CENTRAL BANK OF LESOTHO

ANNUAL REPORT

2006

Maseru
March 2007

BOARD OF DIRECTORS

E. M. Matekane[1]	-	Governor & Chairman of the Board
M. Senaoana[2]	-	Deputy Governor I (Acting Governor)
R. Matlanyane[3]	-	Deputy Governor II
P. M. Makhetha	-	Director
M. G. Tau-Thabane	-	Director
P. M. I. S. Ledimo	-	Director
J. Q. Lesitha	-	Director
E. K. Molemohi	-	Director

MANAGEMENT

E. M. Matekane[1]	-	Governor
M. Senaoana	-	Deputy Governor I (Acting Governor)
R. Matlanyane	-	Deputy Governor II
T. Namane[4]	-	Director of Operations
M. Mofelehetsi	-	Director of Supervision
L. Kirstein nee Kili	-	Director of Administration
M. Makenete	-	Director of Financial Markets
M. S. Mahooana	-	Director of Information & Communication Technology
M. Monyau[5]	-	Director of Research
T. Makara	-	General Manager – Lehakoe Recreation and Cultural Centre

DIVISIONAL HEADS

Governor's Office

A. L. Ramone[6]	-	Board Secretariat
M. Maharasoa	-	Acting Head of Division
N. E. Mashologu	-	Public Relations
J. Nts'ekhe	-	Internal Audit
L. Khaka	-	Accounts & Budget

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[1] Contract expired 10 September 2006
[2] Appointed on 1 April 2006
[3] Appointed on 1 April 2006
[4] Appointed on 1 January 2006
[5] Appointed on 16 January 2006
[6] Contract expired June 2006

Administration

M. Molekane	-	Human Resources
T. Malataliana	-	General Services & Maintenance
M. 'Nyane	-	Security Services

Information and Communications Technology

M. Mahooana	-	Business Solutions Development
T. Mpheteng	-	Infrastructure & Operations

Operations

A. M. Letsie	-	Banking Operations
S. Phate	-	Currency
M. Motebang	-	Payment Systems
M. Tabane	-	Development Finance
N. Bereng	-	Rural Finance

Supervision

M. F. Mohasoa	-	Financial Institutions Supervision
T. Metsing	-	Supervisory Policies & Regulation
F. Morokole	-	Insurance Supervision
M. Keta	-	Policy, Regulations & Exchange Control

Financial Markets

R. Elias[7]	-	Dealing and Strategy
F. M. Hloaele	-	Treasury Operations

Research

Vacant	-	Real Sector
L. M. Lephoto	-	Finance
T. Tlelima	-	Macroanalysis

[7] Up to January 2006

Central Bank of Lesotho
P O Box 1184
MASERU 100
Lesotho

March 31, 2007

Honourable Minister
Ministry of Finance and Development Planning
P O Box 395
MASERU 100
Lesotho

Honourable Minister

I have the honour to transmit the Annual Report of the Central Bank of Lesotho for the year 2006, which includes:

(a) a review of economic developments during the year; and

(b) in accordance with Section 53 (1) of the Central Bank of Lesotho Act No.2 of 2000:

    i) the Bank's annual accounts for the year ended December 31, 2006, certified by Sheeran & Associates assisted by Pricewaterhouse Coopers; and

    ii) a report on the Bank's operations and statement of affairs during 2006.

Yours faithfully

M. Senaoana (Dr)
GOVERNOR a. i.

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PART 1: THE DEVELOPMENT OF THE MONEY MARKET IN LESOTHO

1.1 Introduction

The money market is a market for short-term instruments with a maturity period of one year or less. The market can broadly be divided into two categories: the primary market, and the secondary market. In the primary market, securities and other instruments are sold by issuers to initial buyers. The secondary market relates to re-trading of debt instruments that have previously been issued. The design and term structure of these instruments allows for their resale by original holders before maturity.

A well-developed money market provides a channel through which the central bank implements its monetary policy decisions. The Central Bank of Lesotho (CBL) seeks to influence reserve money as its operating target through the open market operations. The Bank uses the treasury bill rate as its intermediate target while an adequate amount of net foreign assets is the ultimate target of monetary policy. This policy option is driven by the fact that price stability is mainly pursued on a regional level through maintenance of a peg between the local currency (the Loti) and the South African Rand. Within this framework, a well functioning money market allows monetary policy signals in the form of announced auction amounts to be transmitted through determination of market clearing rates by participants.

The money market facilitates the raising of short term funds by investors. This promotes financial stability as institutions are enabled to manage their short-term funds by selling debt instruments to attract idle funds, and providing deficit institutions with funding. Liquidity is a critical feature of the money market as it reduces the cost of borrowing and increases participation and efficiency of the market. The availability of liquidity and proper infrastructure also promote a culture of investing and efficient portfolio management, serving as an important precursor to the development of capital markets.

In Lesotho, instruments traded in this market include government treasury bills, central bank paper, repurchase agreements (repos), interbank funds, and bankers' acceptances. Government securities, central bank paper and repos are issued by the central bank mainly for managing liquidity in the economy. Interbank funds relate to lending of funds between commercial banks while bankers' acceptances are short-term credit instruments that are issued by banks mostly on behalf of their manufacturing customers to guarantee payment of their imported raw materials.

1.2 The Money Market prior to 2001

The development of the money market has been the focus of the CBL for a number of years. The Bank has followed a phased approach in implementing plans in this regard. The processes can be separated into two broad phases: the set up prior to 2001 and improvements undertaken post 2001. The former period was an introductory phase that exposed domestic investors to a securities market. The latter phase improved from the former by introducing more instruments, establishing a competitive bidding system, and pursuing monetary policy objectives using money market based instruments.

The primary market in Lesotho has traditionally been facilitated by issuance of 91-day treasury bills administered by the CBL. Between April 1992 and September 2001, a fixed stock of M153.0 million was sold to banks and the public to encourage a culture of savings and participation in the market. The auctions were held quarterly at first but later the frequency was increased to monthly. The market was characterised by automatic roll-over of mature securities into the next auction. Participation was further encouraged by issuing a minimum value of M100.00, which was perceived to be relatively affordable to small investors. However, an efficient price mechanism failed to emerge as interest rates were determined administratively by the CBL.

Other than government securities, there were virtually no other money market instruments. Commercial banks had huge volumes of surplus funds that the CBL paid interest on, and were not motivated to issue instruments to raise funds. This contributed to the failure of the secondary market to develop during the period. Securities were largely held to maturity and these large players found no reason to trade in-between auctions. Temporary cash needs could be met by simply drawing down on the surplus funds held with CBL. The majority of investors comprised individuals who held securities with small face values which were not useful for secondary market trading. In addition, the secondary market was limited by the absence of a supporting legal framework for changes in ownership of securities. The absence of mechanisms to discourage premature disinvestment encouraged investors to use the CBL as 'buyer of first resort'.

The interbank market remained subdued due to existence of excess liquidity in the banking system, and payment of interest on commercial bank's surplus funds held with CBL. Commercial banks need the interbank market to settle shortages of funds in the banking sector. This shortage can be created directly by the central bank through setting minimum reserve requirements and indirectly through the issuance of securities; or by commercial banks by extending credit. However, the system of paying interest on funds in excess of required reserves enticed banks to keep high liquid balances with CBL. This practice discouraged the active use of the interbank market as banks could withdraw some of their surplus funds held with the CBL when need arose.

1.3 Developments of the Money Market Post 2001

1.3.1 Inception of Open Market Operations (OMO)

Late in 2001 the CBL introduced indirect instruments of monetary policy in the form of open market operations which brought some improvements in the primary market. The 91-day treasury bills were then traded competitively for monetary policy purposes, and were mainly purchased by large investors as the minimum bid amount was set at M250,000.00. The CBL determined liquidity levels in the market and announced the auction amount. In this way the interest rate was market determined through auctions. In addition, the 182-day treasury bills were introduced. These securities comprised a competitive component for setting the rate, and a non-competitive component for small buyers. A higher minimum bid amount of M5000.00 was set for small non-competitive investors to discourage the culture of treating the securities as deposit accounts. The practice of rolling over mature securities into the next auction was dropped to encourage investors to get accustomed to taking investment decisions. The CBL also stopped paying interest on banks' surplus funds and reduced these funds significantly by making arrangements for banks to migrate to treasury bills. The excess above required liquid assets fell from over M500 million before the OMO reform to around M150 million afterwards.

1.3.2 Repurchase Agreements and Lombard Credit Facility

The CBL introduced two more instruments in the primary market targeted towards banks. The first instrument was repos, used at the behest of CBL, and entailed sale of securities with an agreement to buy them back at a specified period. These were introduced for management of liquidity in-between treasury bill auctions. Therefore, an unexpected surge in liquidity would be absorbed by a sale of securities with an agreement for a buy-back within seven days. The second instrument was the Lombard Credit window, used at an initiative of commercial banks, and gives access to overnight funding at punitive rates of interest. This was intended for use as a last resort, to encourage banks to use the interbank market.

1.3.3 Other Developments

Attempts were made to influence the secondary market to develop. Procedures were formulated to allow for change of ownership of securities, and their use as collateral. Furthermore, a penalty for premature disinvestment was introduced to discourage investors to use the CBL as 'buyer of first resort'.

1.4 Current Situational Analysis

The present system of treasury bills' auctions has been running for more than five years. To date, over M500 million of the allocated M700 million stock of treasury bills have been issued. This is divided between 91-day treasury bill issues auctioned monthly and 182-day treasury bills auction held once every two months. Banks enjoy a strong presence in the primary market, especially for the 91-day securities. The increased minimum limit of M5000.00 for participation in the 182-day securities auctions reduced the numbers of investors significantly.

Due to fairly stable liquidity conditions, the repos instrument was used only once since its inception. However, the success of that operation proved that it is a well-designed tool that commercial banks respond to promptly. Operationally, a commercial bank is awarded a Lombard Credit after applying for it and pledging securities to CBL if it foresees a deficit in its clearing account at end-of-day settlement. However, the implementation of the Real Time Gross Settlement (RTGS) system in August 2006 means that banks now have to maintain funds in their clearing accounts.

Debt instruments offered by other market players are still very limited. Bankers' acceptances are minimally being used by manufacturers who export their wares. Excess liquidity levels remain high in the banking system. This is partly caused by lower levels of credit extension, which falls short of deposit mobilisation rate. The credit-deposit ratio closed the year 2006 at a low 26.5 per cent. The existence of excess liquidity will continue to be a disincentive for issuance of money market instruments. Banks are more likely to issue more debt instruments if they are in need of funds.

1.5 Way Forward

The CBL has turned its attention on the money market again with the intention of developing it further. As such, CBL has set up a Task Team to develop a blueprint in consultation with other market players such as commercial banks.

The existing excess liquidity in the banking system continues to be a disincentive to the issuance of more debt instruments by banks. Evidence shows that there is demand for additional instruments with competitive returns by businesses, institutions and the general public.

The under-development of the secondary market despite policy measures undertaken in the past has made it clear that some market making arrangement is also needed. This could be in the form of a discount house, which is an institution that will buy and sell securities in the secondary market and make returns from margins of buy and sell rates. Due to the relatively small size of the market, such an institution might not be financially viable if privately owned. The possibility of establishing such a facility within CBL is being explored.

PART II WORLD ECONOMIC DEVELOPMENTS AND THEIR IMPLICATIONS ON THE ECONOMY OF LESOTHO

2.1 Industrialised Countries

2.1.1 The United States

Economic growth in the US accelerated in 2006 due to observed growth in consumer, government and investment spending. On average, growth in real gross domestic product (GDP) was 3.4 per cent in 2006 compared with 3.2 per cent in 2005.

The IMF estimated that unemployment rate, for the year under review, would improve from 5.1 per cent recorded in 2005 to 4.8 per cent. On a quarterly basis, the rate of unemployment fluctuated between 4.7 per cent and 4.6 per cent from the first to the third quarter of 2006.

The rate of inflation in the US slowed down during 2006. It was recorded at 2.8 per cent in 2006 compared with 3.4 per cent in 2005. This emanated from a subdued increase in the international oil prices in 2006 compared to 2005 even though aggregate demand components surged. At this rate, inflation is still considered to be high since it is above the psychological rate of 2.0 per cent hence interest rates in the US maintained an upward trend. The Federal Reserve Bank's Open Market Committee (FOMC) raised its benchmark lending rate by 100 basis points during the year from 4.25 per cent at the end of 2005 to 5.25 per cent at the end of 2006.

As a result of faster economic growth, the slow down in inflation rate and lower unemployment rate, the overall performance of the US economy was considered positive. These developments bode well for the economy of Lesotho since a large share of Lesotho's exports is destined to the US market.

2.1.2 The Euro-Zone

According to IMF projections, real GDP in the Euro-zone[8] was expected to grow by 2.4 per cent in 2006 against 1.3 per cent realised in 2005. This expected acceleration was based on the benefits of the hosting of

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[8] Euro-zone comprises: Austria, Belgium, Germany, Greece, Finland, France, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain.

Federation International'e de Football Association (FIFA) world cup by Germany in 2006.

Unemployment rate in the region was recorded at 8.1, 7.8 and 7.9 per cent during the first, second and third quarter, respectively. The IMF has forecast a rate of 7.9 per cent for 2006 against 8.6 per cent realised in 2005.

Inflation in the Euro-Zone was expected to have increased marginally during the year on the back of higher international oil prices. According to IMF projections, annual average inflation rate in the region, as measured by changes in the Harmonised Index of Consumer Prices (HICP), closed the year higher at 2.3 per cent in 2006 against 2.2 per cent realised in 2005. At this rate, it is still above the European Central Bank's (ECB) targeted rate of 2.0 per cent. Hence the ECB raised its benchmark-lending rate from 2.5 per cent during the second quarter to 3.0 per cent during the third quarter. At the end of the year, the rate was recorded at 3.25 per cent.

Economic developments in the Euro-zone have a direct effect on Lesotho's economy since most of its diamond exports are destined to this region. Furthermore, the European Union (EU) is also South Africa's (SA) main trading partner. Shocks to the SA economy can easily be transmitted to Lesotho since the two countries are closely linked economically. Thus the positive economic performance of the Euro-Zone as evidenced by the acceleration in the growth rate of GDP and improvement in the unemployment rate augurs well for both SA and Lesotho economies.

2.2 Emerging Markets[9]

Economic activity in the emerging market economies generally slowed down in 2006. While growth in China and India remained relatively robust, the expansion in the rest of the Asian region slowed down, reflecting, among other factors, the negative impact of the high oil prices and monetary policy tightening in response to rising inflation. As a result, the IMF estimated that the region would realise a real GDP growth of 8.3 per cent in 2006 as opposed to 8.5 per cent observed in the previous year.

Annual consumer inflation in the region was estimated at 3.6 per cent in the review year compared with 3.4 per cent in 2005. The observed acceleration in inflation rate in the region could exert upward pressure on the cost of raw materials to Lesotho's manufacturing firms thereby increasing the country's import bill, as most of the local textile firms' source raw materials from Asia.

On the balance of payments (BOP), the current account surplus in the emerging Asian economies was projected to decline to 4.3 per cent of GDP in 2006, from 4.7 per cent in 2005. The current account surplus in China continued to rise and now it accounts for about 70 per cent of the regional surplus due to rapid growth in manufacturing exports. However, current account deficits were observed in other countries in the region such as Bangladesh, India, Pakistan and Thailand.

Economic activity in Latin America was expected to strengthen in 2006, due to a pick-up in domestic demand as well as global economic activity. The IMF projections indicated an acceleration in the growth rate of GDP from 4.3 per cent realised in 2005 to 4.8 per cent in 2006.

Accelerated economic activity in emerging markets bodes well for developing countries like Lesotho, as they would benefit from diversifying their export base across markets, and in particular, increase their export share in emerging markets.

[9] Emerging markets are countries or geographic regions that have large territories and populations, and are undertaking extraordinary development projects. These countries are characterised by economic policies leading to faster economic growth and expanding trade and investment with the rest of the world. Their economic growth has enormous spill-over into their respective regions. Such countries are; Argentina, Brazil, Chile, Czech Republic, Hungary, India, Malaysia, Mexico, Paraguay, Poland, Russia, South Africa, South Korea, Thailand, Turkey, Uruguay, Vietnam, the Association of South East Asian Nations (ASEAN), and the Chinese Economic Area (China, Hong Kong, and Taiwan).

2.3 South Africa

In SA, the economy strengthened throughout the year. In seasonally adjusted and real terms, GDP grew by 4.0 per cent in the first quarter and closed the year at 5.6 per cent. The strong growth was mainly supported by expansion in the construction sub-sector, coupled with increased manufacturing production.

The rate of inflation in SA, as measured by changes in the consumer price index excluding interest on mortgage bonds, CPIX, closed the year lower than at the end of the previous year. As in 2005, it remained within the target range of 3.0 to 6.0 per cent. The CPIX increased by 4.7 per cent in the review year compared to 3.9 per cent realised during 2005. It was recorded higher at 5.0 per cent in December 2006 compared to 4.0 per cent during the same period in 2005. Although the Rand depreciated throughout the year, it stabilised and this helped mitigate the effect of high international oil prices on inflation. On average, producer price inflation (PPI) increased by an annual rate of 7.7 per cent during 2006 compared to 3.1 per cent in 2005. It closed the year at 9.3 per cent in 2006 compared with 5.1 per cent recorded in 2005.

The rising inflation trend influenced the South African Reserve Bank's (SARB) Monetary Policy Committee (MPC) to increase the key interest rate by 200 basis points during the year. Thus the repo rate closed the year at 9.0 per cent compared to 7.0 per cent at the end of 2005.

The improved performance of the SA economy augurs well for Lesotho. However, the upward pressure on prices remained a threat because of the close trade linkages between Lesotho and SA.

Table 1

SELECTED ECONOMIC INDICATORS, 2002 – 2006*

(Annual percentage changes unless otherwise stated)

Indicators	2002	2003	2004	2005	2006*
World Output	3.0	4.0	5.3	4.9	5.1
Advanced Economies	1.6	1.9	3.2	2.6	3.1
Other emerging market and Developing Countries	4.8	6.5	7.7	7.4	7.3
Africa	3.5	4.6	5.5	5.4	5.4
Central and Eastern Europe	4.4	4.6	6.5	5.4	5.3
Commonwealth of Independent states	5.4	7.9	8.4	6.5	6.8
Developing Asia	6.6	8.1	8.8	9.0	8.7
Middle East	4.3	6.5	5.5	5.7	5.8
Western Hemisphere	-0.1	2.2	5.7	4.3	4.8
Consumer Prices					
Advanced Economies	1.5	1.8	2.0	2.3	2.6
Other emerging market and Developing Countries	6.0	6.0	5.6	5.3	5.2
World Trade Volume (Goods and Services)	3.3	5.4	10.6	7.4	8.9
Imports					
Advanced Economies	2.6	4.1	9.1	6.0	7.5
Other emerging market and Developing Countries	6.0	11.1	16.4	11.9	13.0
Exports					
Advanced Economies	2.2	3.1	8.8	5.5	8.0
Other emerging market and Developing Countries	6.6	10.8	14.6	11.8	10.7

SOURCE: IMF World Economic Outlook September 2006. *Financial Systems and Economic Cycles.*
* IMF Projections

2.4 Commodity Price Developments

2.4.1 Gold Prices

The price of gold has maintained an upward trend in recent years. It increased by 35.7 per cent from an annual average of US$445.42 an ounce in 2005 to US$604.65 an ounce. In the review year, the minimum and maximum price levels were recorded at US$516.88 and US$714.80, respectively, compared to the minimum and maximum price levels of US$412.70 and US$528.0 an ounce, respectively, during 2005. The surge in the price of gold was mainly influenced by high demand by European investors as the metal became cheaper due to the depreciation of the US Dollar against major currencies, such as the Euro. In Rand terms, the annual average price increased from R2,837.55 per ounce in 2005 to R4,099.82 per ounce in 2006.

The increase in the price of gold, both in Dollar and Rand terms, bodes well for the SA mining sector and employment prospects for Lesotho. Furthermore, the increase in the Rand price of gold, if sustained, could result in the improvement in profitability of the SA mining companies. This increase could help secure the existing employment status of Basotho migrant mineworkers and their remittances.

2.4.2 Oil Prices

The oil market was characterised by high crude oil prices during the year under review. For the large part of the year, the price remained far above the upper limit of the Organisation of the Petroleum Exporting Countries' (OPEC)[10] target of US$22-US$28 per barrel. In 2006, the minimum and maximum price levels were recorded at US$53.37 and US$72.64 per barrel, respectively, compared to US$35.67 and US$61.37 per barrel, respectively, in 2005. It closed the year at US$56.0 per barrel compared to US$51.73 per barrel at the end of 2005. On average, it registered US$61.19 per barrel in 2006 compared to US$50.61 in 2005.

The increase in international oil prices resulted from a combination of demand and supply-side factors. They increased amid concerns on the intensification of the standoff over the Islamic Republic of Iran's nuclear programme, the outbreak of fighting in Lebanon and Israel, and the closing of a large Alaskan oil field by British Petroleum. Furthermore, continued violence in the Nigerian oil-producing region and security threats to Iraq oil infrastructure contributed to market fears about

[10] OPEC comprises: Algeria, Indonesia, Islam Republic of Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates and Venezuela.

potential supply shortages. Expansion in oil consumption in China, Japan and India also continued to be the main reason for the soaring oil prices.

On average, the price of crude oil increased by 28.7 per cent from M322.41 per barrel in 2005 to M414.92 at the end of 2006. In line with global developments, there were revisions of prices of fuel in the country during the review year. Prices of oil products in Lesotho closed the review year higher at M5.65 per litre of petrol, M6.30 per litre of diesel and M4.25 per litre of illuminating paraffin. These compare with M5.40 per litre of petrol, M5.60 per litre of diesel and M4.05 per litre of illuminating paraffin at the end of 2005. In August 2006, the prices of oil products in the country reached a maximum of M6.50, M6.80 and M4.65 per litre of petrol, diesel and illuminating paraffin, respectively. In addition, in June 2006, the road maintenance levies for petrol and diesel were doubled from 15 cents to 30 cents per litre, and from 20 cents to 40 cents per litre, respectively.

The continued increase in the international oil prices does not bode well for the Lesotho economy. It has implications on inflation, the cost of production and therefore profitability and employment prospects.

2.5 Lesotho in the Context of Regional Economic Integration

Lesotho continued to actively participate in the activities of regional economic organizations in order to address the challenges of poverty reduction and sustainable economic growth. The country continued with its membership in the Southern African Customs Union (SACU)[11], Southern African Development Community (SADC)[12] and the Common Monetary Area (CMA)[13].

During the review year, SACU continued to negotiate various free trade agreements (FTA) with major trading blocs and countries outside its borders, and in particular, it participated in the Doha Development Agenda negotiations. The Doha Development Round negotiations proceeded with a formal meeting of the Trade Negotiations Committee in Geneva, Switzerland in July 2006. The negotiations were intended to address an imbalance against the developing countries that existed in the world trade system. Furthermore, the negotiations intended to reduce the trade barriers between member states and liberalise trade and

[11] SACU comprises: Botswana, Lesotho, Namibia, South Africa and Swaziland .
[12] SADC comprises: Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.
[13] CMA comprises: Lesotho, Namibia, South Africa and Swaziland.

investment rules. However in 2006, there was little progress in this regard and as a consequence the negotiations were suspended.

The SACU-US FTA negotiations that started in 2003, aimed at enabling the region to continue the same benefits as under African Growth and Opportunities Act (AGOA) even after expiry, were inconclusive in 2006. SACU member states did not accept a trade regime offered by the US, which failed to recognise the differing degrees of economic development within SACU. As a result of the breakdown of the US-SACU FTA negotiations, SACU formally accepted an alternative offer made by the US to open new negotiations on trade and investment cooperation agreement (TICA).

During the first half of 2006, SACU and the European Free Trade Association (EFTA)[14] signed an FTA, which was the first concluded with any third country or group since the implementation of the 2002 SACU Agreement. The Agreement is envisaged to promote fair trade relations between the two regions. In particular, it is expected to open up duty-free and quota-free access for SACU industrial products to EFTA's markets and have the same or better rules-of-origin requirements as the trade agreement SA has with the EU.

In July 2006, India cleared a proposal for a framework agreement aimed at promoting expansion of trade and providing a mechanism to negotiate a Comprehensive Free Trade Agreement (CFTA), within a reasonable time, for cooperation between India and SACU. This Agreement is expected to promote trade and economic cooperation between India and SACU members.

Progress was also made with regard to SADC activities. In December 2006, the African Development Bank (AfDB) and SADC signed the Protocol Agreement for the SADC Multinational Project on strengthening institutions for risk management of Trans-boundary Animal Diseases (TADs). The SADC secretariat is the executing agency for the project which is to be implemented in five SADC member states, namely; Angola, Malawi, Mozambique, Tanzania and Zambia. The main objectives of the project are to increase the capacity of these member states to export livestock and its products, and also to reduce incidences of trans-boundary animal diseases.

In addition, SADC continued the Economic Partnership Agreement (EPA) negotiations with the European Community (EC) which were launched in July 2004. The negotiations were suspended, at technical level, in 2005 when both sides realized that any viable regional integration process in

[14] EFTA comprises: Iceland, Lichtenstein, Norway and Switzerland

Southern Africa could not be achieved without sorting out the trade consequences of the EC-SA Trade, Development and Cooperation Agreement (TDCA) on the other members of the SACU. As a consequence, SADC made a proposal in 2006 to align both the TDCA Review process and the EC-SADC EPA into a single negotiating process. These negotiations are expected to be concluded by end of December 2007.

Furthermore, during the year under review, the SADC Finance and Investment Protocol was signed in Maseru, Lesotho. Through the implementation of this protocol, the SADC intends to establish an FTA by 2008, a customs union[15] by 2010, a common market[16] by 2015, and a monetary union[17] by 2016.

A broader economic integration is expected to have positive implications for the economy of Lesotho. Firstly, it could lead to higher access of Lesotho's products in international markets, which is in line with the on-going Government's initiative for local firms to diversify their markets in terms of exporting to variety of countries and regions. Diversification of markets is also envisaged to reduce Lesotho's dependence on SA. Secondly, a broader economic integration could also attract more foreign direct investment (FDI) into the country. Consequently this could lead to higher employment prospects in the country and hence poverty reduction. Thirdly, Lesotho's export earnings could increase and hence lead to the improvement in the Balance of Payments (BOP) position.

[15] A form of economic integration by which a group of countries charges a common set of tariffs to the rest of the world while allowing free trade among themselves.

[16] A form of economic integration, typically formed by nations with the intention to eliminate or markedly reduce trade barriers among its members.

[17] A form of economic integration whereby several countries have agreed to share a single currency

PART III DOMESTIC ECONOMIC DEVELOPMENTS

3.1 Real Sector Developments

3.1.1 Trends in output and income

According to preliminary estimates of the CBL, real GDP was projected to expand by 6.2 per cent in 2006 compared with the revised actual of 2.9 per cent in 2005. Although the economy has improved quite remarkably, it is still below the SADC set target of more than 7.0 per cent growth for 2006, according to the SADC Macroeconomic Convergence Targets.

The upward trend is mostly driven by the secondary sector as manufacturing output assumed an upturn. The expiry of the Multi Fibre Agreement (MFA) turned out to have a less severe impact on the 'textile and clothing' industry than originally anticipated, following some corrective measures undertaken by Government such as the provision of tax incentives and establishment of a one-stop trade facilitation centre. In addition, the depreciation of the Loti *vis-à-vis* the US Dollar improved the competitiveness of the industry. Robust economic activity was also supported by the primary sector as the mining and quarrying sub-sector's production continued to increase.

Gross National Income (GNI) in real terms was estimated to register a 7.1 per cent growth in 2006, following a 4.0 per cent increase realised in 2005. The increase in GNI continued to be fuelled by the rise in net factor income from abroad dominated by miners' remittances. The latter rose on account of, amongst others, the depreciation of the Rand and the high price of gold and platinum which translated into a marginal increase in employment in the mines.

Miners' remittances increased by 22.8 per cent in contrast to 10.1 per cent contraction in 2005. GNI per capita was estimated to increase by 5.8 per cent compared to only 1.9 per cent in the previous year.

Table 2

AGGREGATE ECONOMIC INDICATORS
(Percentage Changes)

	2002	2003	2004	2005	2006*
Constant 1995 Prices					
GDP	3.5	3.3	3.1	2.9	6.2
GNI	1.3	5.4	7.8	4.0	7.1
GDP Per Capita	1.0	0.4	1.8	0.8	4.9
GNI Per Capita	-0.5	3.1	5.5	1.9	5.8

Source: Bureau of Statistics
* CBL Projections

3.1.2 Sectoral Performances

(a) Developments in the Primary Sector

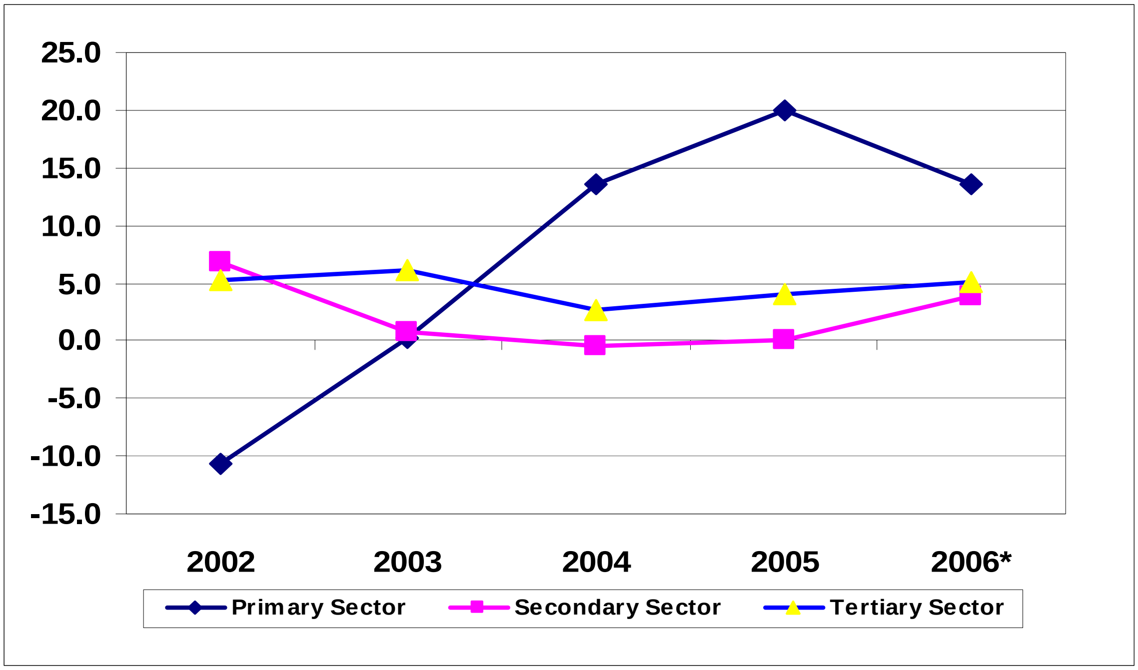
The primary sector consists of agriculture as well as mining and quarrying sub-sectors. Preliminary estimates indicate that performance by this sector improved by 13.5 per cent following a 20.0 per cent increase in the previous year. Growth in this sector continued to reflect the relatively robust performance of the mining and quarrying sub-sector. In addition, the agricultural sub-sector recovered in 2006 following weak performance since 2001.

Value added by the crops sub-sector was projected to expand by 5.3 per cent in 2006, compared with 0.8 per cent in 2005. The strong performance of this sub-sector was attributable to good rainfall experienced at the beginning of the year. The crop review estimates by Government, the Food and Agricultural Organisation (FAO) and the World Food Programme (WFP) indicate a 6.0 per cent increase in the harvest over 2006. Although there was an improvement in production, it was still insufficient to meet domestic cereal requirements. The country produced 126 170 tonnes of cereals, leaving an import requirement of 294 900 tonnes. About 222 000 tonnes are expected to be imported commercially leaving a cereal deficit of 72 900 to be covered by food aid. Productivity continued to be negatively affected by, amongst others, the HIV and AIDS pandemic, which has a prevalence of 31 per cent of the population[18]. According to the WFP, HIV and AIDS was cited as the major contributing factor to food insecurity. WFP has planned to assist up to 250 000 people majority of whom are chronically ill. It is estimated that at the end of 2006 about 90 000 people were assisted.

Performance of the mining and quarrying sub-sector was projected to improve by 40.0 per cent in 2006 compared with 139.2 per cent observed in the preceding year. The slow-down was only indicative of the normalisation in the trend following significant growth in 2005. The increase was underpinned by the persistently good performance of the Lets'eng Diamond mine coupled with the opening of the Liqhobong mine in 2006. Diamond exports by both mines increased by 43.8 per cent in the year under review. In 2006, amongst its major achievements, the Lets'eng Diamond mine discovered a diamond that weighed 603 carats. It was ranked the fifteenth largest diamond ever found in the world. The stone was sold for US$12.36 million. With the possible opening of the Kao mine in 2007, performance of this industry is expected to continue to improve. Strong performance by this industry is important in employment creation and improvement of the external position.

[18] See Kimaryo. S. *et.al* (2004)

Figure 1: Sectoral Real Growth Rates



Box 1: Resource-based Growth: Implications for Diamond Mining in Lesotho

In theory countries that are endowed with natural resources have better growth prospects than resource poor economies. Empirical research on the economic performance of the resource rich and resource poor countries however, contradicts the theoretical proposition. A number of reasons have been advanced for the contradiction. First, dependence on a single or few commodities, the prices of which are often highly volatile and internationally determined, increases economic uncertainty to exporting countries. Second, government dependence on revenue from resource earnings may impair fiscal management by reducing the need to diversify tax collection. Last, prospective rents from the extraction and/or mining of natural resources have the potential to motivate stakeholders to seek private enrichment, to the detriment of socio-economic development.

The coming into operation of the two diamond mines, Lets'eng and Liqhobong diamond mines has enhanced prospects for Lesotho's economic growth. Domestic output has increased, partly driven by the output of diamonds. In 2006, diamond production was estimated at 97 047 carats. The mining and quarrying sub-sector alone accounted for 7.0 per cent of GDP during the same period. Furthermore, with the prospects of expansion, employment in the sector is estimated to have increased. In addition, the exports of diamonds boosted Lesotho exports and the balance of payments (BOP) position. Last, additional investment in infrastructure that is necessary for successful harnessing of this natural resource contributed to economic growth.

It is important that policy measures are taken to ensure that Lesotho transforms natural resources into economic prosperity. These include explicit fiscal rules and transparent treatment of revenues from diamond exports; spending the resultant revenue on infrastructure and human development to facilitate skills transfer; a robust regulatory framework, more specifically, where private mining companies are involved; and the need to establish a stabilisation fund to reduce economic volatility due to external shocks.

(b) Developments in the Secondary Sector

The secondary sector comprises manufacturing, electricity and water, and the building and construction sub-sectors. Value added by the secondary sector was projected to grow by 3.9 per cent in 2006 following a 0.1 per cent marginal increase experienced in the previous year. This rise is owed to the recovery of the textile and clothing industry. Value added by the manufacturing sub-sector increased by 1.2 per cent in 2006 in contrast with 8.0 per cent decline in 2005. Government authorities, trade unions and foreign investors employed a number of short-term measures, *inter alia,* holding of bilateral meetings with the major importers to restore the competitiveness of the industry following the expiry of the quota system. In addition a 'one-stop-shop' was established, whereby the Immigration Department, Ministry of Trade and Industry, Cooperatives and Marketing (MTICM), and Lesotho Revenue Authority (LRA) offer services to foreign investors under one roof.

Furthermore, in the 2006/07 budget, Government introduced a tax incentive package. Company tax for firms that export outside SACU was zero-rated while for industries in the manufacturing and agricultural sub-sectors was reduced from 15 per cent to 10 per cent. In addition, company tax for all other industries was reduced from 35 per cent to 25 per cent.

The US Government extended the third country fabric sourcing requirement to 2012. This meant that Lesotho would continue to source raw materials from anywhere in the world and export duty free to the US. Another factor that contributed to the improved performance of the sub-sector was the depreciation of the currency.

Value added by the electricity and water sub-sector rose by 12.0 per cent in the review year compared with 16.7 per cent in the previous year. The growth remained strong in 2006 mainly due to the increase in consumption of electricity and water by the manufacturing industries. Water consumption increased on account of, amongst others, the on-going Maseru Peri-Urban Water Supply Project.

The construction sub-sector's performance was estimated to improve by 2.8 per cent following a 2.5 per cent rise in the previous year. This sub-sector is expected to have benefited from the construction of the Likalaneng road to Thaba-Tseka and several other roads constructed during the review year. Value added by the building sub-sector is projected to increase marginally based on the number of building permits issued during the year.

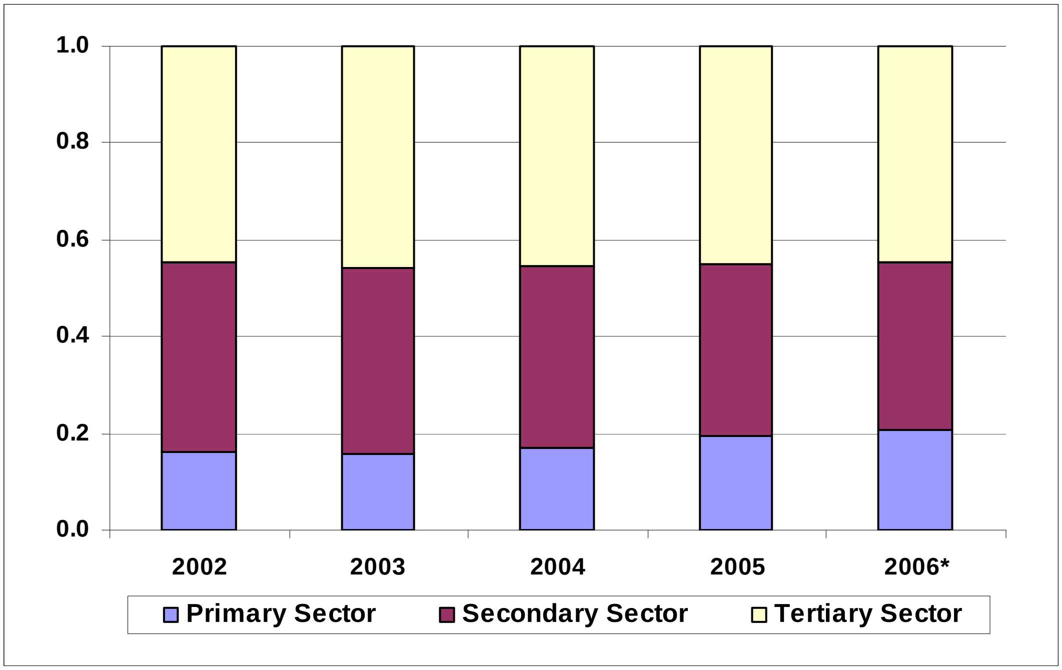
(c) Developments in the Tertiary Sector

The tertiary sector displayed good performance in the review year as it accounted for 42.7 per cent of GDP. Value added by the sub-sector increased by 5.0 per cent compared with 4.0 per cent in the preceding year. Value added by the wholesale and retail trade sub-sector rose by 1.0 per cent in contrast with 4.0 per cent drop in the previous year while that of restaurants and hotels sub-sector improved modestly from 7.0 per cent in 2005 to 7.5 per cent in 2006. Both sub-sectors benefited from a general increase in the level of income in the country.

The performance of the post and telecommunications sub-sector remained relatively unchanged at 14.2 per cent in 2006. Value added by the financial intermediation sub-sector increased from 9.4 per cent in 2005 to 13.2 per cent in the review year. This sub-sector's performance was underpinned by buoyant performance by the depository corporations resulting from growth in credit extension coupled with the rise in global interest rates.

The health sub-sector registered a real growth of 2.8 per cent in the year under review following a 2.7 per cent recorded in 2005. Value added by the education sub-sector increased by 2.5 per cent compared with 1.2 per cent rise in the preceding year. This was largely on account of the continued free primary education in the country.

Figure 2: Sectoral Shares in GDP at Factor Cost
(In Percentages)



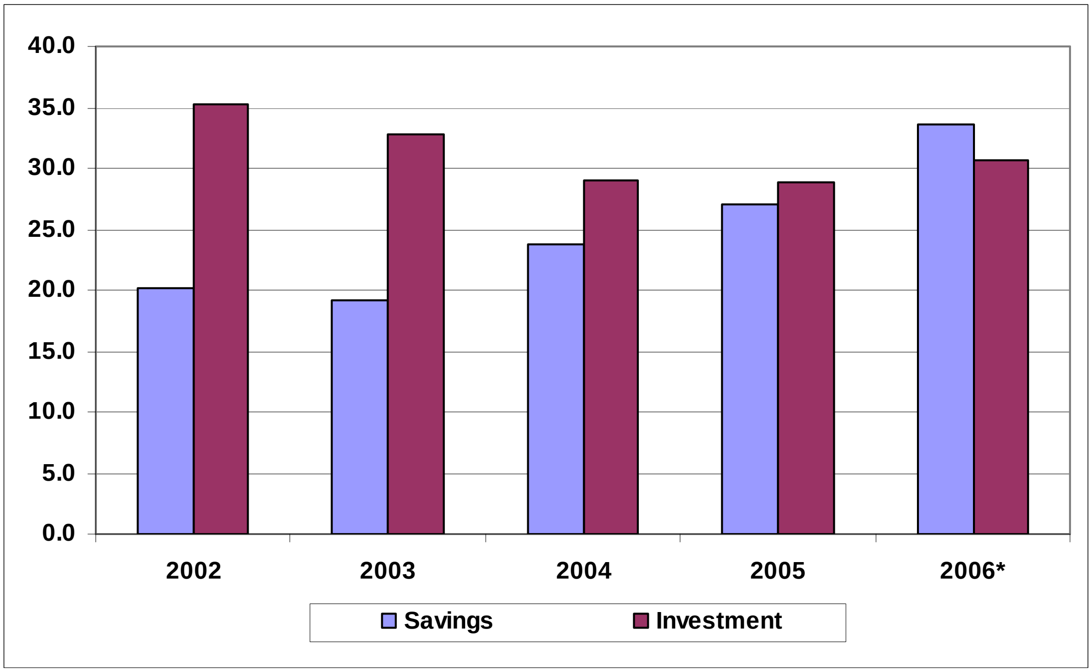
Source: Bureau of Statistics
* CBL Projections

3.1.3 Savings and Investment

The savings-investment gap was 3.1 per cent of GNI in 2006. Gross national savings as a percentage of GNI was estimated at 33.7 per cent. This compares with a lower share of 27.0 per cent realized in 2005. The rise in levels of savings continued to be pushed by the increase in both private and government savings. The increase in the latter was reflective of receipt of SACU revenue windfall.

As a share of GNI, total investment was estimated at 30.6 per cent in 2006. This compared with a share of 28.9 per cent obtained in 2005. The increase was mainly attributable to government investment programme in roads related infrastructure. Private investment remained relatively the same in the current review period in relation to the previous year.

Figure 3: **Savings and Investment**
(As a percentage of GNI)



Source: Bureau of Statistics
* CBL Projections

Saving as a ratio of Gross National Disposable Income (GNDI) was recorded at 27.9 per cent for the year under review against 22.9 per cent in 2005. The low saving-income ratio was due to fluctuations in the current transfers. The movement in savings is also a reflection of prudence in fiscal policy, which resulted in accumulation of government deposits.

3.2 Employment, Wages and Prices

3.2.1 Employment

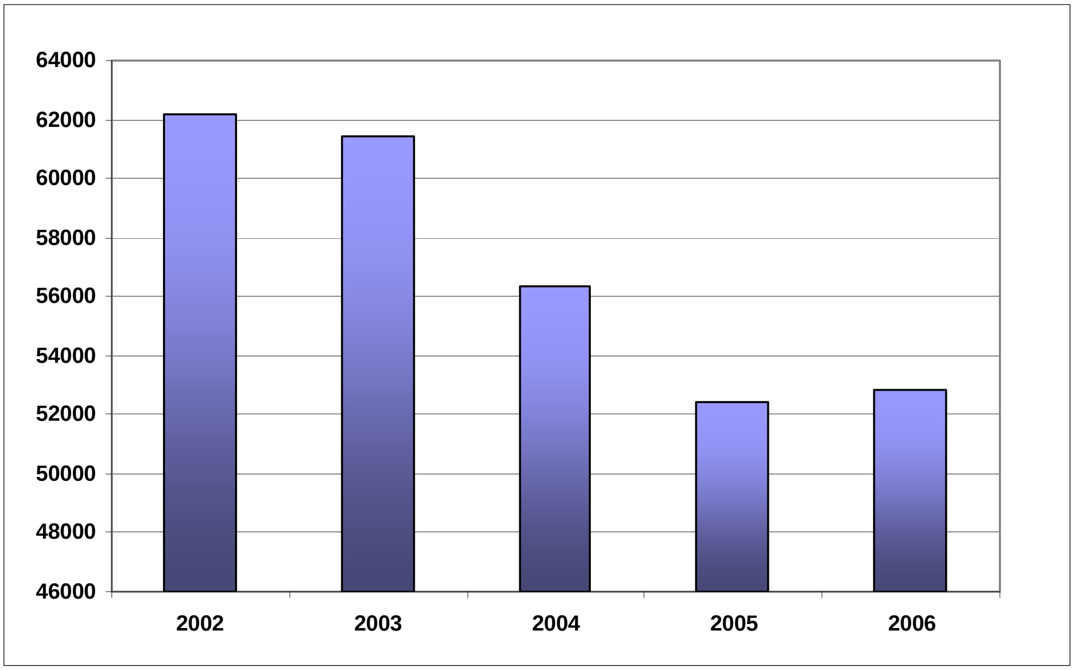
Data on employment in Lesotho National Development Corporation (LNDC) assisted companies, the number of migrant mineworkers in SA, and the Government employees are used as indicators of employment developments.

Employment generated by the LNDC assisted companies was reported at 46 424 in 2006 against 43 131 in 2005. This represented an increase of 7.6 per cent. The increase was a result of improved competitiveness in the manufacturing industry emanating from the tax incentive package accorded the export-based sector. The performance was further complemented by an increase in sales orders from the US. The trend is expected to be sustained in the medium term as Lesotho is likely to maintain its favoured investment destination status in the textile and clothing export sector.

Employment in civil service increased to 38 264 employees in 2006 compared with 37 245 employees in 2005. This represented an increase of 2.7 per cent. The increase was mainly influenced by categories of teachers and general civil servants. The movement in the former was due to the demand for teachers in the implementation of free primary education. The increase in the latter was mainly influenced by hiring support staff for local government structures.

The number of migrant mineworkers increased to 52 852 in 2006 from 52 450 in 2005, an increase of 0.8 per cent. The increase in employment in this category was in line with the recovery of the gold price in international markets.

Figure 4: Average Number of Basotho Mineworkers in SA



Source: The Employment Bureau of Africa (TEBA)

3.2.2 Wages

The minimum wage as determined by the Wages Advisory Board increased at an annual average of 5.5 per cent across industries in the private sector in 2006. The Wages Advisory Board is comprised of representatives of employers' associations, employees, and relevant government departments. The primary objective of the Board is to protect employees by monitoring their income, and ascertaining that it is commensurate with performance of respective industries. It further acts on behalf of less unionised sectors of the economy in order to maintain an appropriate level of remuneration. Industries covered included; manufacturing, construction, transport, hospitality, wholesale and retails, services and other small business enterprises. The percentage of wage adjustment across industries was in the range of 3.5 per cent and 7.8 per cent in 2006. This wage adjustment will remain in effect until the next review period in September 2007.

Government employees received a salary increase of 5.0 per cent for the fiscal year 2006/2007. The salary adjustments in the private and Government sectors allowed for an increase in real wages in the period from 2005 to 2006.

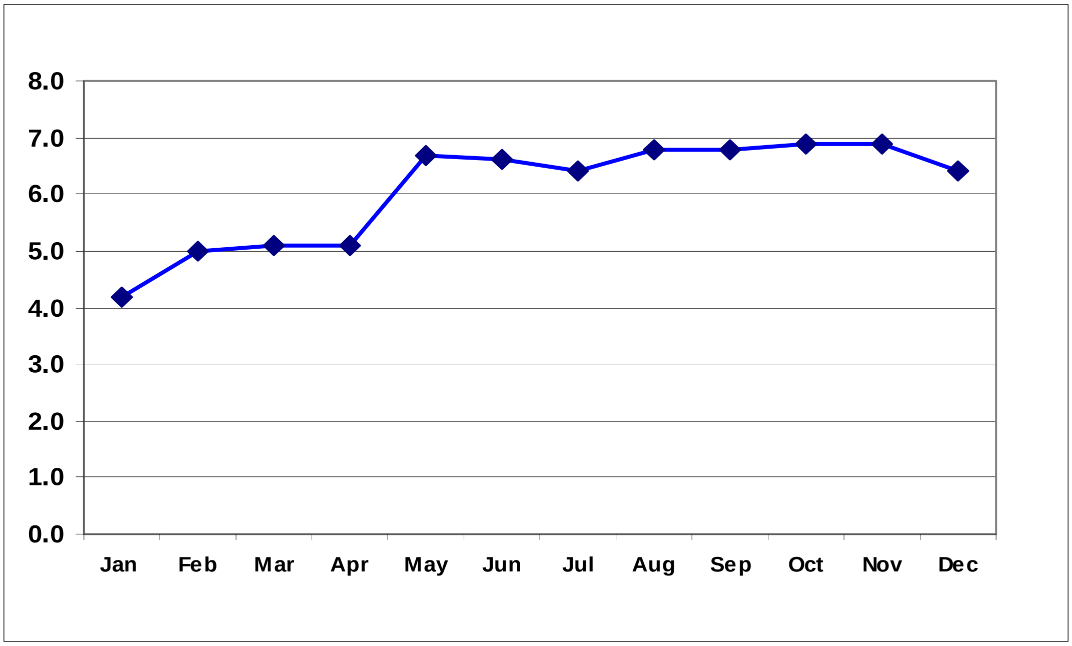
3.2.3 Price Developments

Inflation as measured by changes in the CPI recorded an average of 6.0 per cent in 2006 compared with an average of 3.5 per cent in 2005. As such, Lesotho continued to meet the single-digit inflation target set under the SADC macroeconomic convergence targets.

The increase was due to a general rise in oil and cereal prices. This upward movement in price was predominantly experienced in the first half of the year and moderated in the second half. The increase in the oil price filtered into transportation costs and overall retail prices. Cereal prices exerted a significant upward pressure on consumer prices. It is noteworthy that the food category constitutes the largest weight, 39.8 per cent, in the CPI basket.

Inflation is expected to remain stable in 2007. The moderation in the inflation pressures will be assisted by, among others, reduced impetus from energy prices. The crude oil price range in 2006 was estimated at an average range of US$53.37 and US$72.64. It closed the year at US$56.0, signalling that the price increase was tapering off. This is likely to filter into the domestic price of paraffin which is used by the majority of households in Lesotho.

Figure 5: Lesotho Consumer Price Index
(Annual Percentage Change)



Source: Bureau of Statistics

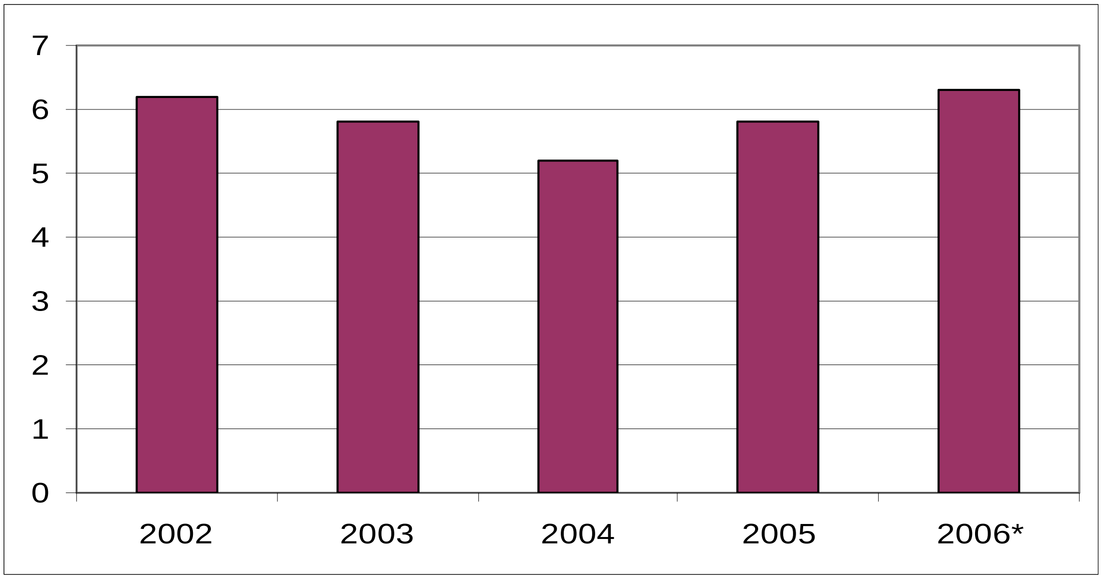
3.3 Balance of Payments (BOP)

3.3.1 Overall Balance

The Lesotho's balance of payments (BOP) position continued to display a surplus in 2006. The overall balance registered a surplus of M1.3 billion in the review period compared with M274.7 million observed in the previous year. The surplus is important for building up foreign reserves and for the maintenance of the fixed exchange rate between the Loti and the Rand.

The improvement in the BOP position is a result of both transactions and revaluation movements. The transactions balance, which represents the overall balance excluding the effect of currency fluctuations, registered a surplus of M1.2 billion in 2006 compared with M181.8 million attained in 2005. The performance of the transactions balance largely reflected an improvement in the current account balance, which improved from a deficit of 6.8 per cent of GDP in 2005 to a surplus of 4.3 per cent of GDP in 2006. The surplus was mainly driven by the increase in non-duty SACU receipts. Furthermore, on average, the local currency depreciated against major currencies, particularly the US Dollar, Euro and Pound Sterling, in which a large proportion of Lesotho's foreign reserves are held. Exchange rate movements contributed M61.7 million to the overall surplus during the review period.

Figure 6: Reserves in Months of Imports



* Preliminary estimates

Gross official reserves increased by 35.7 per cent from M3.6 billion in 2005 to M4.9 billion in 2006. In terms of import cover, this represented an increase from 5.8 months in 2005 to 6.7 months in the review period.

Table 3

SUMMARY OF BALANCE OF PAYMENTS
(As percentage of GDP)

	2002	**2003**	**2004**	**2005**	**2006**
Current account	-20.6	-13.0	-5.7	-6.8	4.3
Capital and Financial account	16.2	11.8	7.1	4.2	-1.3

* Preliminary estimates

3.3.2 Current Account

The current account balance showed a significant improvement from a deficit of 6.8 per cent in 2005 to a surplus of 4.3 per cent as a share of GDP during the review period. As mentioned earlier, the surplus was mainly driven by a surge in current transfers as SACU non-duty receipts increased by 37.9 per cent in 2006. Furthermore, merchandise exports grew significantly over the year, they increased by 14.5 per cent in 2006 compared with a fall of 8.7 per cent observed in 2005.

The improved current account balance is also a result of a decline in payments for services which dropped by 19.1 per cent during the review period compared with a rise of 42.1 per cent recorded in the previous year. In addition, labour and investment income increased during the year reflecting a marginal increase in miners' remittances and higher returns on CBL's investment portfolio. The income account improved by 32.9 per cent against a decline of 0.9 per cent registered in 2005.

3.3.3 Income and Trade in Goods and Services

Exports were estimated to have improved significantly in the review year. In nominal terms, the value of exports was estimated to increase by 14.5 per cent over the year, following a fall of 8.7 per cent recorded in 2005. As a share of GDP, exports were estimated at 45.6 per cent compared with 44.9 per cent observed in the previous year. The major driving factor in the growth of exports during the year was diamond production. Diamond exports rose by 43.6 per cent in 2006 as a result of increased production at Lets'eng and Liqhobong diamond mines. As a share of total exports, their value was registered at 13.1 per cent in 2006 compared with 10.4 per cent in 2005. The other contributing factor was the increase in exports of textiles and clothing. This component benefited from policy reforms aimed at improving the competitiveness of the export sector. The performance was also boosted by the weakness of the local currency against other major currencies coupled with the robust global demand, particularly in the US where the bulk of Lesotho's exports is destined.

The nominal value of merchandise imports was estimated to increase by 11.3 per cent in 2006 compared with a fall of 0.6 per cent registered in 2005. As a share of GDP, imports were recorded at 89.2 per cent in the review period compared with 89.8 per cent registered in the previous year. An increase in the value of imports was attributed to, among others, an increase in demand for imported inputs by the manufacturing industries, improved implementation of government projects and increased consumer demand.

Net payments on services were estimated to fall from M296.1 million in 2005 to M239.4 million in 2006. A decline emanated from a drop in travel payments which fell by 26.0 per cent in 2006 compared with a fall of 12.3 per cent in 2005. Travel receipts also declined marginally by 2.3 per cent in 2006 compared with a fall of 12.0 per cent recorded in the previous year.

The income account showed an improvement in the review period. Net income rose by 33.0 per cent in 2006, in contrast with a fall of 0.9 per cent registered in 2005. The positive development in the income account resulted from a rise in miners' remittances which increased by 22.8 per cent in the review period compared with a fall of 10.1 per cent in the previous year. Another factor that contributed to an improvement in net income was interest earned on CBL investment portfolio abroad. In addition, interest paid by government on foreign loans declined in the review period. This component declined by 73.3 per cent during the year, in contrast with a rise of 43.8 per cent registered in 2005.

3.3.4 Capital and Financial Account

The capital and financial account deteriorated in 2006. Net inflows fell from a surplus of M389.9 million in 2005 to a deficit of M135.3 million in 2006. Expressed as a share of GDP, net inflows declined to a deficit of 1.3 per cent in 2006 from a surplus of 4.2 per cent in 2005. The decline was solely due to deterioration in the financial account. In the financial account, commercial banks' foreign assets increased by M603.6 million in 2006. This was due to the attractiveness of South African interest rates relative to domestic interest rates.

Other components of the capital and financial account displayed some growth. The capital account improved by 43.4 per cent in the review period compared with a fall of 38.4 per cent recorded in the previous year. The growth was indicative of an increase in grants. In the financial account, net official loans were estimated to register a lower net outflow of M84.3 million compared with M295.2 million in 2005. This was driven by an increase in disbursements coupled with the fall in repayments. Loan disbursements rose by 8.3 per cent while repayments declined by 47.4 per cent during the review year. In addition, FDI rose by 5.9 per cent in line with developments in the manufacturing and mining sub-sect

Box 2: The Importance of Private Capital Flows (PCF) Survey

In the year 2006, CBL in collaboration with the Bureau of Statistics (BOS) and the Lesotho National Development Corporation (LNDC) embarked on the first PCF Survey. This was an important step towards the improvement of statistics on Lesotho's balance of payments (BOP) and international investment position (IIP). The BOP is a summary statement of transactions between Lesotho and the rest of the world, while the IIP represents the economy's value and composition of foreign assets and liabilities (FAL).

Since the East Asian crisis, monitoring PCF has gained prominence in macroeconomic policy making. Countries have found it important to know and understand the magnitude and composition of PCF. It is widely acknowledged that stronger policy environments are key for crises prevention, management and containment. Availability of reliable data also assists private investors and other market participants to make informed investment decisions.

As in many other developing countries, private investment has increased significantly in Lesotho, especially in the manufacturing sub-sector due to the benefits accruing from the Africa's Growth and Opportunities Act (AGOA). By quantifying inward and outward investment, the authorities can better formulate policies that allow for increased investor confidence and private sector development. Furthermore, timely, reliable and comprehensive economic statistics are necessary for meeting international standards and codes in reporting which include General Data Dissemination System (GDDS), System of National Accounts (SNA) and Balance of Payments Manual Fifth Edition (BPM5).

3.3.5 Foreign Exchange Rates

The Loti depreciated against major currencies during the review period. On average, it depreciated by 6.4 per cent against the US Dollar. This was mainly due to the increase in returns in the developed countries which encouraged investors to divert their investments in favour of the US market. The currency also depreciated by 5.9 per cent, 7.6 per cent and 8.0 per cent against Special Drawing Rights (SDR), Euro and Pound Sterling, respectively.

3.4 Money and Banking

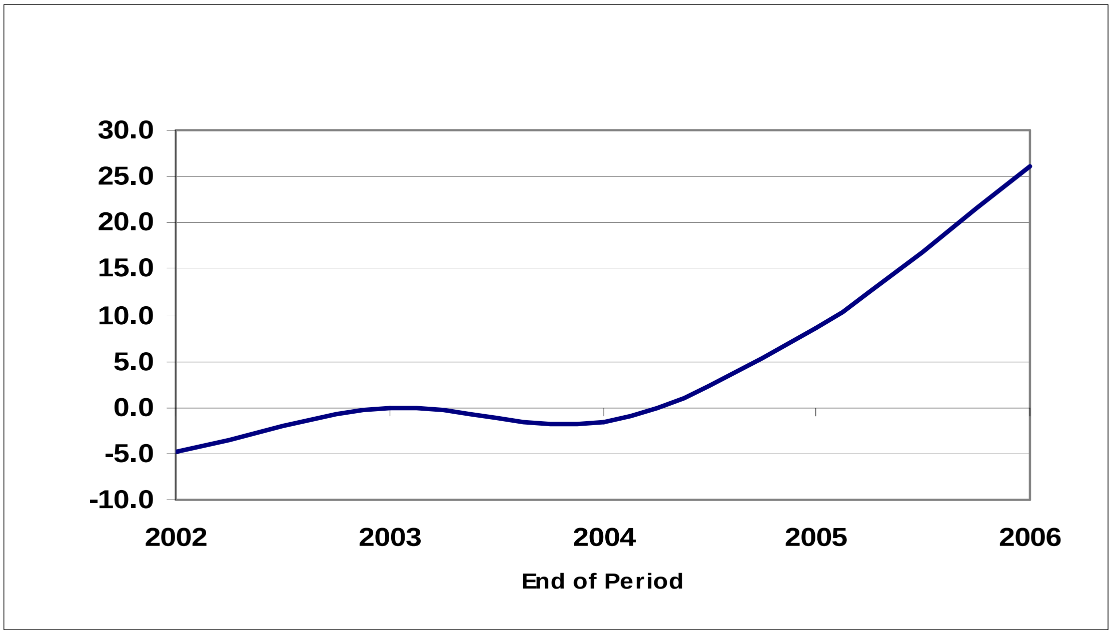
3.4.1 Money Supply

Broad money supply (M2)[19] grew by a substantial 35.4 per cent at the end of 2006 following a 9.1 per cent increase observed at the end of last year. This was on account of an increase in domestic credit including net claims on government, coupled with a rise in the overall banking system's net foreign assets.

The growth in M2 was in line with upward trends in its components, namely M1 and quasi money. M1 registered a 46.9 per cent rise at the end of the review period compared with a 15.1 per cent recorded at the end of last year. This was mainly at the back of a 45.4 per cent rise in Maloti with public and 47.0 per cent increase in demand and call deposits due to increased activity in the mining sub-sector. Furthermore, quasi money registered a 7.7 per cent rise at the end of 2006 in contrast with 2.9 per cent recorded at the end of the previous year. The main driver for the increase in this component was a 24.9 per cent increase in time deposits which offset a fall of 5.0 per cent in savings deposits. The upward trend in interest rates accounted for the growth in time deposits.

[19] M2 is defined as the sum of M1 (currency in circulation, demand and call deposits) and quasi money (savings and time deposits) with the overall banking system.

Figure 7: Money Supply Growth
(Percentage Change)



3.4.2 Domestic Credit

Increased economic activity during the review period was linked to the growth noted in domestic credit, excluding net claims on government and non-performing loans. Domestic credit rose by 13.7 per cent at the end of 2006 compared with its previous year's increase of 40.9 per cent. The increase was mainly driven by credit to the private sector which offset the decline in credit granted to statutory bodies.

Credit to the private sector increased by 16.3 per cent at the end of 2006 following a 49.9 per cent rise registered at the end of 2005. The slower growth in credit to this sector in 2006 compared with 2005 largely reflected the adverse impact of rising interest rates. Nevertheless, the growth indicated commercial banks' sustained confidence in the private sector as well as efforts to widen credit instruments. In 2006 commercial banks continued to alternate their investments largely between the domestic treasury bills market and other instruments in SA.

Lending to statutory bodies continued to follow a steep downward trend. It plummeted by 47.9 per cent at the end of 2006 compared with 36.0 per cent observed at the end of 2005. The size of credit granted to the sub-sector increasingly accounted for the smallest portion of domestic credit in line with the on-going government privatisation strategy.

3.4.3 Net Foreign Assets

The net foreign assets of the overall banking system increased by 46.0 per cent in 2006 compared with 6.0 per cent registered at the end of 2005. As observed in Table 4 below, the rise was mainly driven by an increase in net foreign assets of both the commercial banks and the CBL. Net foreign assets of commercial banks increased by 56.2 per cent while those of the CBL rose by 42.3 per cent.

The increase in net foreign assets of the CBL resulted from an expansion in export earnings, revaluation gains and recapitalisation during the year while for commercial banks it mainly reflected a shrinkage of 31.7 per cent in their foreign liabilities. Nonetheless, foreign assets of the commercial banks increased by 48.6 per cent due to net transfers abroad in search of alternative investments. Since the domestic money market rates closed the year below their SA counterpart rates, commercial banks increased their holding of SA investment instruments.

Table 4

BANKING SYSTEM'S NET FOREIGN ASSETS

(Million Maloti: End of period)

	2002	2003	2004	2005	2006
Commercial banks	672.7	607.7	1117.9	1135.0.	1772.4
Assets	772.3	837.3	1253.8	1241.8	1845.4
Liabilities	-99.6	-229.6	-135.9	-106.9	-72.9
Central Bank	3211.4	2853.1	2854.5	3076.2	4377.2
Assets	3858.2	3341.1	3351.5	3625.6	4918.7
Liabilities	-646.8	-488.0	-497.0	-549.3	-541.5
Net Foreign Assets	3884.1	3460.8	3972.4	4211.2	6149.7

3.4.4 Commercial Banks' Liquidity

At the end of the review period the liquidity ratio rose from 67.2 per cent recorded at the end of December 2005 to 74.9 per cent.[20] The rise in the ratio at the end of the review year, mainly reflected increased holdings of short-term securities by commercial banks both domestically and abroad.

[20] The liquidity ratio measures banks' ability to sufficiently honour customers' demands in making withdrawals. Liquidity is measured by the ratio of commercial banks' notes and coins holdings, liquid balances with banks in Lesotho and abroad, their clearing balances held with the CBL plus their short-term securities to their total deposit liabilities and other borrowings.

The credit deposit ratio decelerated from its previous level of 36.9 per cent at the end of 2005 to 26.5 per cent recorded at the end of 2006.[21] The decline in the ratio reflected that commercial banks mobilised deposits from the private sector at a faster rate than they granted credit to these sectors.

3.4.5 Interest Rates

Major money market rates in Lesotho generally followed an upward trend of similar rates in the region. The rates increased largely reflecting policy responses to inflationary pressures accruing from, among others, oil price hikes during the year under review.

The average prime lending rate in Lesotho increased by 200 basis points from 11.50 per cent registered at the end of 2005 to 13.50 per cent in 2006. The rise resembled an increase in the SA prime lending rate which rose by 150 basis points from its 2005 level of 11.50 per cent. Even though the direction of the change in the two rates was the same, SA prime lending rate remained lower than that of Lesotho due to, among other factors, the differing risk profiles of the two economies.

Similarly, commercial banks' deposit rates followed an upward trend. For example, the one year deposit rate which was at 4.75 per cent at the end of 2005 rose by 175 basis points to 6.50 per cent at the end of 2006. Despite the increase, the real interest rate on this type of deposit closed the year negative.

The 91-day treasury bills rate dropped by 19 basis points from 6.95 per cent at the end of 2005 to 6.76 per cent at the end of 2006. Contrary to the situation that normally obtains, the rate fell short of its SA counterpart by 150 basis points. The SA rate bottomed out faster than the domestic rate due to the high frequency of auctions in SA. The margin widened from 15 basis points observed last year to 150 basis points observed at the end of the 2006.

[21] This ratio seeks to establish how much credit is extended to the private sector and statutory bodies using these sectors' deposits with the banking system. It thus assesses the degree to which the financial sector mobilises deposits from surplus sectors of the economy, and allocates these funds to deficit sector.

Box 3: The Loti-Rand Peg: Benefits and Costs

The existence of the parity between the Rand and the Loti stems from the CMA Agreement. The Agreement provides for circulation of a single currency, the Rand, throughout the entire area, but also allows for the parallel issue of national currencies by the three smaller members for circulation within their own economies.

There are benefits and costs associated with pegging the Loti to the SA Rand. The parity has several positive implications for the economy of Lesotho:

- Firstly, it eliminates transaction costs and foreign exchange rate risk: Due to the trade links between Lesotho and South Africa, particularly Lesotho's heavy reliance on imports from SA, the peg reduces foreign exchange transaction costs and eliminates the risk due to adverse currency movements. Under the current arrangement, the Rand in circulation in Lesotho eliminates the need and costs for individuals and businesses to convert currency.
- In addition, the arrangement minimises foreign exchange rate risk against other world currencies as the local currency is linked to a relatively stable currency (i.e. the SA Rand).
- Currently, the peg also enables Lesotho to benefit from the low inflation environment in SA, which is conducive to macroeconomic stability.
- Moreover, as a result of price stability, investors gain confidence in the economy which in turn gains potential to attract foreign direct investment.

Since the peg is maintained in a dollarised economy, it yields additional gains to Lesotho, namely; that:

- Under the current arrangement, SA compensates Lesotho and other CMA members for lost seignorage revenues.
- The arrangement would act as a launch pad for wider regional integration given the current momentum towards regional cooperation on monetary and financial issues.
- The parity also encourages fiscal discipline. The danger to break the peg through depletion of external reserves if Government policy becomes too expansionary influences the maintenance of sustainable budget deficits.

Needless to say, the arrangement is not costless. It imposes two major costs on the economy. First, it results in a loss of monetary policy autonomy. Since capital is mobile and the arrangement provides for a fixed exchange rate, the CBL has to consistently steer the rate of interest in line with the SA rates. Thus, the authorities partly lose discretion to influence interest rates. Consequently, monetary policymaking in Lesotho essentially involves reacting to monetary policy changes in SA. Second, a loss of confidence in the peg could lead to the emergence of a black market which could eventually break the parity if external reserves are severely depleted.

3.5 Government Finance

3.5.1 Fiscal reforms in recent years

The government of Lesotho is in the process of implementing reforms aimed at improving service delivery in the public sector. These include the recent merging of the Ministry of Finance and Ministry of Development Planning. The merger is intended to achieve the link between policy, planning and budgeting processes, the absence of which has been identified as a critical weakness of the public sector in the past. The reform is expected to raise the efficiency of the public sector and hence, contribute to economic growth and poverty reduction.

The merger followed the privatisation programme which was implemented in 1995. It was, however, observed that the initiative alone, was not sufficient to address all problems Government was faced with. It was in this regard that Government implemented the following three broad categories of reforms:

- Improving financial management and accountability;
- Improving service delivery through decentralisation; and
- Improving public service management.

The Medium Term Expenditure Framework (MTEF) was one of the strategies that accompanied the reforms. MTEF is regarded as a transparent planning and budget formulation process within which Cabinet and Government agencies establish contracts for allocating public resources to their strategic priorities. This framework was piloted in the fiscal year 2004/05 to ensure overall fiscal discipline and facilitate the annual planning and budgeting process. In the year 2006/07, Government broadened the scope of MTEF to implement the Poverty Reduction Strategy (PRS).

In addition, government adopted the Public Private Partnership (PPP) strategy in infrastructure development. The aim of this initiative is to contain government expenditure to a minimum level, while not compromising provision of infrastructure and social services, and to boost private sector development.

To further consolidate fiscal performance measures, while ensuring overall macroeconomic improvement, Government operationalised Local Government structures in 2005. The key objective was to create a conducive environment whereby communities would freely and effectively participate in the planning and management of development projects and have access to improved services through decentralised organisations and institutions. Local Government structures were for the first time provided for in the national budget in 2006/07.

3.5.2 Fiscal performance in 2006/07

The budget outturn for the fiscal year 2006/07 was projected to result in a surplus equivalent to 13.3 per cent of GDP compared with 2.8 per cent realised in 2005/06. This was largely on account of an increase in SACU revenue during the year, and a relatively lower increase in expenditure.

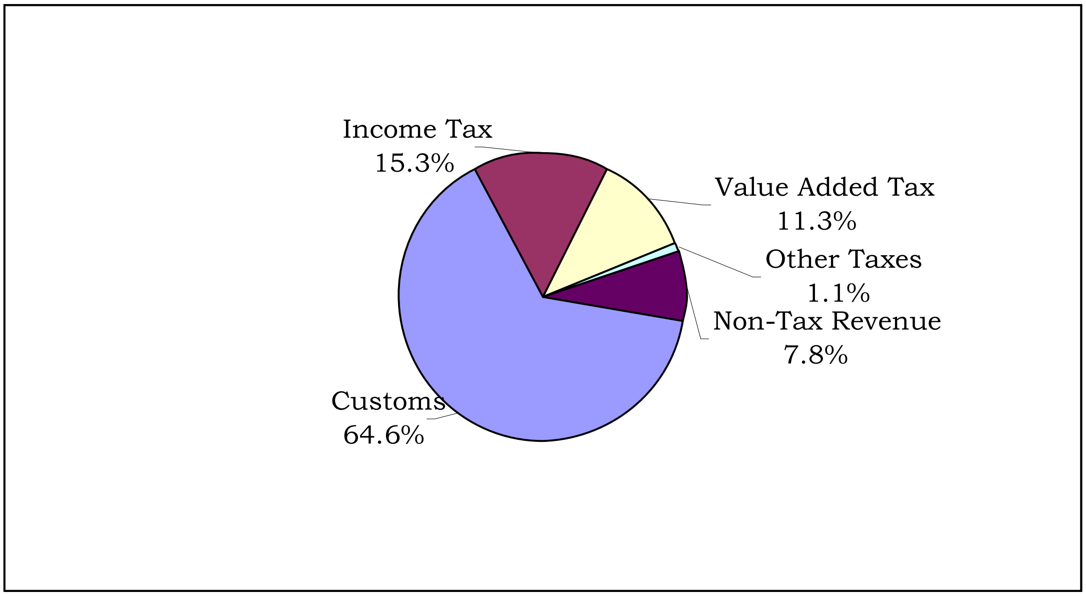
3.5.2.1 Revenue

Total revenue, including grants, was estimated to grow by 44.6 per cent in 2006/07 due to a hike in SACU revenue by 82.5 per cent following backward adjustments made during the year. Income tax collections were estimated to have improved by 7.6 per cent during the fiscal year 2006/07. This was mainly driven by the increase in all income tax components. Personal income tax increased by 7.0 per cent, while company tax grew by 4.5 per cent during the period under review. This increase was despite a downward adjustment of the company tax rate during the year. The other income tax component, which comprises fringe benefits and Withholding taxes rose by 15.6 per cent. Value Added Tax (VAT) collections, increased by 1.6 per cent in contrast to a 2.0 per cent decrease observed in the previous period in response to a number of revenue enhancement measures that were undertaken by LRA.

Non-tax revenue was expected to grow by 7.8 per cent during the period under review. The increase was supported by a 13.7 per cent rise in water royalties, together with income from dividends and interest on loans on-lent to semi-autonomous institutions.

The level of capital grants remained low during the review period. They dropped by 9.6 per cent during 2006/07. The funds were expended on provision of infrastructure in health, education, water supply, tourism and public works.

Figure 8: Sources of Government Revenue



Source: Ministry of Finance and Development Planning (MoFDP) and CBL estimates

3.5.2.2 Expenditure

Total government expenditure was expected to grow by 20.3 per cent during the year 2006/07 on the back of a 21.8 per cent increase in recurrent spending. Expenditure on personnel emoluments was estimated to be the main driving force behind the rise in recurrent spending. This item grew by 10.1 per cent to meet staffing requirements at local government structures, and implementation of the Education Sector Development Programme (ESDP). In addition, expenditure on goods and services was estimated to increase by 15.3 per cent.

Total interest payments were expected to soar by 49.3 per cent during the period under review on account of foreign interest payments which rose by 64.2 per cent. Domestic interest payments decreased by 4.0 per cent.

Subsidies and transfers rose by 37.6 per cent during the year. This was mainly driven by subventions to government institutions which embarked on provision of infrastructure. Transfer payments in the form of pensions paid to elderly people aged 70 years and above, and support to HIV and AIDS affected people also contributed to the rise in this expenditure item.

Following some improvements in the implementation of development projects, capital expenditure was estimated to grow by 13.0 per cent during the period under review. This was mainly due to the construction of a road that links the highlands districts with the lowlands, plus construction and renovation of schools and Government health centres around the country. Government funded projects accounted for 64.7 per cent of these outlays while loan and grant funded projects contributed 23.7 and 11.6 per cent, respectively.

Table 5

SUMMARY OF BUDGETARY OPERATIONS
(Million Maloti)

	2002/03	2003/04	2004/05	Revised 2005/06	Projections 2006/07
Total Receipts	3331.0	3594.5	4361.8	4559.9	6593.5
Revenue	3034.7	3416.7	4130.4	4476.3	6517.9
Customs	1470.0	1421.6	2012.4	2306.0	4208.3
Grants	296.3	177.8	231.4	83.6	75.5
Total Expenditure	3656.1	3532.2	3613.5	4293.2	5165.7
Recurrent expenditure	2876.2	2906.8	2919.7	3590.9	4372.1
Purchases of Goods & Services	2147.1	2059.1	2002.5	2378.5	2677.4
Capital Expenditure & net Lending	779.9	625.4	693.8	702.3	793.6
Surplus/Deficit Before grants	-621.4	-115.5	516.9	183.1	1352.2
Surplus/Deficit after grants	-325.1	62.3	748.3	266.7	1427.8
Government Savings	454.8	687.7	1442.1	969.0	2221.3
Financing					
Foreign, net	53.4	-25.7	-63.7	-282.7	-66.1
Domestic	271.9	-36.5	-684.6	16.0	-1361.7
Bank	320.8	104.0	-638.7	-102.1	-1283.6
Non-Bank	-48.9	-140.5	-45.9	118.1	-78.1
In per cent of GDP (unless indicated otherwise)					
Revenue (excluding Grants)	41.0	42.6	47.5	46.9	60.9
Customs (in % of revenue)	48.4	41.6	48.7	51.5	64.6
Grants	4.0	2.2	2.7	0.9	0.7
Total Expenditure	49.4	44.0	41.5	45.0	48.3
Surplus/Deficit Before grants	-8.4	-1.4	5.9	1.9	12.6
Surplus/Deficit after grants	-4.4	0.8	8.6	2.8	13.3
Government Savings	6.1	8.6	16.6	10.2	20.8
Memorandum item:					
GDP in current prices	7398.7	8025.9	8704.0	9540.6	10704.9

Source : MoFDP and CBL Projections

3.5.3 The overall budget balance and financing

An overall fiscal surplus equivalent to 13.3 per cent of GDP was expected during the period under review. The surplus was expected to augment government deposits, and would cushion Government budgetary operations in the event that SACU receipts decline as tariffs are reduced.

3.5.4 Recurrent Expenditure by Functions of Government

During the fiscal year 2006/07, recurrent expenditure was estimated at M4.4 billion. The largest share of recurrent expenditure was destined towards the community and social services category. As a share of total recurrent expenditure, it was estimated to be at 49.1 per cent of which 55.0 per cent, was destined towards support of the ESDP. Expenditure on education was directed to infrastructure development, bursaries and subventions to semi-autonomous institutions.

In response to the HIV and AIDS scourge and other chronic illnesses, expenditure on the health sub-sector took the second largest share. It stood at 19.2 per cent of expenditure on community and social services. This spending went towards provision of drugs and preventive measures in the form of awareness campaigns. Social security and welfare was estimated at 18.8 per cent.

Expenditure on general government services increased by 4.1 percentage points to 36.5 per cent of total recurrent expenditure. It comprised the general public service, which received the largest share, public order and safety, and defence. Expenditure on economic services constituted 9.0 per cent of recurrent spending. Agriculture was estimated to constitute 45.1 per cent of the economic services, followed by mining and industry, and transport and communication.

3.6 Public Debt

3.6.1 Overview

Outstanding public debt increased by 11.2 per cent during 2006 due to a 12.5 per cent growth in foreign debt. This was at the back of the overall improvement in implementation of Government projects during the year. In addition, the depreciation of the local currency against the major currencies with which debt is contracted raised the debt stock.

As a ratio of GDP, public debt stood at 49.9 per cent, compared with 50.3 per cent recorded in the previous year. The ratio dropped marginally on account of good performance of the economy during the year. External debt constituted 43.5 per cent of GDP, while the domestic component constituted 6.4 per cent. Domestic debt was mainly issued for monetary policy purposes. It is noteworthy that total debt to GDP ratio is lower than the sustainability threshold of 60 per cent of GDP.

Table 6

PUBLIC DEBT INDICATORS FOR END OF YEAR
(Percentages)

	2002	2003	2004	2005	2006
Total debt as % of GDP	83.7	71.1	55.9	50.3	49.9
External debt as % of GDP	70.8	56.4	48.3	43.3	43.5
Domestic debt as % of GDP	12.8	14.8	7.6	7.0	6.4
External debt as a % of total	84.7	79.3	86.4	86.2	87.2
Domestic debt as a % of total	15.3	20.7	13.6	13.8	12.9
Concessional as % of External debt	70.2	72.3	78.5	83.7	84.4
Debt service ratio(1)	2.0	3.3	7.1	6.7	2.8
Debt service ratio(2)	3.4	5.8	11.6	11.1	4.4

Source: MoFDP

(1) Ratio of debt service to exports of goods and services, including factor income
(2) Ratio of debt service to exports of goods and non-factor services, excluding factor income

3.6.2 External Debt

The level of external debt grew by 12.5 per cent during the period under review as a result of 16.7 per cent rise in multilateral loans directed to provision of infrastructure. However, as a ratio of GDP external debt remained almost unchanged at 43.5 per cent. Loans from bilateral creditors and financial institutions dropped by 2.5 and 28.5 per cent, respectively. This confirms Government's commitment to concessional financing.

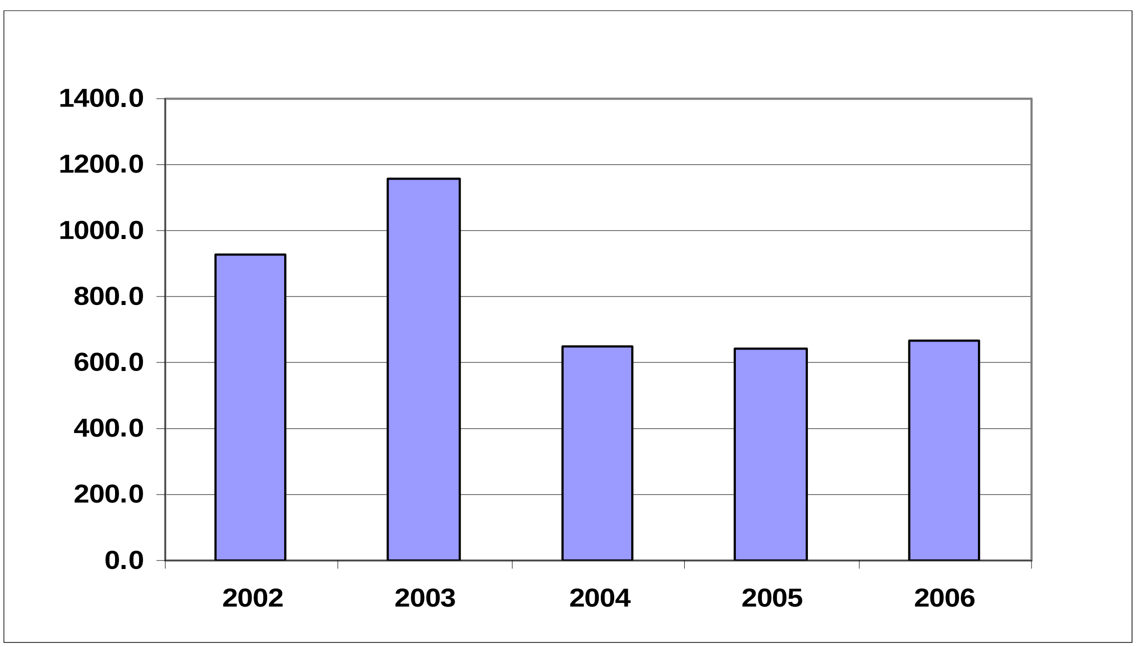
Concessional debt constituted 84.4 per cent of total foreign borrowing compared with 83.7 per cent recorded in 2005. Multilateral loans accounted for 84.7 per cent of the external debt portfolio, while loans from bilateral creditors and financial institutions constituted 9.9 per cent and 3.5 per cent of foreign debt respectively. External debt rose slightly to 87.2 per cent of the total stock of public debt. About 82.1 per cent of external debt had remaining maturities of at least 16 years.

External debt sustainability indicators remained within the generally accepted sustainability thresholds of 60 per cent of GDP and the debt service ratio of 15.0 per cent. Excluding factor income, the latter ratio improved from 11.1 per cent in the previous year to 4.4 per cent. This improvement reflected a recovery in the external sector. However, caution must be exercised in the management of public external borrowing as exports are vulnerable to external shocks.

3.6.3 Domestic Debt

Domestic debt slightly increased by 3.2 per cent during the period under review mainly as a result of a 31.6 per cent increase in holding of short - term debt by the banking sector which constituted treasury bills issued for monetary policy purposes. However, the increase in short-term debt was moderated by a 54.5 per cent drop in holdings by the non-bank institutions.

Figure 9: Government Domestic Debt
(Million Maloti)



Source: MoFDP

PART IV REPORT OF THE BANK'S OPERATIONS

4.1 Supervision of Banking Industry

Several milestones were achieved in the Banking industry in 2006. In 2006, Standard Bank Lesotho Limited (SBL) and Lesotho Bank (1999) Limited (LB) merged to form a new bank, Standard Lesotho Bank Limited with the following shareholding; Standard Bank of South Africa (80%), Lesotho Unit Trust (10.4%) and GOL (9.6%). Kish City Bank was licensed as the first merchant bank in Lesotho in August 2006 and is expected to commence its operations in 2007.

CBL continued with efforts to improve financial intermediation. The CBL continued to explore the best way of establishing a centralised financial database on borrowers. Owing to the importance of information in assessing the credit worthiness of a customer, the system would be useful in providing critical information on risk assessment. The development of the microfinance sub-sector and the strengthening of the efficiency of the Commercial Court remained important projects for CBL.

4.2 Supervision of Insurance Industry

The supervision of the insurance industry in Lesotho continued to combine On-Site and Off-Site surveillance approaches. During the period under review the industry consisted of 32 insurance brokers and 5 insurance companies. The insurance brokers dealt with both long-term and short-term insurance business. Two insurance companies dealt in long-term insurance business while the other two dealt in short-term insurance business. The fifth insurance operation is a composite company.

The revision of the Insurance Act 1976 which commenced in 2004 was finalised during the year under review. The revision resulted in the Insurance Bill 2006. The Insurance Act 1976 was revised to comply with the International Association of Insurance Supervisors (IAIS) core principles and transfer supervisory powers, which were vested on the Minister of Finance and Development Planning, to the Commissioner of Insurance.

During the period under review, a total of 30 complaints from policyholders were handled by the Supervision Department. In most cases these were complaints on refusal or delays to pay claims by the insurance companies; 20 complaints were sufficiently addressed and appropriate insurers paid claims. One of the root causes of the complaints handled during the period under review was inadequate education to policyholders.

In an effort to ensure compliance and promote dialogue with the industry, the CBL continued to hold quarterly meetings with the insurance companies and brokers.

4.3 Policy and Exchange Control

The Bank continued to administer exchange control provisions in accordance with the Bilateral Monetary Agreement between Lesotho and South Africa as well as the Multilateral Monetary Agreement among the CMA member countries.

4.3.1 Enforcement Of Exchange Control Regulations

In an effort to strengthen compliance with the Exchange Control Regulations, the Bank conducted training to ensure that the provisions of exchange control legislation are observed and enforced.

To enhance the reporting mechanism for inward and outward foreign exchange transactions, the CMA member states introduced the Cross Border Foreign Exchange Transactions Reporting System. Through this, communication between the Bank and the commercial banks has been strengthened. The Bank continued to implement the Cross Border Foreign Exchange Transactions Reporting system, introduced towards the end of 2005.

4.3.2 Anti-Money Laundering Activities

The Mutual Evaluation Assessment (MEA) on Lesotho's Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT) regime, released in 2005 found that the Lesotho regime had limitations in terms of compliance with a number of Financial Action Task Force (FATF) recommendations. In 2006, the Lesotho Government acted to rectify some of the weaknesses identified by working vigorously on the Anti-Money Laundering and Proceeds of Crime Bill and also drafted a National Strategy for consideration by Eastern and Southern African Anti-Money Laundering Group (ESAAMLG). Consultations continued in the form of open dialogue between Anti-Money Laundering Task Team members with the aim of ensuring the completion of the Bill.

The strongest check against misuse of the banking system, in terms of either fraud or other financial crime such as money laundering, is for the banks to "know their customers". CBL therefore issued, "Know Your Customer" (KYC) guidelines for financial institutions in Lesotho to lead them in developing and having in place adequate policies, procedures and controls that will ensure rigorous customer due diligence.

4.4 Rural Finance

In 2006 there were several activities performed by the Bank on sensitisation campaigns, monitoring and facilitation of operations of the rural communities under the Rural Savings and Credit Scheme. The scheme aims to address the discrepancy between savings mobilisation and resource utilisation through promotion of access to bank credit by the rural and low income communities. The Bank collaborated with the Ministry of Agriculture and Food Security (MoAFS), non-governmental organisations (NGO) and other development partners in these activities.

Selected villages countrywide were covered in sensitisation campaigns which were conducted in the form of public gatherings organised through chiefs, District Administrators and District Agricultural Officers. A total of 18 resource centres were sensitised during the period.

At the end of 2006, efforts to link groups with commercial banks proved fruitful as a total number of 134 mobilised groups, 54 were banked, and 4 pioneered linkage banking in accessing loans from commercial banks to the tune of M91,050.00. Through intensive training, ten more groups were ready to submit loan applications to commercial banks.

Three NGOs namely, Mineworkers Development Agency, World Vision and Lesotho Council of NGOs through Rural Self-Help Development Agency were engaged to facilitate and support training of groups.

The Bank being a member of the technical working group engaged in developing the PRS, was further involved in microfinance related projects steered by MoFDP to develop a poverty monitoring system.

4.5 Development Finance

Under the Export Finance and Insurance Scheme, indigenous exporters can access a minimum of M50,000.00 and are expected to export 50 per cent of their annual production.

District visits were undertaken to identify cooperatives with an export potential. The activity selected 27 cooperatives with a total membership of 687. The cooperatives were mostly engaged in the handicrafts, Vaseline and garments production, with a few in farming. While these cooperatives showed potential in terms of exportability of their products, activeness and willingness to improve their business models, shortcomings were identified. Most were in the low scale production which made it difficult to qualify for the minimum loan amount of M50,000.00. In addition, they could not meet the Scheme's requirement of exporting 50 per cent of their produce and being in the export business for a minimum of 12 months.

4.6 National Payment System

In 2006, CBL implemented the Real Time Gross Settlement (RTGS) system, one of the components of Lesotho National Payment System (LNPS) Modernisation Project. The RTGS system came into operation in August 2006

4.6.1 Legal and Regulatory Framework

Efforts to review LNPS continued in 2006. The draft NPS Bill was finalised in April 2006 and has since been passed on to the relevant authorities and structures in Government for enactment. Binding rules and procedures on participants of the RTGS form the legal basis for participating in the system. These rules and procedures determine the criteria to be followed by banks to become participants in the system.

4.6.2 Real Time Gross Settlement (RTGS) System

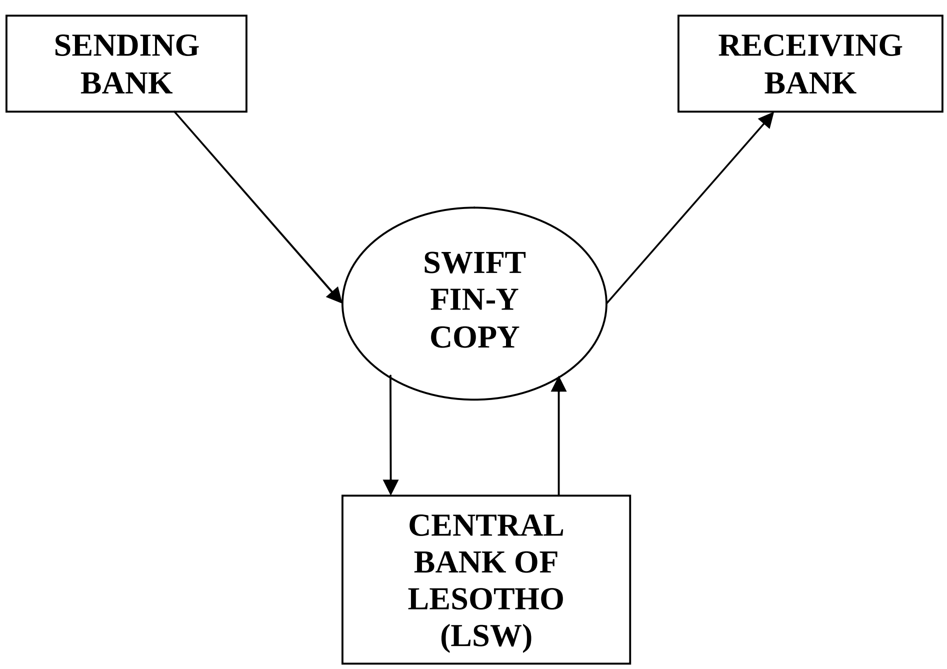
The RTGS system settles large value, time critical transactions in real time and at gross value, without netting. The central system is owned and operated by the CBL and all the commercial banks in the country are participants to the system. CBL further participates on behalf of the GOL.

Lesotho's RTGS system, named Lesotho Wire (LSW) is used to settle all local transactions amounting to M100,000.00 (one hundred thousand Maloti) or more. By this requirement, cheques worth M100,000.00 are no longer accepted in the Maseru Clearing and Settlement House (MCSH) since 1st January 2007.

LSW comprises three sub-systems namely the Settlement (SETS), the Payment and Accounts (PACS) and the Billing (BILL) sub-systems. The SETS maintains and monitors the participants' settlement accounts in real time. The SETS also maintains all the payment queues. The PACS handles CBL initiated payments including those of the relevant Government Ministries as well as CBL's own inward and outward payments. BILL is used for billing the participants for the transactions processed. The central system is at CBL and the commercial banks send payment instructions through SWIFT. In LSW, commercial banks have real time access to their settlement accounts through the use of Virtual Private Network (VPN) and this has greatly enhanced liquidity management by the banks. Liquidity management is one of the most important aspects of LSW since all the payments are settled in real time. The CBL has also put in place a facility for accessing intraday loans to meet short term liquidity requirements which should be fully collateralised by appropriate securities such as the Treasury Bills. LSW is made of the following components: the central system, SWIFT Fin Y-Copy, and Participants workstations.

The payment system mechanism can be depicted by the following picture:

Figure 10: Payment System Mechanism



The CBL has taken utmost care in the implementation of the system to ensure safety and security as well as mitigation of risks. The volumes of transactions in the system are expected to increase post-familiarisation and the grace period extended up to 31 December 2006 for acceptance of high value payments. As at end of December 2006, the system had processed a total of 3,233 transactions out of which 2,452 were CBL transactions.

A number of workshops and seminars were held to train operators of the system within CBL and commercial banks. In addition the CBL embarked on sensitisation campaigns throughout the country to educate the public on the use of the system in 2006. The CBL has planned refresher training on LSW to be undertaken early in 2007 as part of further educational campaigns. More public sensitisation campaigns are also planned for the first quarter of 2007 especially in the northern and southern parts of the country. In furtherance of the Bank modernisation of the NPS, the Bank plans to implement the Automated Clearing House (ACH) will be implemented in 2007. The aim of the ACH is to deal with the low value high volume payments. This initiative is expected to reduce the clearing time significantly and to promote electronic methods of payments while reducing markedly the use of cash and paper-based payment systems. Efforts are underway to implement internet banking in 2007.

4.7 Portfolio Management

The CBL continued to manage the country's foreign exchange reserves in line with its Investment Policy and Guidelines with a view to enhance income generated from investing the reserves. In 2006, the portfolio grew by 31.0 per cent against 11.0 per cent in the previous year. The growth is attributable to a combination of increased value of inflows and investment in fixed income instruments. The Bank continued to enhance internal capacity in risk measurement and monitoring.

4.8 Securities Trading

The CBL continued to conduct auctions of both 91 and 182-day Treasury bills securities. For the year under review, twelve auctions were conducted in respect of the 91-day Treasury bills and six in respect of the 182-day Treasury bills. A total of 59 and 932 bids were processed in respect of the 91 and 182-day maturities respectively for the year. A study of measures to improve the operations of the money and capital markets in Lesotho commenced in 2006 and is expected to be completed in 2007.

The schedule of both 91 and 182 day Treasury bills auctioned during the year is given in the tables below.

Table 7

91-DAY TREASURY BILL AUCTIONS

Auction Date	**Amount Offered***	**Amount Issued***	**Lesotho Discount Rate**	**SA Discount Rate**	**Spread**
04-Jan-06	150.00	150.00	6.84	6.78	0.06
01-Feb-06	150.00	150.00	6.90	6.69	0.21
01-Mar-06	150.00	150.00	6.90	6.59	0.31
05-Apr-06	150.00	150.00	6.80	6.62	0.18
05-May-06	150.00	125.50	7.10	6.74	0.36
31-May-06	150.00	175.00	6.90	6.83	0.07
05-Jul-06	150.00	150.00	6.90	7.16	-0.26
02-Aug-06	150.00	150.00	6.86	7.63	-0.77
30-Aug-06	150.00	150.00	6.86	7.70	-0.84
05-Oct-06	150.00	150.00	6.86	8.00	-1.14
01-Nov-06	170.00	170.00	6.76	8.20	-1.44
29-Nov-06	170.00	170.00	6.76	8.41	-1.65
AVERAGE	153.33	153.38	6.87	7.28	-0.41

* Million Maloti; Face Value

Table 8

182-DAY TREASURY BILL AUCTIONS

Auction Date	Amount Offered*	Amount Issued*	Lesotho Discount Rate	SA Discount Rate	Spread
10-Jan-06	50.00	50.00	6.92	6.80	0.12
08-May-06	20.00	20.00	6.82	6.62	0.20
10-May-06	20.00	19.90	6.75	6.81	0.06
12-Jul-06	50.00	50.00	6.84	7.93	-1.09
05-Sep-06	20.00	20.00	6.79	8.22	-1.43
08-Nov-06	50.00	16.50	7.00	8.48	-1.48
AVERAGE	32.00	29.40	6.85	7.48	-0.60

*Million Maloti; Face Value

Tables 7 and 8 show that the domestic rates in the Treasury bill market in Lesotho fell below those of the same market in SA from the July 2006 auction, and for the remainder of the year. The margin by which the SA rates were higher widened to 1.65 per cent for the 91-day bills, and to 1.48 per cent for the 182-day bills at the end of the year.

4.9 Research and Publications

One of the primary roles of the CBL is monetary policy formulation and provision of advice on fiscal policy matters. This mandate is carried out through routine publications namely; Monthly Economic Reviews, Quarterly Reviews and Annual Reports. In addition, the Bank carries out research on topical economic issues and policy briefs for use by CBL management and Government. In 2006, the following research assignments were initiated and are expected to be concluded in 2007: A comparative analysis of banking costs; the impact of credit screening rules on credit extension in Lesotho; international practice on liquidity requirements; the optimal level of inflation for Lesotho; the role of the financial sector in economic growth; the low-banked Chinese business community in Lesotho; the effects of taxing savings in Lesotho; the under-declaration of Lesotho exports; the impact of privatization on the Lesotho economy; and report on the 2005 Road Transport Survey. As part of its research programme, CBL carried out the first Private Capital Flows survey in order to improve the BOP and IIP statistics (See Box 2).

4.10 Currency Management

The CBL currency management strategy involves handling of bulk deposits and withdrawals by commercial banks, sorting of Maloti notes and coins and the systematic issue of new and reissuable currency.

Currency Management Activities

Maloti Currency Issued

Table 9

MALOTI CURRENCY ISSUED
(Million Maloti)

	2002	**2003**	**2004**	**2005**	**2006**
Maloti Notes Issued	223.8	235.5	257.2	296.0	366.2

The value of Maloti notes issued increased by 23.7 per cent over the year. There has been a steady increase over the past five years, with the exception of 2006, in the currency in circulation as illustrated by table 9 above.

Maloti and Rand Repatriation

Table 10 MALOTI AND RAND REPATRIATION (Million)					
	2002	**2003**	**2004**	**2005**	**2006**
Maloti Repatriation	218.2	270.8	223.8	227.6	184.4
Rand Repatriation	182.8	149.8	321.4	303.7	329.5

Maloti notes and coins repatriated from South Africa declined by 18.9 per cent in 2006. The table above also shows comparative Rand currency deposits by commercial banks that were repatriated to the SARB. There has been a slight increase of 8.5 percent in 2006 as opposed to 2005.

4.11 Human Resource Management

4.11.1 Recruitment

During this year, four vacancies were filled at the Executive level through the recruitment of Deputy Governors and Directors. The Board of Directors further approved the filling of one middle management position in the National Payment System during the third quarter of the year. Other positions have continuously been filled as vacancies occurred throughout the year. A total of six positions at three levels of Head of Division, Head of Section and Professional levels were filled during 2006. Vacancies occurred as a result of transfers on promotion, lateral transfers, resignations, and newly created positions.

4.11.2 Staff Turnover

A total of ten staff members left the employ of the Bank during the year. At Executive level, a contract of employment for the Governor came to an end after serving a five-year-term. Two other contracts of employment that expired during the year are those of Secretary to the Board after the incumbent served the Bank for two four-year terms, and a German expatriate who served the Bank for two years as Senior IT Auditor. There have been four resignations at various levels from Section Head downwards. Additional to these, the Bank also experienced one voluntary retirement and one dismissal.

4.11.3 Training

Training has continued to take place per identified needs in the respective specialised areas required in the Bank's operations. This year there is a total of seven members of staff on long term full time training, three of which are pursuing post graduate qualifications while the other four are studying towards first degrees. Four members of staff have successfully completed their studies, two at post-graduate level while the other two have obtained first degrees.

4.11.4 Administrative Policies and Procedures

As main custodians of Administrative Policies and Procedures, the Human Resource Division continued to monitor compliance of staff to the Bank's Rules and Regulations. New policies have been developed and received Board approval for implementation. Old policies have also been revised in order to ensure their adaptation to changing situations affecting staff.

4.11.5 Social Activities

The annual sporting event for 2006 was hosted by the Bank of Botswana where sister central banks converged for various sporting activities. Various in-house sporting teams have on many occasions challenged other local teams on various sports on friendly sporting competitions.

4.11.6 Community Service

This is an annual event where staff identify areas within the community where there is need for intervention as part of social responsibility. This year staff, in collaboration with the Ministry of Forestry planted trees in Thaba Chitja near Morija.

4.12 International and Regional Meetings

In April 2006, CBL hosted the 22nd meeting of the SADC Committee of the Central Bank Governors (CCBG). The CCBG meeting focused amongst others, on the following:

a) Development of a monetary and financial statistical database;
b) Development of a data bank on the policies and structures of SADC central banks;
c) Macroeconomic convergence and regional monetary and financial integration; and
d) Formulation of Memoranda of Understanding for the SADC region and in particular, the following areas:
    - Payment, clearing and settlement systems;
    - Exchange controls on the cross-border flow of goods, services and capital;
    - Legal and operational frameworks of central banks;
    - Anti-money laundering; and
    - Information and communications technology.

The CCBG meeting ran back to back with the CMA Governors meeting. This meeting aimed at sharing of information on recent domestic and international economic developments in the region, as well as their likely implications on the CMA countries. The deliberations further discussed issues of consultation in monetary policy implementation in the CMA region.