Economic Review January 2013

Contents:

1. Development of a Secondary Market for Government Securities in Lesotho: A Brief

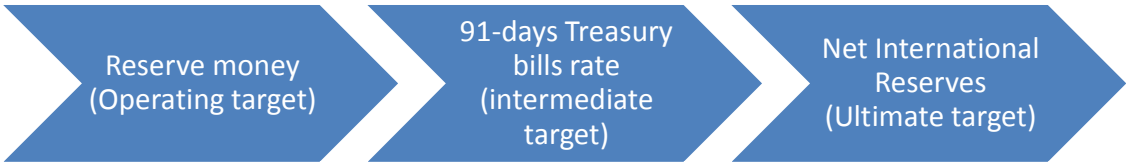
1.1 Background

Lesotho's monetary policy is conducted within the confines of its membership in the Common Monetary Area (CMA). Similar to many economies around the globe, the aim of monetary policy in Lesotho is the maintenance of price stability. Price stability is said to prevail if the consumers and investors in making their economic decisions do not consider large and rapid price increases. To a large extent, Lesotho's inflation is driven by prices in South Africa. Thus, the focus of monetary policy in Lesotho is to ensure that domestic inflation remains is as close as possible to the regional inflation target of 5 per cent. This is achieved through the maintenance of a one-to-one pegged exchange rate system between the Loti and the South African Rand. This type of monetary policy framework is referred to as exchange rate targeting. The monetary policy in Lesotho, therefore aims to ensure that the peg is always backed by adequate level of foreign reserves. In the case of Lesotho, reserve money is the operating target while the Government of Lesotho 91-days Treasury bills rate is the intermediate target.

Therefore, the Central Bank of Lesotho (CBL) conducts open market operations (OMO) to monitor the level of reserve money/money supply in the economy, so that liquidity can be sterilized if there is

excess or injected if there is a shortage. This monitoring is informed by the liquidity forecasting exercise which is conducted bi-weekly.

Figure 1: Flow of Lesotho's Monetary Policy Framework



1.2 The Nature of Securities Market in Lesotho

Informed by the liquidity forecasts, the CBL conducts the bi-weekly Treasury bills (TBs) auctions to mop up excess liquidity and to reach the reserve money target. The tradable instruments in the money market are TBs in four tenors; 91, 182, 273, and 364 days, and every two weeks all four tenors are issued. However, for monetary policy purposes, the reference interest rate is the 91-day TB rate. In 2010, GoL bonds were also introduced for government financing purposes and tenors in government bond issues include 3, 5, 7 and 10 years, and the issuance takes place every two months. This marked a milestone for development of the financial market that initially had only the TBs. The issues of the instruments are usually over-subscribed, suggesting prevalence of excess liquidity in the system. It is therefore not surprising that the OMOs are usually one-directional towards liquidity mop-up. Commercial banks are the main investors in the TBs market and invest mostly to meet their prudential liquidity requirements and hold over 80 per cent of the total TBs issued.

There is a need to build from this successful primary market by way of finding ways enabling and/or inducing the secondary trading of securities. The main inhibitor is that the holders of these securities hold on to them rather than sell them on. This is a result of their motives with commercial banks' stated above as meeting prudential liquidity requirements while the other investors see the instruments as savings vehicles.

The remainder of the article looks at policy options that can ignite the emergence of a secondary market in the system.

1.3 Some Policy Options

The bond market illiquidity is largely attributable to lack of depth in the secondary market. Therefore, this poses a huge challenge to the Ministry of Finance (MoF) and the CBL on policies to ignite the development of the secondary market. Some of these policy considerations are discussed below:

a) Introduction of Primary Dealership

Primary dealership refers to an arrangement in which specialized institutions buy securities in the primary market with the view to sell them on to other investors. One of the advantages for having a dedicated group of market-makers is that the success of the auction is highly guaranteed. Furthermore, this can promote liquidity in the secondary market by providing two-way quotes and hence eliminating the problems of conflicting objectives inherent in giving the responsibility of market-making to central banks. It is widely concurred that establishment of a primary dealership (PD) system is an effective way to develop and execute a coordinated approach to market development and these is highly likely to accelerate the development of the market.

b) Reducing Liquidity Requirements

It must be pointed out at the outset that this is the case of "in theory, theory and practice are the same, in practice they are not". Theoretically, reduction of statutory liquidity requirements will allow commercial banks to have more assets at their disposal and these can then be converted into government securities. This can be achieved through lowering banks' liquidity requirements or by reclassification of government securities into liquidity assets.

c) Elimination of Stamp Duties and Taxes

Duties and taxes paid on transfers of financial instruments impose transaction cost on the side of the seller, and therefore their removal can improve trading and liquidity. This is actually the case in most developed countries, whereby explicit transaction taxes on government securities (e.g. withholding tax) have been abolished.

d) Security Lending

This is an act of loaning stock of securities to an investor or a firm. In so doing, the title and the ownership are also transferred to the borrower. The borrower makes profit by selling the security at a higher price and buying back at a later stage. The fact that the ownership is being temporarily transferred to the borrower implies that the borrower becomes liable to pay some proceeds to the lender. Hence the lending of securities promotes liquidity by preventing settlement failures and increasing arbitrage opportunities. Furthermore, this provides opportunities

for fund managers and institutional investors to earn additional income from their idle security holdings.

1.4 Importance of the Secondary Market

According to the efficient market hypothesis, if the financial system is efficient, the prices are then expected to convey all available information. Therefore, this enables efficient price discovery. Consequently this assists investors in making informed decisions regarding investments. A secondary market can also create room for primary market issues. This may improve the capacity of issuers to issue newly created securities by providing assurance to investors in case they face liquidity problems they can therefore easily dispose of their bonds.

An active secondary market can be used as a guideline in assisting in the determination of rates to be charged on new issues of securities. In addition, a secondary market can be used to send signals about the market conditions. That is, any dynamics in the value of a security after its primary issuance are reflected in its price and therefore this sends market conditions signals.

A secondary market is also important in that it enables investors to make informed decisions with regard to their portfolio allocations. In this regard, the investors consider risk, return, liquidity, maturity, duration and size. This largely depends on the market conditions and also assists central banks to influence the level of liquidity in the economy through the OMO.

1.5 Conclusion

There is a need to develop the securities market in the country and establishment of a secondary market is an important step. There is therefore a need to build capacity within the responsible institutions (Ministry of Finance and Central Bank). Furthermore, the public has to be sensitized to unlock deeper participation in the government securities market. More incentives have to be brought into the government securities market in order to ensure its success.

This featured article benefited from:

- Swaray,S., Zaman, J., Kitonga, M., and Vandepeute, A. (2012). Strengthening Liquidity Management and Enhancing Capacity for Financial Stability Analysis and Reporting – Lesotho Draft. Monetary and Capital Markets Department - International Monetary Fund
- Developing Secondary Market in Government Securities: Policy Options. Financial Markets Department – Central Bank of Lesotho (Working Document)

2. Featured Definition

Primary versus Secondary Securities Markets

There are two levels of securities markets; primary market and secondary market. On the one hand, the primary market is the market for new securities/financial instruments. This level is characterized by primary issuances of securities. The investors purchase these securities directly from the issuers.

On the other hand, the secondary market is the securities market in which previously issued securities/financial instruments are bought or sold. On the secondary market, an investor buys securities from another investor instead of the issuer. Therefore the defining characteristic of the secondary market is that investors trade amongst themselves. Examples of secondary markets includes; Johannesburg Stock Exchange, New York Stock Exchange etc.

3. Featured Economic Event – The Fiscal Cliff

Fiscal Cliff: this was an anticipated combination of expiring tax cuts and across-the-board government spending cuts that were scheduled to become effective on December 31, 2012 in the United States (US). Therefore, the term *fiscal cliff* was used to describe the conundrum that the US government faced at the end of 2012, when the terms of the Budget Control Act of 2011 were scheduled to go into effect.

Among the changes that were set to take place at midnight on December 31, 2012 were the end of 2011's temporary payroll tax cuts (resulting in a 2% tax increase for workers), the end of certain tax breaks for businesses, shifts in the alternative minimum tax that would take a larger bite, a rollback of the "Bush tax cuts" from 2001-2003, and the beginning of taxes related to President Obama's health care law. At the same time, the spending cuts agreed upon as part of the debt ceiling deal of 2011 - a total of $1.2 trillion over ten years - were scheduled to go into effect.

The idea behind the *fiscal cliff* was that if the US government allowed the expiry of tax cuts and coming into effect of government spending cuts they would have had a detrimental effect on the economy.

If US Congress and the President did not act to avert these legislative changes, the US would have "fell over the cliff". Among other things, this would have meant a significant tax increase which has not been seen by Americans in 60 years. Three hours before the midnight deadline on January 1st, 2013 the Senate agreed to a deal to avert the *fiscal cliff*. The Senate version passed two hours after the deadline, and the House of Representatives approved the deal 21 hours later. The government technically went "over the cliff," since the final details weren't hashed out until after

the beginning of the New Year, but the changes incorporated in the deal were backdated to January 1st, 2013.

This featured economic event befitted from ***Bloomberg***

4. Featured Descriptor

Year-on-year: this measurement uses the current period (day/week/month/quarter) in the current year and compares it with the same period (day/week/month/quarter) in the previous year. For instance, consumer price inflation for the month of February 2013, is calculated as the growth rate of the consumer price index (CPI) from February 2012 to February 2013.

5. Selected Economic Indicators

Table 2: Selected Economic Indicators

	Nov 2012	**Dec 2012**	**Jan 2013**
1. Interest rates (% Per Annum)			
1.1 Prime Lending Rate (Lesotho)	9.92	9.92	9.92
1.2 Prime Lending Rate (South Africa)	8.50	8.50	8.50
1.3 Treasury Bill Discount Rates			
- *91-day*			
Lesotho	5.375	5.368	5.362
South Africa	4.930	4.950	5.040
- *182-day*			
Lesotho	5.306	5.307	5.250
South Africa	4.970	5.040	5.130
- *273-day*			
Lesotho	5.555	5.514	5.435
South Africa	4.950	5.040	5.010
- *364-day*			
Lesotho	5.572	5.513	5.400
South Africa	4.920	4.970	4.960
2. Reserve Money – In Million Maloti	1151.70	1203.54	1100.05
2.1 Maloti in Circulation	928.056	998.550	774.433
2.2 Bankers' Deposits	242.716	204.986	325.619
2.3 Reserve Money Target	900	900	900
3. Broad Money (M2)	6832.7	7148.7	6497.7
3.1 Narrow Money (M1)	3055.9	3476.3	3153.2
3.2 Quasi Money	3776.8	3672.4	3344.5

4. Net International Reserves (NIR) – In US$			
4.1 Actual NIR	1056.20	1047.54	1228.04
4.2 NIR Target – Extended Credit Facility	920	920	987
4.3 NIR Target – Monetary Policy Committee	1083	1083	1083
5. Inflation Rate (Annual Percentage Changes)	5.4	4.5	5.1
6. Exchange Rates (Monthly Averages)			
6.1 Loti/United States Dollar (US$)	8.807	8.630	8.801
6.2 Loti/Pound Sterling (£)	14.069	13.938	14.042
6.3 Loti/Euro (€)	11.296	11.321	11.694