Central Bank of Lesotho

Annual Report

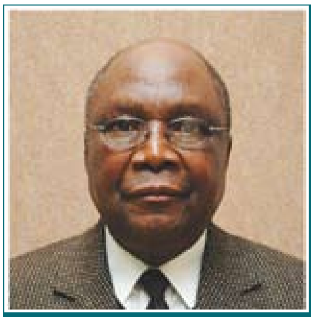
2008

Maseru, March 2009

Central Bank of Lesotho

M. Senaoana
Governor and Chairman (Board)

R. Matlanyane
Deputy Governor I



E.K. Molemohi
Director

J. Q. Lesitha
Director

M.G. Tau - Thabane
Director

M. Posholi
Director

P.M.I.S. Ledimo
Director

P. M. Mangoaela
Director

M. Fako
Director

M. Malope
Board Secretary

BOARD OF DIRECTORS

M. P. Senaoana	-	Governor & Chairman (Board)
A.R. Matlanyane	-	Deputy Governor I
Vacant	-	Deputy Governor II
M. G. Tau-Thabane	-	Director
P. M. I. S. Ledimo[1]	-	Director
J. Q. Lesitha	-	Director
E. K. Molemohi[2]	-	Director
P. M. Mangoela[3]	-	Director
M. Posholi[3]	-	Director
M. Fako[3]	-	Director

MANAGEMENT

M. P. Senaoana	-	Governor
A. R. Matlanyane	-	Deputy Governor I
Vacant	-	Deputy Governor II
T. Namane	-	Director of Operations
M. Mofelehetsi	-	Director of Supervision
L. Kirstein	-	Director of Administration
M.G. Makenete	-	Director of Financial Markets
M. S. Mahooana	-	Director of Information & Communication Technology (acting)
M. P. Makhetha[4]	-	Director of Research
M. Malope[5]	-	Director of Corporate Affairs
T. Makara	-	General Manager – Lehakoe Recreation and Cultural Centre

DIVISIONAL HEADS

GOVERNOR'S OFFICE

J. Ntšekhe	-	Internal Audit
L. Khaka	-	Accounts & Budget
T. Malataliana	-	Currency
M. 'Nyane	-	Security (Acting)

ADMINISTRATION

M. Molekane	-	Human Resources
S. Phate	-	General Services & Maintenance

CORPORATE AFFAIRS

Vacant	-	Legal Services
Vacant	-	Corporate Governance
T. Mohasoa	-	Public Relations (Acting)

FOOTNOTES

1 Until December 2008
2 Until June 2008
3 Appointed December 2008
4 Appointed September 2008
5 Appointed July 2008

INFORMATION AND COMMUNICATIONS TECHNOLOGY

M. S. Mahooana	- Business Solutions Development
T. Mpheteng	- Infrastructure & Operations

OPERATIONS

M. Letsie	- Banking Operations
M. Motebang	- National Payment Systems
M. Tabane	- Development Finance
N. Bereng	- Rural Finance

SUPERVISION

M. F. Mohasoa	- Financial Institutions Supervision
F. Morokole	- Insurance Supervision
M. Keta	- Policy, Regulations & Exchange Control
M. Van Tonder	- Non-Bank Supervision

FINANCIAL MARKETS

B. Phakoe	- Dealing and Strategy
M. Mohapi	- Treasury Operations

RESEARCH

T. Bereng	- Real Sector
L. M. Lephoto[6]	- Finance
R. Masenyetse	- Macroanalysis

[6]On secondment

Lehakoe Recreation and Cultural Centre - CBL

Central Bank of Lesotho
P O Box 1184
MASERU 100
Lesotho

March 31, 2009

Honourable Minister
Ministry of Finance and Development Planning
P O Box 395
MASERU 100
Lesotho

Honourable Minister

I have the honour to transmit the Annual Report of the Central Bank of Lesotho for the year 2008, which includes:

(a) a review of economic developments during the year; and

(b) in accordance with Section 53 (1) of the Central Bank of Lesotho Act No.2 of 2000:

i) the Bank's annual accounts for the year ended December 31, 2008, certified by Sheeran & Associates assisted by Pricewaterhouse Coopers; and

ii) a report on the Bank's operations and statement of affairs during 2008.

Yours faithfully

M. P. Senaoana (PhD)
GOVERNOR

The unfolding global economic recession is posing a threat to the economy of Lesotho during the review period. Economic growth as measured by Gross Domestic Product (GDP) decelerated to 3.4 per cent from 5.1 per cent in the previous year. The prevailing recessionary conditions particularly in the United States (US) is impacting negatively on the domestic textile and clothing subsector. The subsector is projected to decline by 8.0 per cent in 2008. The subsector plays an important role in the economy of Lesotho as it accounts for 13.0 per cent of GDP and provides employment to about 46000 people, mainly women. The prospects of the infant mining subsector is also under threat due to the fall in the price of rough diamonds by over 50 per cent in the second half of 2008. Budgetary operations registered an overall deficit equivalent to 0.1 per cent of GDP. The current account also recorded a surplus equivalent to 12.6 per cent as a share of GDP. However, the rate of inflation was recorded at 10.7 per cent. This emanated from the increases in the prices of oil and food. The price of crude oil has since declined from a high of US$140.7 per barrel in June 2008 to US$34.6 per barrel at the end of the year. Inflation is expected to decline significantly in response to the weakening global demand. The recessionary conditions call for targeted and timely action to assist vulnerable sectors of the economy to cope with the depression. The Government of Lesotho has commissioned the Central Bank of Lesotho, in collaboration with Lesotho National Development Corporation (LNDC), to establish a foreign currency fund and liberalise the current export finance scheme. The scheme will be managed by the Central Bank of Lesotho to assist Lesotho based exporters to access necessary funding for both pre and post shipment. This development is a necessary step towards restructuring of the textile and clothing subsector to facilitate its linkage with the rest of the economy.

During the year, the prices of food, particularly those of cereals, rose to record high levels in two years due to, amongst others, the nature of global food production which has a strong resemblance of an oligopoly market structure; and the strong demand by some developed countries for production of environmentally friendly energy and bio-fuel. These governments have introduced a number of measures to ensure increased bio-fuel production. These developments are believed to have eroded some of the gains achieved towards the Millennium Development Goals (MDG).

The development of sound money and capital markets remain an important priority of the Central Bank of Lesotho as it will provide significant benefits to the economy of Lesotho. The Bank has implemented a number of measures aimed at improving the money market, these include introduction of longer dated money market instruments, reduction of the competitive section thresholds, shorter settlements procedures and increased frequency of auctions. In respect of financial intermediation, efforts towards establishment of the credit bureau under the private sector development component of the Millennium Challenge Account are at an advanced stage. Moreover, the preparatory work towards implementation of the Rural Financial Intermediation Programme (RUFIF) has been completed.

The launch of the Southern African Development Community (SADC) free trade area in August 2008 presents an opportunity for Lesotho based producers to take advantage of the expanded market to increase their exports.

M. P. Senaoana (PhD)
GOVERNOR

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1.1 Introduction

The manufacturing subsector has been the mainstay of Lesotho's economic performance for the last fifteen years. The subsector has seen Lesotho being the largest exporter of textiles and clothing to the United States (US) under African Growth Opportunities Act (AGOA) from Sub-Saharan Africa. In addition, the subsector provides employment to the bulk of semi-skilled Basotho, particularly women. The subsector has been important in poverty reduction efforts by the Government of Lesotho. However, the increased competition in the global textile industry, the current financial crisis that has caused the global credit paralysis, and the unfolding global economic depression pose serious challenges to the subsector's long term sustainability. As a step towards deepening the linkage of the textiles and manufacturing sector with the rest of the economy, it is proposed that the current export finance scheme be liberalised in order to accommodate both large and small exporting business community. Furthermore, establishment of the foreign currency fund will augment value added by Lesotho in the manufacturing value chain and allow the domestic banking sector to play a significant role in the industry.

1.2 Challenges to the Textiles and Clothing Subsector in Lesotho

The long term sustainability of the subsector is under threat due to the changing global trading system governing textiles which has increased competition from other major producers from Asia. The global trading system has been governed by the Multi Fibre Agreement (MFA) which allowed for allocation of quotas. The system guaranteed producers in Less Developed Countries like Lesotho with market access in the US. However, in line with World Trade Organisation (WTO)'s requirements, which advocate for highly competitive trading environment, the MFA expired in 2004. This led to some capital flight from Lesotho as some manufacturing companies' feared increased competition from low cost producers such as China and India, resulting in closure of some firms in Lesotho. Moreover, the third country clause of AGOA which allows AGOA eligible countries to source raw material from Non-AGOA countries is expected to expire in 2012, while AGOA itself is scheduled to end in 2015.

Furthermore, the current financial crisis, followed by the global economic recession has exposed weaknesses in the subsector. This crisis emanated from the sub-prime mortgage lending problem that hit the US in 2006.

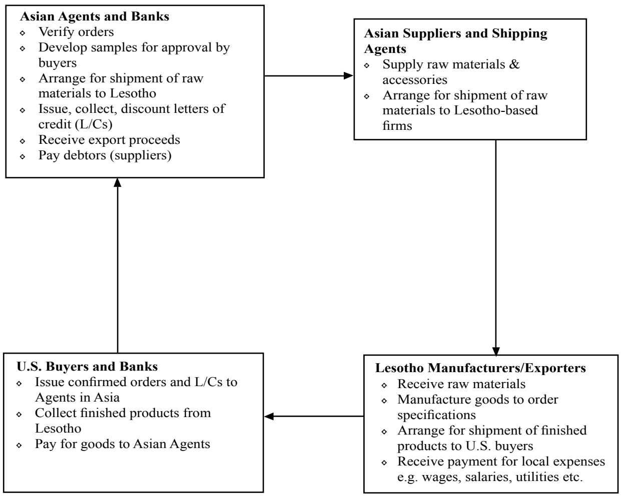
Sub-prime lending is the practice of lending to borrowers who do not qualify under the mainstream lending market because of their weak credit ratings, characterised by a history of defaults, absence of downpayments and verification of assets. This type of lending is effected on terms of higher interest rates than market rates because of the risk involved. The crisis has manifested itself in the squeeze in credit and decline in output. Major US financial institutions have collapsed and have since spread to other financing institutions around the world to the extent that there is global credit crunch. The impact of the crisis feeds into Lesotho's economy through the negative effect on manufacturing subsector, particularly textiles and clothing due to the strong finance link with the Asian Banks.

The unfolding global economic recession has led to contraction of real economic activity in the US. Real gross domestic product (GDP) declined by 3.8 per cent on an annual basis in the fourth quarter of 2008, compared to 0.3 per cent recorded in the third quarter of 2008. In the European area, leading indicators of economic growth also depict a slowdown in economic activity in that region during the short to medium term. Similarly, the real economic growth rate in South Africa (Lesotho's main trading partner) declined by 1.8 per cent in the fourth quarter of 2008 compared with 0.2 per cent in the third quarter of 2008. These figures show weakening international demand particularly from the US. This has, significantly, reduced the size of orders from the US to Lesotho-based producers, to the extent that the textile and clothing subsector is expected to decline by 8.0 per cent in 2008. In that eventually a sizable number of jobs will be lost.

1.3 The Textiles and Apparel Subsector in Lesotho

The textile subsector in Lesotho was established in 1986. The subsector is dominated by Asian owned companies that have established in Lesotho but are still linked to their parent companies in Asia. Since the start of its operations, the subsector has been performing fairly well in terms of its contribution to economic growth and job creation. By 2004, the subsector employed about 45 000 workers. Lesotho has since earned a good reputation as one of the top African exporters of apparel under the African Growth Opportunity Act (AGOA). However, it is now apparent that, over these 20 years, there has not been any serious effort on the side of policy makers to understand how the sector operates, its strengths, risks and the challenges it faces. Figure 1 below presents the current export transaction model operating in Lesotho. The model is such that the buyers place orders with the agents, who are based either in Taiwan, Hong Kong or Singapore. These agents have developed a support network with financial institutions, raw material suppliers as well as shipping agents. The implication of these arrangements is that most of the work involving finances is handled outside of Lesotho and hence more value is added in Asia. The bulk of the proceeds of sale is transferred to the East to repay loans and settle accounts with agents and suppliers of raw materials. The operations in Lesotho are mainly the assembly of finished products for shipment to the US market. The value added translates into a small portion for payment of labour costs and utilities. This situation does not facilitate the sector's linkages with the rest of the economy.

FIGURE 1: The Current Export Transaction Model



With the advent of the credit crunch and the ongoing financial crisis, it has become apparent that banks in East Asia, that previously provided credit facilities to textile companies, including the Lesotho-based firms, have now tightened access to finance, as is the trend worldwide. This has imposed a situation of financial distress among textile firms, a fact that became apparent when a Lesotho based textile firm, China Garment Manufacturers (CGM) requested for financial assistance from the Government of Lesotho in June 2008.

Another source of financial strain on the part of the exporters is a mismatch between the cash inflows and outflows. Buyers have a tendency of demanding favourable terms, to be allowed long periods (90, 120 or 180 days) before effecting payments. While this is advantageous to the importer in terms of cash flow and cost, it is a source of financial strain on the part of the exporter. On the other hand, the suppliers of raw material demand shorter trade terms, the result of which is cash flow problems on the side of the exporter.

It is against this background that the Government of Lesotho has found it necessary to build a financial support facility, by way of a Foreign Currency Fund (FCF), to ease the financial strain of the exporters. It is hoped that this will go a long way in addressing the cash flow problem which is now affecting the operations of the subsector adversely.

1.4 Proposed Foreign Currency Fund (FCF)

The Central Bank of Lesotho has been commissioned by the Government to establish the fund, and to liberalise the current export finance scheme to accommodate both the large scale and the Small Medium Enterprises (SMMEs') exporters. The new facility will take the form of an Export Foreign Currency Facility in Lesotho. This will reduce or eliminate the need for exporters to solicit funds from abroad. The proposed facility will take the form in which the Lesotho-based Authorised foreign exchange dealers will manage the fund (issue and track Letters of Credit, L/Cs, discount L/Cs against shipping documents, collect L/Cs from buyers etc).

The fund will provide a number of benefits to Lesotho's economy. The country will now be in a position to reap full benefits of its export sector, as more value would be added domestically. Since the fund is inclusive, it may assist the diversification process of the manufacturing sector that is being driven by Lesotho National Development Corporation (LNDC). The financial institutions in Lesotho would benefit from increased number of financial products which will generate more revenue.

2. Introduction

The global economy experienced a major downturn in 2008, as the financial turmoil that originated from the sub-prime mortgage crisis in the United States (US) manifested itself in loss of confidence by the global financial institutions and markets resulting in a credit crunch. This led to the collapse in aggregate demand and the subsequent economic recession in the US, where the direct effects of the financial crisis hit harder by tightening credit conditions and intensifying housing market corrections. Developments in the US spilled over to Europe, resulting in the economic growth deceleration. The emerging markets, such as China and India, and developing countries have also not escaped the negative effects of the recessionary conditions in the US, particularly on the trade side as the demand for their exports fell. On the inflation front, the global economies started the year with high inflation on account of high food and oil prices but as the year approached the end, inflation fell along with aggregate demand.

The economy of Lesotho remains highly susceptible to changes in global economies, particularly the US because of close trade ties; and SA due to proximity and strong trade relations and financial linkages. A large share of Lesotho's clothing and textile exports are destined for the US market under the African Growth and Opportunities Act (AGOA). Lesotho's economic relationship with South Africa arises from a number of factors including its dependence on imports of goods and services and migrant mineworkers' remittances from South Africa. A large proportion of Lesotho's exports of diamonds is destined for the Euro-zone. Lesotho is a member of the regional economic integration blocks such as the Southern African Customs Union (SACU) and the Common Monetary Area (CMA), which allow for free trade and capital mobility within the region.

2.1 Industrialised Countries

2.1.1 The United States (US)

According to the International Monetary Fund (IMF) projections, economic growth in the US is expected to have decelerated to 1.5 per cent in 2008 compared with 2.6 per cent recorded in 2007 as the financial market turmoil took its toll on the economy. The financial crisis led to a deceleration in consumption and investment spending and reduced industrial production and residential investments. The US economy was officially declared to have slipped into recession since December 2007. As a result of the slower economic growth in the US, the rate of unemployment increased to 7.2 per cent in December 2008, compared with 5.0 per cent in December 2007. The largest increases in unemployment were recorded in the manufacturing and construction sectors.

The rate of inflation is forecast to have increased from 2.9 per cent in 2007 to 4.2 per cent during the review year, mainly as a result of the surge in the prices of food, oil and other commodities in the first three quarters of the review year. Nevertheless, inflation eased in the last quarter of the review year, registering a meager increase of 0.1 percent in December 2008 compared with 4.1 per cent in December 2007.The slowdown is attributable to the decline in the prices of food and oil, coupled with the decline in consumer demand as economic activity weakened worldwide. Although the inflation rate was, on average, high during the year, it started falling towards the end of the year. In an attempt to avert the recession, the Federal Reserve Bank's Open Market Committee (FOMC) reduced its benchmark lending rate by 400 basis points during the year from 4.25 cent at the end of 2007 to 0.25 per cent in December 2008. In their last monetary policy statement in 2008, the FOMC indicated that the rates would remain at near zero levels until such time that some improvement in the economy's performance is observed.

The slowdown in US economic growth does not bode well for the economy of Lesotho as a large share of Lesotho's exports is destined for the US market. However, the deceleration in inflation, towards the end of the year, is a welcome development as it enabled the FOMC to loosen monetary policy and stimulate economic recovery, which is what Lesotho needs for the buoyancy and growth of its export sector.

2.1.2 The Euro-Zone

The IMF forecast that real GDP in the Euro-zone will register a slower growth rate of 1.3 per cent in 2008 against 2.6 per cent realised in 2007. The Euro-zone economy was, to a large extent, negatively affected by the slowdown in the US economy due to strong financial and trade linkages between the US and a number of countries in the Euro area.

The economic slowdown in the Euro-area is not expected to have had a significant adverse impact on employment as the unemployment rate in the region is projected to increase to 7.6 per cent compared with 7.4 per cent realised in 2007.

The annual average inflation rate in the Euro-zone, measured by changes in the Harmonised Index of Consumer Prices (HICP), is expected to have increased to 3.5 per cent compared with 2.1 per cent in 2007 due to high commodity prices observed early in the year 2008. Similar to the US, some easing in inflation was seen during the last months of the review year, with an annual inflation rate of 1.6 per cent recorded in December 2008 against 3.1 per cent in December 2007. The ECB cut its benchmark-lending rate from 4.0 per cent at the end of 2007 to 2.5 at the end of the review year.

Economic developments in the Euro-zone have an effect on Lesotho's economy as most of Lesotho's diamond exports are destined for this region. Furthermore, the European Union (EU) is South Africa's (SA) main trading partner. Shocks to the SA economy are easily transmitted to Lesotho. Thus the slowdown in economic activity in the Euro-Zone does not augur well for the economies of both SA and Lesotho.

2.2 Emerging Markets

Economic growth in Emerging Asian markets is expected to drop significantly in 2008, along with that of the rest of the world, on account of weakened exports and negative spin-offs from the global financial crisis. According to the IMF projections, economic growth has decelerated in all Emerging Asian markets except Bangladesh. The region is expected to realize a real GDP growth rate of 7.7 per cent in 2008 compared with 9.3 per cent observed in the previous year. Economic growth in China is estimated to have declined to 9.0 per cent, in nominal terms, as opposed to 13.0 per cent in 2007.

High oil and food prices continued to exert upward pressure on regional inflation, which was forecast to increase at an annual rate of 7.3 per cent in the review year compared with 4.9 per cent in 2007. However, the first signs of decreasing inflation were observed at the end of 2008 as a result of the decline in commodity prices. Easing inflation in emerging Asian markets could give policy-makers room to reduce interest rates and stimulate economic growth.

The current account surplus in emerging Asian markets was projected to decline to 5.2 per cent of GDP in 2008, from 6.8 per cent realised in 2007. Foreign direct investment dominates net capital inflows and it is a major source of foreign exchange in India, Korea and Vietnam. However, current account deficits were observed in other countries such as India and Pakistan.

Economic activity in emerging European economies is expected to weaken in 2008, due to the slowdown in economic activity in the US. The IMF projections indicate a deceleration in the growth rate of GDP from 5.7 per cent realised in 2007 to 4.5 per cent in 2008.

Signals observed in emerging markets present mixed implications for developing countries like Lesotho. On the one hand, the easing Inflation in emerging Asia could affect Lesotho's exports competitiveness positively through reduced costs as a bulk of inputs into the textile manufacturing sector are sourced from Asia. On the other hand, weakness in Latin American economic activity could reduce profits and investments of sister manufacturing companies operating in Lesotho.

2.3 South Africa

Real GDP growth rate in SA is projected to fall to 3.8 per cent in 2008 compared with 5.1 per cent in 2007 on account of power shortages that disrupted production at the beginning of the year as well as the contractionary monetary policy that was implemented from late 2007 until June 2008 to contain inflation.

The rate of inflation, as measured by changes in the consumer price index excluding interest on mortgage bonds (CPIX), closed the year 2008 higher than the previous year. From April 2007 till December 2008, the CPIX remained above the upper limit of the target range of 3.0 to 6.0 per cent. On average, the CPIX increased by 11.3 per cent in the review year compared with 6.5 per cent realised during 2007. It was recorded higher at 10.3 per cent in December 2008 compared with 8.6 per cent during the same period in 2007. Among other factors, the high inflation rate was attributable to increases in the prices of food and fuel, as well as high consumer spending in the economy. The observed slowdown in inflation in the last quarter of 2008 is attributable to falling prices of food and oil (emanating from the global slowdown in consumer demand).

On average, producer price inflation (PPI) increased by an annual rate of 14.2 per cent in 2008 compared with 10.9 per cent during 2007. It closed the year 2008 at 11.0 per cent compared with 9.1 per cent recorded in 2007.

The high inflation in the first months of 2008 influenced the South African Reserve Bank's (SARB) Monetary Policy Committee (MPC) to increase the key interest rate from 11.0 per cent at the beginning of the year to 12.0 per cent in June. The result of this was a slight moderation of inflation and deteriorating economic performance. The repo rate was reduced to 11.5 per cent in December 2008.

The price shocks in SA were quickly transmitted to Lesotho through trade links. The deceleration in economic growth in SA will, by all laws of probability, lead to economic slowdown in Lesotho.

Table 1:

SELECTED ECONOMIC INDICATORS, 2004 – 2008*
(Annual percentage changes unless otherwise stated)

Indicators	2004	2005	2006	2007	2008*
World Output	**4.9**	**4.5**	**5.1**	**5.0**	**3.9**
Advanced Economies	**3.2**	**2.6**	**3.0**	**2.6**	**1.5**
Emerging and Developing Economies	**7.5**	**7.1**	**7.9**	**8.0**	**6.9**
Africa	6.5	5.8	6.1	6.3	5.9
Central and Eastern Europe	6.9	6.1	6.7	5.7	4.5
Commonwealth of Independent States#	8.2	6.8	8.2	8.6	7.2
Developing Asia	8.6	9.0	9.9	10.0	8.4
Middle East	5.8	5.7	5.7	5.9	6.4
Western Hemisphere	6.1	4.7	5.5	5.6	4.6
Consumer Prices					
Advanced Economies	2.0	2.3	2.4	2.2	3.6
Emerging and Developing Economies	5.9	5.7	5.4	6.4	9.4
World Trade Volume (Goods and Services)	10.7	7.6	9.3	7.2	4.9
Exports					
Advanced Economies	9.1	6.1	8.4	5.9	4.3
Emerging and Developing Economies	13.9	10.8	11.0	9.5	6.3
Imports					
Advanced Economies	9.4	6.4	7.5	4.5	1.9
Other emerging market and Developing Countries	16.0	12.0	14.7	14.2	11.7

Source: IMF World Economic Outlook October 2008. Financial Stress, Downturns, and Recoveries.
* IMF Projections
# Though not a member, Mongolia is included because of similarities in economic structure as well as geographical reasons

2.4 Commodity Price Developments

2.4.1 Gold Prices

The price of gold increased by 24.9 per cent from an annual average of US$697.08 an ounce in 2007 to US$870.89 an ounce in 2008. The significant increase was observed at the beginning of the year, as uncertainty over global economic performance led to strong purchases of the metal for hedging against risk. However, the gains on high prices were reversed during the second half of the year when financial crisis became eminent and pulled down global demand. In Rand terms, the annual average price increased from R4 618.82 per ounce in 2007 to R7 199.73 per ounce in 2008, which could have increased profitability of the SA mining sector. Nevertheless, the SA mining sector was adversely affected by electricity shortages during the first half of the year and the low global demand during the second half of the year. As a result, the number of Basotho migrant mineworkers in SA declined.

2.4.2 Oil Prices

The oil market was characterised by dramatically high prices during the year under review. In 2008, the minimum and maximum price levels of crude oil were recorded at US$33.36 and US$140.73 per barrel, compared with US$52.8 and US$91.91 per barrel in 2007. As global demand fell, the price of oil also declined and it closed the year at US$34.69 per barrel compared to US$90.82 per barrel at the end of 2007. On average, it registered US$94.67 per barrel in 2008 compared to US$69.21 in 2007.

The average increase in the international oil prices resulted, largely from high global demand, mounting geopolitical concerns in Nigeria and Middle East and supply restrictions by the Organisation of the Petroleum Exporting Countries (OPEC).

On average, the Loti price of crude oil decreased by 37.5 per cent from M458.58 per barrel in 2007 to M286.79 at the end of 2008. In line with global developments, there were several downward revisions of prices of fuel in the country during the review year. Price of petrol in Lesotho closed the review year lower at M6.55 per litre, while that of diesel and illuminating paraffin closed the year higher at M8.75 per litre and M6.20 per litre, respectively. These compare with M7.05 per litre of petrol, M7.95 per litre of diesel and M5.70 per litre of illuminating paraffin at the end of 2007.

2.4.3 Platinum prices

The average price of platinum increased during 2008. It increased from US$1 306.02 per ounce in 2007 to US$1 567.97 per ounce in 2008. In Rand terms, the average price of platinum rose by 49.8 per cent from R8 653.66 per ounce in 2007 to R12 962.58 per ounce in 2008.

2.4.4 Maize prices

In US$ terms, the average prices, for both white and yellow maize decreased during the year under review. The average spot price of white maize decreased from US$244.62 per tonne in 2007 to US$225.47 per tonne in the review year, while that of yellow maize decreased from US$253.23 per tonne in 2007 to US$228.75 per tonne in the review year. In Maloti terms, this translates to an annual average increase of M108.41 per tonne for white maize and M71.67 per tonne for yellow maize due to exchange rate movements.

2.4.5 Wheat prices

The annual average spot price of wheat increased by 29.4 per cent from US$253.39 per tonne registered in 2007 to US$327.81 per tonne recorded in 2008. In Maloti terms, the average spot price of wheat increased from M1 778.54 per tonne realised in the previous year to M2 653.36 per tonne in 2008.

2.5 Lesotho in the Context of Regional Economic Integration

Lesotho continued to show strong commitment to economic cooperation throughout 2008 by actively participating in activities of regional economic organisations such as the Southern African Customs Union (SACU) , Southern African Development Community (SADC) and the Common Monetary Area (CMA), amongst others.

During the review year, SACU continued to negotiate various free trade agreements (FTA) with major trading blocs and countries outside its borders. SACU's agenda focused on a number of trade negotiations in 2008. These include, conclusion of the Preferential Trade Agreement (PTA) with Mercado Comun del Sur (Mercosur) ; the resumption of the Doha Round of negotiations; the SADC Economic Partnership Agreement (EPA) negotiations with the European Union (EU); ongoing SACU negotiations to finalise a PTA between SACU and India as well as the signing of the Trade, Investment and Development Cooperation Agreement (TIDCA) with the US.

The SACU-Mercosur PTA was concluded in April 2008 and approved by the SACU Council of Ministers in June 2008. This is the first trade agreement concluded by

SACU as a single entity. The main objective behind this agreement is to promote trade between the two parties on a number of selected products and it contains 1000 tariff lines on both sides for which trade preferences in the form of reduced customs duties will be granted. The PTA with India is expected to be concluded in December 2009.

SACU participated in the Doha Development Agenda negotiations. The negotiations were intended to address an imbalance against the developing countries that existed in the world trade system. The purpose of the meeting held in Geneva in July 2008 was to agree on the formulae and other methods to be used to cut tariffs and agricultural subsidies; and consider a range of other related provisions as well as to look at the next steps in concluding the Doha round of negotiations. Convergence of views of participants was observed on a number of issues. However, negotiations collapsed over one of the last issues on the agenda, the special safeguard mechanism, over which some countries could not agree on the threshold that would allow its implementation. The mechanism is a measure that is designed to give countries some latitude to protect poor farmers by imposing a tariff on imports of agricultural goods if prices of such goods decline or if there is a considerable increase in imports.

In respect of TIDCA, a trade agreement was signed between trade ministers of SACU and US. This opens the way for an eventual FTA between these two parties in July 2008. This trade agreement is designed as a framework for trade and investment promoting activities that could provide the building blocks for the future signing of FTA negotiations. Such activities could include finalising some interim trade related agreements and engaging in trade and investment enhancing activities such as addressing technical trade barriers, expanding market access for SACU countries and working together to develop trade and economic strategies. Progress was also made with regard to SADC activities. At the beginning of the review year, five SADC countries (Botswana, Lesotho, Namibia, Swaziland and Mozambique) had signed an interim Economic Partnership Agreement (IEPA) with the European Commission (EC), while others (South Africa and Angola) had shown interest in joining. Under this agreement, the EU Council regulation 1528/2007 grants SADC countries that have initialled either an IEPA or a full EPA duty-free and quota-free access to the EU market on a transitional basis on a number of products except sugar, bananas and rice for which special transitional arrangements were established. During the review year, some of the SADC member countries indicated that the EC's approach does not accommodate some regional economic realities and therefore issues to that effect needed to be resolved before they could either sign or ratify the agreement. As a consequence, the envisaged conclusion of negotiations towards a full EPA by the end of 2008 was not attained.

A wider economic integration is expected to have positive implications for the economy of Lesotho. Firstly, it could broaden access of Lesotho's products in international markets, which is in line with the ongoing Lesotho Government's initiative of export market diversification. Diversification of markets is also intended to reduce Lesotho's dependence on SA. Secondly, a broader economic integration could also attract more foreign direct investment (FDI) into the country, hence lead to higher employment prospects and reduce poverty in the country. Finally, Lesotho's export earnings could increase and hence lead to the improvement in the Balance of Payments (BOP) position.

On the negative side, reduction in tariffs is likely to reduce the customs revenue pool and hence adversely affect the fiscal and BOP positions of Lesotho, since they rely heavily on this source of revenue.

BOX 1: SOUTHERN AFRICAN DEVELOPMENT COMMUNITY (SADC) FREE TRADE AREA (FTA) IS LAUNCHED: ECONOMIC IMPLICATIONS FOR LESOTHO

The establishment of SADC[13] FTA in 2008 stems from SADC Trade Protocol signed in 2000 and came into force in 2002. According to the protocol, member countries were required to establish free trade area by 2008 and Customs union in 2010, common market in 2015, monetary union in 2016 and single currency in 2018. At the launch of SADC FTA, about 85 per cent of trade in goods was liberalized among member states. However, each member state retains its own trade barriers with the rest of the world. It marked a very critical step towards the vision of fully integrated economic region.

SADC FTA has a number of positive implications for the economy of Lesotho. First, it widened market base for many Basotho businesses. It created an opportunity for Lesotho businesses to reach out approximately 247 million consumers within the region. This creates incentives for domestic producers to increase their production. In a nutshell, it is envisaged that Lesotho will realise high levels of investment, more employment; and high and sustainable economic growth.

Second, the arrangement will stimulates competition among producers in the region. In Lesotho, producers will be forced to be more efficient to face competition from other producers within the region. It may also result in mergers or joint ventures. Increased competition stimulates development and utilization of cost effective methods of production. All of these efforts will also benefit domestic consumers and producers in the form of high-quality-low-cost goods and services.

Finally, the arrangement will lead to greater specialization based on comparative advantage. The arrangement will result in Lesotho re-allocating resources to production of goods it has comparative advantage in and thereby reducing the cost burden in the production of goods it has comparative disadvantage in. Thus, resources will be allocated efficiently towards their effective and efficient utilization.

It is noteworthy, however, that there are several costs associated with the arrangement. The arrangement reduces the welfare of member states as it diverts trade from more efficient producers outside the region to less efficient producers within the region. This has a potential to worsen the international allocation of resources and shift production away from comparative advantage.

In addition, due to stiff competition from other SADC producers, some domestic producers (especially small producers) will be forced to shutdown their production activities. The implications will be loss of jobs, reduction in domestic production (output) and hence low economic growth.

[13]SADC: Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

3.1 Real Sector Developments

3.1.1 Trends in Output and Income

The performance of the domestic economy slowed down further in 2008 as a result of a fall in performance of the secondary sector. Real GDP growth was estimated at 3.4 per cent in 2008, compared to 5.1 per cent in 2007.

The performance of the secondary sector declined because of the weakening demand in the US where the bulk of Lesotho's exports (from the manufacturing sector) are destined. The unfolding global financial crisis has impacted negatively on the aggregate spending in the US, to the extent that the US economy is reported to be in a recession. About 60 per cent of Lesotho's exports are textiles and clothing and they are destined for the US.

Real Gross National Income (GNI) is estimated to have grown by 3.0 per cent in 2007 and 5.0 per cent in 2008. In per capita terms, GNI is estimated to increase by 4.5 per cent in 2008 compared with 2.0 per cent in 2007.

Table 2:
AGGREGATE ECONOMIC INDICATORS
(Percentage Change, 2004 = 100)

	2004	2005	2006	2007	2008*
Constant 2004 Prices					
GDP	4.6	0.7	8.1	5.1	3.4
GNI	3.4	-1.9	12.0	3.0	5.0
GDP Per Capita	4.6	0.7	8.1	4.0	2.9
GNI Per Capita	3.4	-1.9	12.0	2.0	4.5

Source: Bureau of Statistics
* CBL Projections

The increase reflects the improvement in both miners' remittances and investment income from abroad. Miners' remittances benefited from the high price of gold that prevailed during the first half of 2008 while investment income was due to high interest rates particularly in South Africa.

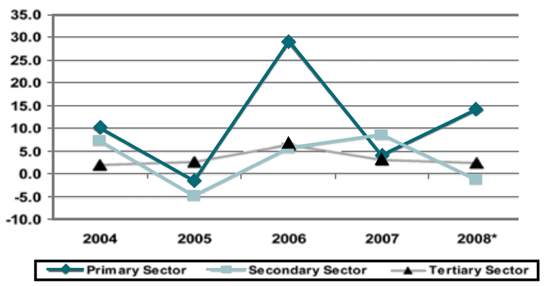
3.1.2 Sectoral Performances

(a) Developments in the Primary Sector

Growth in the primary sector rose by 14.0 per cent in 2008 compared with 4.1 per cent increase registered in the previous year, mainly as a result of a recovery in crops subsector and the continued strength of the mining and quarrying subsector.

The Agriculture, forestry and fishing subsector is estimated to have grown by 1.8 per cent contrary to the contraction of 8.6 per cent recorded in 2007 mainly due to the recovery in the crops subsector and agricultural services. The crops subsector is expected to have contracted by 4.3% in 2008 compared with the 30.9 per cent in 2007. According to the preliminary report on crop forecasting, maize production is expected to have declined by 8.6 per cent while sorghum is expected to have grown by 53.7 per cent. The expected decline in Maize production is due to late planting in most areas and early frost. Block farming could be one of the factors that contributed to the recovery of the sector. The agricultural extension services subsector also registered a smaller decline of 3.5 per cent compared with 33.7 per cent in 2007, mainly due to the inclusion of activities of the forestry ministry. Performance of the mining and quarrying subsector is estimated to have grown by 33.4 per cent in 2008, following the growth of 33.8 per cent in 2007 mainly due to the continued strength of the diamond mining. However, the outlook for the subsector looks bleak as two mining companies, Liqhobong and Kao mines, suspended operations due to the deteriorating global economic performance which has reduced the price of rough diamonds by over 30 per cent. Gem diamonds which is Letšeng holding company has also warned of a possibility of reporting a loss for the financial year 2008.

Figure 2: Sectoral Real Growth Rate
(2004 = 100)



Source: Bureau of Statistics
* CBL Projections

(b) Developments in the Secondary Sector

The secondary sector which comprises manufacturing, electricity and water and building and construction subsectors declined by 1.3 per cent in 2008 compared with 8.5 per cent increase recorded in the previous year.

The slowdown is, most likely, expected to be a result of the contraction of the manufacturing subsector in the face of global financial crisis. Lesotho's manufacturing subsector comprises textiles, clothing, footwear, and leather, which account for 13.0 per cent; food products and beverages which account for 2.7 per cent and other manufacturing at 1.4 per cent. The continuing global economic uncertainty, particularly in the United States, is expected to have a bearing on the textiles, clothing, footwear, and leather subsector because the bulk of this subsector's output is destined for the US, whose economy is reported to be in recession. Other manufacturing subsectors will continue to grow stronger as LNDC intensify efforts to diversify from textiles and clothing products.

The Electricity and Water subsector slowed down from 4.5 per cent in 2007 to 2.3 per cent in 2008, as a result of the weakening performance in the textile and clothing subsector, and the delays in the implementation of supply of water to some parts of Maseru. The subsector is of critical importance to the manufacturing of textiles and clothing as they consume large quantities of water.

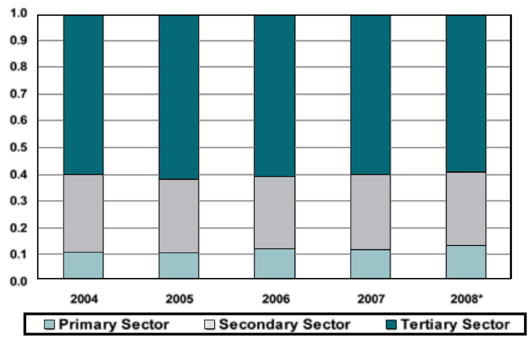
Building and construction subsector increased from 6.9 per cent in 2007 to 7.7 per cent in 2008, because of the Government of Lesotho's infrastructure development, in areas of roads, water and education.

(c) Developments in the Tertiary Sector

The sector slowed down from 3.1 per cent in 2007 to 2.0 per cent in 2008. This was underpinned by a deceleration of 0.5 per cent in 2008 from 2.9 per cent in the previous year, especially, in wholesale and retail trade subsector. The slowdown was caused by sluggish consumer demand as uncertainty grows around the employment prospects in the manufacturing sector. High interest rates and food prices also weakened demand.

Another deceleration was realised in transport and communications. The subsector rose by 4.5 per cent from 6.2 per cent in the previous year. The transport and storage subsector was negatively affected by the high price of fuel that prevailed for the most part of 2008. However, the telecommunications subsector is expected to remain strong due to the introduction of new products by the mobile companies.

Figure 3: ***Sectoral Shares in GDP at Factor Cost***
(Percentages)



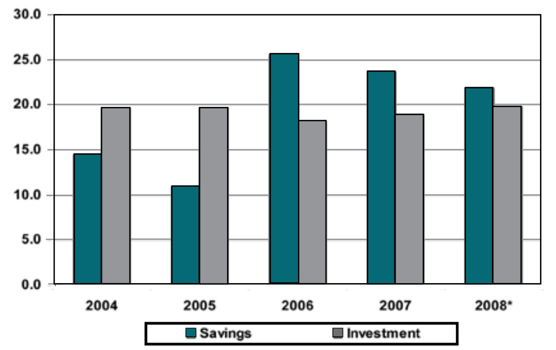
Source: Bureau of Statistics
*CBL Projections

3.1.3 Savings and Investment

The Saving-Investment gap as a share of GNI was recorded at 9.5 per cent. Gross national savings alone was estimated at 21.9 per cent of GNI in 2008 compared with 23.7 per cent of GNI in 2007. Total investment was registered at 12.3 per cent of GNI in 2008 from 13.6 per cent of GNI in 2007. This is consistent with the surplus recorded in the current account.

The decline in savings was driven mainly by government savings which fell to 10.8 per cent of GNI compared with 15.5 per cent in 2007. Private sector savings rose to 11.1 per cent of GNI in the review period from 8.2 per cent in 2007. Investment slowed down due to decline in both Government and private sector. Government investment edged down slightly to 9.0 per cent of GNI from 9.6 per cent of GNI in 2007 while private sector-related investment slowed down to 3.4 per cent of GNI during the year. The decline in private sector investment is consistent with the decline in manufacturing sector due to the current financial crisis.

Figure 4: ***Savings and Investment***
(As a percentage of GNI)



Source: Bureau of Statistics
*CBL Projections

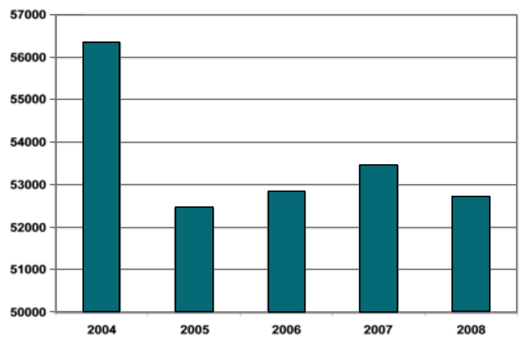
Saving as a ratio of Gross National Disposable Income (GNDI) was estimated at 21.9 per cent in the review year compared with 23.7 per cent recorded in 2007, following an increase in net current transfers, particularly SACU revenue.

3.2 Employment, Wages and Prices

3.2.1 Employment

Employment in LNDC-assisted companies is expected to decline to levels below that of 2007 owing to a decline in the performance of the manufacturing subsector, in particular textile and clothing. The performance in this subsector has been mainly affected by the global economic recession which started in the US (the destination for manufactured products from Lesotho). Employment in the public sector increased by 4.2 per cent to 42352 at the end of the review period, owing to a continuous increase in the number of teachers ,which was consistent with the planned public service expansion. The number of migrant mineworkers declined by 1.4 per cent to 52702 employees in 2008 as compared to an increase of 1.2 per cent in 2007. The downward trend in this category was mainly due to an unfavourable performance of the gold and platinum mines as commodity prices continued to fall worldwide, more especially in the second half of 2008.

Figure 5: ***Avarage Number of Basotho Mineworkers in SA***



Source: The Employment Bureau of Africa (TEBA)

3.2.2 Wages

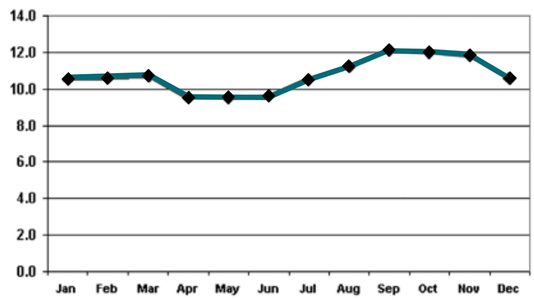
The general minimum wage increased by 10.0 per cent during the review year from the previous period. Other sectors such as manufacturing, construction, wholesale, retail sector, hospitality, transport, small business and domestic workers increased their minimum wages in varying degrees ranging from 5.0 per cent to 15.2 per cent based on their respective performance in 2008. In addition, government employees benefited from an across-the-board salary increase of 15.0 per cent in the fiscal year 2008/2009, of which 5 per cent was meant for pension contribution for employees aged 40 years and below.

3.2.3 Price Developments

Rate of inflation, as measured by changes in the CPI, increased to 10.7 per cent on average in the review period from 7.9 per cent recorded in 2007 as a result of high prices of fuel and food. The rise in fuel prices resulted from an upward trend in the price of crude oil while the latter was as a result of increasing use of maize in bio-fuel production. The petrol pump price increased by 13.9 per cent, diesel by 18.5 per cent, and illuminating paraffin by 22.8 per cent between January and December 2008. Because of the high weight of food in the Lesotho CPI basket, food prices tend to influence the overall CPI more that oil prices.

Inflation is expected to gradually moderate in the year 2009, when the price of crude oil stabilises.

Figure 6: ***Lesotho Consumer Price Index***
(Annual Percentage Change)



Source: Bureau of Statistics

BOX 2: REVISION OF LESOTHO NATIONAL ACCOUNTS

The Bureau of Statistics (BOS) has released revised National Income Accounts of Lesotho. National Income Accounts is a formal framework that provides a classification of information about economic performance of a country. National Accounts are compiled in line with the United Nations System of National Accounts (SNA) 1993. The data on national accounts play an important role in research and policy formulation. Therefore, it is important that statistical figures are accurate and timely.

The revision entailed review and revision of the methodology, incorporation of new sources and updating the base year from 1995 to 2004. Rebasing ensures that national accounts reflect i) accurate structural changes in the economy in terms of both consumption and production patterns ii) alterations in the relative prices of commodities. In this regard, the base year provides appropriate and more reflective weight to new goods and services.

The revised estimates reflect the level of GDP in constant prices that are lower compared to the previous estimates except for 2006. However, on average, the annual growth rate for a ten-year period 1997-2006 is 2.6 per cent compared with 1.8 per cent in the previous estimate. These variations are due to correction of errors in the previous estimates, while at the same time using new sources and improved methods.

The value added by agriculture is lower than the previous estimates. Errors were corrected on valuations of crops which were previously overestimated and an estimate of forestry has been added. On the other hand, clothing exports from Lesotho to USA have been used to improve the estimate of clothing industry. The revision has included the subsidies under the Duty Credit Certificate Scheme. Moreover, the value added for construction is lower after revision mainly because of correction of errors in the previous construction estimates.

An estimate has also been made for government investment. This has increased value added by government. Output is calculated as the sum of costs, which includes consumption of fixed capital. On the expenditure side, total exports and imports of goods and services are aligned with the balance of payments which has been reviewed recently. Government consumption is higher than the previous estimate due to the government increasing its expenditure on teachers that are in schools not operated by the government. Moreover, private consumption and investment are now estimated within the framework of a supply and use table.

On the Gross national income and gross national disposable income front, primary incomes and transfers to and from the rest of the world have been revised. The adjustment is also made for “trading gains/losses” in deriving real GNI and imports deflator is used in estimating Real GNI which was previously the deflator for gross domestic expenditure.

3.3 Balance of Payments (BOP)

3.3.1 Overall Balance

The external sector position continued to improve since 2005. The improvement is manifested in the growth in overall balance, which increased to a surplus equivalent to M2.0 billion in 2008 compared with a surplus of M1.9 billion registered in the previous year. The augmentation of the overall balance was a reflection of improvements in the current account coupled with the depreciation of the local currency against the major trading currencies, particularly the US Dollar, Euro and Pound Sterling. This indicates that the country is building-up foreign reserves and can maintain fixed exchange rate between the Loti and the Rand.

The transaction balance, which represents the overall balance without the effect of currency movements, contracted to a surplus of M1.1 billion in 2008 from surplus of M2.0 billion observed in the previous year. This was brought about by the decline in current transfers which was largely driven by SACU non-duty receipts. However, capital and financial account continued to register net inflows because of a fall in outflows of "other investment category".

Gross official reserves registered a lower growth of 32.5 per cent in 2008, compared with a rise of 38.0 per cent observed in the previous year. The increase was influenced by an expansion of export earnings, returns on investment portfolios and the depreciation of local currency. In months of import cover, foreign reserves fell to 7.4 months in the review period, from 7.6 months recorded in the previous year.

Figure 7: Reserves in Months of Imports

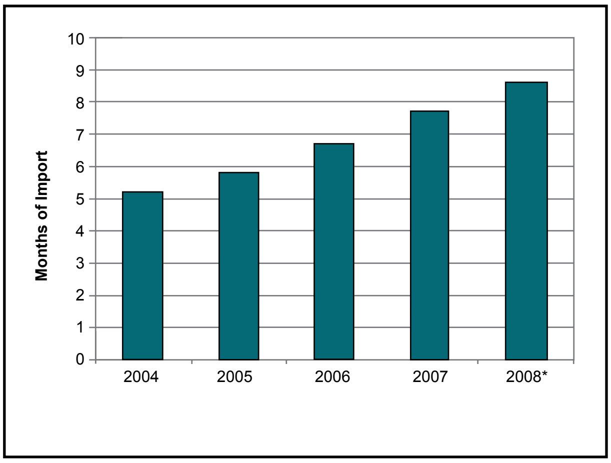


Table 3

SUMMARY OF BALANCE OF PAYMENTS
(As percentage of GDP)

	2004	2005	2006	2007	2008*
Current account	-5.6	-7.2	4.4	12.7	12.6
Capital and Financial account	7.0	4.6	0.8	7.1	6.7

* Preliminary estimates

3.3.2 Current Account

Despite the high merchandise trade deficit, the current account of the balance of payments increased marginally to a surplus equivalent to M1.6 billion in 2008 from M1.5 billion recorded in the previous year. The growth in the current account was a result of improved merchandise export, in particular, diamond exports coupled with an increase in labour income and investment income. In addition, a decline in interest paid on official loans also contributed to the rise in the current account surplus. However, increased payments in trade in services restrained the improvement in the current account. Relative to GDP, the current account narrowed marginally to a surplus of 12.6 per cent in 2008 compared with 12.7 per cent recorded in the previous year.

3.3.3 Income and Trade in Goods and Services

Preliminary estimates indicate that merchandise exports continued to improve in 2008. Merchandise exports, in nominal terms rose by 26.3 per cent during the year compared with a rise of 19.6 per cent observed in the previous year. As a share of GDP, merchandise exports recorded 55.4 per cent in the review period following 48.1 per cent registered in the preceding year. The performance of merchandise exports was largely driven by diamond exports which accounted for 29.8 per cent of the total export. Despite the global financial turmoil and deterioration of diamond production in Kao and Liqhobong diamond mines, during the second half of 2008, diamond exports grew by 84.9 per cent during the year compared with 86.5 per cent observed in the previous year. Moreover, improvement in diamond exports offset the effect of the decline in clothing and textile exports due to a fall in global demand, particularly, in the US market.

The nominal value of merchandise imports is projected to have increased by a lower rate of 19.6 per cent in the review period compared with a revised 22.0 per cent recorded in the previous year. This reflects the general growth in domestic demand. In addition, depreciation of the local currency during the second half of 2008 raised the price of imported goods, especially raw materials used in the manufacturing subsector. Relative to GDP, merchandise imports registered 102.2 per cent in 2008, following a revised 95.9 per cent observed in 2007.

The trade in services registered a higher net outflow of M355.7 million in the review year from M239.2 million in the previous year. The increase emanated from higher payments on transportation services coupled with a rise in expenditure by Lesotho embassies abroad.

Net income improved significantly by 40.3 per cent in 2008 compared with 14.4 per cent registered in 2007, mainly on account of an increase in labour income and earnings on investment portfolios by the Central Bank and commercial banks. The returns on investment portfolios were boosted by higher regional interest rates. Furthermore, a fall in interest paid on official loans contributed to the improvement in the net income.

3.3.4 Capital and Financial Account

The capital and financial account continued to display a surplus, as evidenced by inflows of M866.9 million during the review period, following that of M837.4 million in the preceding year. The growth was largely driven by the financial account. However, as a percentage of GDP, capital and financial account decelerated to 6.7 per cent in 2008 compared with 7.1 per cent observed in the previous year.

The financial account rose to an inflow of M761.0 million during the year from M611.0 million recorded in the previous year, as a result of the decline in commercial banks' foreign assets. Outflow of commercial banks' foreign assets reduced to M220.1 million in 2008 compared with M428.3 million in 2007. Capital transfers, which include grants in government, fell from M226.4 million in 2007 to M105.9 million during the review year.

3.3.5 Foreign Exchange Rates

The Loti, which is pegged at par to the SA Rand weakened against major currencies during the review year. On average, the Loti depreciated by 24.8 per cent against the US dollar in 2008 due to, among other factors, the risk aversion prevailing in the uncertain global environment. The Loti also depreciated by 18.9 per cent, 41.5 per cent and 30.3 per cent, against Pound Sterling, Euro and Special Drawings Rights (SDR), respectively.

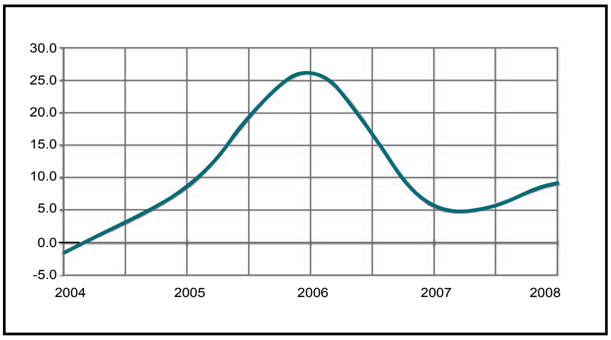
3.4 Money and Banking

3.4.1 Money Supply

Real money supply grew by 7.9 per cent in 2008, up from a growth of 5.9 per cent in 2007. In nominal terms, money supply increased at a rate of 19.7 per cent in 2008. This was higher than the 16.4 per cent growth realised in 2007. The rise in money supply was driven by an increase in net foreign assets, coupled with a relatively lower decline in net domestic assets. Net foreign assets rose by 33.4 per cent in 2008, following a growth of 36.2 per cent in 2007. Conversely, net domestic credit fell by 19.4 per cent in the review period. The decline was lower than the three-fold decrease observed in 2007. In addition, credit to statutory bodies fell in 2008, and private sector credit growth decelerated.

Components of money supply that reflected the increase were demand deposits and currency with public. The former rose by 33.8 per cent year-on-year, from a decline of 13.3 per cent in 2007. Currency outside the banking system increased at a lower rate of 0.7 per cent in the review year compared with 29.1 per cent the previous year. Other components of broad money declined during the period. Quasi-money fell by 7.8 per cent.

Figue 8: Real Money Supply Growth
(Annual percentage Change: End of Period)



3.4.2 Domestic Credit

The behaviour of domestic credit continued to reflect changes in net claims on government, its major component. Domestic credit continued to fall in 2008, but the fall slowed down significantly to 19.4 per cent. The fall was attributed to a decline of 2.2 per cent in net claims on government, following a decrease of 3.2 per cent in 2007. The slower decline in net claims on government reflected a slowdown in the build-up of deposits of the government held by the banking system, due to a smaller surplus in 2008 compared to 2007.

Credit to the private sector recorded an increase of 21.3 per cent, which was lower than the 34.6 per cent registered in 2007. The deceleration was influenced by repayment of loans to business enterprises, which partially dampened the effect of a strong increase in credit to households. Credit to statutory bodies declined by 15.0 per cent in the twelve months ended December 2008.

3.4.3 Net Foreign Assets

Net foreign assets of the banking system continued to show strong growth in 2008. However, the growth was slower at 33.6 per cent compared with 36.0 per cent in 2007. Net external reserves held by the Central Bank increased by 33.6 per cent in 2008, higher than the 24.1 per cent increase realised in 2007. Commercial banks also saw an increase in their net foreign asset. They grew by 32.8 per cent in the review year from an increase of 24.1 per cent in 2007.

The slowdown in the growth of net foreign assets of the country was influenced by a decline in SACU non-duty receipts. The receipts fell by 4.2 per cent in 2008, though from a high base. They had gone up by 75.8 per cent the preceding year, 2007. However, net exports resulted in a smaller net outflow of foreign currency in 2008. They fell by 12.8 per cent due to the resilience of exports against the hostile global economic developments. Net exports declined by 24.6 per cent in 2007.

Table 4
BANKING SYSTEM'S NET FOREIGN ASSETS
(Million Maloti: End of period)

	2004	2005	2006	2007	2008
Commercial banks	1117.9	1135.0.	1772.4	2200.3	2921.1
Assets	1253.8	1241.8	1845.4	2273.7	3013.7
Liabilities	-135.9	-106.9	-72.9	-73.4	-92.7
Central Bank	2854.5	3076.2	4377.2	6177.3	8251.6
Assets	3351.5	3625.6	4918.7	6786.3	8989.2
Liabilities	-497.0	-549.3	-541.5	-609.0	-737.7
Net Foreign Assets	3972.4	4211.2	6149.7	8377.6	11172.6

3.4.4 Commercial Banks' Liquidity

At the end of December 2008, the liquidity[16] of commercial banks remained almost unchanged at 73.1 per cent compared with the same period the previous year. The ratio measures banks' ability to adequately honour customers' demands in making withdrawals. The rise in liabilities was matched by the growth in liquid assets, leading to the steady ratio. The growth in liabilities reflected a strong increase in deposits of the private sector. The jump in liquid assets was influence by a 12.6 per cent rise in balances due from foreign banks, which offset the effect of decreases in balance from banks in Lesotho and holdings of domestic securities. At its present level, the ratio is too high. A liquidity ratio of 30 per cent is considered sufficient to meet customers' withdrawals without adversely affecting the financial position of banks. The high ratio is an indication of low credit extension by commercial banks.

This is confirmed by the credit-deposit ratio which was recorded at 34.1 per cent in 2008. It had grown up from 30.9 per cent the preceding year. The slight growth in the ratio indicates that the 21.2 per cent increase in private sector credit was modestly stronger than the increase in deposits.

3.4.5 Interest Rates

Major money market rates in Lesotho generally continued on an upward trend in 2008. This trend, which also prevailed in the region, was due to inflationary pressures that came mainly as after-effects of the increase in prices of food and crude oil. Inflation was further driven by rand depreciation and strong growth in consumer demand in South Africa, as evidenced by expansion of private sector credit during the year. The slump in the rand currency was partly influenced by capital flight as investors withdrew from regional capital markets on concerns of adverse effects of the global financial crisis.

The average prime lending rates in Lesotho ended the review year at 16.58 per cent, which was higher than 15.42 per cent at end of 2007. The changes in this rate tracked the RSA prime lending rate that increased from 14.00 per cent in 2007 to 15.00 per cent in 2008. The increase in the RSA lending rate was influenced by the two hikes in the repo rate by the SARB in an attempt to curb inflationary pressures.

The Lesotho 91-day treasury bill rate ended the year 2008 at 10.05 per cent, up from 8.82 per cent the previous year. The rate increased despite the overall increase in total amount announced for auction and the introduction of additional securities in 2008. It was, however, lower than the similar rate in RSA, which was at 10.84 per cent at the end of the year.

Most deposit rates of commercial banks rose by less than one percentage point in the twelve months to December 2008. This implied that the margins between these rates and the Treasury bill rate widened during the year. However, real deposit rates increased during the review period, given the similar rates of inflation at the end of 2007 and 2008. The one year deposit rate was the only deposit rate to grow by more than one percentage point. It increased in real terms from negative 5.83 per cent in December 2007 to negative 2.85 at the end of 2008.

[16]Liquidity is measured by the ratio of commercial banks' notes and coins holdings, balances with banks in Lesotho and abroad, their clearing balances held with the CBL plus their short-term securities to their total deposit liabilities and other borrowings. The ratio measures banks' ability to adequately honour customers' withdrawals.

BOX 3: THE CENTRAL BANK INTRODUCES MEASURES AIMED AT DEVELOPING THE MONEY MARKET

The money market is the market for short-term financial instruments with a maximum maturity period of one year. In Lesotho, the market comprises government treasury bills, Central bank paper, repurchase agreements (repos), interbank fund, bankers' acceptances and other short-term instruments issued by financial institutions.

In the year 2008, Central Bank of Lesotho (CBL) continued with its gradual approach towards the development of money market. This includes the introduction of longer dated money market instruments (273-day and 364-day Treasury bills), reduction of threshold of the competitive section of the auction from M250 000 to M100 000, shorter settlement procedure and increased frequency of auctions.

The development of money market has several benefits for the economy of Lesotho. First, it increases (improves) the effectiveness of monetary policy. It allows the monetary policy signals to be transmitted into the economy through determination of market clearing rates (interest rates) by participants. A well developed money market provides a channel through which the government can borrow (access) funds domestically. Without a well functioning money market, it would be difficult for the government to borrow (access) funds in the domestic market. In addition, a well developed money market reduces the cost of government financing. It reduces the borrowing costs as well as the risk associated with auction failures.

Moreover, money market promotes financial stability and development within an economy. It enables financial institutions to cover their short-term liquidity needs by selling debt instruments to attract idle funds. This will enable financial institutions to meet liquidity needs of their customers.

The development of money market also stimulates competitive behaviour among participants. This has a potential to stir interest rates within the economy in the downwards direction. Low interest rates are catalyst of economic growth as they encourage both investment and consumption which are critical to economic growth and development.

3.5 Government Finance

3.5.1 Fiscal reforms in recent years

Public Financial Management remains Government priority to improve efficiency on service delivery. This is demonstrated by the initiatives put into operation to facilitate a success of the process. The following are the identified pillars to provide the necessary support:

- The medium term expenditure frame work, which was piloted at three line ministries that are considered the big spenders, has been rolled out;
- Procurement system has been modernised and the authority is vested with the line ministries; and finally.
- Support to the oversight bodies. It is acknowledged that success of public financial management is dependent on the effective oversight and reporting mechanism. The Office of the Auditor General and Public Accounts Committee have a vital role to play.

The Government of Lesotho realised that installation of computer software and hardware alone was not sufficient to realise efficiency, it has to be complemented by relevant human resources with necessary skills and experience. As a result, officials from finance cadre were identified to undergo a tailor-made training programme to achieve the objectives. The Centre for Accounting Studies offers training in Public Finance and Accountancy in which participants are awarded certificates in Chartered Institute of Public Finance and Accountancy (CIPFA). The first group of 38 students were awarded CIPFA Certificates in October 2008 following a successful completion of the first year of the two-year Diploma course. A similar programme for Government Procurement, the Chartered Institute of Purchasing and Supply (CIPS), is offered by the Institute of Development Management (IDM).

In addition, it is recognised that employee motivation is key to realising efficiency in service delivery. As a result, Government introduced an improved Civil Servants Contributory Pension Fund. The new pension scheme is meant for employees aged 40 years and below. Government and the staff contribute 16.2 per cent of the current wage bill, 11.2 per cent Government and 5 per cent staff. This is in contrast to the old system in which government operated unfunded pension scheme which was paid from the recurrent budget.

Furthermore, Government introduced tax concessions on Personal Income Tax to reduce the burden on compliant tax payers. This is broken down as follows:

- Tax credit increased from M3,500 to M4,500 per year;
- The lower tax rate reduced from 25 per cent to 22 per cent; and
- The threshold increased from M35,065 to M37,378.

This is equivalent to 100 million Maloti that Government gave back to compliant tax payers. It is clear from the above discussions that the adjustments have implications on government budgetary operations, both revenue and expenses.

3.5.2 Fiscal performance in 2008/09

The projected deficit in the government budgetary operation for the fiscal year

2008/09 was 0.1 per cent of GDP. This was mainly attributed to the transfer of pension liabilities to a newly established Civil Servants Contributory Pension Scheme. The deficit is in contrast to a surplus equivalent to an 8.5 per cent of GDP realised in the previous fiscal year. This is the first time Government realised deficit in the last five fiscal years.

3.5.2.1 Revenue

Total revenue, including grants, was estimated to grow by 15.0 per cent in 2008/09. This was mainly on account of 17.9 per cent increase in tax revenue. Both Income tax collections and revenue from SACU contributed to the hike in tax revenue. SACU revenue grew by 19.6 per cent, following 3.9 per cent in the previous period.

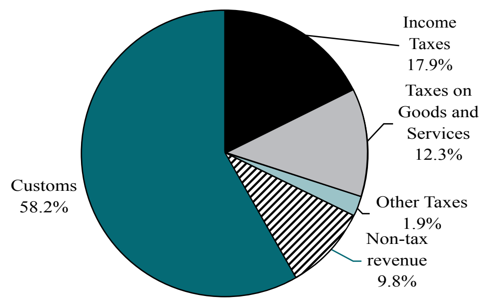
Income tax rose by 16.4 per cent during the period under review. This was mainly aided by a 25.3 per cent rise in company tax. This more than offset a 0.3 per cent decrease in collections from personal income tax, largely reflecting the concessions effected during the year. The other income tax component, which comprises fringe benefits and Withholding taxes, surged by 90.0 per cent during the year.

Value Added Tax (VAT) collections rose by 2.6 per cent, following a 29.3 per cent growth observed in the previous period. The 2008 performance was influenced by stronger economic activity, higher inflation and gain in revenue collection efficiency.

Non-tax revenue almost remained unchanged during the period under review. This was mainly attributed to the fall in other property revenue which moderated a 14.3 per cent rise in water royalties. Property income comprises dividends, diamond royalties, interest on loans on-lent to semi-autonomous institutions and rand monetary compensation.

The level of capital grants fell by 13.0 per cent during the period under review. The funds were expended on provision of infrastructure in health, education, tourism and public works.

Figue 9: Source of Government Revenue



Source: Ministry of Finance and Development Planning (MoFDP) and CBL estimates

3.5.2.2 Expenditure

Total government expenditure was expected to surge by 33.3 per cent during the year 2008/09 on account of a 35.8 per cent increase in recurrent spending. Expenditure on transfers and subsidies was the main driving force behind the rise in recurrent spending. The expenditure on transfers and subsidies increased by 71.2 per cent as a result of the establishment of the new contributory pension fund for civil servants; and increased government transfers in the form of pensions for the elderly (aged 70 and above) and HIV and AIDS affected people.

Expenditure on personal emoluments grew by 30.7 per cent because of 15.0 per cent salary adjustment effected at beginning of the year, coupled with an increase in government employment as discussed in subsection 3.2. Expenditure on goods and service grew by 21.5 per cent.

Total interest payments were expected to plummet by 57.3 per cent during the period under review on account of the fall in both domestic and external interest payments. The plunge in external interest payments was due to normalisation following accelerated payment made in the previous fiscal year. Expenditure on capital projects was estimated to grow by 25.2 per cent during the period under review. This expenditure financed construction of roads network, schools and health related infrastructure.

Table 5

SUMMARY OF BUDGETARY OPERATIONS
(Million Maloti)

				Revised	Projections
	2004/05	**2005/06**	**2006/07**	**2007/08**	**2008/09**
Total Receipts	4361.8	4559.9	6431.9	7512.3	8635.6
Revenue	4130.4	4476.3	6339.5	7264.0	8419.6
Customs	2012.4	2306.0	3943.2	4097.7	4901.0
Grants	231.4	83.6	92.4	248.3	216.0
Total Expenditure	3613.5	4293.2	5137.9	6484.1	8645.9
Recurrent expenditure	2919.7	3590.9	4363.2	4973.8	6755.8
Purchases of Goods & Services	2002.5	2378.5	2777.6	3002.3	3794.9
Capital Expenditure & net Lending	693.8	702.3	774.7	1510.3	1890.1
Surplus/Deficit Before grants	516.9	183.1	1201.7	780.0	-226.3
Surplus/Deficit after grants	748.3	266.7	1294.1	1028.3	-10.4
Government Savings	1442.1	969.0	2068.8	2538.6	1879.8
Financing					
Foreign, net	-63.7	-282.7	-28.8	-4.5	108.2
Domestic	-684.6	16.0	-1265.3	-1023.8	-97.8
Bank	-638.7	-102.1	-1248.0	-998.5	-82.4
Non-Bank	-45.9	118.1	-17.2	-25.3	-15.4
In per cent of GDP (unless indicated otherwise)					
Revenue (excludin Grants)	47.5	46.9	60.8	60.0	62.9
Customs (in % of revenue)	48.7	51.5	62.2	56.4	58.2
Grants	2.7	0.9	0.9	2.1	1.6
Total Expenditure	41.5	45.0	49.3	53.6	64.6
Surplus/Deficit Before grants	5.9	1.9	11.5	6.4	-1.7
Surplus/Deficit after grants	8.6	2.8	12.4	8.5	-0.1
Government Savings	16.6	10.2	19.8	21.0	14.1
Memorandum item:					
GDP in current prices	8704.0	9328.9	10429.5	12101.9	13378.0

Source : MoFDP and CBL Projections

3.5.3 The overall budget balance and financing

The budget outturn is projected to result in a deficit equivalent to 0.1 per cent of GDP during the period under review. The deficit was mainly attributable to the hike in transfers and subsidies discussed in subsection 3.5.2. This is in contrast to a surplus equivalent to 8.5 per cent of GDP in the previous fiscal year.

The deficit was expected to be financed from foreign sources to the tune of M108.2 million. It should, however, be cautioned that persistent fiscal deficit pose threat to macroeconomic stability.

3.5.4 Recurrent Expenditure by Functions of Government

The bulk of recurrent expenditure for 2008/09 was estimated to go towards provision of community and social services. This accounted for 54.3 per cent of total recurrent expenditure. Education subsector received the largest share of this category at 42.0 per cent. Expenditure on education was directed to infrastructure development, bursaries and subventions to institutions of higher learning. This share reflected Government commitment to provision of quality education from primary through tertiary level.

Social security and welfare was the second largest recipient of spending on social services at 33.1 per cent. The thrust of social welfare during the year was the provision of old age pensions to elderly people aged 70 years and above, as well as, support to vulnerable people. In response to the HIV and AIDS scourge and other chronic illnesses, expenditure on the health subsector took the third largest share, occupying 18.6 per cent. This spending went towards provision of drugs and preventive measures in the form of awareness campaigns.

General government services continued to be the second largest spending category at 32.7 per cent of total recurrent expenditure. This mainly went towards the general public service, public order and safety, and defence. Expenditure on economic services constituted 6.8 per cent of recurrent spending. Agriculture was estimated to constitute 44.1 per cent of the economic services, followed by transport and communication, and mining and industry.

3.6 Public Debt

3.6.1 Overview

Outstanding public debt grew by 32.9 per cent during 2008, mainly driven by currency depreciation. External debt accounted for 90.7 per cent of total public debt compared with 9.3 per cent of domestic debt. As a result, a slight currency movement dictates direction of debt growth. This was complemented by improvement in implementation of Government projects during the year.

As a ratio of GDP, public debt stood at 55.0 per cent, in contrast to 45.5 per cent recorded in the previous year. External debt constituted 49.9 per cent of GDP, compared with a 5.1 per cent of domestic component. Domestic debt was mainly issued for monetary policy purposes. It is worth noting that though the current ratio is approaching 60 per cent sustainability threshold , the nature and structure of Lesotho's debt still makes it sustainable. Concessional debt as a share of external debt stood at 97.0 per cent, with an average lifespan of 40 years.

3.6.2 External Debt

The level of external debt grew by 38.0 per cent during the period under review, mainly due to currency depreciation. This is on top of the rise that was aided by improvement in projects' implementation. Accordingly, loans from bilateral creditors and multilateral institutions grew by 31.8 per cent and 40.6 per cent, respectively. Consequently, multilateral loans accounted for 91.9 per cent of the external debt portfolio, while loans from bilateral creditors and financial institutions constituted 6.0 per cent and

Table 6

PUBLIC DEBT INDICATORS FOR END OF YEAR

(Percentages)

	2004	2005	2006	2007	2008
Total debt as % of GDP	55.9	51.4	51.2	45.5	55.0
External debt as % of GDP	48.3	44.3	44.6	39.7	49.9
Domestic debt as % of GDP	7.6	7.1	6.6	5.7	5.1
External debt as a % of total	86.4	86.2	87.2	87.4	90.7
Domestic debt as a % of total	13.6	13.8	12.8	12.6	9.3
Concessional as % of External debt	78.5	83.7	84.4	93.6	97.0
Debt service ratio(1)	7.1	10.3	4.2	6.8	6.8
Debt service ratio(2)	11.6	17.0	7.0	11.5	10.9

Source: MoFDP

(1) Ratio of debt service to exports of goods and services, including factor income
(2) Ratio of debt service to exports of goods and non-factor services, excluding factor income

1.2 per cent of foreign debt, respectively.

Concessional debt increased to 97.0 per cent, against 93.6 per cent in the previous period. In addition, about 75 per cent of public debt had remaining maturity of more than 15 years. This confirms Government's commitment to concessional financing.

As earlier mentioned, the largest share of debt financed provision of infrastructure, with a marginal portion provided towards supporting poverty reduction. The largest share of debt, 24.7 per cent, was expended in financing ground transport, followed by education related infrastructure at 17.6 per cent while energy accounted for 14.9 per cent.

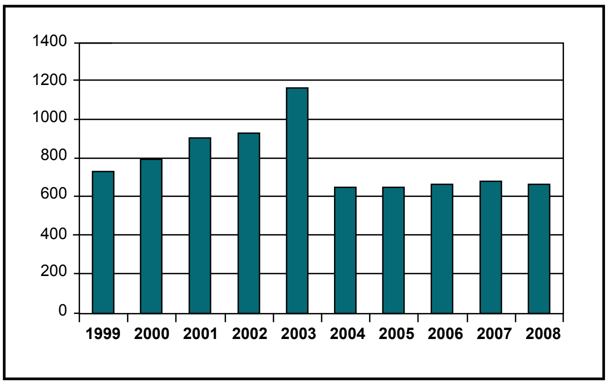
External debt sustainability indicators exhibited mixed signals during the review period, with debt to GDP ratio suggesting worsening sustainability position. The 55 per cent of GDP is not desirable, especially when global economy is experiencing a downturn. The debt service ratio was recorded at 2.5 per cent compared with 6.8 per cent in the previous period. Excluding factor income, debt service ratio improved from 11.5 per cent in the previous year to 10.9 per cent in the review year. This is in contrast to debt to GDP ratio which has increased in response to currency depreciation.

3.6.3 Domestic Debt

Domestic debt comprises treasury bills issued for monetary policy purposes, and a 10 year bond issued for restructuring of the financial sector. The bond, which is due to retire in the fiscal year 2009/2010, remained unchanged during the period.

Short term debt, which was held by the bank and non-bank sectors, fell by 2.3 per cent. This largely reflected a 34.3 drop in holding of debt by the non-bank public, which more than offset a 3.3 per cent rise in holding by the banking sector. This is despite introduction of two longer dated tenures. The banking sector continued to dominate holding of short term debt at 89.2 per cent.

Figure 10: Government Domestic Debt
(Million Maloti)



BOX 4: THE GOVERNMENT OF LESOTHO ESTABLISHES THE DEFINED CONTRIBUTION PENSION SCHEME FOR ITS EMPLOYEES

During the 2008 Budget Speech, The Minister of Finance and Development Planning announced the Government of Lesotho (GoL)'s intention to reform pension scheme for its employees in the fiscal year 2008/2009 by switching from the Defined Benefit (DB) scheme to the Defined contribution (DC) scheme. This would be applicable to all employees of age 40 years and below. With the DB scheme also known as final Salary scheme, the amount of pension payable to the pensioner upon retirement depends mainly on three factors: i) the length of time served under the scheme ii) final pensionable salary (earnings prior to retirement and iii) the scheme accrual rate, which is the proportion of salary that is received for each year of service.

On the other hand, under the DC scheme which is also known as money purchase scheme, both employees and employers contribute to the scheme the amount of money to be invested. In the case of Lesotho, an employee will contribute 5.0 per cent while the government (the employer) will pay 11.2 per cent. In DC scheme, the pension payable also depends upon three factors, namely, the amount of money paid in the scheme both by the employer and the employee, the performance of the investment funds and the 'annuity rate', a factor used to convert the invested pool of funds into pension upon retirement

The pension funds in Lesotho are likely to have an impact on macroeconomic variables such as household saving and consumption and fiscal position of government. Household consumption expenditures are summarized in the household saving ratio which is defined in terms of ratio of household's saving to disposable income, plus the adjustment for the changes in the net equity of households in pension funds. In an environment where there is stable inflation and increased overall income levels, savings, an important factor in capital formation, may be positively influenced. On the other hand, introducing these types of pension schemes is likely to introduce predictability in the statement of government operations as there will certainty in terms of the amount of pension liability and its mode of financing. Moreover, this new development will reduce annual recurrent budget thereby giving more room to capital budget.

The Government has undertaken this pension reform at the background of problems realized under the Defined Benefit Scheme. First, if unforeseen demands loom during a certain year, then under DB, the pension payable would be reduced because it would be paid out of recurrent budget. This is unfavourable on the side of the pensioner because it would make him/her worse off and it would be problematic because the government's liability may not be adequately estimated. Secondly, if the pensioner dies the payable pension ceases, thereby leaving a series of economic and social problems to the beneficiaries. But under the new scheme, the pensioner would receive a share of the contributed fund as well as the interest accrued over the years of service.

Finally, the reform and development of pension funds is likely to contribute to the development of financial markets. As more funds are available, such funds will need more products that will be invested, which is a welcome attempt in the development of capital and money markets. This augurs well for the Central Bank efforts to develop financial markets in Lesotho.

4.1 Supervision Department

4.1.1 Supervision of Banks and Non-Bank Financial Institutions

In addition to the core functions of on-site examinations and off-site monitoring of financial institutions, a further detailed review of the Financial Institutions Act 1999 was undertaken during the year. The main purpose of the review was to align the Act with the evolving developments in the financial sector as well as best internationally accepted standards. It is hoped that the draft Bill will be submitted to Parliament in 2009.

Strategic developments were seen in the banking industry in 2008. One of the banks that hitherto had been operating as a foreign branch converted its status to a fully fledged subsidiary. With the conversion came the creation of a new branch and the expansion of the automated teller machine (ATM) network. In fact all the commercial banks substantially increased their outreach through installation of a number of new ATMs. The banking industry was, however, greatly challenged by the rising incidents of fraud and spate of robberies.

Under the Millennium Challenge Corporation programme of assistance to Lesotho, preparations are afoot for the establishment of a credit bureau that will facilitate the exchange of financial information and the screening of prospective borrowers. Furthermore, developments towards the strengthening of the commercial court as well as the establishment of a national identity system are on track. A consultancy has been commissioned to propose amendments to the existing laws and to draft new legislation necessary for the implementation of the credit bureau. The requisite laws relate to privacy, national identity system, credit information systems and trans-border flows of credit information.

With regard to the non-bank financial subsector, a lot of preparatory work for the implementation of the Rural Financial Programme (RUFIP) of the International Fund for Agricultural Development (IFAD) has been completed. Activities undertaken include the collection of microfinance laws and regulations within SADC countries and beyond with the aim to develop a regulatory framework for the microfinance sector. FIRST Initiative has identified a consultant that will assist with the drafting of the framework in the new year.

In the 2007 report, a mention was made of action taken by the Bank against two institutions that were illegally accepting deposits from the public. In 2008, investigations into the operations of those institutions were completed with the assistance of a renowned firm of accountants and reports were duly submitted to the High Court. In both cases, the Court ruled that the institutions were indeed operating illegally. Applications for liquidation have been lodged with the High Court by the Bank and the final outcome is awaited.

4.1.2 Supervision of the Insurance Industry

The Insurance Act no. 18 of 1976 mandates the CBL to supervise the insurance industry. During the period under review the industry consisted of 26 insurance brokers and 5 insurance companies. Four (4) insurance brokers applied for deregistration. The reason for the application for deregistration as explained by them, was that the industry was too competitive for small insurance brokers. Two (2) insurance brokers were deregistered by CBL due to non-compliance with Regulation 19(2) of the insurance Regulations of 1985 which requires an insurance broker to transmit the insurance premiums collected from the policyholders within 60 days of receipt. These insurance brokers are DIB International and Wealth.

On- site inspections of all insurance companies were conducted in 2007 by CBL through the Insurance Supervision Division. The main objectives of the inspections were to determine the financial condition and soundness of the insurance companies as well as the compliance with statutory and prudential requirements of the Insurance Act no. 18 of 1976 and its' implementing regulations. One company did not comply with section 45 of the Insurance 1976 which deals with margin solvency. A directive in this regard has been issued requiring the company to comply on or before 31 March 2008.

The accuracy and completeness of the statutory returns submitted periodically to the Central Bank of Lesotho were also verified.

In an effort to promote interaction between insurance companies and the insurance brokers, CBL continued to hold quarterly meetings with the Chief Executives of the insurance companies and Chief Executives of the insurance broking companies. In both cases, all issues of concern were discussed and measures taken, where possible, to deal with them. During these meetings a resolution was made to establish association of insurance brokers which will be used to police the industry, especially with regard to unlicensed insurance brokers operating in the insurance industry. The association would also be responsible to take action against its members who contravene the law and are involved in the malpractices in the industry.

4.1.3 Policy and Exchange Control

a) Exchange Control Regime

The Bank is responsible for administration of Exchange Control laws under powers delegated by the Minister of Finance and Development Planning. In addition to Exchange Control laws, the Bank carries out this mandate as a specific function in terms of Section 7 of the Central Bank of Lesotho Act 2000.

b) Applications to sell Foreign Currencies

Lesotho acceded to the IMF Article VIII in 1997. Consequently, it embarked on a substantial, but gradual abolition of many restrictions over current account transactions. A lot of restrictions on capital account transactions were also relaxed.

In view of Lesotho's peculiar circumstances of an economy that is intertwined with that of South Africa and its membership in the Common Monetary Area (CMA), the Central Bank has a responsibility to ensure that the country is not used unlawfully as a conduit through which South African exchange controls can be undermined.

In 2008, seventy-nine (79) applications were submitted by Authorised Dealers to Exchange Control for approval. The total amount of M734,179,676.48 was approved for outward transfer. The payments were in respect of professional services, management fees, dividends, royalties, insurance premiums and off shore investments by institutional investors.

c) Capital Account Liberalisation

The gradual move away from stringent controls brought new developments in the realm of capital account transactions. These developments included the opportunity for residents to make capital investments outside the CMA. The indicative limits for these transactions were categorised into regions like SADC, Africa and the rest of the world.

Another development was the opportunity for residents to operate foreign currency accounts in Lesotho. The number of Foreign Currency Accounts (FCAs) held by individuals remained small at only five (5) accounts during 2008. The small number reflects lack of interest on the part of individuals for this type of service because it brings little reward by way of interest earned.

To the contrary, interest in accounts held by juristic persons, namely Customer Foreign Currency Accounts (CFCs) remained high. The number of these accounts increased from forty (40) in 2007 to forty-four (44) in 2008. Although the number of accounts did not increase significantly, many of the accounts recorded big increases in amounts held.

Although the accounts offer a hedge against fluctuations in exchange rate, there seems to be little interest in operating them. The manufacturing companies which constitute the bulk of CFC account holders manage exchange rate risk through these accounts when they make payments for raw materials and related trade expenses.

d) Cross-Boarder Foreign Exchange Transactions Reporting System

Since its introduction in 2006, the Cross Border Foreign Exchange Transactions Reporting System has been plagued by all sorts of problems. During 2008, two of the Authorised Dealers (ADs) continued to experience difficulties during transaction reporting. One AD encountered problems of classification of transactions while the other one had difficulty in reporting transactions to the Bank. Although by the year end there have been improvements at both institutions, the situation is still far from the ideal.

The Reporting System is a useful tool for reporting actual inflows and outflows of funds among and between member countries of the CMA. The reports give a comprehensive picture of funds movements for balance of payments purposes.

e) Anti-Money Laundering / CombatingFinancing of Terrorism (AML/CFT)

The long awaited Anti-Money Laundering Law, the Money Laundering and Proceeds of Crime Act 2008 came into operation in 2008. This was the culmination of sustained efforts by the Bank and the Anti-Money Laundering Task Team. The enactment of this legislation will pave the way for implementation of institutional framework for fighting money laundering and related crimes. The law established the Directorate on Corruption and Economic Offences (DECO) as the anti-money laundering authority and provides law enforcement agencies with an appropriate tool for fighting these types of crimes.

It also provides for establishment of the Financial Intelligence Unit (FIU) which will be charged with the responsibility of receiving, analysing and disseminating financial information to all relevant stakeholders. It will also link the country with relevant institutions all over the world for information sharing on illicit financial activities. In its formative stage the FIU is intended to be housed in the Central Bank of Lesotho.

Following the successful anti-money laundering workshop conducted in 2007, at the invitation of the Bank on behalf of the Task Team, there were further developments in this regard in 2008. Technical assistance was secured from the United States Treasury which is aimed at the following areas: facilitating the implementation of the Money Laundering and Proceeds of Crime Act, 2008; assisting in the drafting and implementation of regulations of the Act; and assisting in the establishment of the FIU Technical Assistance, as it is expected to take off in early 2009.

f) Other Developments

During the review period, the country's first and only independent Bureau de change commenced operations. Due to logistical and technical teething problems, this Bureau de change has not yet made an impact on the market which had, hitherto, been dominated by the large Authorised Dealers. At the end of 2008, two more applications for the Bureaux des change were under consideration.

g) Regional Meetings

The Eastern and Southern African Anti-Money Laundering Group (ESAAMLG) has two statutory meetings per annum. Policy and Exchange Control Division, on behalf of the Bank, attended both the March and August meetings held in Dar es laam, Tanzania and Mombasa, Kenya, respectively. The Central Bank of Lesotho and other members attended and took part in deliberations relating to various sectors. The Bank participates in AML/CFT issues, representing the financial sector, to network and exchange invaluable information with other members in the region.

Policy and Exchange Control Division represented the Bank, hence the country, at the CMA Exchange Control Quarterly meetings held in each of the member countries in 2008. These are consultation meetings held on a rotational basis. The Division also represented the Bank at the SADC Exchange Control Committee meeting held in Botswana in 2008. This is the forum where harmonisation of Exchange Controls in the SADC region is discussed.

4.2 Operations Department

4.2.1 Currency Management

The Central Bank of Lesotho continued to undertake bulk withdrawals and deposits by commercial banks, sort Maloti notes and coins, and repatriate Rand to South Africa.

Management of Currency

Maloti notes and coins issued as at December 31, 2008 amounted to M467 484 654 and M14 175 518 respectively. This represents an increase of 19.48 per cent compared to Maloti issued in 2007 as per table 8 here below.

Table 7

Maloti Issued

	2006	2007	2008
Maloti issued	378 009 003	403 115 838	481 660 173

4.2.2 National Payment Systems

The year 2006 saw the kick-start of the implementation of modernisation strategies of Lesotho National Payment System (LNPS) with the implementation of Lesotho's Real Time Gross Settlement (RTGS) system called Lesotho Wire (LSW). Large value payments system is regarded as key in managing systemic risk inherent in payment systems and was identified as a priority strategy. The Central Bank of Lesotho (the Bank), through the National Payment System (NPS) Division, is still in pursuance of modernising the LNPS to the achievement of its Vision that "By 2015 Lesotho will have a widely accessible, secure, reliable and efficient payment and settlement system. The system shall facilitate and support Lesotho's development objectives"

Legal and Regulatory Framework

The National Payment System Bill (NPS Bill) was drafted through IMF Technical assistance in 2005. This Bill aims at regulating LNPS and was submitted to the Ministry of Finance and Development Planning for onward transmission to cabinet for approval. A Policy paper accompanying the Bill was also prepared and submitted to the same office.

The latest information from the Law Office (the draft office) is that the NPS Bill could be passed to Parliament towards end of 2009 to be enactment. Currently, NPS uses legally binding Rules and Procedures to operate the two systemically important payment systems (LSW and Maseru Clearing and Settlement House). Participants in the afore-mentioned systems have duly signed these Rules and Procedures and have confirmed their commitment to adhere to them.

Automated Clearing House

Subsequent to live operation of LSW, the LNPS modernization project will, as stipulated in the Vision Document, implement the Automated Clearing House (ACH) project. ACH is intended for retail or small-value-high-volume payments as the LSW system deals with large-value payments. There are three types of payment instruments that will be cleared through ACH, namely, cheques, electronic fund transfers and card transactions (debit and credit cards). Implementation of ACH is expected to improve commercial activity through increased speed at which funds will be transferred by reducing clearing cycle. The ACH project was at the design and planning stage as at the end of 2008. It is expected that the ACH implementation process will be finalised towards the end of 2009.

Lesotho Wire Performance

LSW is primarily for processing large-value and time-critical payments and is only open to commercial banks and the Bank as a participant for its own payments and on behalf of the Government of Lesotho. Introduction and implementation of LSW involved heavy capital investment in system's software, hardware, communication/ connectivity costs, and maintenance costs. However, it is not the Bank's objective to recover all these costs (at least not in the interim) as this would jeopardise increased use of the system which is the ultimate aim of the Bank. Therefore, the Bank developed a cost recovery strategy (RTGS Pricing Policy), that seeks to encourage high usage of the LSW system (through minimal fee structure). It also facilitates vigilant and disciplined conduct by the participants through penalties for improper use of the system.

For the year under review, payment instructions processed by LSW stood at 16,904 transactions with the total value of M54.67 billion. From 2007 to 2008, the total volume and value of payments processed rose by 25.94 per cent and 47.35 per cent, respectively. The Bank undertook 5,024 transactions in 2007 and 6,211 transactions in 2008, reflecting a hike of 23.63 per cent while the value jumped by 39.21 per cent.

The volume of participant credit payments was 1,983 in 2007 and 2,271 in 2008, whilst the value for those payments stood at M11.3 billion and M15.21 billion, respectively. In 2007, the participant debits payments volume was 1,992 and it rose by only 4.99 per cent to 2,088 in 2008. Commercial banks made payments totalling 6,415 in 2007 which fell slightly by 1.26% to 6,334 in 2008. Despite the minor decrease in number of transactions, their value increased by 92.82 per cent indicating that payments were of high value. The analysis in Table 9 below provides a comparative analysis of LSW performance for 2007 and 2008.

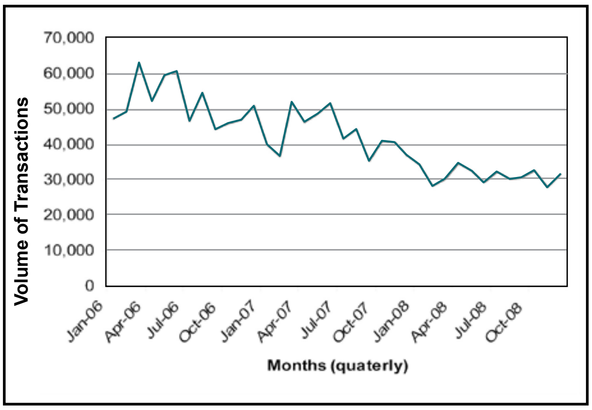
Table 8
Participants' Debits and Credits

Banks	2007		2008		Percentage increase/decrease	
Payments	Volume	Value (M billion)	Volume	Value (M billion)	Volume %	Value %
Central Bank	5,024	3.8	6,211	5.29	+23.63%	+39.21%
Participants credits	1,983	11.3	2,271	15.21	+14.52%	+34.60%
Participants debits	1,992	13.5	2088	17.91	+4.99%	+32.67%
Commercial banks	6,415	8.5	6,334	16.39	-1.26%	+92.82%
Total	13,422	37.1	16,904	54.67	+25.94%	+47.35%

Maseru Clearing and Settlement House (MCSH)

This is another systemically important payment system, which has rules and procedures to be adhered to. MCSH is for clearance of cheques and other small retail payments. The introduction of LSW has resulted in a downward spiral in a number of transactions processed by MCSH. Review of the volume of transactions processed before and after the implementation of LSW reveals that the cheque payments are steadily declining. Overall decrease in volume of transactions processed by MCSH since the implementation of LSW system was 39 per cent, as at end of 2008. This is evidenced by the figure 9 below which shows the trend of transactions processed by MCSH since January 2006 to December 2008.

Figure 11: MCSH Volume of Transactions



Oversight Function issues

The Oversight section of the NPS division was established in 2005 and is manned by three officers: Section Head and two analysts. The section has primarily been involved in policy issues of the division. The oversight framework has been drafted, reviewed with the assistance of IMF consultant and it is awaiting final approval. This framework contains among others, the guidelines and the tools that will be used to perform oversight exercises. That is, it will form the basis of the Bank's oversight function. As part of the framework, a quarterly statistical return has been developed and shall be used to collect data which will be used to monitor developments and risks in payment systems.

The Oversight section undertook a comprehensive self assessment of the LSW system to determine its compliance with the Core Principles for systemically important payment systems, NPS Rules and regulations and International Standards. It was concluded that the system largely complies with the Core Principles, International Standards, rules and regulations, safe from the fact that the NPS Bill has not been enacted.

4.2.4 Rural Finance

Introduction

The year under review has been a challenge for Rural Finance Division (RFD) due to inadequate budgets and shortage in staff complement coupled with additional responsibilities following implementation of the Rural Financial Intermediation Programme. The following are milestones achieved during the period.

Regional countrywide workshops continued where facilitators from the Ministry of Agriculture and Food Security (MAFS), as the main stakeholder, were sensitised and trained on the Rural Savings and Credit Guarantee (RSCG) scheme with the aim of later handing over to them the functions now discharged by the Rural Finance Division . These were followed by educational campaigns in eight resource centres. In addition to the planned sensitisation campaigns conducted throughout Lesotho, 65 groups and 25 individuals were received at the Bank during the period to acquire information and guidance on the RSCG scheme.

A total of ten groups received loans out of which six, comprising 4 from Standard Lesotho Bank and 2 from Nedbank, received loans approved under the guarantee fund during the period under review. However, more loan applications emanating from the districts have been submitted and are currently under processing. Monitoring of financed groups reported satisfactory repayment rates where one group even completed its loan in record time. From this experience, the maximum amount of loan available poses a challenge as most of the groups have concern on its inadequacy. It, therefore, calls for a review upwards which could be addressed during the overall review of the RSCG policy.

The performance of the Credit Guarantee Fund from initial capital of 2.5 million to 2.6 million coupled with repayment rate of 98.69% is testimony that the RSCG scheme is well founded and therefore has potential given the right attention and facilities. This figure excludes funds that were disbursed to settle NGO fees for services rendered during the period of their engagement.

Moreover, the International Fund for Agricultural Development, through a joint venture of IFAD and Lesotho Government has offered assistance to strengthen activities under the RSCG scheme to include capacity building of rural groups and training of service providers in collaboration with the Rural Finance Division. In line with this, sensitisation campaigns to active self help groups in the rural areas were conducted jointly by the Division and the established Rural Finance Intermediation Programme (RUFIP) coordinating unit. The Division also participated in monitoring and evaluation (M&E) workshops organised by M&E unit within RUFIP in the four project pilot districts of Quthing, Maseru, Leribe and Berea. The above workshops combined both RSCGs and cooperatives in preparation for a possible takeover of all groups by cooperatives.

RSCGs quarterly Steering Committee Meetings were held during the year under review and among the important issues raised were re-engagement of Non-Governmental Organisations for training and monitoring of groups and purported exorbitant bank charges imposed on RSCGs' bank accounts. Action to resolve these matters is due by CBL Management.

Sensitisation campaigns were cut short by inadequate budget provisions hence narrowing the intended countrywide coverage of the scheme. Besides, the capacity of only two personnel within RFD hampers a smooth and continuous flow of work especially with added responsibilities by RUFIP. Inadequate capacity by facilitators in training and monitoring of RSCGs calls for financial resources to engage NGOs especially when IFAD supports engagement of one service provider in two districts only.

4.2.3 Development Finance

(a) Development Fund

The Government of Lesotho has, for some time, been considering the idea of establishing a Development Fund as one of the instruments which will be used in development of the private sector. However, for some time, it has been very difficult to make a decision on how to implement this idea because of some impediments which needed to be addressed first. Some of the concerns from the stakeholders are the following: risk sharing; institutional arrangements; structural impediments; and other issues such as the mechanisms which will be put in place to make sure that all the issued loans to the public will be fully recovered when they fall due and the Fund itself will be sustainable.

The Development Finance Division has reviewed and made proposals regarding the improvement of the proposed Development Fund so as to address the concerns raised by the stakeholders regarding the effective and efficient running of this Fund.

(b) The revision of the Export Finance Scheme

The Export Finance Scheme had to be revised due to the fact that the Scheme could not be accessed by the indigenous small scale exporters because of some conditions which they could not meet, yet they are the most targeted group of exporters. This is done so as to address the question of unemployment and poverty. It is hoped that with these proposed changes, with regard to the conditions to be met by exporters, the indigenous small scale exporters will be able to access the Scheme.

4.3 Financial Markets Department

4.3.1 Foreign Reserves Management

There were no changes to the broad approach of managing the Country's foreign reserves in 2008. However, major changes are expected in 2009 following review of Reserves Management Policy and Guidelines that was undertaken in 2008 and expected to be completed in 2009. The reasons for the review of the two policy documents were their expiry and new inputs from the Reserves Advisory Management Programme of the World Bank, which the Bank joined in late 2007, but implemented in 2008.

Money and Capital Markets Development

The first phase of the new developments that were proposed in 2007 was completed in 2008. This phase focused on development of the money market. The improvements include introduction of the revised Local Loans (Government Treasury Bills) (Trading) Regulations 2008 that came into effect in September 2008. The developments are efforts by the Government, the Central Bank and other stakeholders to improve both the money and capital markets. This phase also includes the following improvements:

- increased number of tenures of Trea sury bills from two to four issues, with the introduction of the 273 and 364 day issues;
- extended maturity profile from six months to one year;
- increased frequency of auctions from monthly and bi-monthly for the 91 and 182 days respectively, to twice every month for all tenures;
- improved communication between the Bank and other financial institution by establishing the Financial Markets Forum which meets monthly to discuss issues pertinent to the development of the market;
- establishment of the Reuters Pages, LTB1 and LTB2, for reporting auction announcements and results; and
- improved communication between the Bank and the Ministry of Finance's Debt Management Office. The second level of reforms to be undertaken in 2009 will focus on the Treasury bond market.

4.3.2 Securities Trading

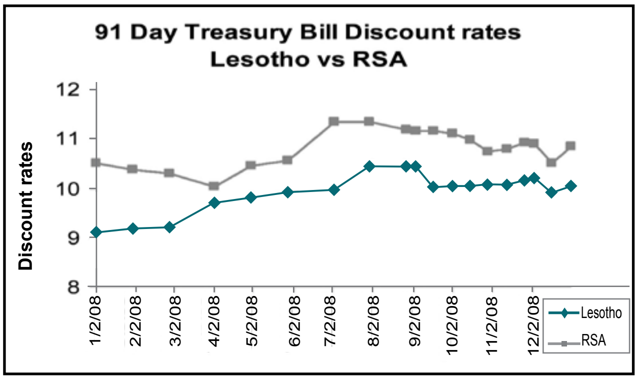
The Bank continued to conduct auctions of both 91 and 182 day Treasury bill securities monthly and bi-monthly for the two securities respectively, until August 2008. From September 2008, four tenures were auctioned on a bi-weekly basis. Total amounts outstanding as at 31st December 2008 on all issues were as per the schedule below:

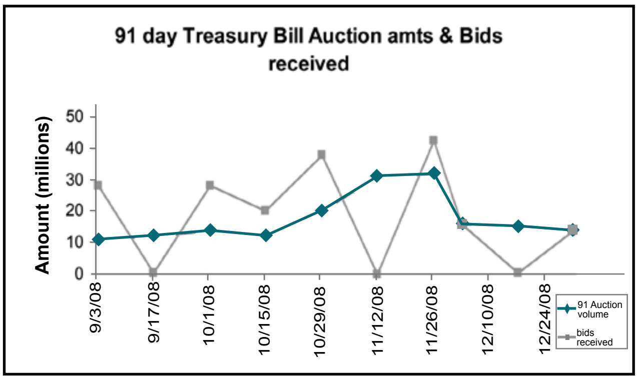
Table 9

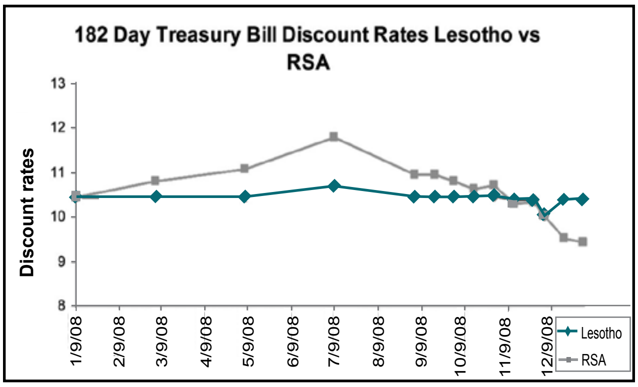
Outstanding Treasury Bills

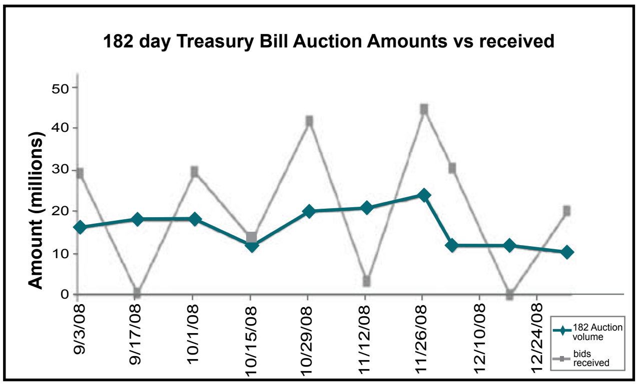
Maturity	Amount Outstanding as at 31st December 2008 (Maloti)
91 day	82,586,700
182 day	115,500,100
273 day	125,296,600
364 day	121,794,100

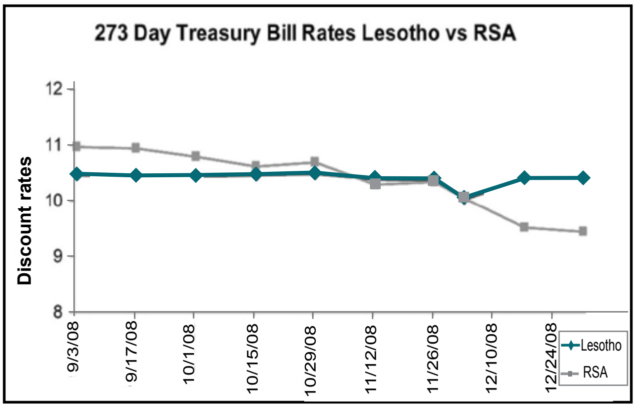
The Lesotho market clearing discount rates for the first three tenure compared with those of South Africa are as depicted below:

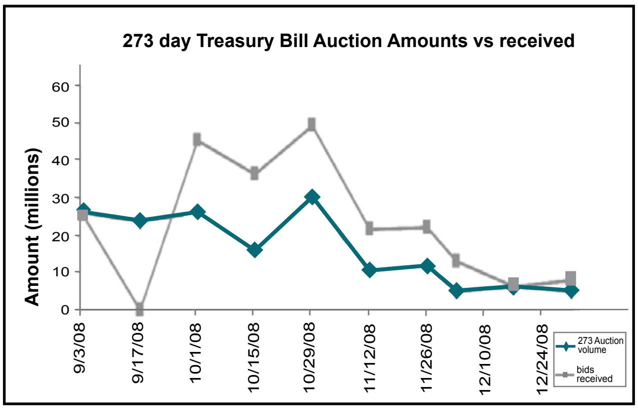




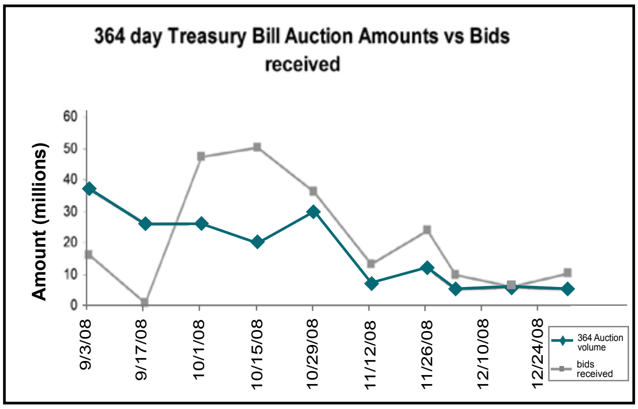








The graphs on the right show the extent of over and under subscriptions for all tenures of Treasury bills from January to December 2008.



4.4 Research and Publications

The Central Bank disseminates information of the Lesotho economic environment and its relationship with the international community through its publications such as; Monthly Economic Reviews, Quarterly Reviews and Annual Reports. Research papers were also produced in view of advising government and management of the Bank. In 2008, the following research assignments were undertaken:

- Monetary policy Shocks and their Effects on Output
- Inflation Targeting Regime in South Africa – implication for Lesotho
- Inflation and Economic Growth An estimates of an Optimal Level of Inflation in Lesotho
- Interest rate Determination in Lesotho – Fundamentals and Policy Options
- Soaring Global Food Prices – Nature, Causes and Responses: The case of Lesotho
- Anatomy of the Manufacturing Sector in Lesotho – How Deep are the Roots
- The role of Fiscal Reforms in Lesotho
- The Impact of Trade Liberalisation on Fiscal Policy: the Case of Lesotho

The Bank continued to conduct annual Private Capital Flow's (PCF) survey in order to improve the Balance of Payments and International Investment Position Statistics. The third cycle of the PCF was undertaken in 2008. In addition, the Bank undertook the credit survey in Lesotho.

4.5 Administration Department

4.5.1 Human Resource Management

(a) Growth of Human Resource Function

A new Department of Corporate Affairs with three divisions was formed in order to consolidate all relevant functions under one Department. This exercise resulted in migration of one Division from the Department of Supervision to the new department.

(b) Schemes of Service Review

The Bank completed the review of its Schemes of Service which started in 2007. A revised set of Rules and Regulations shall be implemented at the beginning of the new year. In the meantime, more urgent policies were processed for immediate implementation during the course of the year.

(c) Safety, Health & Environment (SHE) Section

New policies regarding health and safety within the Bank were developed for simultaneous implementation with the revised HR policies, more especially the Integrated Employee Wellness Programme that covers HIV/AIDS. There are no reportable injury-on-duty cases in the year under review.

(d) Recruitment

Twenty-one new members of staff were recruited at various levels and Divisions in the Bank. Vacancies continued to occur particularly during the second half of the year as a result of implementation of a new policy on early exit. Staff members who had attained an approved age opted to take up early retirement.

(e) Training

Out of thirteen (13) members of staff who were on this year's approved training programme, three (two post-graduates and one first degree) have successfully completed their studies while others are still continuing.

(f) Separation

Eleven members of staff separated from the Bank during the year from the level of Director to professional staff. There were five retirements, five resignations and one death.

(g) Promotion & Movement of Staff

During 2008, six members of staff were promoted: three within their grading levels and three to higher positions. Furthermore, three members of staff were transferred to different positions.

(h) Community Service

As part of community service, members of staff this year teamed up with World Vision through its support project to AIDS orphans in Mapoteng area. Bank staff assisted to build key-hole gardens for growing vegetables, planted a field of potatoes as well as providing clothes and Christmas groceries for the orphans.

(i) Death

The Bank lost one of its security officers, Mr. Mosala Mosala, through an accidental death. May his Soul rest in peace.

(j) Social Activities

The Bank continued to demonstrate its concern for the social welfare and general well-being of the people of Lesotho, by providing financial and other forms of support to selected projects and causes. A school in Motšoanakaba, Mantšonyane was assisted with the construction of two classrooms. Financial assistance was also extended to a charitable organization, in an endeavour to help the less privileged in Lesotho's rural communities.

The Bank also participated in a fund-raining endeavour of the South-African High Commission, by contributing to its Women's Day celebrations. In this regard, selected female staff members attended these celebrations, with the main objective of raising funds for needy causes and projects.