follows:

1.2.1 Business Enterprise

Business enterprises enter into debt market when they experience an increase in demand for output. This implies that a rise in demand for output will significantly influence demand for loans.

1.2.2 Household

Household enter into credit in order to smooth out consumption fluctuation over the course of lifetime. According to life-cycle hypothesis, credit can improve a household's lifetime welfare by allowing it to spread consumption more smoothly across different stages of its life cycle.

A change in credit to household influenced by the following factors:

1.2.2.1 Personal Disposable Income

When disposable income increases it accelerates savings and strengthens assets, and thus reduces credit. In contrast, when disposable income declines, households will use their savings and make greater use of credit in order to maintain consumption expenditure at the desired level.

1.2.2.2 Cost of Credit

The changes in the cost of credit are important factor which influence demand for credit. High interest rate on credit could limit demand for credit, but low interest rate encourages demand for credit.

1.2.2.3 Age Distribution of the Population

When income is relatively low during the early adult years, household will enter into credit to support higher consumption than could be finance by current income alone. Conversely, if income increases during the middle years of the life-cycle, households save and reduce their debt in order to accumulate the wealth necessary to support consumption during retirement years when income is lower.

1.2.2.4 Growth Rate of Deposits

The growth in deposit has a positive effect on credit extension. That is, an increase in deposits provides banks with more funds available for credit extension.

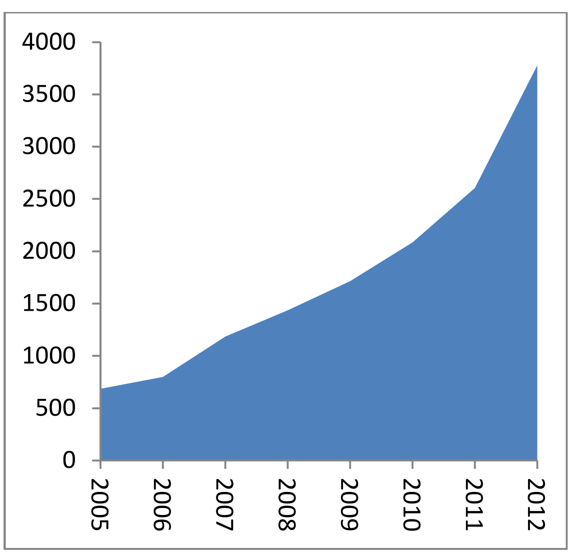
1.2.2.5 Real GDP growth

Real GDP growth measures the country's overall performance, therefore high growth signifies high consumption and investment which may translate into higher demand for credit extension.

1.3 Recent Development in Private Sector Credit Extension in Lesotho

As indicated earlier, credit to the private sector continued to increase and closed the year 2012 at M3.8 billion from M685.9 million registered in the 2005. This is quite encouraging given an important role the private sector plays by stimulating economic growth. *Figure 1* illustrates the development of credit extended to the private sector over eight years.

Figure 1: Credit Extension to Private Sector (Million Maloti)

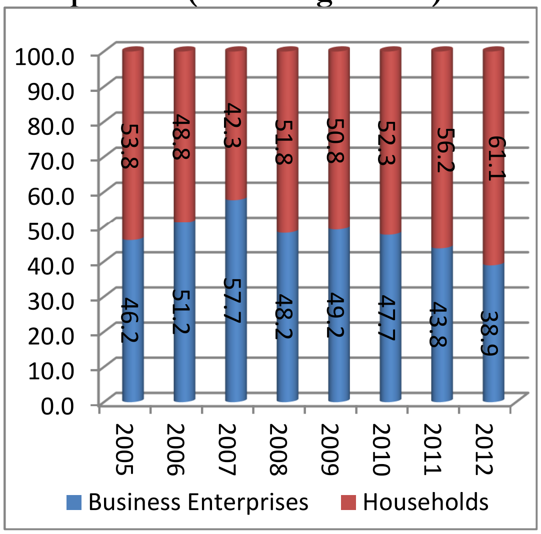


Source: *Central Bank of Lesotho*

Figure 1 depicts a continuous increase in credit to the private sector which rose significantly by 45.0 per cent in 2012 compared with an increase of 25.0 per cent in 2011. This reflected a prudent monetary policy and financial stability in Lesotho. CBL employs Open Market Operation (OMO) instruments to pursue its monetary policy. This can be achieved through maintaining the parity between the loti and the rand by holding adequate level of Net International Reserves (NIR), and it can be done through Treasury Bills' auctions. With regard to financial stability, CBL maintained its responsibility of supervising financial institutions to ensure that financial stability is achieved and maintained in the banking system of Lesotho.

Lesotho's economy is characterized by a higher share of credit to the household than to the business enterprises. This is in contrast with the other economies where a share of credit to business enterprises is higher than a share of credit to household. *Figure 2* depicts the percentage share of credit of each component on total credit.

Figure 2: Credit to Private Sector Components (Percentage Share)

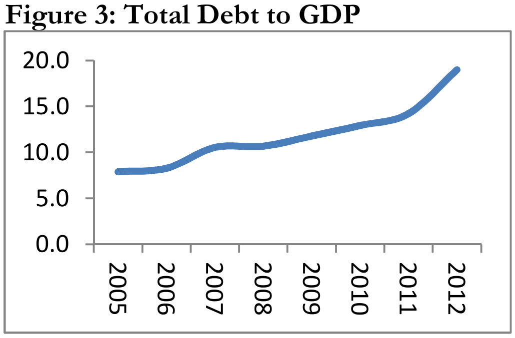


Source: *Central Bank of Lesotho*

In 2012, lending to household accounted for 61.1 per cent of total credit, higher than 38.9 percentage share in business enterprises. Credit to business enterprise started to show a noticeable decline in percentage share since 2010.

Relative to GDP, credit extended to the private sector grew to 19.0 per cent in 2012, from 7.9 per cent in 2005. *Figure 3* indicates an upward trend.

Figure 3: Total Debt to GDP



Source: *Central Bank of Lesotho*

The financial sector in Lesotho, in particular, deposit taking corporations, extends credit to private sector through the following credit products:

a. *Business enterprise*

Business enterprises get credit through overdrafts and term loan, Micro, Small and Medium Enterprises'(MSMEs) loans, trade financing, letters of credit, guarantees foreign exchange contracts, documentary bills for collection, credit derivatives and credit default swaps as well as property financing.

b. *Household*

Households access credit through credit cards, personal loans, housing or mortgage loans, property financing and car or auto loans.

1.4 Conclusion

The developments in the financial debt markets have thus far supported the growth in both business enterprises and household consumption. They also made positive contributions to other sectors in the economy. However, there must be more comprehensive risk management system in order to ensure that banking institutions are able to effectively manage the risks at all times and under all economic conditions.

Firstly, credit to private sector is expected to expand further due to the on-going reforms such as in the introduction of national identification card system and establishment of credit bureau intended to provide valuable information to banking institutions, thereby enabling them to screen out non-viable borrowers. Secondly, the lease-hold system which now can be used as collateral against credit may also lead to higher private sector credit. Thirdly, the establishment of a commercial court intended to address all commercial issues in Lesotho is also expected to lead to more credit.

An increase in credit extension was also supported by Partial Credit Guarantee Fund (PCGF) which was signed by the government and commercial banks, in order to provide guarantee on MSMEs that do not have access to credit and make sure that banks recover portion of their money in an event of a default.

This featured article benefited from:

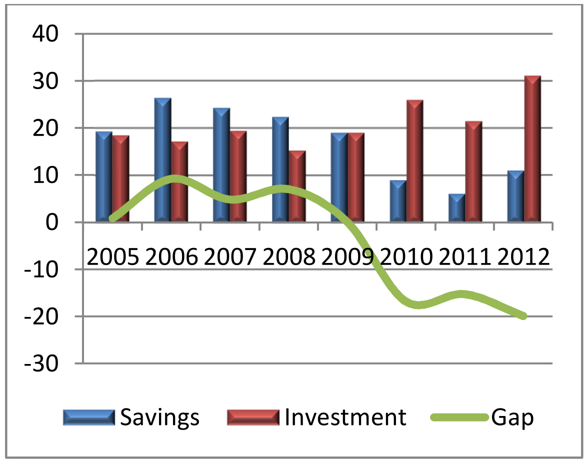
- Chen K.C. and Chevakul, M. (2008). What Drives Household Borrowing and Credit Constraints? Evidence from Bosnia and Herzegovina. IMF Working Paper 08/202.
- Pua Tan, T.B. (2012). Determinants of Credit Growth and Interest Margins in the Philippines and Asia : IMF Working paper 12/123
- Van der Walt, B.E. and Prinsloo, J.W. (1995). The Compilation and Importance of Household Debt in South Africa. Occasional paper No. 8.

2. Saving-Investment Gap

Saving-investment gap refers to the difference between domestic saving and domestic investment. The net results can be positive or negative, and this mirrors current account surplus or deficit in an open economy. The higher domestic saving or higher positive gap signals the level of commitment to the higher future output and thus, raises creditworthiness to international investors because it indicates that the country will be able to service and reduce its external debt. This surplus can also be used to accumulate foreign reserves in order to provide a buffer against external vulnerabilities.

When domestic investment exceeds domestic saving or having a negative gap or current account deficit, the country becomes external vulnerable to finance the gap/deficit. This means that the country must borrow the difference abroad or receive inflows of foreign investment to finance the deficit. In terms of Lesotho, current account deficit continued to widen in 2012, reflecting a decline in savings while level of investment sustained. *Figure 4* depicts the performance of savings-investment gap. The observed continuing negative gap or current account deficit is expected to be financed by external debts or inflows from foreign direct investments.

Figure 4: Savings-Investment Gap in Lesotho (Percent of GNI)



Source: *Central Bank of Lesotho*

3. An Increase in Domestic Fuel Prices

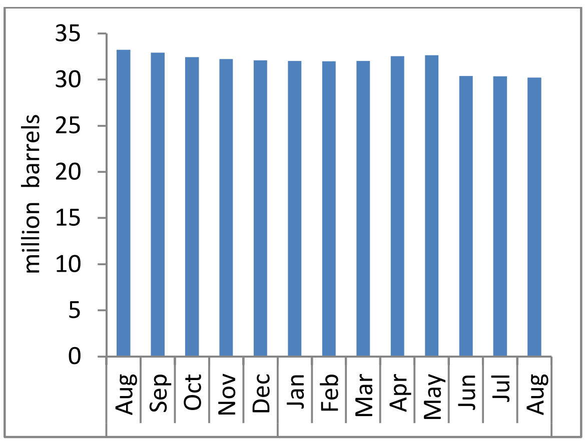
The international crude oil price has risen in recent months and poses a threat to oil-importing economies. In August 2013, price of crude oil reached an average of US$107.52 per barrel, representing an increase of US$3.07 per barrel relative to the previous month. During the review month, the price of crude oil recorded a minimum and maximum of US$104.47 per barrel and US$112.80 per barrel, respectively. An increase in crude oil price led to an upward revision of domestic fuel prices which hampered domestic economic activity.

3.1 Determinants of Oil Prices

The fundamental determinant of crude oil prices is basically the demand-supply balance of oil in the international markets. Therefore, oil price surge is usually a result of demand-supply disequilibrium. Whenever demand exceeds supply, there will always be a shortage hence prices will rise. On a demand side, the demand for oil is determined primarily by rates of economic growth in the major regions of the world. In recent months, the drivers for higher price were US as its economy is recovering, sporadic recovery in the Euro-Area and higher Chinese oil demand as well as economic recovery in other emerging market economies. On the supply side, the supply disruptions emanated largely from some oil producers and exporters in North and West Africa as well as the political instability in the Middle East.

Figure 5 illustrates the movement of crude oil production by Organization for Petroleum Exporting Countries (OPEC). OPEC crude oil production dropped by 0.12 million barrels in August 2013, while the average price of crude oil per barrel rose by US$3.07 during the same period.

Figure 5: OPEC Crude Oil Production (Monthly Average)

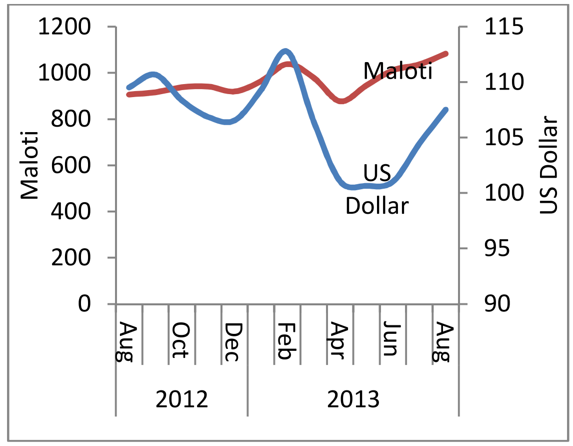


Source: *Bloomberg*

3.2 Implications for Lesotho

In terms of domestic prices, higher price of crude oil was supported by the weakness of the local currency against the US dollar as depicted in *Figure 6* below. In terms of US dollar, it started to grow again in June 2013, after a continuous drop of four months, while in Maloti term it rose from April 2013 at the back of depreciation of the rand/loti.

Figure 6: Crude Oil Price (monthly average)



Source: *Bloomberg*

Lesotho is a net oil-importing country and it is therefore a price-taker on the international oil market. Therefore, an increase in the price of oil poses several challenges for countries such as Lesotho. The immediate and direct effect of a surge in international oil price is an increase in pump prices of petroleum products (petrol, diesel and paraffin). This increase in petroleum products usually has a pass-through effect into prices of other goods and services, and hence this results in higher inflationary pressures. In particular, prices of transportation services will be affected and this has adverse effects on taxi operators since their profit margins will be reduced. Governments' policy response in such instances would be to revise the taxi fare upwards thereby affecting commuters adversely.

In addition, in Lesotho, the rural community uses paraffin for cooking and lighting and diesel for agricultural activity, while urban community use all petroleum products.

Furthermore, Lesotho's economy relies heavily on migrant mineworkers' remittances from South Africa (SA) and the increase in the price of oil might have negative effects on SA mining and manufacturing industries. SA economy is characterised by high energy intensity, especially in its mining and manufacturing sectors (Kohler, 2006). Production costs are likely to increase due to higher oil prices, and therefore manufacturing and mining companies could address this problem by laying-off workers and this implies a fall in migrants' remittances to the country, given that the remittances constitute an important source of foreign reserves for Lesotho. The fall in remittances would in-turn lead to the deterioration of the balance of payments position for Lesotho.

The agricultural sector may also be affected by an increase in fuel prices, particularly diesel. The residents living in rural areas are mostly dependent on subsistence farming. As a result, this will worsen the position of the sector as it is already experiencing negative effects of drought and floods. This indicated that government spending on subsidies such as diesel for tractors as well as seeds and fertilizers will be affected, and thus affect food security.

The following table illustrates domestic fuel price changes in four zones[1] of the country.

Table 1: Domestic Fuel Prices as at 08 August 2013

	Zone 1	Zone 2	Zone 3	Zone 4
Petrol	11.95	12.01	12.04	12.13
Diesel	12.35	12.41	12.44	12.53
Paraffin	9.20	9.25	9.28	9.36

Source: *Lesotho Petroleum Fund (August, 2013)*

4. Featured Descriptor

Quarter-to-quarter: This measurement uses the current period (e.g. day/week) in the current quarter and compares it with the same period (e.g. day/week) in the previous quarter. For instance, Lesotho is publishing Balance of Payments statistics on quarterly basis, comparing the developments in the current quarter versus previous quarter.

[1] ***Zone 1*** *comprises Butha-Buthe, Leribe, Berea, Maseru, Mafeteng and Mohaleshoek, Quthing, Qacha's Nek.* ***Zone 2*** *comprise of Mphaki (Quthing),* ***Zone3*** *comprise of Thaba-Tseka and* ***Zone 4*** *comprise of Mokhotlong*