

## **1. The Introduction of an Over the Counter (OTC) Trading Mechanism by the Central Bank of Lesotho: Implications for the Economic Growth**

### **1.1 Introduction**

The Central Bank of Lesotho (CBL)<sup>1</sup> is mandated by the Central Bank Act (2000), among others, to develop capital markets<sup>2</sup> in the country. In pursuit of this mandate, the Bank started the process of developing government bond market in 2010. This involved the issuance of medium and long-term Government bonds, namely 3, 5, 7 and 10-years bonds in 2010. On the one hand, the development of the bond market provided an alternative avenue for financing the fiscal deficit. This reduces the country's vulnerability to donor fatigue. On the other hand, the development of the bond market was instrumental for the establishment of the yield curve which serves as a benchmark for pricing financial assets issued by the corporate sector.

Following the establishment of the bond market, the Bank is presently embarking on

another phase in its endeavor to further develop capital markets. This involves establishment of an organized market for stock (shares) trading in a form of an Over the Counter (OTC)<sup>3</sup> trading mechanism. The objective is to provide a formal and regulated framework for a sound and safe shares trading. This occurs against the backdrop of existing equity trading as some companies had already started offering shares to the public in a bid to raise capital to finance various investment projects. Such trading stimulated interest from other companies within the economy.

This article provides a brief overview of operational and institutional requirements for an OTC trading mechanism and also highlights the implications of the establishment of an OTC trading mechanism for Lesotho's economy.

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<sup>1</sup> Hereafter referred to as the Bank.

<sup>2</sup> This consists of the bond (debt) market and stock (equity) markets.

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<sup>3</sup> By definition, an OTC market is trading mechanism in which market participants trade with one another in unlisted securities through various communication modes such as the telephones, cellphones and computers based electronic trading system.

## 1.2 Operational and Institutional Requirements for an OTC Trading Mechanism

In order to make an OTC trading mechanism successful, proper securities market infrastructure in the form of information technology (IT), legal and institutional framework should be put in place. This involves establishment of Automated Trading System to be interfaced with the current clearing and settlement system and other associated IT infrastructure. This will facilitate transactions in equity trading to take place safely and efficiently, and allow finality of such transactions. Capital markets need to operate within a certain legal and regulatory frameworks. These govern activities and operations of the markets and facilitate the development of new financial products and institutions. They also ensure fairness, orderliness and efficiency of the capital markets. However, owing to absence of Capital Markets Act (the principal law that monitors and regulates activities in the capital markets), the Bank developed Capital Markets Regulations<sup>4</sup> in 2014 to provide guidance in this regard. The Bank will also develop the Lesotho's Interim Stock Trading Rules to govern the operation on the trading floor. Furthermore, the process is underway to review the Companies Act (2011) in order to ascertain its adequacy in relation to regulating issuance of shares.

The OTC market also requires participation of investors (individual and institutional) to act as suppliers of funds, brokers to intermediate between investors and companies, financial and/or business

advisers and borrowers such as firms or companies in need of capital. In line with this, the Bank continues to sensitize different stakeholders about these developments. This is done to prepare stakeholders for participation in the OTC market when it becomes operational. In the absence of institutions such as the Securities and Exchange Commission (SEC) and the Capital Markets Authority (CMA), the Bank will not only provide an Interim Securities Trading Facility<sup>5</sup> but also license and regulate market operations including stock trading, share transfers and clearing and settlements.

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<sup>4</sup> However, these regulations have not yet been gazetted.

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<sup>5</sup> A trading floor for equity trading.

### 1.3 The Implications of an OTC Market for Economy of Lesotho

Liquid and efficient OTC markets pool domestic funds and channel them towards productive investment activities on behalf of individual savers. In this way, the funds, which could have been consumed or invested unproductively, are redirected to finance profitable business activities in several sectors of the economy. This improves efficient allocation of financial resources, with positive effect on economic growth. OTC markets also serve as an alternative for efficient mobilisation of savings. This promotes capital accumulation and investment and ultimately contribute positive to economic growth.

In addition, OTC markets promote foreign investment. This provides needed seed money for creative capital development and acts as a reliable medium for broadening the ownership base of different companies.

A well-functioning OTC market provides an opportunity for investors to diversify their financial investments across a range of investments (different economic activities) and spread risk. They allow entrepreneurs or investors to hold portfolio investments in different firms or projects from different sectors of the economy. Additionally, the fact that investors have limited liability enables them to disinvest their funds from failing ventures and reinvest them in higher return projects or investments. Thus, the existence of risk reduction mechanisms provided by OTC markets can spur more investments, which can ultimately impact positively on economic growth.

The efficiency of OTC markets and the tradability of its instruments also create high liquidity and volume of active trading in the market. This gives investors<sup>6</sup> peace of mind that they can make investments in shares and sell them quickly whenever they want to access their savings or want to alter their portfolios. While this makes investors more willing to make the long-term investments critical for development on one hand, it enables companies to enjoy long-term access to capital raised through equity issues, on the other hand. Thus, by facilitating long-term investments in high return projects, stock markets improve the allocation of capital to more productive and innovative firms and enhance prospects for long-term economic growth.

Equity markets lead to enhanced corporate governance within firms. They necessitate the creation of a legal and regulatory frameworks and stringent rules within organizations. Therefore, these improve transparency and enhance investor confidence. Good financial, ethical or managerial records within firms increases the value of the firm as they increase the stock prices. There is ample evidence in the literature that link good corporate governance to industry efficiency with resultant positive effect on economic growth. Furthermore, efficient equity markets can also influence corporate control

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<sup>6</sup> Those who are reluctant to relinquish control of their savings for long periods.

in that they help to mitigate the agency (principal-agent) problem by making it easier to tie managers' compensation to stock performance of firms and therefore

assist to align the interests of managers and owners. This eventually leads to efficient allocation of resources and growth.

#### **1.4 Conclusion**

The establishment of an OTC market marks an important milestone towards achieving an active capital market in the country. Its successful implementation will provide a formal and regulated framework for existing equity trading and create a structure for a sound and safe equity trading. It will also go a long way in opening diverse financing channels or avenues for businesses and therefore steer the economy towards growth prospects.

However, to achieve these private sector companies need to collaborate with the Bank by adhering to good corporate governance practices and best standards to be able to list and act as brokers, dealers and financial and/or business advisers. In addition, there is need for the Bank to undertake extensive public campaigns to invite public support in this endeavor.

## **2. Turmoil in the emerging market economies (EMEs): implications for Lesotho's economy**

### **1. Introduction**

The emerging market economies (EMEs) have suffered the financial turmoil due to the winding down of policies that the advanced countries undertook following the recent global financial crisis of 2009. The financial turmoil in the emerging economies refers to extreme volatility in domestic financial markets, which caused capital to flow out of the EMEs back to the advanced countries as a result of the turnaround in the United States policy of quantitative easing. This eventually led to the selloff of the emerging market currencies as they came under pressure, falling sharply such that some countries even resorted to hiking interest rates in order to minimise the weakness of their currencies.

The aftermath of the recent global financial crisis of 2009 forced the advanced countries to take precautions in order to cushion themselves against the negative impacts of the crisis. Most of the measures taken by these countries were targeted towards reviving consumer spending and economic growth. As one of the countries which were severely hit by the crisis, the United States (US) initiated the policy of quantitative easing (QE) aimed at supporting growth as ordinary monetary stimulus was no longer effective in stimulating economic recovery.

Quantitative easing refers to large-scale asset purchases, such as corporate bonds or mortgage backed securities (MBS), by central banks to pump more money into the banking system. This is an unconventional

monetary policy which is undertaken to stimulate an economy when the standard policy of setting interest rates low has lost its effectiveness. This policy works much through the same channels as the ordinary monetary stimulus, by affecting interest rates in the economy to which private spending is sensitive. However, since interest rates are very low, this policy also lowers the yields on investment. This implies, therefore, that QE has had an effect of lowering US Treasury interest rates.

While it is evident that QE has lowered yields on US long-term Treasury bonds and similar securities, it has been seen that these lower yields have pushed investors out of

the US to seek higher returns in the fast-growing emerging market economies (EMEs). Thus, following the implementation of QE, EMEs saw influx of cash in search for higher returns, which boosted their economies and the global economy in general. EMEs used these inflows to finance their large fiscal and current account deficits and high foreign debts. Although they knew from the onset that these inflows were temporary until the US economy stabilized, the emerging economies turned the blind eye in terms of preparing for such time. That was why the signaling, in the first half of 2013, that the US could soon start winding down the QE policy led to financial turbulence in the emerging countries.

## **2.2 Causes of the turmoil in the emerging markets**

The turmoil in the emerging markets has been driven by both global and domestic factors. The global factors include the uncertainty surrounding the tapering of QE as well as the decision to start scaling back

in January 2014, and China's recent slowdown in economic growth. Domestic factors, on the other hand, were driven by weak fiscal and structural policies and political uncertainties.

### **2.2.1 Global factors**

#### **1. Uncertainty surrounding the tapering of QE**

The emerging market economies benefited from high capital inflows from the advanced economies until May 2013, when the US Federal Reserve Bank suddenly announced that it would scale back its monetary stimulus later that year. Many investors in emerging markets feared the US Fed decision

would trigger capital flight from these emerging markets, and thus they took their money to what they perceived as safer industrial country havens. That caused a lot of commotion in the emerging market countries as they had to part with the cheap money that flew to their economies in search for higher returns.

#### **1. China's slowing growth**

Another issue that shook the EMEs was the economic growth concerns in China late in 2013. Over the past few years, many

emerging market countries have benefited from China's enormous appetite for commodities thus concerns about its slowing growth have recently caused volatilities in commodity exports dependent economies.

Furthermore, China's indicator of consumer confidence in the manufacturing sector, contracted for the first time in six months in January 2014. This indicator, which serves

### **2.2.2 Domestic factors**

#### **1. Weak fiscal and structural policies**

Failure of domestic policies of the emerging economies' governments has been central to the mayhem. The weak policies have resulted in twin fiscal and current-account deficits, slowing growth and rising inflation as well as sluggish structural reforms. These have made the EMEs vulnerable to external shocks since they are running high twin deficits, which are being increasingly financed through short-term foreign inflows. Others, like Argentina (which defaulted on its foreign debt in January 2014), had

#### **2. Political Uncertainty**

Political uncertainty has also been seen as one of the major factors that contributed to the turmoil in the

as a major gauge of the overall global economic performance, renewed fears that China's growth was losing momentum.

severely depleted foreign exchange reserves, which made it difficult for them to defend their currency. These factors contributed to their vulnerability as investors made a flight-to-safety following the Fed taper tantrum. Since the role of the central banks is to maintain price stability, keep currency values stable, support growth and maintain financial stability, it has become almost impossible to achieve these goals due to loose fiscal policies which resulted into weak structural policies in the EMEs.

emerging markets. This uncertainty has made investors grow risk averse and to bet their money on advanced economies instead of emerging countries' financial markets.

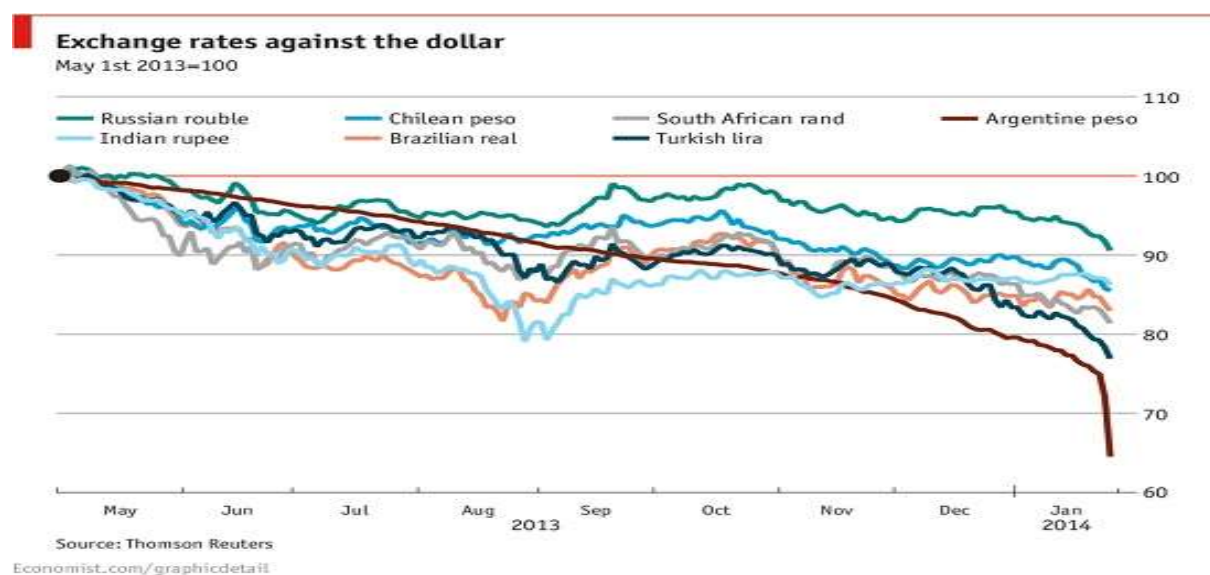
### **2.3 Effects of turmoil on the emerging market economies**

Countries that highly depended on foreign capital to finance their external deficits remained the most vulnerable to the Fed's tapering plans. These countries experienced high capital outflows which led to volatilities in their markets and ultimately the depreciation of their currencies. Turkey, South Africa, Brazil, India and Indonesia, labeled the fragile five, have been seen as the most fragile looking at their current account deficits and external debt situation.

Another round of currency depreciation, which caused the value of currencies of the

emerging markets, especially those of the fragile five and Argentina, to reach their multi-year lows, emerged following the contraction of China's manufacturing index. This could translate into higher inflation and jeopardise these countries' ability to finance the twin fiscal and external deficits. As depicted in Figure 1 below, most of the EMEs currencies fell by more than 10 per cent in value since May 2013, when the talks of QE were first heard.

Figure 1



## 2.4 Implications for Lesotho's economy

Both positive and negative implications of the emerging market economies' turmoil can be outlined. From the negative side, the turmoil has resulted in excessive depreciation of the South African Rand to which Loti is pegged one to one, which is likely to threaten imports of South Africa. A fall in imports is likely to reduce customs revenue, which will result in reduction in size of the SACU revenue pool and consequently Lesotho's share of SACU revenue. Moreover, since most of Lesotho's debt is denominated in foreign currencies, the weakening of the Rand and hence Loti is

likely to increase the Maloti value of Lesotho's external debt.

From the positive side, the depreciation of the Loti is likely to increase Lesotho's exports competitiveness. This will reduce the current account deficit and increase investment opportunities within the economy as investors will realize higher returns. This is particularly evident in the textiles and clothing industry as most of their products are destined for the US where the exchange rate plays the crucial part in investors' profitability.