Economic Review September 2007

LESOTHO SOVEREIGN RATING FOR 2007

According to Fitch Rating Agency, Lesotho's long term foreign currency credit rating remained unchanged at "BB -", Local currency credit rating also remained unchanged at "BB" with a stable outlook; short-term foreign currency credit rating was affirmed at "B"…

Background

Fitch sovereign credit ratings provide credit research and opinion on more than 100 countries, and assigns ratings to the foreign and local currency debt of sovereign governments that account for virtually all of sovereign international debt issuance.

Investors use credit ratings as indicators of the likelihood of getting their money back in accordance with the terms on which they invested. On the scale employed by Fitch, the top rating is 'AAA' and the bottom is 'D'. The lower the rating, the bigger the probability of default, and vice versa. Governments rated above 'BBB' are known as 'investment grade' while those rated below fall into the 'speculative grade' category. In determining the payment capacity and willingness to repay debt, Fitch considers macroeconomic indicators such as the available stock of foreign currency reserves, balance of payments flows, economic growth prospects and capacity to generate revenue and a variety of political and social factors (See October 2006 Economic Review for further details).

INSIDE

Lesotho Credit Rating

As in the previous year, Lesotho's Long Term Foreign Currency (LTFC) rating has remained unchanged at BB-. This rating is the same as that received by, among others, Indonesia, Nigeria, Turkey, Venezuela and Vietnam. This rating implies that there is a possibility of credit risk developing which may be due to adverse macro economic dynamics. Hence, this rating depicts the capacity for continued payment depending on a sustained, favourable business and economic environment.

Table 1: Credit Rating History

Date	LTFC	LTLC
29 Aug 2007	BB-	BB
18 Sept 2006	BB-	BB
30 Nov 2004	BB-	BB+
02 Sept 2002	B+	BB

Lesotho's ability to pay off its short-term foreign currency loans also remained unchanged at 'speculative (B)', meaning that the country has 'minimal capacity for timely payment of financial commitments, plus vulnerability to near-term adverse changes in financial and economic conditions'. Similarly the country's Long-term Local Currency (LTLC) rating remained unchanged at BB due to concerns about the Government's ability to cope with the expected future decline in Southern African Customs Union (SACU) revenues.

Fitch identified both strengths and weaknesses. On the one hand, strengths emanate from; current strong SACU revenue, net public external creditor (strong debt repayment record), structural reforms supported by strong financial support from the Millennium Challenge Corporation (MCC); and faster economic growth due to the diamond sector. On the other hand, weaknesses emanate from; threats to political stability, weak business environment, public expenditure management reforms; and low level of development.

Strengths

Strong Fiscal Consolidation

Fiscal consolidation continues to be robust primarily due to exceptional SACU revenues from the import boom in the region. Most of this revenue is either spent (including reducing commercial debt) or used to increase cash balances of the Government with the central bank to provide a cushion for when SACU revenues eventually decline. SACU revenue has also supported the balance of payments (BOP) and Lesotho achieved a current account surplus equivalent to 4 per cent of GDP in 2006 and a further surplus is expected in 2007.

Strong Official Reserves

High SACU revenues have facilitated a faster build-up of official reserves and enabled the Government to pre-pay some of its commercial external debt. Gross external debt ratios have improved significantly, declining from around 90 per cent of GDP in 2002 to around 43 per cent of GDP in 2006 as a result of, among others, repayment of public debt. The country's net external creditor position strengthened to about 21 per cent of GDP in 2006 and the country has been a net external creditor since 2004 as a result of a strong build-up in official reserves and commercial banks' foreign assets.

Structural Issues

- Diamond mining

Diamond production which started in 2004, has helped diversify Lesotho's exports and brought increased economic growth. Most of the mines are low grade (in terms of carats per ton) but high quality gem mines. Currently two diamond mines are operational in Lesotho, namely; Lets'eng and Liqhobong Diamond Mines. The former started production in 2004 and is due to double capacity in 2008 and the latter started production in 2006. Three other diamond mines are expected to start production in the medium term and these are; Kao, Kolo and Mothae. At the end of 2006, the operational mines produced around 100,000 carats compared with 2 million in Namibia, 3.3 Million in Botswana and 10 million in South Africa. The mining sector accounts for about 7 per cent of GDP and employs around 900 people.

- Clothing and Textiles

The clothing and textile sub-sector has been recovering following a decline emanating from the expiry of the Multi-Fibre Agreement (MFA) in 2004. The recovery has been due to, among others, government intervention, imposition of safe-quards against Chinese imports until 2008 and the extension of the third-party sourcing agreement under the Africa's Growth and Opportunities Act (AGOA) to 2012. New firms are coming into the country due to introduction of tax incentives in 2006/07 and favourable working conditions such as lower wages and lower electricity rates. In 2006, the manufacturing sub-sector accounted for about 15.2 per cent of GDP of which textiles and clothing sub-sector accounted for about 6.6 per cent of GDP.

- Millennium Challenge Account

Lesotho signed the Millennium Challenge Corporation (MCC) Compact with the United States government for a grant to a tune of US$363 million in July 2007. The grant is to be disbursed over a period of five years and is aimed at projects that will promote private-sector activity and eliminate extreme poverty.

Weaknesses

Political Instability

Political instability can have detrimental effects on the investors' sentiments, and hence on economic growth in general. Since the Parliamentary elections held in February 2007, there has been political instability due to the opposition parties' dissatisfaction with the way the 40 proportional representation seats in the 120-member parliament were allocated after the elections. Fitch iterates that the situation is a potential concern and could lead to negative rating if political violence increased or reduced government effectiveness.

Expected Decline in SACU Revenues

The anticipated long-term decline in SACU revenue remains a threat. SACU revenue is threatened by lower tariffs due to the European Union (EU) and other Free Trade Agreements (FTA), possible expansion of the SACU revenue into the Southern African Development Community (SADC) customs union and by South African desire to re-negotiate the current revenue-sharing agreement.

Conclusion and Credit Outlook

The outlook is stable and the Government is focusing on structural and institutional reforms and investment in infrastructure with the support of a large grant from the MCC and other donors with the ultimate objective of addressing the country's fundamental credit weakness of low level of development and the weak business environment. Credit worthiness would improve depending on the impact of reforms, enhanced infrastructure, diversification of government's revenue base and the ability to foster development.

Road Infrastructure as a Strategy for Development

Introduction

The development of essential public infrastructure is a vital ingredient for economic growth and poverty reduction. Investment in infrastructure can support social services through health, education, water and sanitation services. Likewise transport infrastructure improves access to exclusive services and markets to rural areas.

It is with this in mind that the government of Lesotho is reconstructing and improving a variety of road networks that connect the capital Maseru with its periphery and other districts.

Identified Roads for Construction

In September 2007, the Government of Lesotho and the European Commission (EC) signed a road financing agreement to an estimated M212 million for upgrading and improving road networks to the length of 110 kilometres. These involve the following;

- 65 kilometres of the main south road from Ha Matala to the Mafeteng roundabout
- 15 kilometres of the main north road from Lakeside traffic lights to Maqhaka.
- 7 kilometres from Hleoheng to Seretse Khama junction.
- 6 kilometres from Peka town to Peka Bridge.
- 18 kilometres from Ha Moruthoane to Morija via Matsieng.

The above road networks are likely to improve among others the distributory capacity of services in the economy, where reliable and widened roads would facilitate more flow of traffic and sequentially reduce road accidents.

Importance of roads Infrastructure

The Government maintains comprehensive monitoring and implementation system of the state of road networks and integrates road infrastructure development in the the overall development agenda of the economy. This is in line with the observation that Poverty Reduction Strategies and Millennium Development Goals (MDGs) do not put much emphasis on the nature of road infrastructure both at rural and urban areas.

The MDGs proclaim international initiative to monitor 48 target indicators. But it is interesting that a deeper analysis reveals that none of these are directly related to road infrastructure. This therefore implies that the transport sector is left out. Some authors and policy-makers blame this exclusion to less emphasis that is put on roads networks internationally.

There is a general consensus in transport economics that it is always better and economically advisable to maintain roads infrastructure on a consistent basis. This is with the observation that it is generally costly to improve a road at an advanced stage of deterioration.

Making Finance Work for Africa: A Partnership

Making finance work for Africa is a shared goal among policy makers in Africa. This is with the acknowledgement that Africa needs stronger, innovative financial institutions that can extend credit and other financial services that can easily be accessed by ordinary citizens and small firms can afford them.

The importance of this initiative is consistent with the declaration of the 2007 G8 Heiligendamm on Africa Growth and Development which stated that *'Countries with functioning financial markets grow faster and achieve lower poverty rates by helping to channel resources to their most productive use, reduce deficiencies such as the lack of long term financing in local currency'.*

It is reported that access to finance is one of the three biggest constraints for enterprise growth in Africa. The African Development Bank states that only 20 percent of adults in Sub-Saharan Africa hold a bank account at a formal or semi-formal institution. Increasing access to financial services will particularly benefit the majority of the poor and women in particular. A similar initiative seems to be consistent with the introduction of the Lesotho Post-Bank which provides banking services predominately to the rural households.

The availability of credit to the private sector is generally improving in Africa estimated at 14 percent of GDP. However, this is considered insufficient to be a catalyst for private sector led growth. Further-more the African Development Bank projects that an increase of credit to the private sector from the current 14 per cent to at least 25 per cent of GDP is likely to pull an estimated US$70 million of additional investment to African households and firms. In Lesotho, private sector credit is estimated at 22 per cent of GDP. This therefore means that Lesotho should accelerate growth of private sector credit and its associated sector led growth.

Interest costs, administrative expenses and collateral requirements for loans are considered high in Africa. The interest rate spreads which are used as a measure of financial sector efficiency is estimated at 8 per cent, while in Lesotho it is estimated at a slightly higher 10.87 per cent. This translates into a negative real interest rate on household deposits with the commercial banks. Lesotho and the rest of Africa are worst performers compared with the world average of 4.8 per cent. This therefore implies that African borrowers would pay an estimated US$3 billion less in interest costs if the African average can be brought down to the world average.

Surveys have also revealed that much of investment demands are not met by financial institutions in Africa. This is despite the presence of high liquidity in the financial sector. Lesotho is no exception in this rule with a liquidity ratio of 74 per cent, which is high by international standards.

'*Making Finance Work for Africa'* ; an initiative that will be coordinated and hosted by African Development Bank serves as an opportune platform for Lesotho to get technical assistance to strengthen the current government program on private sector led growth that is being implemented with the technical assistance of the World Bank.

The initiative is expected to uphold the following principles as countries implement it:

- The Making Finance Work for Africa (MFW4A) partners agree to establish a partnership framework to support the growth, access, stability and regional dimensions of financial sector development in Africa. This includes; expanding access to financial services by all sectors of the economy: as measured by the number of firms, individuals and households with access to quality and sustainable financial services.
- Increasing financial depth, diversity and efficiency, as indicated by the ratio of credit to the private sector as a percentage of GDP, interest margins and indicators of capital market and other non-bank financial sector development across African financial systems,
- Strengthening institutional and regulatory capacity; as measured by business environment and other institutional development indicators.

Partners will develop a shared framework of key performance indicators and a common results framework.

The partnership is open to all financial sector stakeholders. Partners actively seek inputs from all financial sector champions, especially the private sector, to develop shared activities and achieve its objectives.

The partnership is based on an open architecture to permit partners to participate in a variety of ways. Activities will be implemented and financed through the partners on a case-by-case basis. A partnership secretariat will facilitate, moderate and coordinate partner activities under the partnership. The partnership secretariat work will be funded by partners willing to make in-kind financial contributions to support its activities. All partners will support the partnership secretariat through their active engagement, sharing of information about programs and activities and collaborating in the dissemination of knowledge, experience and best practice.

The paper benefited from www.afdb.org/mfw4a

Monetary Policy Operations for September 2007

The CBL's objective of maintaining price stability in the present policy framework is attained through the maintenance of an adequate level of foreign reserves and fighting domestically generated inflation. The objectives of the operations were:

(i) to attain a reserve money target of between M400m and M450m;

(ii) to ensure that the discount rate on GOL treasury bills moves in line with regional interest rates movements; and

(iii) through (i) and (ii), to attain the required NIR target, which was a minimum of $500.0 million for the review period.

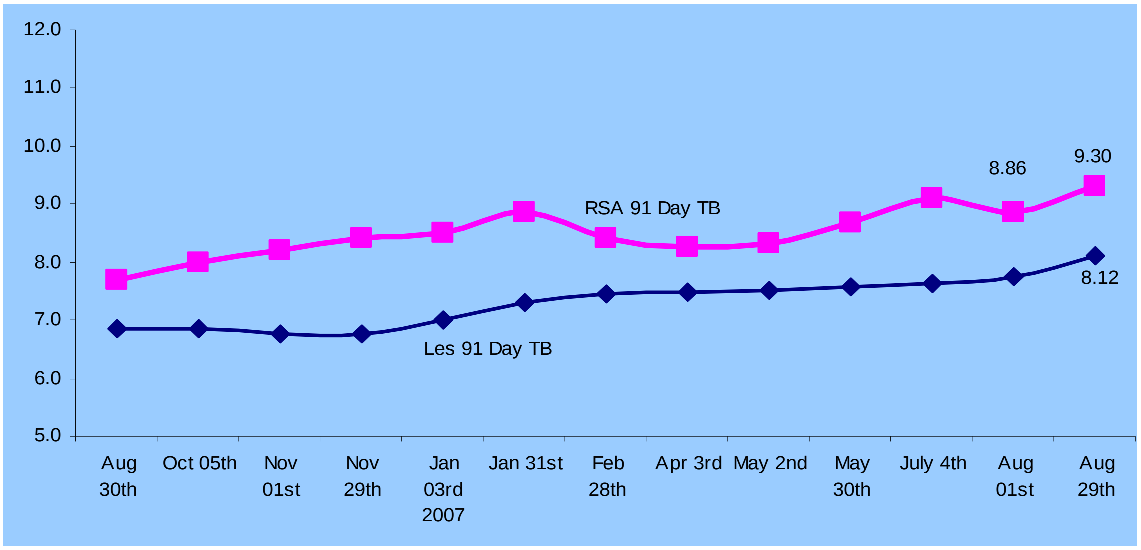
Table 2 below shows amounts auctioned and discount rates that prevailed for each of the auctions. The level of competitiveness in the market is estimated by the number of participants in an auction. The recent auction saw a participation level of 7 bidders who submitted 13 bids for the auction and this was lower than the August figure of 9 bidders with 19 bids. All bidders became partially successful and 12 bids were successful against 16 in the previous auction.

Table 2: Treasury Bill Auctions

Type of Security	Auction Date	Maturity Date	Auction Amount (million)	Amount Issued (million)	Discount Rate	RSA Disc. Rate
91-day TBs 182-day TBs	28 Feb 2007 06 Mar 2007	01 Jun 2007 07 Sep 2007	M170.0 M20.0	M170.0 M20.0	7.46% 7.46%	8.41% 8.35%
91-day TBs	03 Apr 2007	06 Jul 2007	M160.0	M160.0	7.49%	8.27%
91-day TBs 182-day TBs	02 May 2007 08 May 2007	03 Aug 2007 09 Nov 2007	M170.0 M50.0	M170.0 M30.2	7.50% 7.45%	8.32% 8.38%
91-day TBs	30 May 2007	31 Aug 2007	M170.0	M171.0	7.56%	8.68%
91-day TBs 182-day TBs	04 Jul 2007 11 Jul 2007	05 Oct 2007 11 Jan 2008	M170.0 M50.0	M170.0 M32.0	7.62% 8.20%	9.10% 9.42%
91-day TBs	01 Aug 2007	02 Nov 2007	M170.0	M170.0	7.76%	8.86%
91-day TBs 182-day TBs	29 Aug 2007 05 Sep 2007	30 Nov 2007 07 Mar 2007	M160.0 M20.0	M160.0 M20.0	8.12% 8.90%	9.30% 9.67%
Total for reporting period			M180.0	M180.0		

Although the Lesotho 91-day treasury bill rate continued to increase in September, it still remained below its SA counterpart rate. The Lesotho 91-day treasury bill rate rose by 36 basis points to 8.12 per cent. The counterpart SA rate also increased from its previous level of 8.86 per cent in August to 9.30 per cent in September. Consequently, the margin between the two rates widened from 110 basis points to 118 basis points at the end of the review period, as depicted in figure 1 below.

Figure 1: Measuring the Success of Monetary Policy Objectives: Performance of Lesotho 91-Day T-Bills vs RSA T-Bills



Conclusion

The overall observation is that the monetary policy operations undertaken during the review month were successful in attaining their desired objectives such as financial stability and attainment of the target NIR level.

Table 3: Selected Monetary and Financial Indicators

	2007		
	July	***August***	***September***
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	*14.08*	*14.75*	*14.17*
1.2 Prime Lending rate in RSA	*13.00*	*13.50*	*13.50*
1.3 Savings Deposit Rate	*3.21*	*4.05*	*4.05*
1.4 Interest rate Margin(1.1 – 1.3)	*10.87*	*10.7*	*10.12*
1.5 Treasury Bill Yield (91-day)	*7.62*	*7.76*	*8.12*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*3591.21*	*3780.71*	*3766.13*
2.2 Net Claims on Government by the Banking System	*-3544.02*	*-3302.17*	*-3100.09*
2.3 Net Foreign Assets – Banking System	*8126.46*	*8136.10*	*7939.53*
2.4 CBL Net Foreign Assets	*7039.86*	*6828.32*	*6670.07*
2.5 Domestic Credit	*-2402.50*	*-2135.25*	*-1909.39*
2.6 Reserve Money	*488.72*	*500.89*	*509.00*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	***7.1205***	***7.2232***	***7.1083***
4. Inflation Rate (Annual Percentage Changes)	***8.0***	***8.6***	***8.7***
5. External Sector (Million Maloti)	***2006***	***2007***	
	QIV	***QI***	***QII***
5.1 Current Account Balance	*18.50*	*697.20*	*1.68*
5.2 Capital and Financial Account Balance	*-81.15*	*190.60*	*202.63*
5.3 Reserves Assets	*-32.81*	*-1023.89*	*143.38*

+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 4: Selected Economic Indicators

	2004	***2005***	***2006****	***2007+***
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	*4.2*	*2.9*	*7.2*	*4.9*
1.2 Gross National Product – GNI	*7.9*	*5.5*	*3.1*	*3.6*
1.3 Per capita –GNI	*7.9*	*5.5*	*3.1*	*3.6*
2. Sectoral Growth Rates				
2.1 Agriculture	*-1.9*	*-1.7*	*1.7*	*-22.5*
2.2 Manufacturing	*2.1*	*-8.6*	*10.5*	*11.0*
2.3 Construction	*-4.4*	*-3.4*	*0.6*	*2.5*
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*	*8.6*
3.3 Capital and Financial Account	*5.8*	*3.6*	*-1.2*	*5.9*
3.4 Official Reserves (Months of Imports)	*5.2*	*5.5*	*6.7*	*7.2*
4. Government Budget Balance (Percent of GDP)	*5.7*	*4.8*	*12.6*	*4.8*

* *Preliminary Estimates* + *CBL Projections*