Economic Review **August 2008**

CENTRAL BANK OF LESOTHO IMPLEMENTS STRATEGIES AIMED AT STRENGTHENING MONEY MARKET IN LESOTHO: IMPLICATIONS FOR ECONOMIC GROWTH

In implementing the gradual approach towards the development of money and capital market, the Central Bank of Lesotho has opted to commence with the money market……

Introduction

The development of the money and capital markets has been one of the major priorities of the monetary authorities in Lesotho for sometime. In 2007, the Central Bank of Lesotho (CBL) with the technical assistance from the International Monetary Fund (IMF) embarked on a study to investigate the measures that could be adopted to develop the money and capital markets in Lesotho. The study placed emphasis on the money market. Money market is defined as a market for short term instruments. Short term often refers to maturity of one year or less. Money market instruments include treasury bills, central bank paper, repurchase agreement (repo), bankers' acceptance and interbank fund. Treasury bills, central bank paper and repos are normally offered by CBL for monetary policy purposes. Bankers' acceptance is a short credit instrument issued by commercial banks on behalf of their customers to guarantee payment of their imported goods, while interbank fund refers to lending of fund between commercial banks.

This report intends to briefly highlight the importance of a well functioning money market in economic development and poverty reduction. The proposed strategies aimed at improving money market in Lesotho and their implications will be presented.

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The Importance of Developed Money Market in Economic Development

The importance of a well functioning money market in economic development is well articulated in the literature. Money market is a channel through which the central bank implements its monetary policy decisions. Therefore, CBL seeks to influence reserve money as its operating target through the Open Market Operations (OMO). The Bank uses the treasury bill rate as 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.

Current Situation of the Money Market

The Lesotho money market was overhauled in 2001 with the introduction of the indirect instruments of monetary policy in the form of OMO. The 91 days and 182 days treasury bills are traded competitively. The 91 days TBs are mostly used by the central bank for the management of liquidity in the economy. The 91 days TBs are traded monthly while the 182 days were traded every two weeks. The minimum required amount in the competitive section is M250 000 while in the non-competitive section is M5000. The auction is designed such that securities are sold firstly to the highest bidders until the entire allotment has been exhausted. With regard to non-competitive market, participants are largely members of the public and small to medium companies. In non-competitive market, the price at which treasury bills are sold is set by the CBL and all participants are buying at the same price. Table 1 below presents the level of participation in the treasury bills market during the period August 2007 to August 2008. On average, there are seven bidders in the market. This is due to domination by large companies and commercial banks.

Table 1: Level of Competitiveness

Period	Bids	Success Bids	Bidders	Success Bidders	Rejection
Aug- 2007	19	16	9	8	0
Sept- 2007	13	12	7	7	0
Oct- 2007	19	15	7	7	0
Nov- 2007	22	18	6	6	0
Dec- 2007	12	9	5	5	0
Jan- 2008	14	10	6	6	0
Feb- 2008	22	15	9	9	0
Mar- 2008	12	7	7	6	0
Apr- 2008	15	13	6	6	1
May- 2008	16	10	5	5	0
Jun- 2008	17	11	6	6	0
Jul- 2008	18	10	6	6	0
Aug- 2008	12	11	6	6	0

Proposed Strategies to Develop the Money Market

a) *Introduction of longer dated money market instruments*

The longer dated treasury bills being the 273 days and 364 days will assist to move investors away from the 91 days and 182 days. The longer dated instruments will reduce the cost of roll over which is prone in shorter term securities. In addition, it would be possible to develop a yield curve.

b) *Increased competition in the Market*

The threshold of the competitive section of the auctions will be reduced from M250 000 to M100 000. This would increase the number of participants in competitive bidding and would ensure that the price is very competitive. This market was mainly dominated by the large institutional investors' mainly commercial banks.

c) *Introduction of Shorter Settlement Procedures*

The settlement procedure will be shortened from two days to the same day. This improvement involves settlement through the commercial banks using the Lesotho Wire.

d) *Increased Number of Auctions*

The number of auctions will be increased from once a month to fortnightly. This will apply to all tenors unlike in the current practice where the 91 days auctions were held every month and those for the 182 days conducted every two months.

Implications on Lesotho Economy

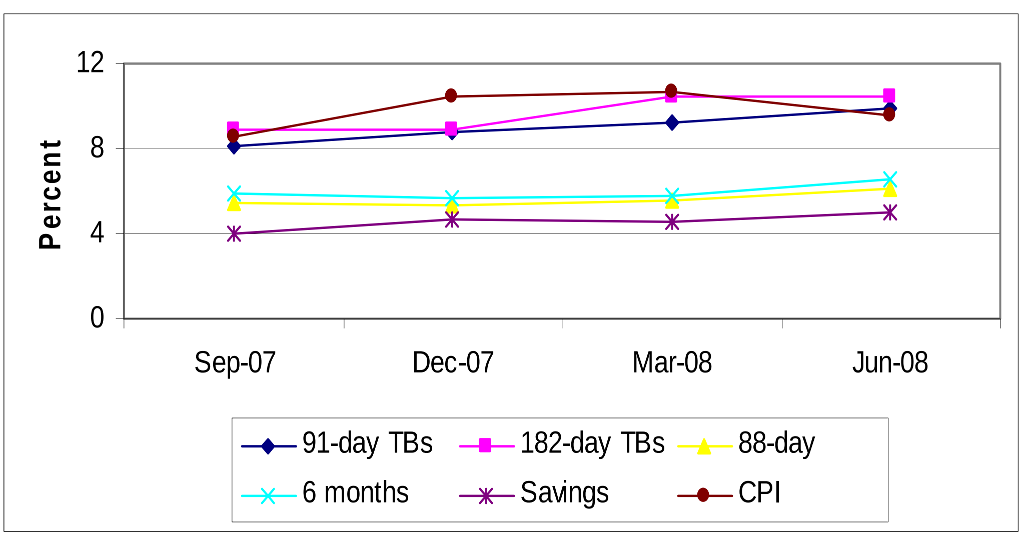
The implementation of the strategies to improve the money market has a number of implications for Lesotho economy. First, the increase of frequency of auctions will enhance monetary policy transmission in

Lesotho. The Central Bank will be able to effect monetary policy changes timely through the OMO. The experience in the current system indicates that the monetary developments were transmitted with a lag into Lesotho markets. This is because South Africa holds their auctions on weekly basis. Second, the money market would be more active with increased frequency of auctions and number of market participants. The lowering of the threshold to M100 000 would allow more investors to participate in the competitive market. In addition, all treasury bills tenors have been opened to all participants thus allowing broader participation. This is likely to make treasury bills an alternative investment vehicle in Lesotho. The competitive nature is likely to cause other interest rates in the economy to respond accordingly. Graph 1 below presents the evolution of 91 days TBs, 182 days TBs, 31 day time, 6 months, savings deposit rates and consumer price index (CPI) in the period from September 2007 to June 2008. Last, the proposed measures may be a solid platform for further improvements in the money and capital market and saving culture in Lesotho. Currently, the real return on most money market instruments is negative. The increased activity in the market and the number of participants is likely to trigger the development of the secondary market in the country.

Conclusions

The successful implementation of the proposed measures would require that all stakeholders engage in extensive public awareness campaign to sensitize all about the benefits of the improvements. The treasury bills market would offer a better alternative instrument to individual investors and to groups that pool together their savings. This would contribute significantly towards economic growth and ultimate eradication of poverty in Lesotho.

Graph 1: Money Market Interest Rates and CPI



2. Southern African Development Community (SADC) launches Free Trade Area (FTA)

Introduction

SADC has placed regional integration at the forefront of its economic development agenda. According to the SADC regional integration programme, SADC intends to establish a free trade area in 2008, Customs union in 2010, common market in 2015, monetary union in 2016 and single currency in 2018. These forms of regional integrations differ in complexities. Free trade area member countries remove tariff barriers among themselves and maintain them against non members. Customs union members remove trade barriers between them and adopt a common external tariff against the non members. Common market is similar to the customs union but further allows for free movement of factors of production and the monetary union involves a single central bank.

At its Summit held in South Africa in August 2008, SADC Heads of States and Governments launched the SADC FTA implying that about 85 per cent of the trade in goods is free. This marked an important milestone towards regional integration in the southern region. Twelve SADC member countries; Botswana, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe have established an FTA while Angola and Democratic Republic of Congo(DRC) will join at a later stage. The launch followed a process of gradual reduction of tariffs that commenced in 2000. Southern African Customs Union (SACU) front loaded its liberalization process, thus reduced its tariffs by equal installments from 2000 to 2007. Thus trade between SACU and other SADC members has been relatively free for sometime.

Status of Regional integration in Southern Africa

Regional integration in Southern Africa particularly within the membership of SADC warrants a number of observations. There are a number of regional integration forms already in existence which have overlaps. SACU whose members are Lesotho, South Africa, Botswana, Swaziland and Namibia was established in 1910. SACU plays an important role in the region as it pools the customs and excise revenue to share among members using the agreed formula. This revenue accounts for a significant share of the revenue of the smaller members' budgets. As shown in Table 2 below, Angola, DRC, Malawi, Mauritius, Swaziland, Zambia and Zimbabwe are members of Common Market for Eastern and Southern Africa (Comesa). Furthermore, Tanzania is a member of East Africa Community (EAC).

Table 2: Regional Integration In Southern Africa

Country	SADC	COMESA	SACU	EAC
Angola	X	X		
Botswana	X		X	
DRC	X	X		
Lesotho	X		X	
Madagascar	X	X		
Malawi	X	X		
Mozambique	X			
Mauritius	X	X		
Namibia	X	X	X	
South Africa	X		X	
Swaziland	X	X	X	
Tanzania	X			X
Zambia	X	X		
Zimbabwe	X	X		

Source: Various

Implications for Lesotho's Economy

Regional integration provides a number of benefits for the member countries. First, Lesotho based producers would have access to increased market. SADC region represents cumulative gross domestic product (GDP) of US$431 billion and the population of 247 million people. This compares to SACU GDP and population of US$307 and 54.4 million, respectively. Second, the FTA provides firms with the opportunity to enjoy the economies of scale. This is likely to lead to increased economic growth in the domestic economy. Last, increased competition in the product market will force the prices downwards to the benefit of domestic consumers. This will arise because firms will be forced to introduce cost effective methods of production.

Conclusion

It is important that the business community in Lesotho realign their operations in order to reap the benefits of the liberalized trade. This includes proper management of the cost structures such that they can be competitive in the newly opened markets. The FTA represents an opportunity for the realization of private sector led economic growth in Lesotho. Because of the geographical proximity, even small producers can manage to export without significantly high costs.

3. Monetary Policy Operations Report for August 2008

During the review quarter, monetary policy operations undertaken by Central Bank of Lesotho (CBL) were successful in attaining the desired objectives. The primary objective of monetary policy is to achieve price stability. As a result, the Bank uses Open Monetary Operations (OMO) to maintain the stated objective. This is done through maintenance of adequate level of Net International Reserves (NIR). The NIR ensures that the parity between the Loti and the South African Rand is maintained. The parity allows Lesotho to benefit from relatively low inflation in South Africa. A large portion of Lesotho's inflation is imported from South Africa because of close trade relations between the two countries. The Monetary Policy Committee (MPC) of CBL sets the target level of NIR quarterly. The NIR target range remained unchanged at US$450 to US$500 million in the review period. This indicates that external reserves were sufficient to preserve the fixed exchange rate between the Loti and the Rand at this range.

Table 3 below shows the amount auctioned and discount rates that prevailed for each of the auction. The August auction was over-subscribed, as a result the whole auctioned amount to the tune of M150.0 million was issued. The number of successful bids declined from 12 in August to 18 recorded in the previous month.

Table 3: Treasury Bill Auction

Type of Security	Auction Date	Auction Amount (million	Amount Issued (Million)	Discount Rate
182-day TBs	12-Mar-08	M20.0	M20.0	10.45
91-day TBs 182-day TBs	30-Apr-08 07-May-08	M150.0 M30.0	M150.0 M30.0	9.81 10.45
91-day TBs	28-May-08	M150.0	M150.0	9.91
91-day TBs	02-July-08	M150.0	M150.0	9.94
91-day TBs	30-July-08	M150.0	M150.0	10.43

During the review month, the Lesotho's 91-day treasury bill rate remained below that of South Africa with a margin of 92 basis points. The Lesotho's 91-day treasury bill rate increased from 9.94 per cent registered in July to 10.43 per cent in August 2008. However, the counterpart South African treasury bills rate declined marginally from 11.38 per cent in July to 11.35 per cent in August. Monetary policy operations undertaken during the review month were successful in attaining their desired objectives of financial stability and the target NIR level.

Figure 2: Measuring the Success of Monetary Policy Objectives

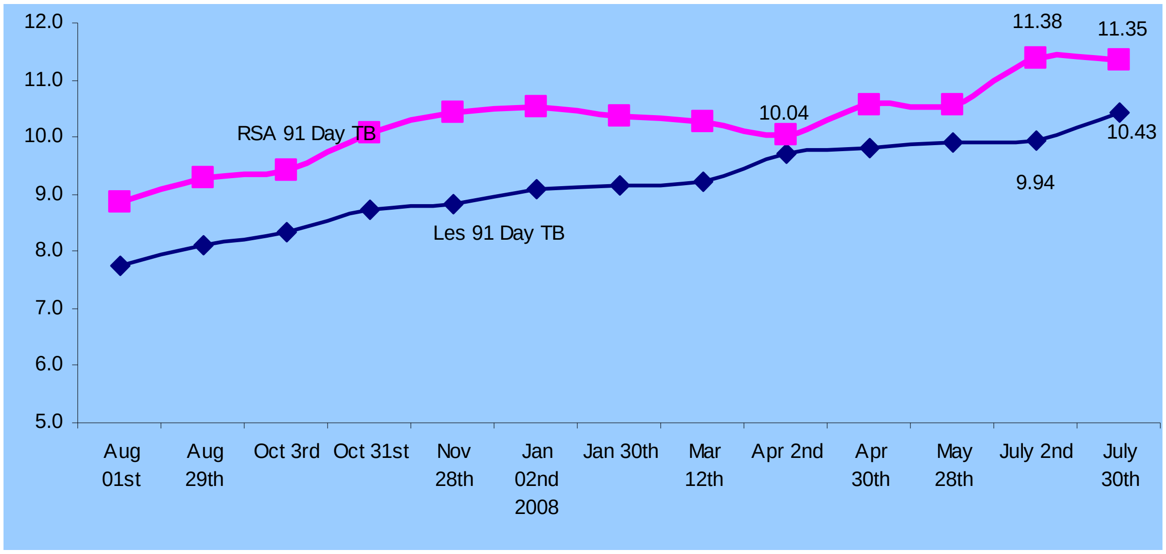


Table 5: Selected Monetary and Financial Indicators

	2008		
	May	***June***	***July***
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	*15.92*	*16.25*	*16.58*
1.2 Prime Lending rate in RSA	*15.00*	*15.50*	*15.50*
1.3 Savings Deposit Rate	*4.84*	*5.04*	*5.28*
1.4 Interest rate Margin(1.1 – 1.3)	*11.08*	*11.21*	*11.30*
1.5 Treasury Bill Yield (91-day)	*9.81*	*9.91*	*9.94*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*4626.55*	*4747.90*	*4337.04*
2.2 Net Claims on Government by the Banking System	*-3741.15*	*-3531.18*	*-4747.69*
2.3 Net Foreign Assets – Banking System	*9746.02*	*9821.21*	*10189.05*
2.4 CBL Net Foreign Assets	*7205.83*	*6638.62*	*8036.69*
2.5 Domestic Credit	*-2325.60*	*-2059.84*	*-3151.06*
2.6 Reserve Money	*617.67*	*521.45*	*572.17*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	***7.6179***	***7.9408***	***7.6272***
4. Inflation Rate (Annual Percentage Changes)	***9.5***	***9.6***	***10.5***
5. External Sector (Million Maloti)	***2007***		***2008***
	QIV	***QI***	***QII***
5.1 Current Account Balance	*328.39*	*506.26*	*829.25*
5.2 Capital and Financial Account Balance	*-83.21*	*330.96*	*72.44*
5.3 Reserves Assets	*-116.19*	*-774.19*	*-165.33*

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities