



Introduction of Government Pension Fund and its Implications on Inflation, Saving and Investment in Lesotho.

The Honourable Minister of Finance and Development Planning announced in the 2008/09 budget speech that the Government of Lesotho will reform public employees' pension fund.....

Background

The Government of Lesotho, in its 2008/2009 Annual Budget Speech, has proposed to establish a Pension Fund in which employee and the employer contribute 5.0 percent and 11.2 percent respectively of the employee's annual salary, respectively. The Government will transfer M800 million to the pension fund as payment in terms of the proposed reform. The Government proposed to switch from the Defined-Benefit (DB) Pension scheme to Defined-Contribution (DC) scheme, and this will affect only employees aged 40 years and below. The article, therefore, seeks to explore possible economic implications of such a pension Fund.

This reform comes against the background of the problems realized under the current system. Firstly, it was realised that the DB scheme will reduce the pension should there be unforeseen demands on that year's budget thereby making the pensioner worse-off. This is

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particularly the case because pension funds are historically paid out of recurrent budget. This is problematic in that government's liability may not be adequately accommodated. For instance if it is assumed that the number of pensioners is 4 500, given the current government staff compliment, liability would be estimated at M4 billion. It can be observed that this liability is too high to be financed under recurrent budget. There is, therefore, need for a properly structured system as the one proposed under the DC. Secondly, under the current arrangement, if the pensioner dies,

the pension also stops thereby leaving a series of problems to the family as no benefits will accrue to the affected family. Under the new scheme, the pensioner would receive a share of the contributed fund together with the interest accrued over his/her service years when the fund would have been invested.

Comparisons between DB and DC

The DB can be broadly equated to what is generally known as final salary schemes. The amount of payment of pension payable is dependent on three main issues: the length of time served in the scheme; earnings prior to retirement (final pensionable salary); and the scheme accrual rate, which is the proportion of salary that is received for each year of service.

The DC is generally called money purchase schemes. In this form, employers and employees contribute to the scheme, where the money is invested. The pension payable is also dependent on three main considerations, namely, the amount of money paid into the scheme, both by the member and the employer; how well the investment funds perform; and the 'annuity rate' (this is the factor used to convert the invested pool of funds into pension) at the date of retirement.

The following observations are made about the two methods to run public employee pension funds; in a DB scheme there is uncertainty about the solvency of such funds and how

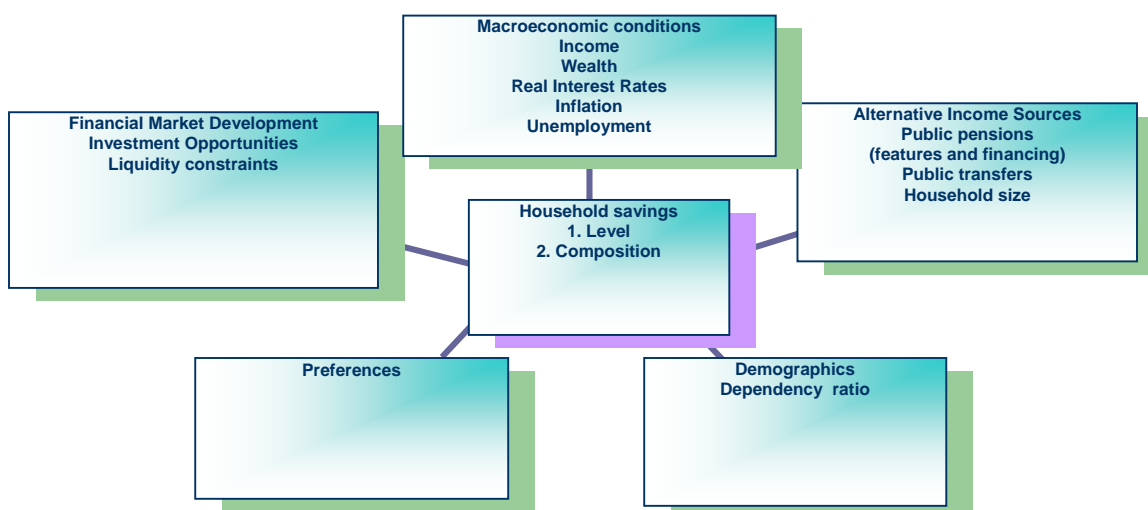
much any pension is worth. This is mainly complicated by the nature of presentation of the full valuation by actuary. The reports are generally long and complicated, thus not user friendly to most beneficiaries. However, DB, if well managed through trustees, tends to be more beneficial to employees through guaranteed payments.

In DC schemes funds are generally invested in equity and when stocks in the markets fall, the funds will almost definitely fall in value. The employer is unlikely to pay-up the difference. This therefore makes DC cheaper for employers and leaves few guarantees for employees.

Pension funds and likely impacts

Generally pension funds in developing countries (Lesotho inclusive) are likely to affect household, saving, fiscal position of government and income stream of household with a possibility of social repercussions. Household saving and consumption expenditure are summarized through 'household saving ratio'. It is however noted that different countries define it differently. Some countries such as the US follow a traditional definition which is household saving divided by household disposable income. Others follow the SNA 93 categorization, an approach that is advisable in the case of Lesotho. This is defined in terms of the ratio of household saving to disposable income, plus the adjustment for the changes in net equity of households in pension funds.

Figure 1: Factors that affect household savings level and composition



Source: Tuladhar, 2007

Figure 1 depicts a schematic view of factors that influence households in their savings structure. It is important to note that households feel more comfortable to be involved in some form of savings if there is macroeconomic stability and prudence. Stable inflation and increased overall income levels are likely to positively influence higher savings, an important factor for investment.

The introduction of the pension fund is likely to introduce more predictability in the statement of government operations, since there will be certainty in terms of the amount of pension liability and how it will be financed. Moreover, this new development will reduce annual recurrent budget, thereby giving more room for the capital budget. Preference and dependency ratio are other considerations, where high dependency leads to lower household savings level.

Development of capital and money market¹

Theoretically, there is a positive relationship between per capita income and household investment. Lesotho has recorded an increase in per capita income from 2000 to 2006, with an estimated average of 3.4 percent. And from this alone it can be expected that the country will be receptive to any introduction of pension funds as a form of investment. This would be consistent with pension reforms in countries such as India where in 2004/05 government relaxed the rules covering pension funds to allow non-government pension funds to invest in the same products as government.

Pension funds are a form of saving and are expected to raise aggregate national saving. It is also important that the instruments that are used to invest these savings are carefully

¹ This article benefited from Funke, K and Standtmann, G. 2004. Operations of a pension fund after the Asian crises: The Thai experience

chosen in order to preserve the value of such savings for future consumption. In the recent financial markets turmoil there is a shift from investment of pension funds in equity to bonds. A recent survey of European and North American pension funds indicates that funds are being switched to fixed income and infrastructure. A similar trend was observed in Japan's pension fund, the world largest pension fund, estimated at JPY120 trillion of assets. It has been decreasing the holding of stocks because of market volatility and for the period ending March 2008 stock holding was only JPY 3 trillion.

The current shift from equity to low risk securities is a reversal of historical investment strategy in pension funds. Empirical research indicates that over centuries, stock returns have been considerably higher than Treasury bills and bonds. It is estimated that in 110 years to 2004 US stock returns has been 7.9 percent. And over the same time period return on low risk debt securities was not higher than 1.0

percent. It was then argued that the risk of volatility of markets was more than overcompensated by its return. It is therefore concluded that it is important for pension investment portfolio to be balanced between equity and low risk long term securities depending on prevailing financial environment.

The development of pension funds as is the case in the country is likely to contribute to the development of the financial markets, as more funds are available such funds will need more products that will be invested in.

Under this landscape, large volumes of funds could be mobilized in order to provide resources for productive use of capital emanating from the fully funded pension pool. Through different components of aggregate national savings such as private savings which forms a larger part, higher national savings could be obtained which would translate into expanded capital accumulation base of a country owing much to saving-investment relationship.

2. Continuing Global Financial Crisis: An Update

Background

The world economy is currently facing an economic downturn due to financial market crisis. This report intends to briefly highlight the current and continuing financial market crisis developments caused by the sub-prime lending problem in the US.

The financial market crisis originated from the collapse of the United

States (US) sub-prime mortgage market in August 2007. Sub-prime lending is the practice of lending to borrowers who do not qualify under the normal market interest rates because of their weak credit ratings, characterised by a history of defaults, no down-payments and no verification of assets. This type of lending is effected on terms of higher

interest rates than market rates because of the risk involved. Proponents of sub-prime lending maintain that the practice extends financial services to people who would otherwise not have access to them.

The problem emerged when credit-unworthy mortgage borrowers began to default on their loans; and investment banks that purchased securities backed by these loans began to collapse. It deepened further and is now affecting many parts of the global financial system, including emerging markets. The problem extended beyond the sub-prime mortgage sector in the US and elsewhere as credit conditions tightened across the board and parts of the credit markets in various countries ceased to function effectively leading to restrictions on the availability of credit.

Some regions of the world such as the United Kingdom felt the impact of this credit crunch fairly early. Northern Rock bank in the UK was one of the banks that was affected early in the unfolding of this problem as it encountered financial problems during the first half of 2008. Other banks in other developing countries such as France and Germany announced the presence of liquidity constraints. These institutions in various countries undertook a desperate attempt to obtain funding in the inter-bank market.

The Current Situation

Sub-prime mortgage meltdown and credit crunch led to a number of big financial institutions in the US to

experience liquidity problems to the extent that some of them collapsed while others were bailed-out by third parties. Among others, the fourth largest investment bank in the US, Lehman Brothers collapsed in September 2008. Lehman Brothers has been among the leaders in mergers and acquisition advice, debt and equity underwriting, and global finance. However, its rival Merrill Lynch & Company Inc. was rescued and bought out by the Bank of America.

In a similar token, the US government bailed-out one of the world's largest insurance firm, American International Group (AIG) and mortgage finance companies, Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). Washington Mutual Inc. was also closed by the US government and its banking assets were sold to JPMorgan Chase & Co.

Other investment banks, namely Goldman Sachs and Morgan Stanley changed their operational status, enabling them to tap into commercial banking. The liquidity problems due to this financial crisis led to loss of confidence in the financial markets. Therefore, restoring confidence requires some calculated, strong and immediate interventions.

Remedial Measures

In response, the US and the European authorities have taken extraordinary measures aimed at stabilizing markets, including;

massive liquidity provisions, prompt intervention to resolve weak institutions, extension of deposit insurance and recent US legislation to use public funds to purchase troubled assets from banks. In doing so, the US Treasury Secretary and the Federal Reserve Chairman proposed a loan equivalent to US\$700 billion (of which US\$250 billion is for banks' recapitalisation) package in order to improve the availability of credit which has been harder to obtain for banks and businesses as well as individuals. This package is expected to help finance firms to offload bad debt which was triggered by a global credit crisis. The deal is envisaged to boost global financial stability, increase investor confidence, prevent global slowdown and encourage banks to lend to each other and therefore overcome the credit crunch. The House of Representatives in the US (the Congress) approved the bail-out after long debates. Similarly, the United Kingdom government has also approved a bail-out package equivalent to £37 billion.

Furthermore, the US Federal Reserve, the European Central Bank and the Bank of England reduced

their key interest rates in order to stabilise the financial conditions and hence restore confidence.

Implications for Lesotho's Economy

The resulting slowdown in economic activity including the U.S. would lead to a fall in demand of Lesotho's exports. This could result in rising unemployment in the country since manufacturing is the largest formal sector employment in the country. In addition, the depreciation of the loti could further exacerbate inflation pressures in the economy and increase public debt service levels.

Furthermore, diamond exports which are largely destined to the Euro Area are likely to be affected negatively by lack of liquidity in the European market.

The country's reserves are also likely to be affected by this financial market crisis. Some of Lesotho's reserves are held in US Dollar, Pound sterling, South African Rand and the Euro. Financial market problems in these regions will, by all laws of probability, impact negatively on the reserves in terms of return on investments.

3. Monetary Policy Operations for September 2008

This article reports economic and operational issues surrounding the monetary policy operations conducted in September 2008. The Bank issued government securities in response to liquidity conditions that prevailed in the economy. Following the assessment made on

the sources of liquidity, M300 million worth of securities were offered during the auctions. Table 1 shows amounts auctioned and discount rates that prevailed mainly for the 91-day auctions of treasury bills. The auction amount for 91-day treasury bills was M153.0 million, of which

M141 million was eventually issued. This represented the M130.0 million worth of securities that was auctioned on August 27 and subsequent auctions for September.

The auction amount for 182-day, 273-day and 364-day were M34.0 million, M50.0 million and M63.0 million, respectively.

Table 1: 91-day Auctions of Treasury Bills

Type of Security	Auction Date	Maturity Date	Auction Amount (million)	Amount Issued (million)	Discount Rate	RSA Disc. Rate
91-day TBs	30-Jan-08	02-May-08	M150.0	M150.0	9.17%	10.37%
91-day TBs	05-Mar-08	06-Jun-08	M150.0	M150.0	9.21%	10.26%
91-day TBs	02-Apr-08	02-Jul-08	M150.0	M150.0	9.71%	10.04%
91-day TBs	30-Apr-08	1-Aug-08	M150.0	M150.0	9.81%	10.46%
91-day TBs	28-May-08	29-Aug-08	M150.0	M150.0	9.91%	10.55%
91-day TBs	02-July-08	02-Oct-08	M150.0	M150.0	9.94%	11.38%
91-day TBs	30- July-08	30-Oct-08	M150.0	M150.0	10.43%	11.35%
91-day TBs	27-Aug-08	27-Nov-08	M130.0	M130.0	10.43%	11.18%
91-day TBs	3-Sep-08	3-Dec-08	M11.0	M11.0	10.43%	11.16%
91-day TBs	17-Sep-08	17-Dec-08	M12.0	M0.575	10.01%	11.16%
Total for reporting period			M153.0	M141.575		

The response was positive for the first two auctions, while the last auction of September 17 experienced low allocations at cut-off interest rates. However, this is expected to improve with the subsequent auctions as market participants begin to appreciate the new tenures and the auction frequency. The discount rates for all the tenures ranged from 10.01 percent to 11.50 percent, with the shorter tenure securities attracting the lowest rate.

The new trading system has revised the minimum bid amount for

competitive bids down from M250 000 to M100, 000. As a result, the volume of non-competitive bids has increased for all tenures. Therefore, the number of bidders for 91-day treasury bills declined from 6 observed in August to 2 in the second September auction. All bidders succeeded in the auction and were allocated a portion of their bids. The total number of bids fell with the subsequent bids, from 17 observed at the beginning of September to 2 at the last auction of the month.

Figure 2: Performance of Lesotho 91-Day T-Bills vs RSA T-Bills

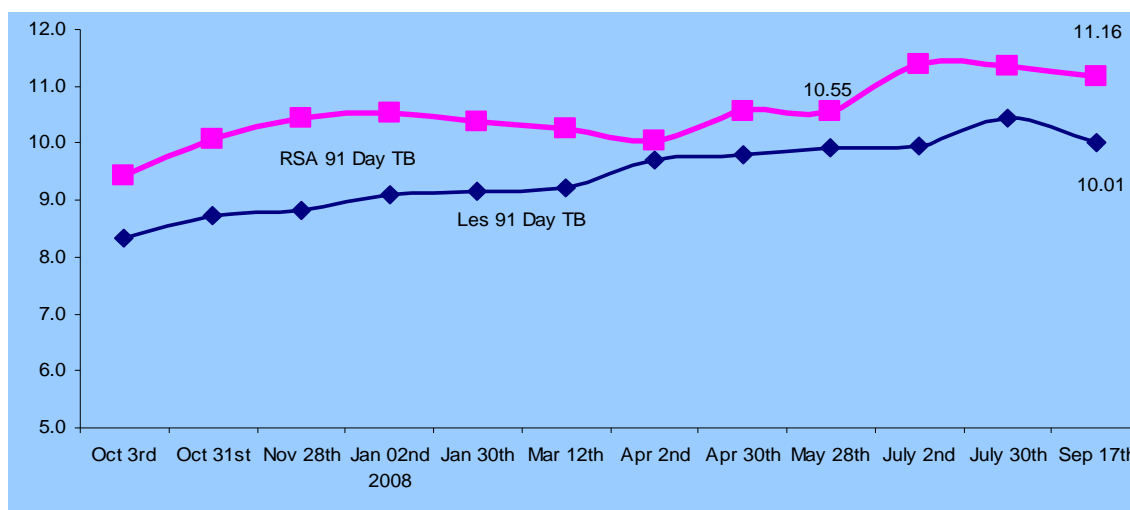


Figure 2 shows that the Lesotho 91-day Treasury bill rate fell from 10.43 per cent in August to 10.01 per cent in the last September auction. The rate remained below its SA counterpart rate which recorded 11.16 during the period. The margin

between the two rates widened from 92 basis points to 115 basis points in September (see figure 2 above). It is acknowledged that the other longer tenure Treasury bill attracted higher discount rates than their SA counterpart during the auction.

Table 2: Selected Monetary and Financial Indicators

	2008		
	June	July	August
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	16.25	16.58	16.58
1.2 Prime Lending rate in RSA	15.50	15.50	15.50
1.3 Savings Deposit Rate	5.04	5.28	5.28
1.4 Interest rate Margin(1.1 – 1.3)	11.21	11.30	11.30
1.5 Treasury Bill Yield (91-day)	9.91	9.94	9.94
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	4747.9	4337.04	4375.75
2.2 Net Claims on Government by the Banking System	-3531.18	-4747.69	-4677.78
2.3 Net Foreign Assets – Banking System	9821.21	10189.05	10021.10
2.4 CBL Net Foreign Assets	6638.62	8036.69	8441.19
2.5 Domestic Credit	-2059.84	-3151.06	-2786.73
2.6 Reserve Money	521.45	572.17	581.73
3. Spot Loti/US\$ Exchange Rate (Monthly Average)	7.9408	7.6272	7.6680
4. Inflation Rate (Annual Percentage Changes)	9.6	10.5	11.2
5. External Sector (Million Maloti)	2007		2008
	QIII	QIV	QI
5.1 Current Account Balance	440.15	328.39	517.63
5.2 Capital and Financial Account Balance	248.60	-83.21	310.40
5.3 Reserves Assets	-870.86	-116.19	-774.19

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

Table 3: Selected Economic Indicators

	2004	2005	2006	2007+
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	4.2	2.9	7.2	5.1
1.2 Gross National Product – GNI	7.9	5.5	3.1	4.9
1.3 Per capita –GNI	7.9	5.5	3.1	4.0
2. Sectoral Growth Rates				
2.1 Agriculture	-1.9	-1.7	1.7	-39.3
2.2 Manufacturing	2.1	-8.6	10.5	11.0
2.3 Construction	-4.4	-3.4	0.6	3.5
2.4 Services	2.1	4.1	6.6	6.3
3. External Sector – Percent of GNI				
3.1 Imports of Goods	86.3	83.1	80.1	86.5
3.2 Current Account	-4.7	-5.7	3.5	9.5
3.3 Capital and Financial Account	5.8	3.6	0.7	8.2
3.4 Official Reserves (Months of Imports)	5.2	5.5	6.7	7.6
4. Government Budget Balance (Percent of GDP)	5.7	4.8	11.8	5.3

* Preliminary estimates

+CBL Projections