Economic Review October 2005

LESOTHO SOVEREIGN RATING FOR 2005

Lesotho's long term foreign currency credit rating by Fitch Rating Agency remains unchanged at BB-.....

Background

Fitch sovereign credit ratings refer to the capacity and willingness of a sovereign government to service its debt within the maturity dates and in accordance with the conditions agreed with the creditors at the time the loans were contracted. Regarding the currency in which the debt is denominated, the ratings refer to financial obligations denominated either in national or foreign currency. Furthermore, as for the maturity terms involved, the ratings reflect long-term and short-term obligations. A short-term rating refers to obligations maturing in less than 12 months and thus places greater emphasis on the liquidity necessary to meet financial commitments in a timely manner.

Investors use credit ratings as indications of the likelihood of getting their money back in accordance with the terms on which they invested. The ratings are variations of the scale A, B, C or D. On the scale employed by Fitch, the top rating is 'AAA' and the bottom 'D'. The lower the rating, the bigger the probability of default, and vice versa. Governments rated above 'BBB' are known as 'investment grade' while those rated below fall into the 'speculative grade' category. In determining the payment capacity and willingness to repay debt, Fitch considers macroeconomic variables such as the available stock of foreign currency reserves, balance of payments flows, economic growth prospects and capacity to generate revenue and a variety of political factors.

Lesotho Credit Rating

Lesotho's Long Term Foreign Currency (LTFC) rating has been left unchanged at BB-. It received the same rating as Brazil, Indonesia, Serbia, Turkey, Ukraine and Vietnam. This rating is on the lower end of the 'BB' rating, thus implying that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time. However, this 'speculative' credit rating shows that capacity for continued payment is dependent on a sustained, favourable business and economic environment. As in the previous year, Lesotho's ability to pay off its short-term foreign currency loans is rated 'speculative (B)'. This means that the country has 'minimal capacity for timely payment of financial commitments, plus vulnerability to near-term adverse changes in financial and economic conditions'. The country was rated on a better position to honour long-term local currency commitments than foreign currency obligations at 'BB+' rating.

In the rating process, Fitch identified strengths as well as weaknesses to the rating of Lesotho. Relative political stability, strong integration with the South African economy, strong fiscal position and strong international liquidity were identified as major rating strengths. However, the external shock to the textile sector, public expenditure management and social and development challenges were gauged weaknesses to the rating of Lesotho.

Strengths

Relative Political Stability

Political stability is key to creditworthiness as it implies that there would be minimal disruptions to economic and business activity. Lesotho has enjoyed relative political stability since the 2002 elections, which introduced an element of proportional representation into the electoral system, thereby ensuring a broader representation in parliament. In addition, local elections were conducted for the first time for 129 local councils this year, with one-third of the seats reserved for women. However, the administrative structures are still being put in place.

Integration within the South African Economy

Lesotho is strongly integrated with the South African economy. First, it benefits from access to South Africa's sound transport infrastructure. Second, the South African Government investment in the Lesotho Highlands Water Project (LHWP) which provides water to South Africa is not only a source of revenue for Government but has also resulted in an upgrade of transport infrastructure in the rural areas. Third, its membership of a common monetary area (CMA) has helped in terms of credibility and price stability. Last, it is also a member of the South African Customs Union (SACU) from which it obtains strong customs revenue. Therefore, all these are considered rating strengths.

Strong Fiscal Consolidation and International Liquidity

Lesotho's rating has also been supported by strong fiscal position since 2004/05 fiscal year as well as strong international liquidity. On the one hand, the relatively strong fiscal stance was attributable to receipt of SACU revenue windfall, which caused the revenue to rise to 22 per cent of GDP from 18 per cent in the previous year. In addition, non-SACU revenue performance also continued to benefit from the impact of tax administration reforms. However, Fitch argues that the medium to long-term outlook is less favourable owing to shrinkage in the SACU revenue pool.

On the other hand, Lesotho's external position is characterised by low debt burden and strong liquidity position. Lesotho's net external debt ratios which typically benefit from high official reserves and commercial banks' foreign assets have historically been low. Similarly, in 2004, the country became a net external creditor, and this was largely owing to a substantial increase in commercial banks' foreign assets and further increase in official reserves.

Weaknesses

External Shock to the Textile Industry

Fitch argued that the expiry of the Multi-Fibre Agreement (MFA) at the end of 2004 had a detrimental effect on Lesotho’s textile and clothing industry, despite the continued advantage of duty-free access to the US under Africa Growth and Opportunity Act (AGOA). This has been cited as the major weakness to Lesotho’s rating. The report further showed that the elimination of the quotas system in international trade, resulted in the closure of a number of factories which in turn led to a decline in number of people employed.

Public Expenditure Management

Fitch indicated that more efforts to further improve public expenditure management are needed. Although there was significant expenditure underperformance on account of partial spending on local government elections which took place in April 2005, the postponement of the National Identity card system and a substantial shortfall in capital expenditure, the medium to long-term outlook is less favourable. The main problem from the expenditure side is most likely to stem from growing pressure from social spending (including the old-age pension scheme implemented in November 2004), plans to introduce free secondary school education, the scheme for higher education abroad and the food relief for the most vulnerable. Therefore, a lot must be done to enhance public expenditure management, improve the productivity of public finances and prioritise spending in line with the poverty reduction strategy.

Development and Social Challenges

The report highlights that social and developmental challenges pose a significant constraint to Lesotho’s ratings. The main social issues remain food security caused by erratic weather conditions, soil degradation and erosion and HIV/Aids. Due to its limited arable land, Lesotho has for a long time been a net food importer. According to the report, relief from the Government and international agencies is targeted at around 550,000 vulnerable people including the elderly, HIV/Aids orphans and schoolchildren.

Conclusion

The country has maintained its international credit rating at the same level as the previous year. The build-up of official reserves and commercial banks’ foreign assets, an important rating strength, allowed Lesotho to become a net external creditor. In addition, strong fiscal position due to amongst others, strong SACU revenues was also considered a major rating strength. However, the country is faced with quite a number of challenges. First, structural reforms to restore the competitiveness of the economy following the expiry of the quota system at end-2004 remain the major medium-term challenge. Therefore, efforts to mitigate the situation in the textile and clothing industry should improve the country’s prospects. Second, efforts to further improve public expenditure management and address social and development issues should boost Lesotho’s domestic and international position.

Table 1. Monetary and Financial Indicators+

	August	September	October
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	11.50	11.50	11.50
1.2 Prime Lending rate in RSA	10.50	10.50	10.50
1.3 Savings Deposit Rate	2.00	2.00	2.00
1.4 Interest rate Margin(1.1 – 1.3)	9.50	9.50	9.50
1.5 Treasury Bill Yield (91-day)	7.02	6.89	6.74
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2564.99	2538.31	2519.64
2.2 Net Claims on Government by the Banking System	-1027.26	-866.98	-1209.13
2.3 Net Foreign Assets – Banking System	4495.75	4293.31	4683.29
2.4 CBL Net Foreign Assets	3095.29	2985.48	3436.30
2.5 Domestic Credit	-422.96	-270.09	-573.47
2.6 Reserve Money	374.71	448.77	425.40
3. Spot Loti/US$ Exchange Rate (monthly average)	6.4669	6.3609	6.5895
4. Inflation (year-on-year percentage change)	2.9	3.2	3.4
5. External Sector (Million Maloti)	2005		
	QI	QII	QIII
5.1 Current Account Balance	22.3	-163.3	14.7
5.2 Capital and Financial Account Balance	-15.2	247.7	-53.3
5.3 Reserves Assets	-199.8	-94.6	26.5

+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 2. Selected Economic Indicators

	2001	2002	2003	2004*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	3.2	3.5	3.1	3.1
1.2 Gross Domestic Product Excluding LHWP	3.5	2.9	2.9	3.7

1.3 Gross National Product – GNI	0.2	1.6	6.0	6.1
1.4 Per capita –GNI	-1.9	-0.4	3.8	3.9
2. Sectoral Growth Rates				
2.1 Agriculture	0.5	-4.2	-1.8	0.2
2.2 Manufacturing	7.9	6.9	5.2	5.9
2.3 Construction	1.4	6.9	4.3	0.4
2.4 Services	2.2	2.2	3.9	4.4
3. External Sector – Percent of GNI Excluding LHWP				
3.1 Imports of Goods	75.3	93.9	79.4	73.0
3.2 Current Account	-2.9	-11.6	-5.7	-0.8
3.3 Official Reserves (Months of Imports)	11.7	6.2	5.8	5.8
4. Government Budget Balance (Percent of GDP)	0.3	-5.5	-1.9	7.7

* Preliminary estimates