CENTRAL BANK OF LESOTHO

ANNUAL REPORT

2012

Maseru

March 2013

BOARD OF DIRECTORS

R. A. Matlanyane	-	Governor & Chairman (Board)
M. P. Makhetha	-	Deputy Governor I
M. G. Makenete	-	Deputy Governor II
P. M. Mangoaela	-	Director
O. Letebele	-	Director
M. Rapapa	-	Director
M. Posholi	-	Director
S. Malebanye	-	Director

MANAGEMENT

R. A. Matlanyane	-	Governor
M. P. Makhetha	-	Deputy Governor I
M. G. Makenete	-	Deputy Governor II
S. Ntelo	-	Director of Operations
M. Mohasoa (acting)	-	Director of Supervision
T. F. Sefali	-	Director of Administration
B. Phakoe	-	Director of Financial Markets
M. S. Mahooana	-	Director of Information & Communication Technology
P. L. Mohapi	-	Director of Research
M. Malope	-	Director of Corporate Affairs
M. Mohapi (acting)	-	Director of Finance
M. Mpheteng (acting)	-	Director of Enterprise Risk Management
P. Letlela (acting)	-	Director of Internal Audit
M. Mthwalo	-	General Manager – Lehakoe Recreation and Cultural Centre

DIVISIONAL HEADS

Governor's Office

M. 'Nyane (acting)	-	Security

Administration

M. Molekane	-	Human Resources
T. Malataliana	-	General Services & Maintenance

Information and Communications Technology

R. Motjolopane (acting)	-	Business Solutions Development
T. Makula (acting)	-	Infrastructure & Operations

Operations

J. Ntšekhe	-	Banking Operations
M. Motebang	-	National Payment Systems
L. Ratia	-	Currency

Supervision

N. Sixishe	-	Financial Institutions Supervision
N. Bereng	-	Non-Banks Supervision
F. Morokole	-	Insurance Supervision
T. Makau (acting)	-	Deposit Protection

Financial Markets

B. Phakoe	-	Dealing and Strategy
M. Mochebelele (acting)	-	Reserves Management
M. Thamae (acting)	-	Market Risk

Research

M. Fuma (acting)	-	Finance
S. Khoabane (acting)	-	Real Sector
L. M. Lephoto	-	Macroanalysis

Corporate Affairs

N. Mokitimi (acting)	-	Legal Services
S. Letsie (acting)	-	Corporate Governance
T. Mohasoa (acting)	-	Public Relations

Finance

M. Mohapi	-	Accounts & Budget
L. Khaka	-	Treasury Operations

Enterprise Risk Management

M. Mabote (acting)	-	Risk Management
M. Sekoati (acting)	-	Business Continuity Management

Internal Audit

P. Letlela	-	Chief Internal Auditor

Central Bank of Lesotho
P O Box 1184
MASERU 100
Lesotho

March 28, 2013

Honourable Minister
Ministry of Finance
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 2012, 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, 2012, certified by Deloitte and Touche and Letacc ; and

    ii) a report on the Bank's operations and statement of affairs during 2012.

Yours faithfully

A. R. Matlanyane *(Ph.D.)*
GOVERNOR

Table of Contents

PART I PROSPECTS OF THE TEXTILE AND APPAREL INDUSTRY IN LESOTHO

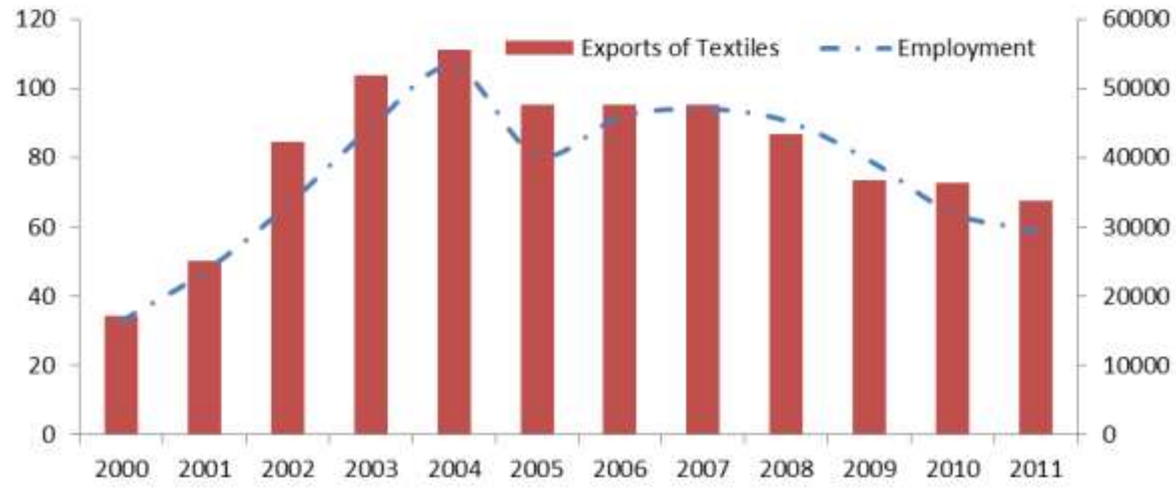
1.1 Introduction

The manufacturing sector, particularly through the clothing and textile sub-sector, has over the years been a key driver of the Lesotho's economy. In 2011, for instance, the sector's contribution to GDP was 17.0 per cent. The clothing and textiles sub-sector accounted for more than 90.0 per cent of that contribution. Further to that, the sector is currently the second largest formal employer with about 29,500 employees presently, second only to the Government of Lesotho. At the peak of its powers in 2004, the sector employed more than 45, 000 people. At the time, it had surpassed the GOL as the largest formal employer in the country. The performance of the clothing and textile sub-sector has been on a progressive decline since 2005 due to a plethora of challenges, which have since intensified. It is in light of these challenges that the prospects of the sub-sector need to be faithfully and frankly scrutinised. That this the chief aim of this article. A brief overview of the sub-sector's performance prior to AGOA to date is presented followed by a restatement of fairly well known challenges that have dogged the sub-sector. The section closes by drawing some conclusions about its prospects for the future.

1.2 Overview of Performance

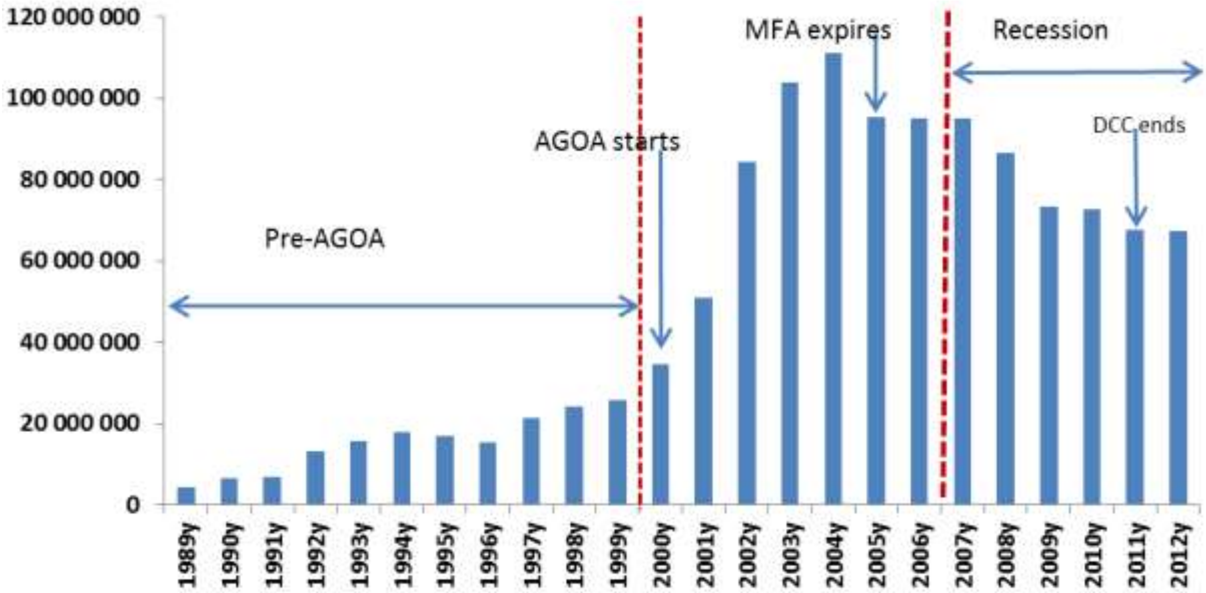
Prior to the enactment of the African Growth and Opportunities Act (AGOA) by the United States (US) Government, the textile and apparel industry was a very small in terms of its contribution to GDP. Total units exported just before enactment of AGOA was just 25.8 million square metres in 1999. However, following the enactment of the AGOA in 2000 the industry gained prominence. In 2001, the units of textile and apparel exported to the US jumped from 34.3 million square meters to 50.9 million square metres, representing a 48.8 per cent growth (Figure 2). The textile and apparel exports continued on an upward trend until at least 2004. The level of employment also increased from a low of 16,417 in 2000 to a peak of 53,087 in 2004 and in 2011 it stood at 29,500. In 2005 performance of the textile and clothing took a slide and was affected by the expiry of the Multi-Fibre Agreement. The expiry implied that other low-cost producers could also export to the US market. The situation was further exacerbated by the on-set of the recession in 2008. Since the onset of the economic and financial crisis, the unemployment rate in the US has been rising and in 2010 it reached a high of 10.0 per cent compared with 4.4 per cent before the financial crisis. The high unemployment rates led to weak consumer demand in the US and as a consequence demand for textile and clothing imports also declined. In 2011 performance further deteriorated following the end of the Duty Credit Certificate (DCC) scheme. As can be observed in Figure 1 performance deteriorated slightly. The next section discusses the challenges facing the sector, which threaten existence of the industry beyond 2012.

Figure 1: Exports of Textiles to the US vs. Employment in the Textile and Apparel Industry



Source: Lesotho Textile Exporters Association and US Department of Commerce

Figure 2: Textile and Apparel Exports to the US Market (Square Metres)



Data Source: US Department of Commerce

1.3 Threats and Challenges to the Industry

The following challenges and threats to the sustainability of the sub-sector have been identified and analysed in various studies and documents:

1. The eventual (now impending) expiry of AGOA
2. The expiry of Multifibre Agreement
3. Phase out of DCCS
4. Inadequate infrastructure (factory shells, waste treatment plant, etc)
5. Undiversified product lines and markets
6. Old equipment and out-dated production processes
7. Relatively inhibiting business environment
8. Lack of competitiveness

Perhaps the most notable and the one that threatens sustainability of the sub-sector the most is lack of competitiveness. Lack of competitiveness drives business to bankruptcy. In this instance lack of competitiveness, if it continues unabated, will eventually lead to the collapse of the sub-sector. Specifically, Lesotho competes with countries like Bangladesh, Vietnam and Cambodia. Scientific evidence shows that these countries have been gaining competitiveness while Lesotho has been losing the same over time. The remainder of the section focuses on this threat and highlights three elements to that contribute to it the most. These are operational costs, lead times and exchange rate fluctuations.

1.4 Loss of competitiveness

The textile and apparel manufacturers in Lesotho have become less competitive compared to their competitors in Asia and Africa, owing to amongst others burgeoning operational costs. Table 1 below shows that the minimum wage in the textile and clothing in 2010 was fairly high compared to its competitors. In 2010, the minimum wage was USD125 compared with approximately USD50 in other countries. Textile exporters are also subjected to import and export charges while in other countries such charges are non-existent (Table 1). This places Lesotho at a disadvantage in terms of product pricing and ultimately receipt of orders.

Table 1: Cost Comparison across Countries in 2010

	Lesotho	Vietnam	Cambodia	Bangladesh
Minimum Wages	USD125	USD53	USD55	USD45
Import Cargo Due	632.5 per 40'container	0.0	0.0	0.0
Export Cargo Due	314.1 per 40'container	0.0	0.0	0.0

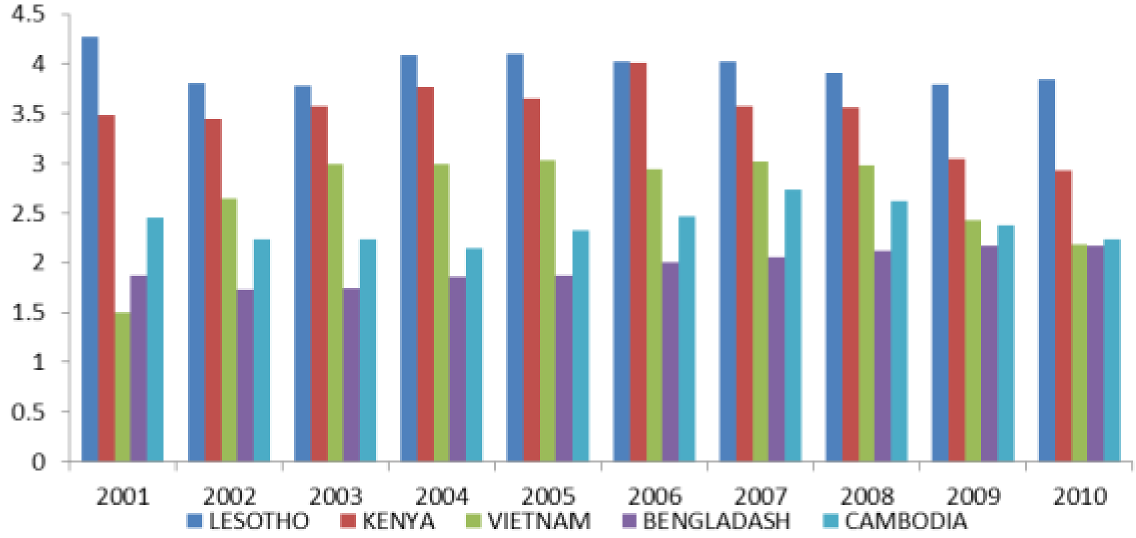
Source: Lesotho Textile Exporters Association (LTEA)

Figure 3 shows an approximate price (in US dollars) per unit of apparel exported. As shown in Figure 3, the price of a unit of apparel for Lesotho has consistently been above those of its competitors implying that the costs of producing garments are much higher in Lesotho relative to other countries. Since Lesotho is landlocked, it incurs huge inland costs of transporting raw materials and finished products to the ports in South Africa which is not the case in countries such as Vietnam, Cambodia, Taiwan and Bangladesh. The production base in these countries is located adjacent to the ports. This reduces the profit margins of the local textile manufactures and therefore their ability to price their products competitively and as a result loose orders to relatively cheaper countries.

Further, textile producers in Lesotho face higher utility costs compared to its competitors. Prices of both water and electricity have been rising quite sharply, and these costs are a major concern as they account for a large proportion of overall production costs. Recently the tariffs for high volume industrial users and low volume industrial users were increased by 23.5 per cent and 21.4 per cent, successively. Electricity tariffs were revised upwards by more than 10.0 per cent each year from 2009 to 2011. Water tariffs were increased by 20.0 per cent in April 2008, following single digit rates of increase of less than 9.0 per cent since 2004.

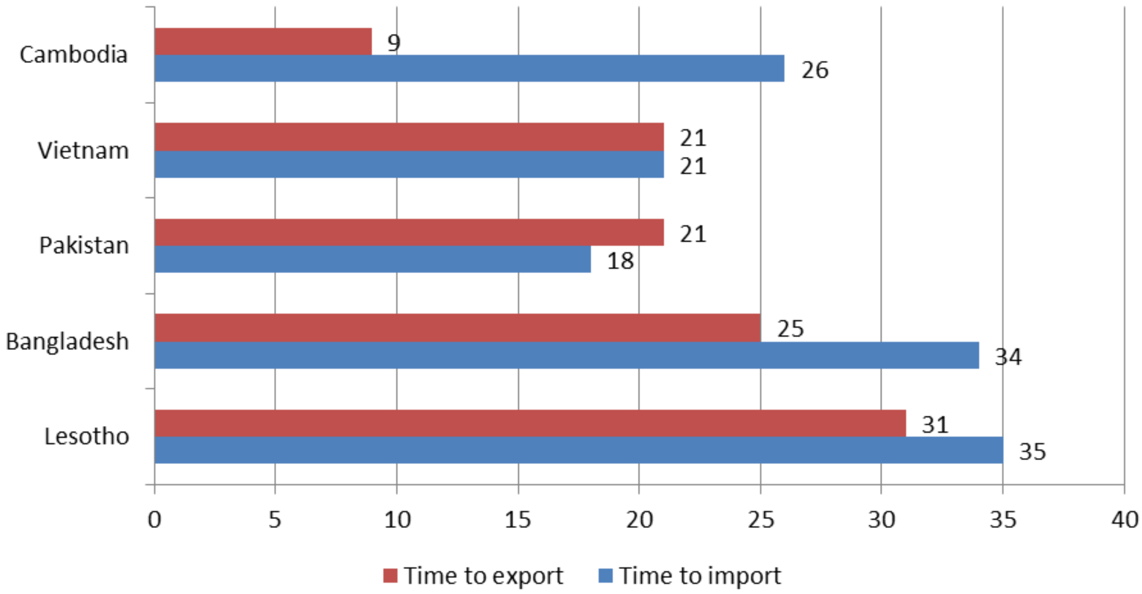
Low labour productivity in Lesotho compared to its competitors is another important factor inhibiting competitiveness of the industry. Empirical evidence shows that the productivity level in Lesotho's textile industry is 50.0 per cent lower than in Asian competitors.

Figure 3: Prices per Unit Exported



Data Source: US Department of Commerce

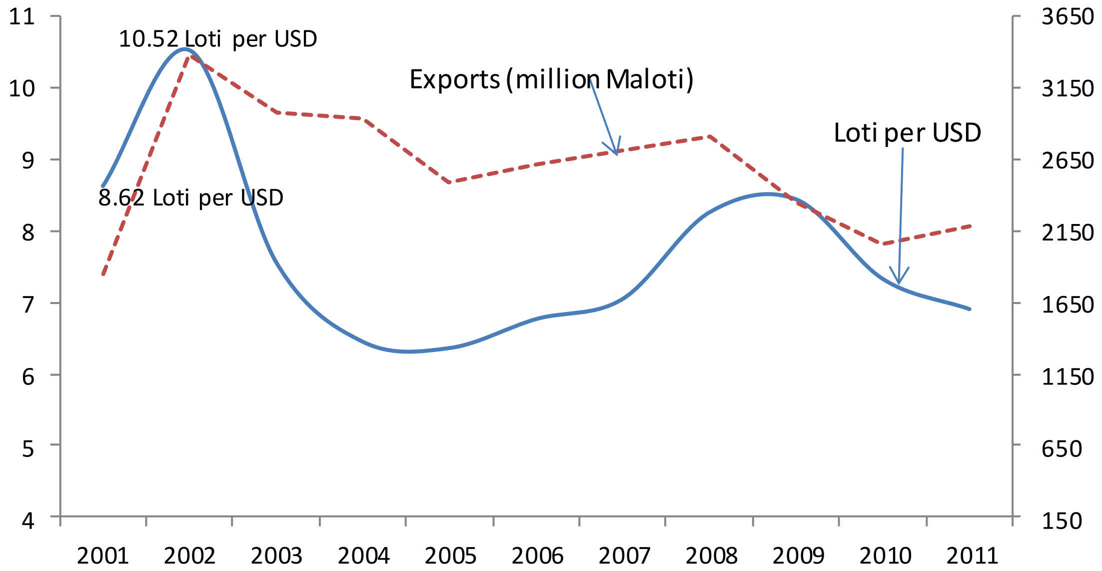
Figure 4: Lesotho and other Textile Exporters: Time to Export (Days)



The other challenge Lesotho faces is that the lead time is very long in Lesotho compared to its competitors. The number of days it takes to import raw materials and export finished products is much longer in Lesotho compared to these other countries because Lesotho is further from the key input markets in Asia than its competitors. As a consequence, existing companies are not as competitive in cost or turnaround time as their competitors. As shown in Figure 4 it takes as much as 35 days for Lesotho to receive the imported materials and 31 days for its finished products to reach the market. For countries such as Cambodia, it takes quite a short period to import and export and therefore US buyers would prefer to place its orders with such countries. Therefore an importer prefers to place orders with whose lead time is shorter and as a consequence finds it difficult to compete with these countries.

The other factor that undermines Lesotho's competitiveness relative to its competitors is the movement in the exchange rate. Textile producers argue that the rand (hence loti) has remained strong over a long period and this has impacted on their export earnings. The movement in the exchange rate also plays an important role in the performance of the textile and apparel industry and hence the sustainability of the industry. When the exchange rate depreciates, export earnings increase and therefore allowing Textile producers to cover their operational costs and therefore price competitively. Similarly, when the exchange rate appreciates it squeezes exporters' profit margins and puts them at a disadvantage in terms of pricing. Figure 5 shows the relationship between export earnings and the movement in the exchange rate. For instance, rand-dollar exchange rate moved from 8.62 in 2001 to 10.52 loti per US dollar and over the same period, the export earnings jumped from M1852.7 million to M3373.2 million. Therefore, the movement in the exchange rate is key to the performance of the textile and apparel industry.

Figure 5: Exports of Textiles (Million Maloti) vs. Loti-USD Exchange



1.5 Conclusions

The textile and apparel industry remains the largest contributor to manufacturing and the second largest employer in the formal sector, after Government. Initially, the performance of the sector has largely been driven by the preferential benefits under AGOA. However, despite these preferential benefits under AGOA, the sector's share in GDP has been dwindling over the years and performance has stagnated recently due to a number of factors. The following are the major factors that pose threat to the existence of the industry; high wages and utility costs, long lead time in Lesotho, the appreciation of the exchange rate between the rand the US dollar and low labour productivity in Lesotho. All these factors undermine Lesotho's competitiveness vis-à-vis its competitors.

PART II: WORLD ECONOMIC DEVELOPMENTS AND THEIR IMPLICATIONS FOR THE ECONOMY OF LESOTHO

2.1 Introduction

The world economic growth in 2012 has been shrouded by uncertainty about the ultimate resolution of the sovereign debt crises despite recent progress. The preliminary estimates from the IMF World Economic Outlook (update January 2013) indicate that world output grew moderately by 3.2 per cent against 3.9 per cent recorded in 2011. Output growth was expected to remain sluggish in advanced economies while a relatively strong growth was expected in some emerging market and developing economies at the back of increased consumer demand and the gains in business investment. Growth in emerging market economies is estimated at 5.1 per cent in 2012 against 6.3 in 2011, while growth in advanced economies is estimated at 1.3 per cent in 2012 against 1.6 per cent in 2011. Growth in advanced economies have been derailed by weak financial system, as banks remained weak in terms of their lending capacity and the much needed fiscal consolidation, which has weighed heavily on demand.

On the other hand a modest growth in some emerging economies was supported by sound domestic policies although others continued to struggle with weak external demand and domestic bottlenecks. In addition, emerging and developing economies were held back by the negative spillovers, which increased commodity prices. The IMF has also pointed to the fact that fiscal cutbacks seemed to have had larger-than-expected negative short-term multiplier effects on output.

According to the IMF a much needed policy action to put the world economy on an elevated and sustainable path would have to focus on the Euro Area. The lessons of the past few years have shown that Euro Area countries can be hit by strong, country-specific, adverse shocks, while weak banks can considerably intensify the adverse effects of such shocks. A new policy direction should therefore aim at reducing the amplitude of the shocks by centralising the supervision, resolution and the recapitalization process for banks to the EU level. However, in the short-term, there will be a need for Italy and Spain to make concerted efforts to follow through with the adjustment plans to re-establish competitiveness and fiscal balance and therefore maintain growth.

Given lessons from the recent global financial crisis and specifically European sovereign debt crises, recent studies have actually pointed to a need for a fiscal union as a condition for the euro to succeed.

2.2 Industrialized Countries

2.2.1 The United States (US)

According to the IMF projections (WEO update, January 2013), annual US GDP growth is estimated to have accelerated from 1.8 per cent in 2011 to 2.3 per cent in 2012. The increase in the growth rate was attributable to positive contributions from personal consumption expenditures, non-residential fixed investment, exports, residential fixed investment, and private inventory investment. However, these positive developments were partly offset by a slowdown in government spending and increased imports.

Despite the improvement in economic growth, the unemployment rate remained unchanged at 8.3 per cent throughout the year. Average annual inflation decelerated from 3.2 per cent in 2011 to 2.1 per cent in 2012. The slower growth reflected the drop in all basket categories during the review period. Due to the stable inflation outlook together with the mandate to continue supporting economic activity the Federal Reserve Bank's Open Market Committee (FOMC) decided to leave the benchmark lending rate unchanged at 0.25 per cent during the review period.

The positive rebound in consumer demand in the US bodes well for Lesotho's exports since most of the domestically manufactured clothing and textiles are destined to the US market.

2.2.2 The Euro Area

The crisis in the Euro Area[1] deepened during 2012. According to the IMF projections, the Euro Area contracted by 0.4 per cent in 2012 compared with an expansion of 1.4 per cent in 2011. The contraction emanated from slow production in countries such as Austria, Finland, France, Germany, Greece, Netherlands, Portugal and Spain due to tight financial and fiscal conditions.

The inflation rate in the Euro Area, measured by changes in the Harmonized Index of Consumer Prices (HICP) fell to 2.5 per cent in 2012 compared to 2.7 per cent in 2011. The European Central Bank (ECB) reduced its key interest rate to 0.75 per cent in the second half of 2012 in order to encourage spending and boost economic recovery. The economic contraction in the Euro Zone does not augur well for Lesotho as most of diamond exports are destined to the region. It is however important to indicate that Europe's

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[1] Euro Area comprises: Austria, Belgium, Cyprus, Estonia, Germany, Greece, Finland, France, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

demand for Lesotho's diamonds to a large extend depends on the appetite of the world's largest consumers of diamonds, being the US, China and India. Moreover, given the growing importance of the diamond sector in Lesotho, this could lead to reduced exports hence worsening the country's current account balance.

2.2.3 Japan

In Japan there was a recovery in the economic growth rate from -0.6 per cent in 2011 to 2.0 per cent in 2012. The recovery was driven by increased domestic demand, particularly by government expenditures. The recovery took place despite the slowdown in the Euro Zone and China, indicating that a large share of expansion was due to increased domestic demand.

On average, the consumer price index in Japan declined by 0.03 per cent in 2012 compared with an annual average decline of 0.28 per cent in 2011. Factors which were responsible for the continuing deflation were the furniture and household utensils category which declined by 1.9 per cent; the culture and recreation category which fell by 1.2 per cent, and the medical care category which declined by 0.7 per cent. The continuous deflation episodes are attributable to, among others, underlying structural weakness such as public attitudes towards price stability, weaker growth expectations coupled with declining potential growth and the risk averse behaviour of banks.

In an attempt to boost economic activity the interest rates in Japan were kept at zero per cent. Japan's unemployment rate declined marginally to 4.6 per cent, compared to 4.7 per cent in 2011. This was higher than the long term average of 2.72 per cent.

2.3 Emerging Market Economies

2.3.1 South Africa (SA)

According to the African Economic Outlook, economic activity in South Africa deteriorated in 2012. Real GDP growth rate fell to 2.8 per cent compared to 3.1 per cent in the previous year. The decline was due to continued weakness in the global economy and domestic structural constraints. Growth of real value added in the mining sector slowed due to strikes, which led to lower production.

The annual average rate of inflation, measured by changes in the consumer price index (CPI) increased from 5.0 per cent recorded in 2011 to 5.8 per cent in 2012. This was attributable to hikes in fuel and food prices, and depreciation of the rand during the period under review. In line with recent domestic and international economic developments, the South African

Reserve Bank (SARB) left the benchmark interest rates unchanged at 5.0 per cent in the last quarter of 2012. This was 0.5 per cent lower than the previous year's rate.

2.3.2 China

China's economic growth decelerated to 7.8 per cent in 2012 compared with the 9.3 per cent growth in 2011. Several factors contributed to this slowdown: firstly, decreased exports, mainly to Europe because of the weak demand in the Euro Area; secondly, the reduction of government investment in public works and the slowdown in the housing market due to government intervention aimed at reducing house prices; thirdly, consumption was slightly lower due to the downturn in the housing market and the market for automobiles.

The inflation rate, measured by annual changes in the consumer price index (CPI) decelerated from an annual average of 5.5 per cent in 2011 to 2.6 per cent in 2012. The deceleration was attributable to a drop in commodity prices during the period. Furthermore, the 2012 producer price index (PPI) dropped by 1.7 per cent from that of the previous year, reflecting a decrease in both international prices of materials and domestic demand. Since Lesotho is the net importer of the raw materials from China, this fall in PPI greatly benefited the country.

However, the low inflation environment prompted the People's Bank of China to lower its key interest rate several times during the year. The key interest rate was reduced from 6.56 per cent in the first quarter to 6.31 per cent in the second quarter and eventually to 6 per cent in the last 2 quarters. The Bank also tried to spur growth by cutting the amount of money banks are required to hold in reserves. The unemployment rate remained unchanged at 4.1 per cent throughout the year.

2.3.3 India

India's economic growth generally slowed down from 7.9 per cent in 2011 to 4.5 per cent in 2012. The slowdown in the economy was as a result of lower industrial output which contracted by 1.8 per cent in 2012. The manufacturing sector which accounts for about 76 per cent of total industrial output shrunk by 3.2 per cent on yearly basis and was therefore the main cause of the economic slowdown. The fall in industrial production was influenced by reduced external demand coupled with low domestic demand. In addition, foreign direct investment fell by 67 per cent during the period under review.

Average annual inflation accelerated from 8.8 per cent in 2011 to 9.3 per cent in 2012. This high inflation was as a result of increased diesel prices. The India's Central Bank kept the key interest rate unchanged at 8 per cent in 2012. The unemployment rate in India stood at 3.8 per cent throughout the year.

2.4 Lesotho in the Context of Regional Economic Integration

Lesotho continued to show strong commitment to economic cooperation throughout 2012 by actively participating in activities of regional economic organizations, namely; the Southern African Customs Union (SACU)[2], Southern African Development Community (SADC)[3] and the Common Monetary Area (CMA)[4].

SACU is an important international agreement for Lesotho since a large share of Government revenue is generated through the customs revenue sharing agreement. SACU revenues, which historically contributed about 60 per cent of Government revenues, declined sharply in 2010/11 and 2011/12 to 31 per cent and 29 per cent, respectively, amid the 2008 global financial crisis. In 2012/13 SACU revenues improved considerably to 44 per cent of total government revenue as a result of improved economic activity in South Africa which resulted in higher imports into the SACU revenue pool.

SACU continued its trade negotiations with Mercado Comun del Sur[5] (Mercosur) during 2012. The SACU-MERCOSUR Preferential trade agreement is still being considered by the Argentine Parliament. In Brazil and Paraguay, the Agreement was approved by the Congress, but awaits approval by the Executive Branch. The Agreement was ratified by both the Congress and the Executive Branch in Uruguay.

On the other hand Lesotho benefits from being a member of SADC as a result of the Trade Protocol which came into operation in 2000. The intention of the protocol was to establish a SADC Free Trade Area by 2008, a custom union in 2010, a common market in 2016, a monetary union in 2016 and an economic union with a single currency in 2018. Generally, SADC-FTA has made significant progress in liberalising trade as most countries have reduced and eliminated tariffs and quotas. Tariffs which remained after 2008 would be on those goods that are regarded sensitive,

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[2] SACU: Botswana, Lesotho, Namibian, South Africa and Swaziland.
[3] SADC: Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.
[4] CMA: Lesotho, Namibia, South Africa and Swaziland.
[5] Mercosur comprises: Argentina, Brazil, Paraguay (suspended), Uruguay and Venezuela.

but those tariffs should have been eliminated or be fully liberalized by 2012. Although this target has not been met, SADC is progressing well in this regard. The 2010 targeted date for the establishment of a custom union was not met and is unlikely to be realised in the near future. This is due to the outstanding issue of the overlapping membership of SADC countries in a number of other similar regional integration initiatives. This means that the process of laying critical foundations for negotiations of the other deeper integration milestones remains a challenge.

SADC has also resorted to liberalizing trade in services bearing in mind that services are critical to the development of most economies in the SADC region. In this regard the SADC Protocol on Trade in Services was approved by the SADC Council and signed by nine of the fourteen Heads of States/Government as at September 2012. Negotiations on the six agreed-upon priority sectors for intra-SADC liberalization (construction, communication, transport, energy-related, financial, and tourism and transport services) however had already commenced in April 2012 (before the signing of the services protocol) and expectation is that they will take 3 years. Subsequent negotiations are envisaged to cover all services sectors.

Negotiations for the Common Market for Eastern and Southern Africa (COMESA), Southern Africa Development Community (SADC) and the East Africa Community (EAC) Tripartite Free Trade Agreement (TFTA) were launched in June 2011 to start with a six to 12 month preparatory phase and actual negotiations to commence in 2012. This tripartite alliance was established in 2005 with the main objective of strengthening and deepening economic integration of the Southern and Eastern Africa region. This is being achieved through various initiatives aimed at harmonising policies and programmes of the three regional economic communities (RECs) in the areas of trade, customs and infrastructure development, and implementing these in a coordinated manner, and wherever possible jointly. In 2012, the member states continued to finalise their internal preparatory processes intended to prepare them for the negotiations. In this regard, SACU held a consultative meeting during 2012 with an intention to prepare for a common position in the areas being negotiated. The negotiations are on areas such as; Sanitary and Phytosanitary measures (SPS), Standards (TBT), Non-tariff barriers (NTB's), Customs Cooperation and Rules of Origin (ROO).

Negotiations for the SADC and European Community-Economic Partnership Agreement (SADC-EC-EPA) continued in 2012 and these are envisaged to end by June 2013. The early conclusion of these negotiations would enable member states to start the processes required for the ratification and implementation of the EPA. As a way to show commitment towards economic integration, SACU continued with other negotiations in 2012 including; SACU-EFTA Free Trade Agreement, SACU-India Preferential

Trade Agreement and SACU-USA Trade, Investment and Development Cooperation Agreement (TIDCA).

The African Growth and Opportunity Act (AGOA) is another agreement which Lesotho is also a beneficiary. AGOA is a unilateral preferential trade arrangement offered by the US to Sub-Saharan African countries. This has allowed Lesotho's textile and clothing exports competitive access into the US market as Lesotho textile and clothing manufactures source fabric inputs from the most cost effective countries around the world, mostly from Asia. The Third Country Fabric Sourcing (TCFS) under AGOA has been the force that drives the textile industry and sustained it for just over a decade. The TCFP was due to expire in September 2012. During the period leading to that, before its extension, the sub-sector experienced some distress with reduction of orders and subsequently redundancy of workers. This suggests that Lesotho could not maintain the sector's competitiveness without the preferential treatment. The provision was however extended to 2015 a period during which AGOA will also be ending. The challenge is for the Government of Lesotho to aggressively promote alternative sectors for job creation. Part I of this report has shown that AGOA aside, the sub-sector has been progressively loosing competitiveness and is not going to survive for much longer.

2.5 Commodity Price Developments

2.5.1 Gold Prices

In the year under review the price of gold increased by 6.3 per cent to US$ 1669.50 per ounce from an annual average of US$1 570.64 per ounce in 2011. Gold prices hiked in 2012 mainly due to weak demand in the emerging markets, in particular; Russia, Mexico, Thailand and South Korea, given the fact that gold can be used as a safe haven. In Maloti terms, the average price of gold rose by 19.8 per cent to M13 711.01 per ounce from M11 441.18 per ounce observed in 2011.

2.5.2 Oil Prices

The average price of oil rose by 2 per cent to US$109.49 per barrel from US$107.39. The increase in the price of oil was mainly attributed to production disruptions in some major oil-exporting countries such as Syria, Sudan, and Yemen, which took about 1 million barrels of oil per day off the world market. Furthermore the on-going U.S. and European sanctions on imports of Iranian oil (intended to pressure Iran to give up its nuclear program) played a part in reducing Iran's oil exports, and raised fears that Iran would retaliate by disrupting oil shipments through the Strait of Hormuz.

On average the loti price of crude oil increased by 15 per cent in 2012 to US$897.80 per barrel from US$779.57 per barrel reported in 2011. Due to the global developments in petroleum products, there were several upwards revisions of fuel prices in the domestic economy in 2012. Price of petrol in Lesotho closed the review year at M10.75 per litre, while that of diesel and illuminating paraffin closed the year at M11.35 per litre and M8.50 per litre, respectively. These compare with M9.55 per litre of petrol, M10.80 per litre of diesel and M7.90 per litre of illuminating paraffin in 2011.

2.5.3 Platinum Prices

The price of platinum declined by 9.7 per cent to US$1 553.70 per ounce from US$1 720.49 registered in 2011. Despite strikes in the SA platinum mines (SA is the largest producer of platinum in the world) the price of platinum fell in the review period. Furthermore, consumption and lower demand for platinum in automobile industries, and decline in auto sales in the European Union also led to the decline in platinum prices. In rand terms, the average price of platinum rose by 2.6 per cent to M12 755.39 per ounce from M12 437.33 per ounce in the previous year, reflecting the exchange rate movements.

2.5.4 Maize Prices

In US dollar terms, the average spot price of white and yellow maize increased by 13.1 per cent and 11.8 per cent respectively in 2012. The average spot price of white maize was recorded at US$294.27 per tonne while that of yellow maize was recorded at US$293.40 per tonne. These compare with US$260.29 and US$262.39 per tonne, respectively in the previous year. The increase was mainly due to bad weather conditions in the United States attributable to high temperatures and lack of rainfall, which lead to the worst drought in 53 years. The increase in the price of maize was also driven by increases in energy prices. In Maloti terms, the average price of white and yellow maize increase by 26.8 per cent and 25.6 per cent, respectively to M2 410.86 per tonne and M2 404.95 per tonne, respectively.

2.5.5 Wheat Prices

The average spot price of wheat declined by 0.9 per cent to US$309.76 per tonne in 2012 from US$ 312.42 per tonne reported in 2011. The decline was mainly attributed to excess global supplies, especially after Russia made a decision not to impose any tariff on its grain exports. In Maloti terms, the spot price of wheat increased by 13.2 per cent to M2 553.38 per tonne from M2 255.21 per tonne registered in the previous year, reflecting the exchange rate movements.

Table 2: SELECTED ECONOMIC INDICATORS, 2008 – 2012*
(Percentage changes unless otherwise)

Indicators	2008	2009	2010	2011	2012*
World Output	2.8	-0.6	5.1	3.9	3.2
Advanced Economies	0.0	-3.6	3.0	1.6	1.3
Of which:					
United States	0.3	-3.5	2.4	1.8	2.3
Euro Area	0.4	-4.3	2.0	1.4	-0.4
Japan	-0.1	-5.5	4.5	-0.6	2.0
Emerging and Developing Economies	6.1	2.7	7.4	6.3	5.1
Of which:					
Africa					
Sub Saharan	5.6	2.8	5.3	5.1	5.4
South Africa	3.1	-1.7	2.9	3.5	2.3
Developing Asia					
China	9.6	9.2	10.4	9.3	7.8
India	7.3	5.7	10.1	7.9	4.5
Consumer Prices					
Advanced Economies	3.4	0.1	1.5	2.7	2.0
Of which:					
United States	3.8	-0.3	1.6	3.1	2.0
Euro Area	3.3	0.3	1.6	2.7	2.3
Japan	1.4	-1.3	-0.7	-0.3	0.0
United Kingdom	3.6	2.1	3.3	4.5	2.7
Emerging and Developing Economies	9.3	5.1	6.1	7.2	6.1
Of which:					
Africa	6.0	10.3	9.0	7.1	7.1
Sub Saharan	12.6	9.4	7.5	9.7	9.1
South Africa	11.5	7.1	4.3	5.0	5.6
Developing Asia					
China	5.9	-0.7	3.3	5.4	3.0
India	8.3	10.9	12.0	8.9	10.2
World Trade Volume	3.0	-10.4	12.6	5.9	2.8
(Goods and Services)					
Exports					
Advanced Economies	2.2	-11.3	12.0	5.6	2.1
Emerging and Developing Economies	3.9	-7.6	13.7	6.6	3.6
Imports					
Advanced Economies	1.0	-11.9	11.4	4.6	1.2
Emerging and Developing Countries	8.6	-8.3	14.9	-8.4	6.1

Source: IMF World Economic Outlook, October 2012; and IMF World Economic Outlook Update, January 2013. * IMF Projections

PART III DOMESTIC ECONOMIC DEVELOPMENTS

3.1 Real Sector Developments

3.1.1 Trends in Output and Income

Economic activity in Lesotho accelerated modestly in 2012, following a slowdown in 2011. Real output grew by 4.3 per cent in 2012 compared with 3.7 per cent in the previous year. The faster growth in real GDP reflected higher but varying output growth rates in all the sectors of the economy. The secondary, tertiary and primary sectors accelerated by 5.8 per cent, 4.6 per cent, and 1.6 per cent, respectively.

The increase in production by the primary sector reflected buoyant performance of the mining and quarrying sub-sector. The strong performance of this sub-sector outweighed the contraction in the output of the agriculture, forestry and fishing sub-sector. The robust growth of value added by the secondary sector was at the back of the stronger performance of the building and construction sub-sector and the modest recovery of the manufacturing sub-sector. Real output growth in the tertiary sector accelerated, supported mainly by the wholesale and retail trade as well as hotels and restaurants sub-sectors.

Real Gross National Income (GNI) was estimated to have expanded by 0.1 per cent in 2012, following a contraction of 0.8 per cent in 2011, reflecting a marginal increase in factor income received from abroad, particularly, mineworkers' remittances. This happened despite the continued decline in the number of Basotho workers in SA mines. The substantial increases in the salaries and wages of mineworkers in SA, effected both in 2011 and 2012, resulted in an increase in the earnings by Basotho in SA mines. Interest earnings by the domestic banking system on their assets abroad continued to decline in 2012, mainly due to the low global interest rates.

Factor income paid by Lesotho to the rest of the world registered a substantial increase in 2012. Dividends paid to direct investors rose in line with the recent increase in foreign direct investment in Lesotho. In addition, interest payments on government foreign debt rose due to the depreciation of the Loti against the major currencies during the review year.

Table 3: AGGREGATE ECONOMIC INDICATORS (Percentage Change, 2004 = 100)					
	2008	**2009**	**2010**	**2011**	**2012***
GDP	5.7	3.6	7.9	3.7	4.3
GNI	5.2	1.5	4.4	-0.6	0.1
GDP Per Capita	5.7	3.6	7.7	3.5	4.0
GNI Per Capita	11.3	-5.7	4.2	-0.8	-0.1

Source: Bureau of Statistics
* CBL Projections

3.1.2 Sectoral Performances

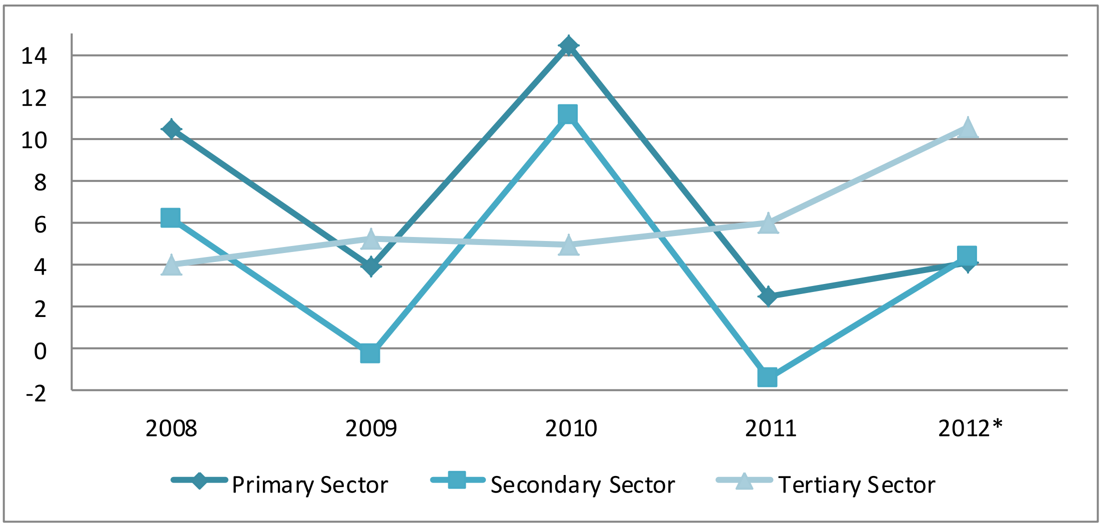
(a) Developments in the Primary Sector

The primary sector, comprising of the agriculture, forestry and fishing sub-sector and the mining and quarrying sub-sector, grew at a higher rate of 4.1 per cent in 2012 compared with 2.5 per cent in 2011. The growth of the primary sector was largely at the back of the strong performance of the mining and quarrying sub-sector, which outweighed the contraction in the agriculture, forestry and fishing sub-sector.

The agriculture, forestry and fishing sub-sector contracted at a steeper rate of 8.7 per cent in 2012 compared with that of 5.4 per cent in the previous year. This was mainly attributable to the continued poor performance of the crops sub-sector, which was negatively affected by the drought that was experienced in some parts of the country at the beginning of the 2011/2012 agricultural year coupled with floods in other parts of the country. Farming of animals also remained lackluster during the review year.

The performance of the mining and quarrying sub-sector strengthened further during the review year. The sub-sector registered a robust growth rate of 25.7 per cent in 2012 compared with 19.4 per cent in the previous year. This was despite the decline in the global prices of rough diamonds caused by the slump in demand by the major world consumers of diamonds, China and India, during the year. It mainly reflected the good quality of Lesotho's diamonds, particularly from the Letšeng mine. In addition, the depreciation of the Loti against the US Dollar during the course of the reference year also helped boost export earnings and profitability of the mining sub-sector, hence mining production.

Figure 6: SECTORAL REAL GROWTH RATES
(2004 = 100)



Source: Bureau of Statistics
* CBL Projections

(b) Developments in the Secondary Sector

The secondary sector, which comprises the manufacturing, and the electricity and water, and the building and construction sub-sectors, recovered strongly, registering a growth rate of 4.4 per cent in 2012 following a contraction of 1.4 per cent in 2011. The manufacturing sub-sector recovered modestly while the electricity and water, and the building and construction sub-sectors accelerated.

Lesotho's manufacturing sub-sector comprises textiles, clothing, footwear, and leather, which accounted for 63.5 per cent, food products and beverages, which account for 19.9 per cent and other manufacturing at 16.6 per cent of the manufacturing sub-sector's output. The sub-sector was estimated to have recovered modestly in 2012 following a slump in the previous year. It increased by 1.5 per cent in 2012 compared with a contraction of 5.7 per cent in 2011. This mainly reflected the positive performance of the food products and beverages sub-sector and the other manufacturing sub-sector. The other manufacturing sub-sector had contracted by 10.7 per cent in 2011 due to, amongst other things, the permanent closure of a firm that produced radios and televisions. The sub-sector recovered into positive territory, registering a growth rate of 1.7 per cent in 2012 mainly reflecting the impact of the efforts of the Lesotho National Development Corporation (LNDC) to diversify Lesotho's manufactured products.

The textiles, clothing, footwear and leather manufacturing sub-sector contracted at a lower rate of 0.1 per cent in 2012 compared with 7.7 per cent in 2011, mainly reflecting a slowdown in the output of the textiles and apparel manufacturing industry. The textile sector slowed because of the shortfall in export orders by US based retailers, associated with the uncertain prospect for the TCFP under the US AGOA, before it was extended in August 2012. Lesotho's textiles and clothing industry remained under pressure due to loss of competitiveness in the US market to the Asian producers who face relatively lower production costs.

The electricity and water subsector was expected to have registered a higher growth rate of 7.3 per cent in 2012 compared with 1.8 per cent in 2011. This increase was at the back of the rise in electricity and water connections throughout the country. The high level of activity in the building and construction sub-sector, particularly the construction of the real estate and residential structures was expected to have given the sub-sector an impetus that was strong enough to outweigh the impact of the low activity in the wet industries, especially the garment manufacturing industry.

The building and construction sub-sector was estimated to have expanded by 9.2 per cent in 2012 following a growth rate of 7.7 per cent in 2011. The performance of the sub-sector was largely supported by the building and construction projects that were implemented during the year. These included the continuation of the construction of the Metolong Dam, upgrading, renovation and construction of roads, residential property development, which has recently gained momentum in the country and construction of shopping centres during the review year.

(c) Developments in the Tertiary Sector

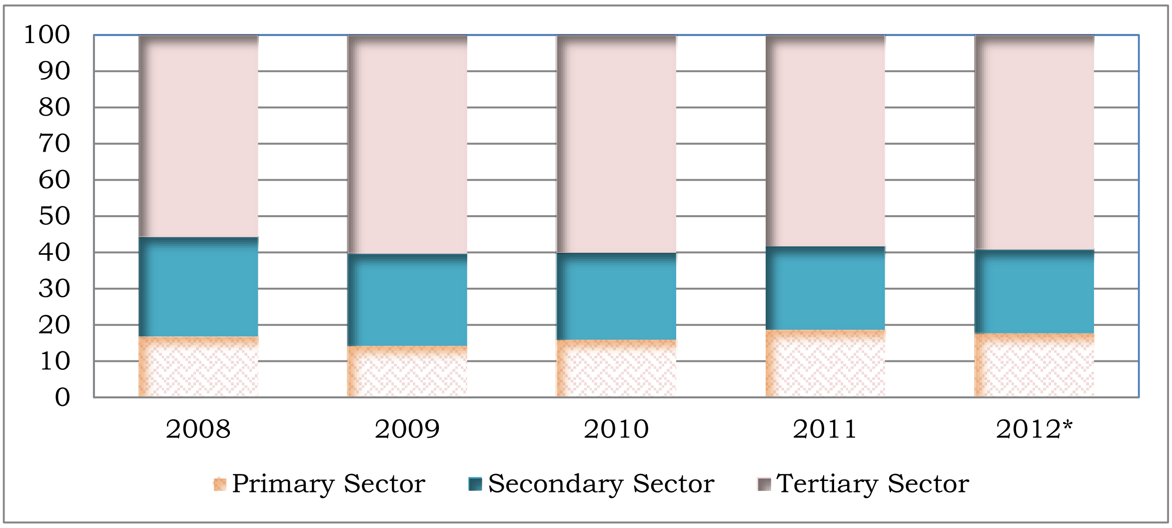
The real value added by the tertiary sector was estimated to have increased at a higher rate of 10.6 per cent in 2012 compared with 6.0 per cent in 2011. The rapid increase resulted mainly from higher growth in the real value added by the wholesale and retail trade sub-sector, the transport and communications sub-sector, and the financial intermediation sub-sector.

Growth in the real output of the wholesale and retail trade sub-sector accelerated to 8.3 per cent in 2012 from 6.9 per cent in 2011. The sub-sector benefited from strong demand in the economy. The increase in the building and construction activity, particularly the construction of residential and real estate structures led to an increase in the sale of building material and cement. The retail trade sub-sector also expanded during the review year as the biggest shopping mall in the country was expanded and another new mall was opened.

The real value added by the transport and communications sub-sector grew by 8.6 per cent in 2012 compared with 8.0 per cent in the previous year, mainly reflecting good performance of the communication sub-sector.

Telecommunications services providers, particularly in the mobile phone market, have introduced a wider range of products and services, including affordable airtime packages in an effort to beat the increasing competition. The low prices and resultant increase in the number of subscribers led to some quality of service challenges on the networks of the operators that require attention.

Figure 7: SECTORAL SHARES IN GDP AT FACTOR COST
(Percentages)



Source: Bureau of Statistics
*CBL Projections

BOX 1: Contribution of Diamond Mining Sector to the Lesotho Economy

Introduction

The economic contribution of the mining industry on the economy of Lesotho has increased significantly in recent years as a result of the reopening of the diamond mines in 2003. While the industry's contribution to economic growth was negligible prior to 2004, it has increased to around 5.0 per cent in 2012. The industry has also become a very important source of exports and foreign exchange earnings for the country. The purpose of this article is to highlight the nature of the Lesotho's diamond sector and its impact on the economy.

The Diamond Mining Industry in Lesotho

Prior to 2003, diamond mining production had not been consistent and there were periodic closures of the mines as they were perceived not to be commercially viable. However, recent production capacity indicates that Lesotho's diamond mining has significant potential. Currently, the diamond sector consists of five mines, namely Letšeng, Liqhobong, Kao, Kolo and Mothae. All these mines have a majority foreign shareholding (see table below).

***Table B1*: Ownership Structure of the Mining Industry in Lesotho**

Name of Diamond Mine	Foreign Ownership	Government Ownership	Private Ownership
Lets'eng	Gem Diamonds (70%)	30%	0.0
Kao	Namakwa (62.5%)	25%	12.5%
Liqhobong	Firestone Diamonds 75%)	25%	0.0
Mothae	Lucara (75%)	25%	0.0

The Impact of the Diamond Mining Sector on Lesotho's Economy.

The economic impact of the mining sector in Lesotho can be observed in the following economic variables:

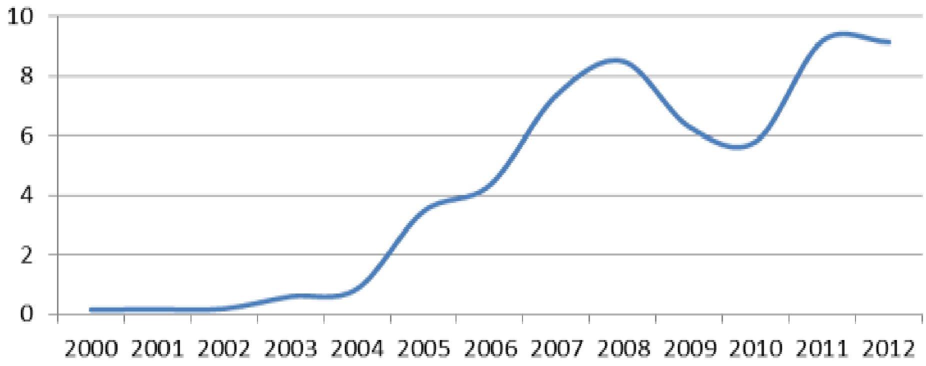
- ***Foreign Direct Investment***

In Lesotho, like many developing countries, the contribution of the mining sector to FDI is significant. As indicated earlier, all the current mining companies in Lesotho have a majority foreign ownership. Thus, they are foreign direct investment enterprises. Mining sector contribution to FDI is estimated to have grown from 10.8 per cent of total FDI in 2005 to 35 per cent in 2010.

- ***Output Growth***

The contribution of the diamond sector to Lesotho's economic performance has been significant since 2004. The growth of the sector has contributed to the increase in the share of the mining and quarrying sub-sector to GDP from 0.9 per cent in 2004 to around 5.5 per cent in 2012. Diamond production has been increasing progressively in recent years, albeit with fluctuations due to changing international diamond market conditions in some years.

***Figure B1*: The Share of Mining Output in GDP (% of GDP)**



- ***External Sector***

The diamond mining industry has contributed significantly to Lesotho's export earnings since 2004. Thus, contributing to the building up of foreign reserves and improving the external sector position of the country. The maintenance of a sufficient level of foreign reserves at all times is important for Lesotho in order to maintain the exchange rate peg between the loti and the South African rand and to meet the country's external obligations. Diamond exports have become the second major contributor of foreign exchange earnings after textiles. The ratio of diamond exports to total exports increased from 0.1 per cent 2002 to 31.0 in 2012. During the same period, the ratio of diamond exports to GDP grew from 0.1 per cent to 12.5 per cent.

- ***Employment***

Although diamond mining has become an increasingly important contributor to the Lesotho economy, its capital-intensive nature has rendered it poor in terms of employment capacity. Nonetheless, the sector is estimated to have employed 2000 workers in 2012, contributing about 0.3 per cent of total employment. Employment is expected to rise in the medium term as mining production expands.

- ***Government Revenue***

The diamond mining industry also contributes to government revenues through payment of corporate taxes, royalties and dividends. This is important for boosting domestic revenue collection and reducing the government dependence of on SACU revenues. The company tax and royalties have increased significantly since the coming into operation of mines in the 2003/2004 financial year.

Conclusion

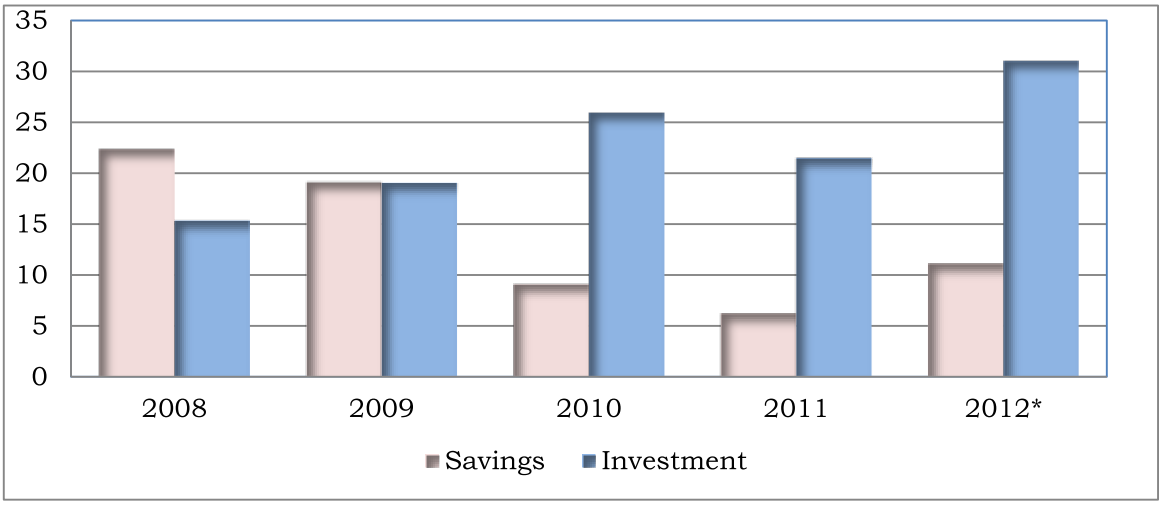
The diamond sector contributes significantly to economic growth, foreign direct investment, government revenue and the balance of payments of Lesotho. Its contribution to employment is limited by the capital intensive nature of the sector. The contribution of the sector is expected to increase further in the future on account of the planned expansion in operations of some of the mines.

3.1.3 Savings and Investment

The gross national savings increased to 11.1 per cent of gross national income (GNI) in 2012 from 6.2 per cent of GNI in 2011, mainly reflecting an increase in government savings while the private sector registered a dissaving during the review year. The gross national investment remained above the gross national savings for the third consecutive year in 2012. It rose to 31.1 per cent of GNI in 2012 from 21.5 per cent of GNI in 2011 as private sector investment more than doubled while investment by the public sector declined moderately.

The saving-investment gap worsened to negative 19.9 per cent of GNI in 2012 compared to the negative 15.3 per cent in 2011. This indicated that a significant share of the investments that took place in the country during the review year was financed through foreign debt and equity capital inflows.

Figure 8: SAVINGS AND INVESTMENT
(As a percentage of GNI)



Source: Bureau of Statistics
* CBL Projections

3.2 Employment, Wages and Prices

3.2.1 Employment

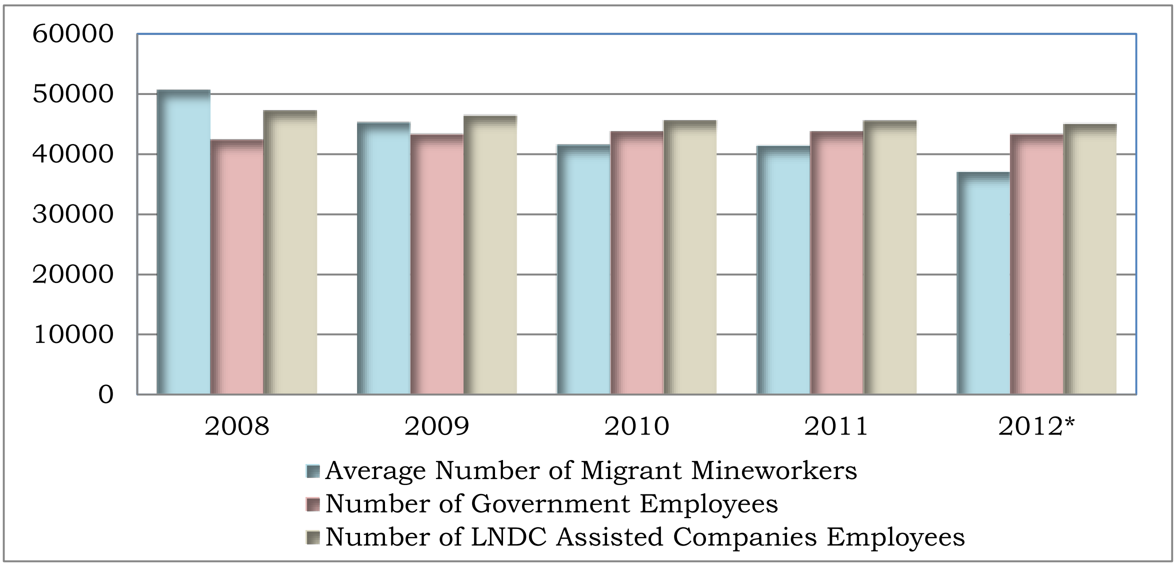
Employment in LNDC-assisted companies[6] continued on a downward trend in 2012. It fell to 45,006 in December 2012 from 45,501 in December 2011. This resulted mainly from the decline in employment by the textiles and apparel industry, which was in line with the fall in the industry's output, as explained in Section 3.1.2 above. The industry has been losing competitiveness in its biggest export market, the US, due to tough competition by Asian producers and relatively higher production costs faced by Lesotho's producers.

Employment in the public sector declined further by 1.0 per cent in 2012 following a marginal decrease of 0.1 per cent in the previous year. All the categories of public sector workers registered declines during the review year. The most significant decline was observed in the category of daily paid workers, which fell by 3.7 per cent, while the number of teachers and civil servants recorded modest declines of 0.8 per cent and 0.6 per cent, respectively. This was in line with Government's fiscal consolidation efforts. In the budget speech for the 2011/2012 fiscal year, Government had indicated that measures would be undertaken to contain recurrent expenditure by, amongst other things, keeping the growth of the public service at zero by freezing new positions.

The number of Basotho migrant mineworkers in SA continued to fall, registering a much steeper rate of decline of 10.6 per cent in 2012 compared with 0.3 per cent in the previous year. The number of migrant mineworkers stood at 37,051 in December 2012 from 41,427 in December 2011. The number of Basotho men recruited by TEBA to work in the SA mines declined consistently throughout the year. This was despite an increase in SA's mining sector employment during the same period, reflecting the continuing replacement of foreign workers in SA mines as South Africans continue to show interest in working for the mines.

[6] LNDC-assisted companies include textiles and clothing; leather and footwear, retail, sandstone and hotels.

Figure 9: AVERAGE NUMBER OF BASOTHO MINEWORKERS IN SA, GOVERNMENT EMPLOYEES AND LNDC-ASSISTED COMPANIES' EMPLOYEES



Source: The Employment Bureau of Africa (TEBA), Lesotho National Development Corporation

3.2.2 Wages

The general minimum wage as determined by Lesotho's Wages Advisory Board increased by an annual average rate of 10.0 per cent during the review year, higher than the 7.4 per cent effected in 2011. The construction industry realized a higher increment relative to the rest of the industries. The minimum wage for the textiles, clothing and leather manufacturing sector was revised upwards by 9.0 per cent in 2012. The upward revision of the minimum wages was intended to minimize the erosion of the purchasing power of workers income by inflation. In addition, government employees' salaries were increased by 3.0 per cent in the 2012/2013 fiscal year, lower than an across-the-board salary increase of 5.0 per cent in the 2011/2012 fiscal year.

3.2.3 Price Developments

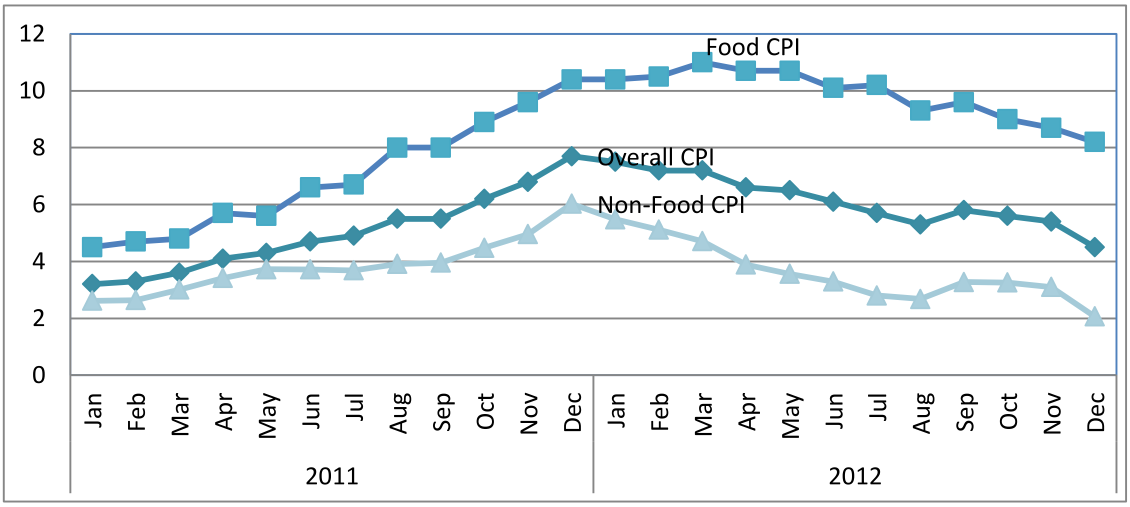
The annual inflation rate for Lesotho, as measured by the change in the Consumer Price Index (CPI), accelerated to an average of 6.1 per cent in 2012 from an average of 5.0 per cent in 2011. The rise in the general price level was mainly attributable to exogenous factors, particularly the surge in international food and fuel prices. The increase in international food prices was mainly due to weather related setbacks to production. According to the

World Bank, the most significant increase in food prices was observed in July 2012, reflecting an 18.0 per cent surge in the price of grains. This was caused by the severe drought that damaged summer crops in the US. The World Bank's grains price index increased by 12.0 per cent in October 2012 over October 2011. As indicated in Section 2.5, the international price of crude oil rose during the year resulting in an increase in the pump prices of petrol, diesel and paraffin in Lesotho. The depreciation of the Rand against the US Dollar exacerbated the impact of the surge in the price of crude oil on Lesotho's inflation. It also resulted in higher imported inflation by SA, which was transmitted to Lesotho because of the latter's heavy reliance on imports of goods and services from SA. As a consequence, the components of Lesotho's CPI basket that were mostly affected by inflationary pressures in 2012 were the food and non-alcoholic beverages, and the transport.

Lesotho's inflation continued to move in line with that of SA during the year. For the larger part of the year, Lesotho's inflation was higher than SA's. This changed in October 2012, when both countries registered the same inflation rate of 5.6 per cent. In the latter two months of 2012 Lesotho's inflation rate fell below that of SA. This mainly reflected the moderation in the rate of increase in food prices, which carry a much higher weight in Lesotho's inflation basket than in SA's basket. SA's inflation rate was 5.7 per cent in December 2012, 1.2 percentage points higher than Lesotho's inflation rate during the same period.

Figure 10: LESOTHO CONSUMER PRICE INDEX

(Annual Percentage Change)



Source: Bureau of Statistics

3.3 Balance of Payments (BOP)

3.3.1 Overall Balance

Preliminary estimates indicated an improvement in Lesotho's external sector position in 2012. The overall balance of payments (BOP) registered a surplus of M1.2 billion or 6.1 per cent of GDP in 2012. This was higher than M588.7 million, which was 3.2 per cent of GDP realised in 2011. The widening of overall balance was largely on account of increased inflows in capital and financial account. The surplus was also supported by the gains derived from the depreciation of the local currency against the currencies of the major trading partners. However, the worsening trade deficit coupled with deterioration in the income account balance moderated the observed performance in the external sector. The transactions balance, which measures the overall balance excluding the effects of exchange rate, also recorded a surplus estimated at 4.0 per cent of GDP during the review year in contrast with a deficit of 0.7 per cent registered in the previous year. In months of import cover, gross official reserves remained unchanged at 4.7 months in 2012, compared with a year ago.

Figure 11: Reserves in Months of Import

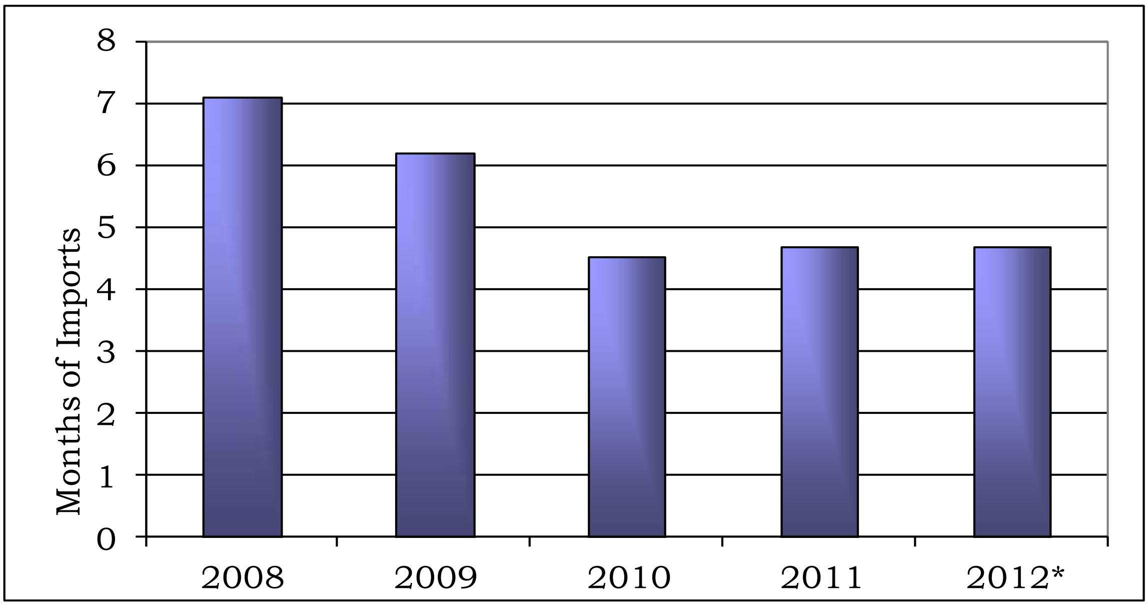


Table 4: SUMMARY OF BALANCE OF PAYMENTS
(As percentage of GDP)

	2008	**2009**	**2010**	**2011**	**2012***
Current account	8.31	-2.68	-20.05	-17.28	-22.03
Goods	-39.78	-48.90	-52.01	-38.91	-51.90
Services	-20.30	-18.80	-21.05	-19.33	-18.43
Income	25.95	23.26	23.77	13.17	10.59
Current transfers	42.44	41.78	29.24	27.80	37.71
Capital and Financial account	-3.52	4.14	4.58	11.04	18.59
Transaction balance	9.52	3.55	-8.27	-0.70	4.03

** Preliminary estimates*

3.*3.2 Current Account*

The current account deficit widened to 22.0 per cent of GDP in 2012, from 17.3 per cent in the previous year. Almost all major components of the current account (i.e. trade in goods and services as well as income account) deteriorated, except *current transfers* which improved during the review year. The main driver of the current account deficit was *trade* deficit which widened by 31.1 per cent. This was followed by the *income account inflows*, which declined by about 12.7 per cent.

The deterioration in the trade account was mainly driven by an increase in merchandise imports together with high payments for services acquired abroad during the review year. Demand for imports was envisaged to have benefited from the construction activities related to the Metolong dam and other Millennium Challenge Account (MCA) projects. The worsening of the trade deficit was also influenced by a decline in exports of diamonds, and textiles and clothing. Diamond exports fell by 5.0 per cent due to unfavourable international prices as a result of weak global economic activity. Also, a fall of 3.0 per cent in textiles and clothing emanated from among other factors, uncertainty about the expiration of TCFP which led to a fall in orders for Lesotho's manufactured goods in 2012. In addition, an increase in payments for services acquired abroad which rose by 3.5 per cent, driven largely by freight services contributed to the widening of trade deficit. A decline in returns on portfolio investments abroad by both CBL and commercial banks contributed to the observed performance of income account.

As indicated earlier, improved current transfers moderated the widening of the current account deficit. A larger portion of current transfers' inflows resulted from the growth in customs receipts driven by SACU.

3.3.3 Capital and Financial Account

The capital and financial account continued to register net inflows of M3.7 billion in 2012, following net inflows of M2.0 billion in the previous year. Inflows benefited from both capital and financial accounts. The capital account inflows rose to M1.5 billion in 2012 from M1.0 billion in the previous year, driven largely by major government's capital projects undertaken during the review year which were mainly financed through foreign grants and foreign borrowings. As indicated earlier, the major capital projects included the construction of Metolong dam and, urban and rural roads. The financial account balance improved substantially from a net surplus of M1.2 billion in 2011 to M2.4 billion in 2012, resulted largely from a drawdown of commercial banks' foreign assets during the year. This could have been attributable to the need of funds by the commercial banks to fund local activities, including investment in the recent construction of a shopping centre that was completed in late 2012. Moreover, a rise in government foreign loans during the review period supported a surplus in financial account.

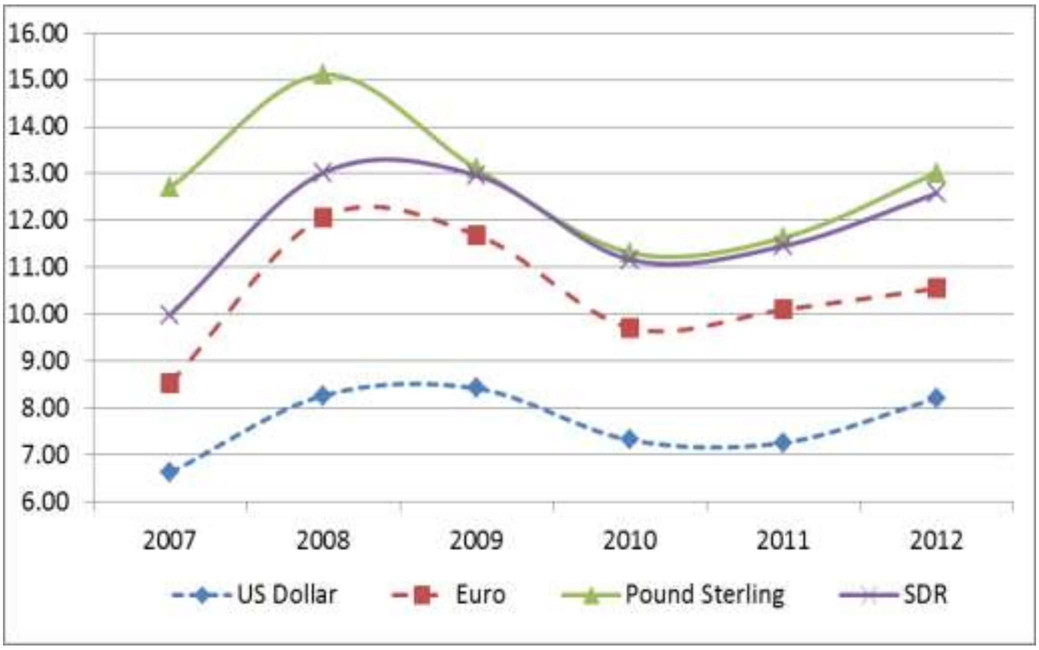
3.3.4 Foreign Exchange Rates

The Loti, which is fixed at par to the SA rand, remained volatile but depreciated significantly against the major world currencies during the review year. The weakness of the Loti/Rand resulted from a combination of factors such as the deterioration of SA's current account of balance of payments during the period, the downgrading of SA's sovereign rating amid, among others, labour unrest in the SA mining industry. Investors' perception relating to changes in global and SA developments also affected rand exchange rate negatively.

In nominal terms, the local currency depreciated by an annual average of 13.1 per cent against the US Dollar in 2012 in contrast with an appreciation of 0.8 per cent observed in 2011. Against the Pound Sterling, it depreciated by 11.9 per cent compared with 2.3 per cent depreciation in the previous year. It also depreciated by 4.5 per cent against the Euro compared with 3.9 per cent in 2011, while it depreciated by 9.8 per cent against the SDR in 2012 compared with a of 2.6 per cent depreciation in the previous year.

The loti closed the review year at M8.48 and M11.20 per US Dollar and Euro, respectively, while against the Pound sterling and SDR it stood at M13.72 and M13.04, respectively. The continuing weakness of the loti could on one hand, pose an upside risk to the inflation outlook, while on the other hand it improves earnings of the export sub-sector.

Figure 12: Nominal Exchange Rate of Loti/Rand against the Major Currencies (Annual Averages)

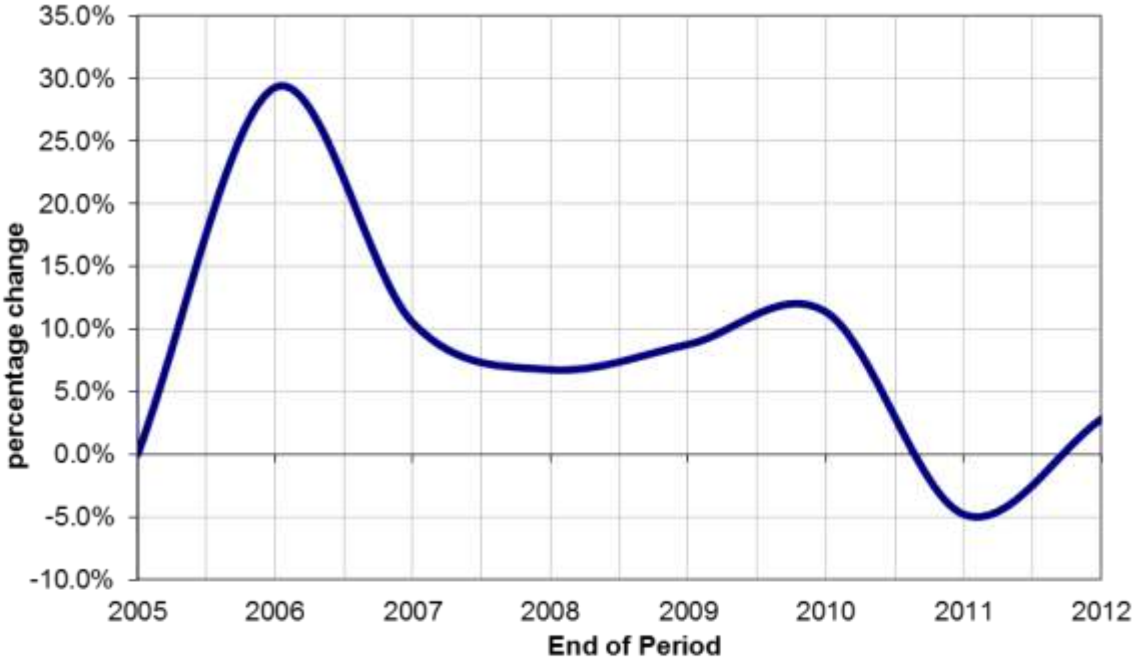


3.4 Money and Banking

3.4.1 Money Supply

Money supply growth was 7.3 per cent in 2012 compared with 2.9 per cent in 2011. The growth in money supply was largely as a result of a 39.9 per cent jump in domestic credit excluding net claims on government and a 2.4 per cent build-up in net foreign assets. Real growth in money supply, measured by the change in M2 excluding the change in CPI, also increased by 2.8 per cent at the end of 2012 after contracting by 4.8 per cent in 2011. This was due to acceleration in nominal money supply against a deceleration in inflation rate from 7.7 per cent in December 2011 to 4.5 per cent in December 2012, as already noted.

Figure 13: Growth of Real Money Supply



Source: CBL Monetary Survey, December 2012

Changes in M2 are also observed through its components, which comprise narrow (M1) and quasi money. On the one hand, M1 surged by 24.1 per cent following a 4.4 per cent rise observed in the previous year. The growth in M1 was largely driven by an 11.7 per cent rise in currency outside the banking sector and 28.2 per cent jump in transferable deposits. On the other hand, quasi money continued to contract. It contracted further by 4.8 per cent from 1.8 per cent in the previous year.

3.4.2 Domestic Credit

Domestic credit expanded further by 488.0 per cent in 2012 following a 166.9 per cent jump in the previous year. The large expansion in domestic credit was mainly driven by the increase in credit to the private sector moderated by a decline in net claims on government. Net claims on government declined by 21.5 per cent while credit to the private sector increased by 39.9 per cent. The drop in net claims on government reflected the improvement in government deposits with the central bank. The massive rebound in government deposits is as a result of a fiscal surplus facilitated by higher SACU receipts.

Table 5: DOMESTIC CREDIT

Million Maloti: End of period

	2008	**2009**	**2010**	**2011**	**2012**
Claims on Government (Net)	-2443.8	-2136.2	-1000.8	-2592.6	-3148.9
Claims on Central Government	-3950.7	-3996.0	-3197.6	965.1	1318.9
Liabilities to Central Government	1005.8	692.4	716.4	3557.7	4467.8
Claims on Public NFCs (Official entities)	43.8	0.00	3.0	1.4	-0.1
Claims on Private Sector	1463.2	1859.8	2193.8	2687.0	3778.2
Claims on Other Resident Sector (Households)	26.1	27.0	27.1	32.6	42.3
Claims on Other NFCs (Enterprise)	1437.0	1832.8	2166.7	2654.4	3735.9
Domestic Claims	-2443.8	-2136.2	-1000.8	107.0	629.1

Credit to the private sector rose further by 39.9 per cent in 2012 after increasing by 23.0 per cent in 2011. Credit extended to households constitutes the largest share of domestic credit with 61.1 per cent while the share of credit extended to businesses declined to 38.9 per cent. Credit extended to households increased by 55.3 per cent while credit to business enterprises rose by 23.0 per cent at the end of 2012. The growth in credit to households continues to be fuelled by the willingness by the commercial banks to lend more through creation of lending facilities aimed at households and Micro Small and Medium Enterprises (MSMEs) which were not able to access credit previously. The growth in credit extension to the business enterprises in 2012 was dominated by strong economic activity related to the real estate; construction; and mining sub-industries.

Nonetheless, sectoral distribution of credit in Lesotho is concentrated on a few sectors and is uneven across sectors and this may expose the banking system in case of shocks to such dominant sectors. Generally the growth in credit extension to the private sector is in line with structural reforms which were implemented in recent years such as the establishment of the commercial court and the enactment of the Land Act. It is expected to expand further in the short to medium term as other reforms are on-going, such as, the implementation of the national identification card system and the establishment of a credit bureau.

3.4.3 Net Foreign Assets

Growth in the net foreign assets (NFA) of the overall banking system recovered from a 0.3 per cent decrease recorded at the end of 2011 to a 2.4 per cent increase in the previous year. The rise in NFA was at the back of an increase in net foreign assets of the Central Bank which was moderated by a decline in net foreign assets of commercial banks. Net foreign assets of the Central Bank accumulated by 14.3 per cent following a 9.1 per cent rise observed in the previous year. On the contrary, net foreign assets of the commercial banks shrank by 22.5 per cent.

The increase in net foreign assets of the central bank was in line with a fiscal surplus resulting from higher SACU revenues and the low rate of budget execution, especially the capital expenditure.

Table 6: BANKING SYSTEM'S NET FOREIGN ASSETS

Million Maloti: End of period

	2008	**2009**	**2010**	**2011**	**2012**
Commercial banks	2921.1	2986.7	3799.8	3209.5	2486.7
Assets	3013.7	3297.2	3917.5	3390.9	2569.5
Liabilities	-92.7	-310.5	-117.7	-181.4	-82.8
Central Bank	8251.6	7664.9	6138.9	6696.1	7654.2
Assets	8989.2	8345.4	6749.5	7350.6	8563.6
Liabilities	-737.7	-680.5	-610.6	-654.5	-909.3
Net Foreign Assets	11172.6	10651.6	9938.7	9905.7	10140.9

3.4.4 Commercial Banks' Liquidity

The liquidity ratio[7] measures banks' ability to sufficiently honour short-term customers' demands with their short-term or liquid assets. At the end of the review period, the ratio dropped by 10.9 percentage points from 71.4 per cent recorded at the end of December 2011 to 60.5 per cent at the end of 2012. The decline in the ratio, at the end of the review year, reflected a decline of 25.5 per cent in balances due from foreign banks exacerbated by a 6.8 per cent increase in private sector deposits. Despite the decline in the liquidity ratio, the banking sector remained highly liquid.

Credit to deposit ratio increased to 57.7 per cent in 2012 from 44.1 per cent in the previous year. The expansion in this ratio was indicative of a faster growth in credit extension relative to deposits mobilised from the private sector.

3.4.5 Interest Rates

The interest rates environment in Lesotho was relatively low at the end of 2012 compared to the end of 2011. Interest rates under commercial banks generally maintained a downward trend while interest rates under the Central Bank were slightly higher. These movements were in line with interest rate developments in the common monetary area (CMA). The monetary authorities in SA cut the repo rate further in July 2012 by 50 basis points from 5.50 per cent to close 2012 at 5.00 per cent. The MPC considered that the demand pressures on inflation remained relatively benign and that there were signs of moderation of consumption expenditure against the backdrop of a weak supply side of the economy. The negative output gap, its persistence and the balance of downside risks to the growth outlook were also considered. In the light of these factors, the MPC was of the view that the accommodative stance remained appropriate.

The Lesotho 91-day Treasury bill rate increased slightly by 9 basis points from 5.28 per cent in December 2011 to 5.37 per cent in December 2012. The South African counterpart rate however fell by 51 basis points from 5.46 per cent at the end of 2011 to 4.95 per cent at the end of 2012.

The average prime lending rate in Lesotho and South Africa declined by 58 and 50 basis points respectively. The former was 9.92 per cent while the latter was 8.50 at the end of December 2012. Similarly, commercial banks' deposit rates in Lesotho and SA were also descending in 2012.

[7] Liquidity is measured by the ratio of commercial banks' notes and coins holdings, liquid 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

3.5 Government Finance

3.5.1 Fiscal performance in 2012/13

Since the downturn experienced after the 2008/09 financial and economic crisis, Lesotho's fiscal performance has been gradually improving. The Government continued to strengthen its efforts in the implementation of economic reforms, including the most needed fiscal adjustments. As a result, in 2012/13 fiscal year, the fiscal balance is projected to be a surplus equivalent to 5.0 per cent of GDP. Total revenue and grants were estimated to increase by 44.0 per cent on an annual basis, while total expenditure was projected to rise by 17.9 per cent. The projected surplus will continue to increase government deposits with the banking system.

3.5.1.1 Revenue

Preliminary projections indicate that total revenue and grants increased by 44.0 per cent during the 2012/13 fiscal year. This was mainly driven by a significant recovery in SACU revenues, which is in line with positive regional economy developments. SACU receipts rose by 116.7 per cent during the review period in comparison with an increase of 4.8 per cent recorded during the previous fiscal year. The surge in total revenue was also complemented by an increase in tax revenue of 52.9 per cent and an 8.4 per cent rise in non-tax revenue. This growth was largely a result of improved performance in the retail and mining sectors, and enhanced tax collection during the year.

Non-customs receipts were estimated to have gone up by 8.4 per cent, mainly as a result of an increase in taxes on goods and services and other taxes. Both, tax on goods and services and other taxes increased by 14.9 per cent and 154.2 per cent, respectively, while Income taxes marginally declined by 1.7 per cent. The domestic sources of revenue were also boosted by increased VAT collections during 2012/13, which rose by 15.7 per cent following a 1.6 per cent decrease observed in 2011/12. The pick-up demonstrated signs of recovery in general economic activity, in addition to the growth in domestic shopping activity as a result of new shopping center opened during the year.

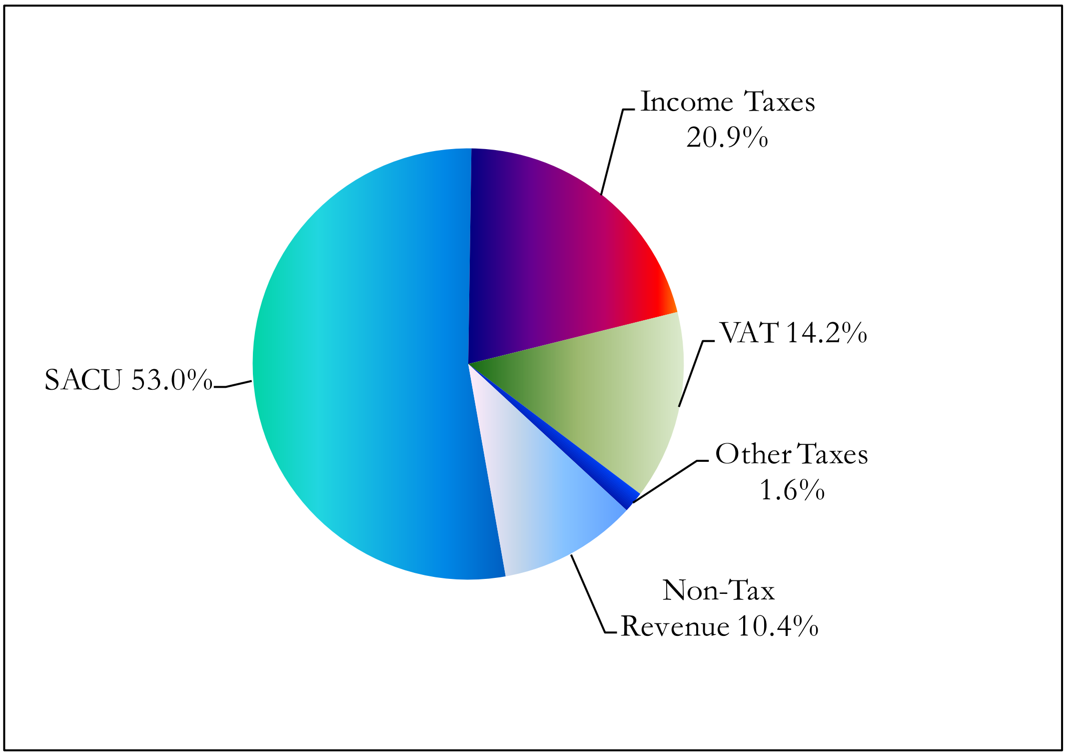
Non-tax revenue includes dividends from operations of organizations with public ownership, royalties, rand compensation and other revenues. It is expected to have increased by 8.4 per cent in the review period, following a decline of 26.6 percent recorded in 2011/12 fiscal year. Water royalties rose by 15.9 per cent compared with 4.9 per cent increase recorded in 2011/12. This growth reflected the increase in the volume of water exported to South

Africa in 2012 compared to 2011, coupled with adjustments made due to changes in inflation.

The level of capital grants is expected to have gone up by 29.3 per cent during the period under review, up from 15.4 per cent recorded in the previous year. This rise was primarily due to large disbursements targeted at financing capital projects including several large programmes, such as the construction of the Metolong Dam and the Millennium Challenge Account (MCA) related projects, as well as other infrastructure projects which include construction of several urban and rural roads.

As depicted in the figure below, SACU was the main source of government revenue at 53.0 per cent, followed by income taxes at 20.9 per cent while Value Added Tax (VAT) accounted for 14.2 per cent of total revenue.

Figure 13: Sources of Government Revenue



Source: Ministry of Finance (MoF) and CBL estimates

3.5.1.2 Expenditure

Total government expenditure was estimated to have grown by 17.9 per cent during 2012/13 fiscal year. This was expected to be driven by a 6.3 per cent increase in recurrent expenditure and an expansion of 66.8 per cent in capital spending. This rise was reflective of government's objectives, as spelled out in the NSDP, of infrastructure development, job creation and economic growth. Nonetheless, amid slow economic recovery environment, government has managed to steadily increase its allocation towards capital projects, while at the same time, it continued with its efforts to contain recurrent expenditure. This will not only improve economic growth but most importantly, it will ensure that Lesotho's fiscal policy remains sustainable over a long horizon.

For 2011/2012 fiscal year, purchases of goods and services were projected to rise by 13.7 per cent, in contrast with a drop of 16.2 per cent recorded in the previous year. These expenses constituted amounts payable to Government employees, contractors and self-employed workers for services rendered to the Government. Total interest payments are expected to have increased by 39.0 per cent during the period under review due to a rise in debt stock and the rand/loti depreciation against major currencies.

The share of capital expenditure in overall expenditures during the review period was 27.2 per cent, in contrast to 19.2 per cent observed in the previous fiscal year. This partly reflected a more expansionary approach to capital expenditure aimed at achieving government medium-term objectives, and also reflected several exceptionally large on-going programmes. in health and water sectors as well as infrastructure projects which include construction of several urban and rural roads.

Table 7: **SUMMARY OF BUDGETARY OPERATIONS** (Million Maloti)					
	2008/09	**2009/10**	**2010/11**	**Revised 2011/12**	**Projections 2012/13**
Total Receipts	8265.30	9089.03	8684.00	9225.90	13286.19
Revenue	8076.20	8185.13	7327.70	7777.20	11412.99
Customs	4635.20	4918.00	2628.10	2752.80	5966.40
Grants	189.10	753.90	1356.40	1448.70	1873.20
Total Expenditure	7653.40	8546.70	10050.80	10582.70	12474.6
Recurrent expenditure	5975.44	6014.20	8775.70	8551.40	9086.6
Purchases of Goods & Services	3996.54	4456.10	6789.40	5686.60	6466.57
Capital Expenditure & net Lending	2029.20	2532.50	951.40	2031.30	3388.00
Surplus/Deficit Before grants	422.80	-762.00	-2723.10	-2805.50	-1061.62
Surplus/Deficit after grants	611.90	-8.10	-1366.70	-1356.80	811.58
Government Savings	2100.76	586.90	-1448.00	-774.20	2326.38
Financing					
Foreign, net	57.6	8.1	134.90	116.10	300.27
Domestic	-669.70	40.90	1231.87	1240.7	-1111.87
Bank	-648.30	-14.80	1227.07	1223.80	-1097.75
Non-Bank	-21.40	55.70	4.80	16.90	-16.70
In percent of GDP (unless indicated otherwise)					
Revenue (excluding Grants)	59.30	55.50	45.30	42.42	57.33
Customs (in % of revenue)	56.08	54.00	30.86	35.40	52.28
Grants	1.40	5.10	8.40	7.90	9.41
Total Expenditure	56.20	61.70	62.20	57.73	62.66
Surplus/Deficit Before grants	3.10	-5.17	-16.80	-17.1	-6.5
Surplus/Deficit after grants	4.50	-0.10	-8.50	-8.3	5.0
Government Savings	15.43	3.98	-8.95	-4.22	11.69
Memorandum item:					
GDP in current prices	13612.8	14736.30	16171.80	18330.92	19906.95

Source: MOF and CBL Projections

3.5.2 The overall budget balance and financing

The budget outturn was projected to result in an overall surplus equivalent to 5.0 per cent of GDP during the period under review. The surplus was reflective of a substantial recovery in SACU receipts coupled with improved revenue collection during the year, while growth in recurrent expenditure was constant (in real terms) in 2012, which is consistent with medium-term fiscal framework. Capital budget execution rate was also low due to capacity constraints. The surplus will continue to build Government deposits with the banking sector.

BOX 2 : Progress on Implementation of the International Monetary Fund's Extended Credit Facility (ECF) supported program

The Executive Board of the IMF approved a three year ECF arrangement with Lesotho in June 2, 2010. The purpose of the a program was to support policies to restore macroeconomic stability that had been threatened by unprecedented decline in SACU revenues, the fall in exports of textiles and clothing as well as in workers' remittances as a result of the global economic crisis. Program access (concessional lending) was approved at 120 percent of quota (SDR 41.88 million) in June 2010 and an augmentation equivalent to 25 percent of quota (SDR 8.73 million) to cushion the impact of the 2010–11 flood damage and high international commodity prices was approved in March 2012.

The policies under the program are consistent with Lesotho's medium-term development objectives for growth and poverty reduction and the program is anchored around:

- Restoring fiscal sustainability while limiting the adverse impact of fiscal consolidation on the poor and vulnerable;
- Achieving external sustainability and broad-based growth for sustained poverty reduction; and
- Strengthening the financial sector and enhancing access to financial services.

Implementation of the program would be monitored quarterly through a set of quantitative performance criteria (PCs) and structural benchmarks, with March and September being performance test dates while June and December performance is indicative. Satisfactory achievement of the PCs, on the test dates, would form the basis for completion of a review and subsequent disbursements under the ECF program

Program performance has generally been satisfactory. Four reviews under the program were successfully completed. Of these, the fourth review related to performance in March 2012. All quantitative PCs for end March were met except one pertaining to the ceiling on the amount of new non-concessional debt contracted or guaranteed by the public sector. This was attributed to a lapse of proper internal control when contracting external debt. A waiver of non-observance of this performance criterion was approved by the IMF Executive Board, given the corrective measures undertaken by the authorities to address this breach. All the indicative targets for June were met and preliminary indications are that the September 2012 PCs have also been met. The satisfactory implementation of the program largely reflects the progress being made in fiscal consolidation efforts by the Government.

The two structural benchmarks set for March 2012 were implemented on time while those for September 2012 a comprehensive inventory of Government accounts and submission of the Industrial licencing Bill to Parliament were implemented with a delay. The reforms that have been completed are those of audit of domestic arrears and implementation of the front office revenue receipting system in three pilot ministries and one sub Accountancy.

Table B2: **Lesotho's Performance on Quantitative Benchmarks in 2012**

<table>
<tr><td colspan="2"></td><td colspan="2">March</td><td colspan="2">September</td></tr>
<tr><td colspan="2"></td><td>Target/ Performance Criteria</td><td>Actual Attained</td><td>Target/ Performance Criteria</td><td>Actual Attained</td></tr>
<tr><td colspan="2"></td><td colspan="4">(In millions of Maloti)</td></tr>
<tr><td colspan="2">Ceiling on domestic financing requirements of the central government</td><td>1629</td><td>1284</td><td>227</td><td>-950</td></tr>
<tr><td colspan="2">Ceiling on the net domestic assets of the Central Bank of Lesotho</td><td>1275</td><td>515</td><td>118</td><td>-1072</td></tr>
<tr><td colspan="2">Floor on the central government social expenditures</td><td>170</td><td>170</td><td>183</td><td>183</td></tr>
<tr><td colspan="2"></td><td colspan="4">(In millions of US Dollars)</td></tr>
<tr><td colspan="2">Floor on the stock of Net International Reserves</td><td>736</td><td>851</td><td>723</td><td>974</td></tr>
<tr><td colspan="2">Ceiling on the stock of external payments arrears</td><td>0</td><td>0</td><td>0</td><td>0</td></tr>
<tr><td>Ceiling on the amount of new non-concessional external debt</td><td>Maturity of less than one year</td><td>0</td><td>0</td><td>0</td><td>0</td></tr>
</table>

contracted or guaranteed by the public sector	Maturity of one year or more	182	274	182	274

3.6 Public Debt

3.6.1 Overview

Total outstanding public debt rose by 19.5 per cent during 2012, following a 17.8 per cent increase recorded in the previous year. The growth was mainly attributable to an increase in both external and domestic debt. External debt continued to constitute a greater proportion of overall debt. It constituted 85.5 per cent of total public debt while domestic debt constituted 14.5 per cent.

As a ratio of GDP, public debt stood at 40.6 per cent, in contrast to 36.9 per cent recorded in the previous year. External debt constituted 34.7 per cent of GDP, while domestic debt amounted to 5.9 per cent of GDP. Domestic debt represented Treasury bills issued mainly for monetary policies purposes and bonds which were issued, initially, to encourage market development. The ratio of public debt to GDP remained below the 60.0 per cent sustainability threshold[8], and at this level leaves enough fiscal space for the future borrowing. The high concessionality and long term nature of the bulk of external debt implies that the total debt remains sustainable.

[8] The Maastricht Rule of Thumb and SADC Convergence Criteria

Table 8: **PUBLIC DEBT INDICATORS FOR END OF YEAR** (Percentages)					
	2008	**2009**	**2010**	**2011**	**2012**
Total debt as % of GDP	54.0	38.3	37.1	36.9	40.6
External debt as % of GDP	49.0	34.9	31.4	31.2	34.7
Domestic debt as % of GDP	5.0	3.5	5.7	5.6	5.9
External debt as a % of total	90.7	91.0	84.6	84.9	85.5
Domestic debt as a % of total	9.3	9.0	15.4	15.1	14.5
Concessional as % of External debt	97.0	94.6	93.7	90.6	85.9
Debt service ratio(1)	3.3	2.6	1.1	2.0	1.5
Debt service ratio(2)	5.3	4.7	1.8	2.9	2.3

Source: MoF
(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

3.6.2 External Debt

The external debt stock increased by 20.4 per cent during 2012 compared with an increase of 15.8 per cent recorded in the previous year. Apart from new debt stock, movements in external debt were a result of fluctuations in exchange rate; in this case, it was a depreciation of rand/loti against major currencies. Within the external debt portfolio, the largest loan was from the European Investment Bank in respect of the Metolong project, with other loans being provided by the World Bank and the African Development Bank.

The primary source of external debt was multilateral institutions which constituted 88.7 per cent of external debt stock, followed by loans from bilateral creditors at 4.9 per cent while supplier's credit contributed 0.9 per cent of foreign debt. Loans from bilateral creditors rose by 42.3 per cent and loans from multilateral creditors went up by 18.6, while supplier's credit grew by 41.6 per cent. Loans from financial institutions went down by 5.9 per cent.

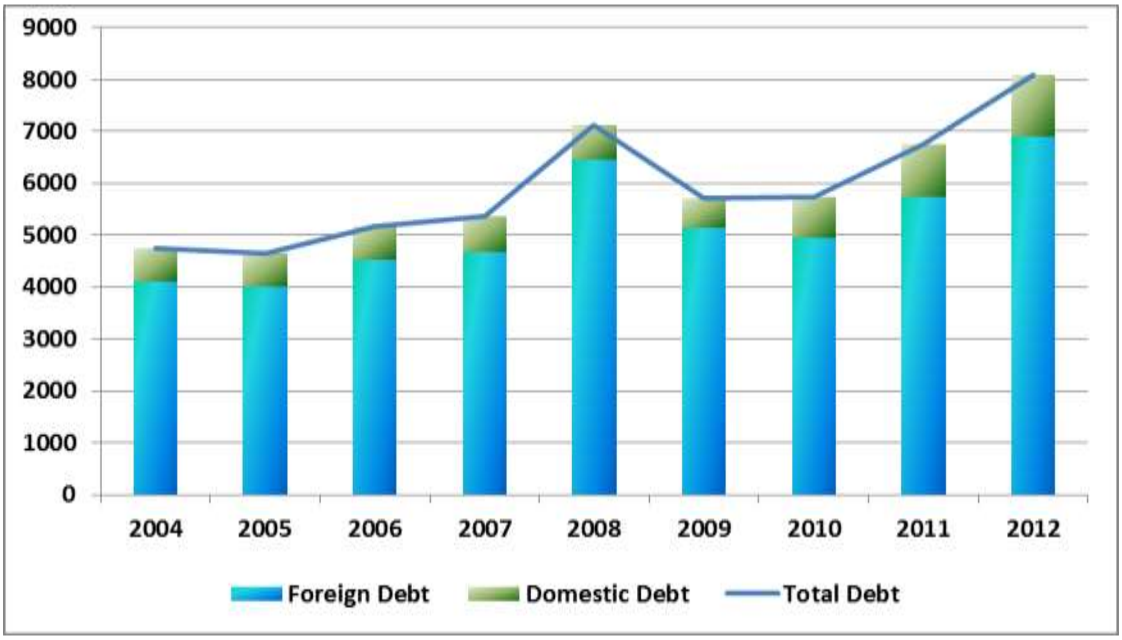
Concessional debt as a proportion of external debt dropped to 85.9 per cent at the end of 2012 from 90.6 per cent a year ago. External debt indicators suggest that Lesotho's external debt remained within the sustainability guidelines. The external debt to GDP ratio improved to 34.7 per cent in 2012 in comparison to 35.0 per cent recorded at the end of 2011. The ratio of debt service to exports of goods and services including factor income declined to 1.5 per cent from 2.0 per cent observed in the previous year. With factor income excluded, debt service ratio was 2.3 per cent in contrast to the 2.9 per cent recorded in the previous year.

3.6.3 Domestic Debt

Domestic debt was estimated to have increase by 14.5 per cent in the period under review, down from an increase of 31.0 per cent realized in 2011. This was largely a result of the reduction in the stock of treasury bonds issued in the course of the review period. Treasury bonds were introduced as a step towards development of the capital market in Lesotho, and to provide government with an alternative source of borrowing for future fiscal requirements. Short-term debt, constituted 47.8 per cent of total domestic debt while long-term debt amounted to 52.2 per cent. The banking sector continued to dominate the holding of domestic debt at 73.1 per cent while the non-banking sector held 26.9 percent.

Figure 14: Outstanding Public Debt

(Million Maloti)



PART IV REPORT ON THE OPERATIONS OF THE BANK

4.1 Governance

In the period under review, the Bank made credible attempts to fill the vacancies that had arisen in its governance structures. The position of the Governor became substantively filled with effect from the 1st of January 2012 after being vacant since March 2011. For the first time in years, the positions of the two Deputy Governors were both filled substantively, again with effect from the 1st of January 2012. All vacant positions of non-executive directors became filled by end of May 2012.

The Board expanded the mandate of its Audit Committee, during the reporting period to include risk management. The committee is now called the Audit and Risk Committee. During financial year 2012, the Board met ten times to review strategy, internal controls, operational performance and capital expenditure; to approve budget and to oversee other material governance aspects pertaining to the Bank's business. The Board's committees also convened to deliberate upon matters requiring their attention.

The Bank further filled the vacancies that existed in its management structures by appointing heads of department for Operations, Administration, Research and Financial Markets as well as the General Manager for the Lehakoe Recreational & Cultural Centre (LRCC).

4.1.1 Organizational Review

In an effort to keep pace with its dynamic operational and regulatory environment, the Bank embarked on an organizational review (OR) in the financial year under review. The OR was meant to align the Bank's organizational structure with the changing regulatory and policy landscape and to better position itself to respond timeously to other emerging challenges in the financial sector.

The OR resulted in the creation of three new departments, namely, Finance, Internal Audit and Enterprise Risk Management. The first two were originally divisions housed in Financial Markets and Governor's Office, respectively, while the third is an entirely new department. Apart from establishment of new departments, existing departments' structures were reviewed, rationalized and reorganized in order to improve their focus and efficiency.

4.1.2 Monetary Policy

The Central Bank's objective of maintaining price stability is attained through maintenance of the level of foreign reserves which is sufficient to underwrite the peg between the rand and the loti. The Bank uses reserve money, made up of currency issued and commercial banks' deposits held with the Central Bank, as an operating target of monetary policy. During the review period, the monetary policy operations have been geared towards absorbing excess liquidity in the economy with a view to:

- attaining a monetary base target;
- ensuring that the discount rate on Government of Lesotho's Treasury bills moves in line with regional interest rates movement and;
- through (i) and (ii), to attain the net international reserves target required to maintain the peg between the loti and the rand as well as the IMF's extended credit facility program target.

The Bank's Monetary Policy Committee (MPC) convened six (6) times during the reporting period to review international and domestic economic developments and monetary policy operations with the view to adopting an appropriate policy stance which is in line with the objectives above. Management of the Bank implemented decisions of the MPC with success throughout the review period. This culminated in subdued inflation rate and meeting set targets with the respect to the Net International Reserves (NIR), and successful maintenance of the Loti and Rand peg.

4.2 Reserves Management

For the year under review the Bank, through the Department of Financial Markets, continued to manage foreign exchange reserves prudently. With pressing economic conditions and uncertainties surrounding the global economy, the reserves management function of the Bank continued to be challenged throughout 2012. However, the Bank's portfolio managers continued to adhere to the Strategic Asset Allocation that the Bank adopted when joining the World Bank Reserves Advisory Management Program (RAMP) in 2008. Foreign exchange reserves increased by 17 per cent from 2011, reaching 4.7 months of import cover at the end of December 2012 and the increase is attributed to a surge in SACU revenue as well as the depreciation of the Loti against major currencies that form part of the Bank's portfolio.

4.3 Financial Sector Supervision and Regulation

Towards the objective of maintaining a healthy and sound financial sector that stimulates economic growth, the Bank licenses financial institutions, regulates and supervises them through offsite surveillance and onsite inspections. The data provided by these institutions is analyzed in accordance with international standards and local regulatory requirements. The Bank continues to implement and enhance the Risk Based Supervision (RBS) approach in supervisory activities with technical support from the International Monetary Fund (IMF). Noteworthy milestones in the review period are in the areas of regulatory instruments and sector growth in terms of service footprint.

4.3.1 Regulatory Instruments

- The Financial Institutions Act (FIA) 2012 was passed by Parliament.
- The Credit Reporting Act 2011 was published and Credit Reporting Regulations were drafted.
- The Data Protection Act of 2011 was published.
- The Credit and Deposit Taking Institutions Regulations were reviewed.
- The review of Money Transfers and Foreign Exchange Bureau Regulations was completed.
- Review work on the Collective Investment Scheme Regulations, 2001 commenced in 2012.
- The Insurance Bill 2012 was passed to the Office of the Parliamentary Counsel for consideration.
- A policy paper on Pension Fund Regulations was presented for consideration and approval by the Cabinet.
- The Bank established the Deposit Protection Division whose primary function is to provide a financial safety-net for troubled banks and ensuring timely intervention and resolution of disputes.

4.3.2 Sector Footprint Increase

The period was marked by remarkable increase in the local banks' distribution footprint:

- new branches were opened
- 16 Automated Teller Machines (ATMs) were commissioned
- 123 points of sale were installed

4.3.3 Licensing and Compliance

In the review periods, the Bank considered applications for licensing of regulated entities in accordance with relevant statutory provisions as follows:

- Sixty (60) existing money lending licenses were renewed and fifty four (54) new licenses were issued.
- Momentum Life Limited was licensed but never operated and the license was not renewed.
- Seventeen (17) incorporated insurance brokers' licenses were renewed.
- Five (5) new insurance brokerage applications were received and their processing is in progress and expected to be finalized in the first half of 2013.

Propriety and fitness tests were conducted to achieve requisite quality in the leadership and governance of regulated entities. Compliance with laws, regulations, policies and directives was monitored continuously during the year.

4.4 Payment Systems

The Bank continually pursues reforms aimed at improving and modernizing payments systems in the country, with technical support from the IMF. The Automated Clearing House (ACH) project was launched, with the full functionality of its Electronic Funds Transfer (EFT) payment stream achieved, in February 2012 as planned. Coming into operation of the EFT stream paved way for the cheque clearing stream, the Maseru Image Automated Clearing House (MIACH). Implementation of MIACH will reduce time taken to clear an instrument and avail funds to the customer on the same day.

In the review period, the Bank, in collaboration with Mobile Network Operators (MNOs) and the commercial banks, facilitated a successful implementation of mobile payments systems and mobile banking. One MNO successfully launched its product during the year under review while the other lodged an application with the Bank. This is a notable stride towards financial inclusion.

4.4.1 Relationship With Government

The Bank continued to perform various functions on behalf of the Government of Lesotho (GoL) such as auctioning of Government Treasury securities, with bi-weekly Treasury bill auctions and the issuance of the 7-year Treasury bonds in February 2012. Furthermore, the Bank collaborates with the GoL, through the Ministry of Finance, in economic policy affairs. During the year under review the Bank authored commentary and advisory notes as well as participating in various government fora on economic issues.

The Bank continued to apprise the Minister of the state of the economy on a quarterly basis having monitored international economic trends and the performance of the domestic economy. The findings thereof have been published in the Bank's economic quarterly reviews and disseminated to a wide array of stakeholders.

The Bank further executes payments on behalf of the GoL. Towards improving this function the Bank, through its ICT department, commenced work on the automatic and secure interfacing of the Government Integrated Financial Management Information System (IFMIS) and the Bank's Real Time Gross Settlement (RTGS) and EFT systems to enable faster processing of the Government's payment instructions. Interfacing of the Bank's central securities depository system to the Ministry of Finance debt management function is in progress. Its completion will enable monitoring and analysis of public debt.

4.4.2 International Cooperation

The Bank continued to participate in meetings and conferences of various international structures to which it is a member. In the review period, the Bank was elected as a representative of the Southern African sub-structure of the Association of African Central Banks and as an observer, on behalf of the SADC Committee of Central Bank Governors (CCBG) in the Financial Stability Board Regional Consultative Group for Sub-Saharan Africa. It continued to be a member of the Research Review Panel of the SADC Committee of Central Bank Governors, and a chair of the Financial Markets sub-committee of the same committee of Central Banks Governors. The Bank also joined and became a member of the Alliance for Financial Inclusion network during the review period.

4.5 Internal Affairs

4.5.1 Human Resources

The Human Resources Division continued to strive for excellence in human resources management by, among other things, reviewing the staff welfare policies, reviewing remuneration strategies and training its personnel in critical areas to the Bank's mandate, functions and internal efficiency. The Bank puts emphasis on good health and wellbeing of its employees. To that end, the LRCC runs gymnasium and the clubhouse for members of staff and the general public. Several upkeep activities were carried out during the review period to ensure that the Centre remains a facility of high standards for the benefit of the users.

In terms of staff movements, the Bank separated with 9 staff members while at the same time recruited 23 new members of staff to its various ranks in this period.

4.5.2 Risk Management

In an effort to adopt a coordinated and uniform approach to managing its risk, Central Bank of Lesotho established an Enterprise Risk Management Department (ERMD) to coordinate the bank's risk management efforts. During 2012, the ERMD has:

- Established a risk management framework and sensitized the Bank's departments on the framework to facilitate compilation of an enterprise risk register. The compilation of the risk register though commenced in the review period is expected to be completed in the next reporting period.

- In line with risk management and business continuity management's best practices, the Department put together the necessary polices to guide its operations. The policies have since been approved by the Board.

- Through interaction with business departments, ERMD was able to test the Bank's new Disaster Recovery (DR) site, as an on-going effort to ensure the site's readiness at times of disaster.

4.5.3 Information and Communications Technology

The Information and Communications Technology (ICT) department provides centralized ICT services to the Bank. The services include infrastructure, data processing, help desk support and business applications. In 2012, the department embarked on a number of projects some of which are:

Completion of the establishment of a temporary ICT and Work Areas recovery site: This entailed installation of equipment, communications infrastructure and enabling continuous replication of critical systems to meet the set recovery time and recovery point objectives.

Server Virtualisation and Internal Network upgrade was completed towards the end of the review period. The server virtualisation project has enabled elimination of physical servers in the data centre, thereby saving space, reducing power consumption and significantly improving available data storage capacity and responsiveness to server requirements to host new systems. This infrastructure project has further been extended to the Disaster Recovery site with enabled replication between the Bank and the site thereby further improving the Bank's ability to resume its operations with minimal delay in the event of disruptions at the primary site. The internal network was also upgraded and this improved stability significantly. This was further improved by enabling remote access and monitoring by the technical support team to quickly respond and correct problems which arise outside of normal working hours.

4.5.4 Finance

A newly created Department of Finance, through the Accounts & Budgets Division, continued to prepare and monitor the Bank's budget, monitor and account for all movements of the Bank's assets, and to prepare the financial statements in accordance with the International Financial Reporting Standards and in the manner required by the Central Bank of Lesotho Act of 2000. The Reconciliation and Verifications Section continued carrying out its watchdog role of the Department through monitoring and ensuring that policies and procedures within the Department have been followed and that internal controls have been adhered to.