CENTRAL BANK OF LESOTHO

ANNUAL REPORT

2011

Maseru
March 2012

BOARD OF DIRECTORS

M. P. Senaoana	-	Governor & Chairman (Board)[1]
R. A. Matlanyane	-	Deputy Governor I
Vacant	-	Deputy Governor II
J. Q. Lesitha	-	Director
P. M. Mangoela	-	Director
M. Posholi	-	Director

MANAGEMENT

M. P. Senaoana	-	Governor
R. A. Matlanyane	-	Deputy Governor I
Vacant	-	Deputy Governor II
M. Motebang/J. Ntšekhe	-	Director of Operations (acting)
M. Morokole	-	Director of Supervision (acting)
M. Molekane	-	Director of Administration (acting)
M.G. Makenete	-	Director of Financial Markets
M. S. Mahooana	-	Director of Information & Communication Technology (acting)
M. P. Makhetha	-	Director of Research
M. Malope	-	Director of Corporate Affairs
M. Mohasoa	-	General Manager – Lehakoe Recreation and Cultural Centre (acting)

DIVISIONAL HEADS

Governor's Office

P. Letlela	-	Internal Audit
L. Khaka	-	Accounts & Budget
T. Malataliana	-	Currency
Vacant	-	Security

Administration

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

Information and Communications Technology

M. Sekoati	-	Business Solutions Development (acting)
R. Motjolopane	-	Business Solutions Development (acting)

[1] Until March 2011

T. Mpheteng	-	Infrastructure & Operations

Operations

J. Ntšekhe	-	Banking Operations
M. Motebang	-	National Payment Systems
M. Tabane	-	Development Finance
Vacant	-	Rural Finance

Supervision

T. 'Mokose	-	Financial Institutions Supervision (acting)
F. Morokole	-	Insurance Supervision
L. Leuta	-	Policy, Regulations & Exchange Control (acting)
N. Bereng	-	Non-Bank Supervision

Financial Markets

B. Phakoe	-	Investments and Market Operations
M. Mohapi	-	Treasury Operations

Research

T. Tlelima	-	Real Sector (acting)
L. M. Lephoto	-	Finance
R. Masenyetse	-	Macroanalysis

Corporate Affairs

N. Mokitimi	-	Legal Services (acting)
T. Ntlhakana	-	Corporate Governance
T. Mohasoa	-	Public Relations (Acting)

Central Bank of Lesotho
P O Box 1184
MASERU 100
Lesotho

March 29, 2012

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

Honourable Minister

I have the honour to transmit the Annual Report of the Central Bank of Lesotho for the year 2011, 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, 2011, certified by Deloitte and Touche and Letacc ; and

ii) a report on the Bank's operations and statement of affairs during 2011.

Yours faithfully

A. R. Matlanyane (PhD)
GOVERNOR

PART I FISCAL POLICY SUSTAINABILITY IN LESOTHO: LESSONS FOR THE FUTURE

1.1 Introduction

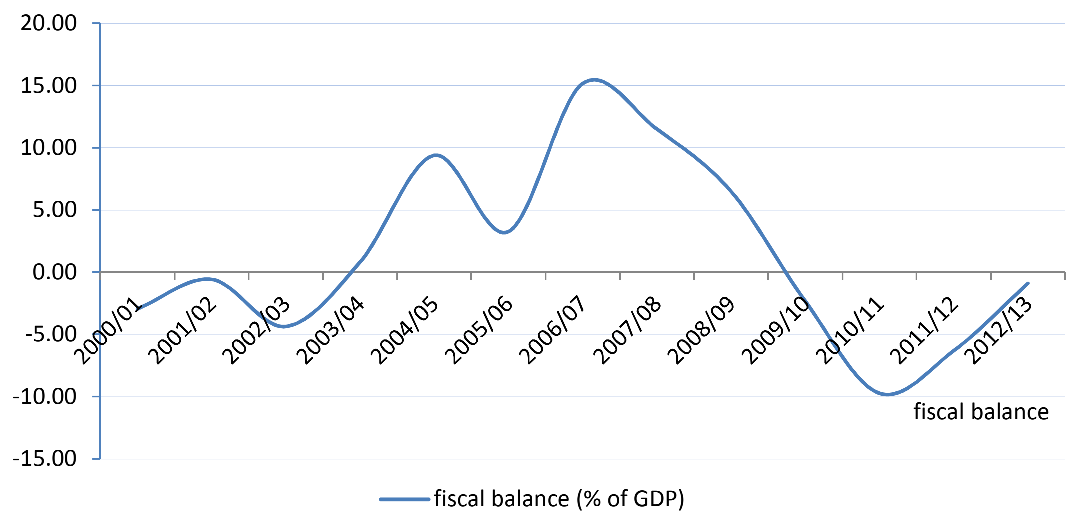
Of major macroeconomic challenges facing economies globally, the attainment of fiscal sustainability stands out as the most predominant in recent years. Policy makers and academics have deliberated on how best to conduct fiscal policy without jeopardizing sustainability. Nevertheless, no consensus has been reached. The concern about fiscal sustainability has intensified since the onset of the global financial crisis as most countries responded to the crisis by undertaking huge financial injections in order to mitigate the effects of the global financial crisis. As a consequence, this pushed many countries, especially Europe and the US, into financial woes. Although the financial crisis had a disproportionate effect on all countries, the impact was felt by almost every country. Developing economies such as Lesotho were also not immune to the contagion effects of the crisis. The impact was felt mostly on the fiscal side through the deterioration in customs revenue. The Southern African Customs Union (SACU) revenue, which accounts for over 50 per cent of Lesotho's revenue, deteriorated by over 50 percent at the height of the crisis.

Consequently, Lesotho had to undertake major fiscal adjustments aimed at restoring fiscal sustainability. Despite the fiscal consolidation efforts by the Government of Lesotho (GoL), the fiscal deficit as percentage of GDP still remained high. Therefore, it is important to discuss the sustainability of Lesotho's fiscal policy in light of these challenges. Although there are many definitions of fiscal sustainability, the commonly adopted definition is the ability of a government to maintain the debt to GDP ratio stable or declining over time. The paper starts by giving the evolution of fiscal policy over the period 2000/01 to 2012/13 as well the structure of both revenues and expenditure over time. The next section evaluates Lesotho's fiscal sustainability by adopting the following determinants of changes in the debt-GDP ratio; primary balance, the differential between the interest rate and economic growth, stock-flow adjustment.

1.2 Evolution of Fiscal Policy 2000/01 -2012/13

Figure 1 below depicts the evolution of fiscal policy over the period 2000/01 to 2012/13. A quick glance at figure 1 shows that the overall balance has been volatile over the period 2000/01 to 2012/13. That is, between 2000/01 and 2003/04 fiscal policy was largely expansionary and the deficit was financed through the domestic banking system, specifically the drawdown of Government deposits with the Central Bank of Lesotho. However, from 2003/04 to 2009/10, fiscal surpluses were attained. In 2006/07, the fiscal surplus as a percentage of GDP reached a peak of 15.2 per cent. The surpluses were underpinned by a steady increase in SACU receipts over that period. Consequently, Government deposits with the banking system increased substantially over this period. The relatively high SACU receipts resulted from significantly high imports, from the rest of the world, into the SACU region. It is important to emphasize that the higher the imports into the SACU region the higher the customs revenue pool. However, as the financial crisis set in, there was a deterioration in trade performance between the SACU region and the rest of the world, and that led to a steep decline in the customs revenue pool. The deterioration in SACU receipts, triggered by the global financial crisis, showed the susceptibility of the customs revenue to trade volatility. But of even much concern is the vulnerability of Lesotho's fiscal performance to changes in SACU receipts as it accounts for over 50 percent of total revenue. In the absence of a buffer, Lesotho would have to instantly cut its expenditures, which would have knock-on effects on the rest of the economy.

Figure 1 Fiscal Balance as a Percentage of GDP

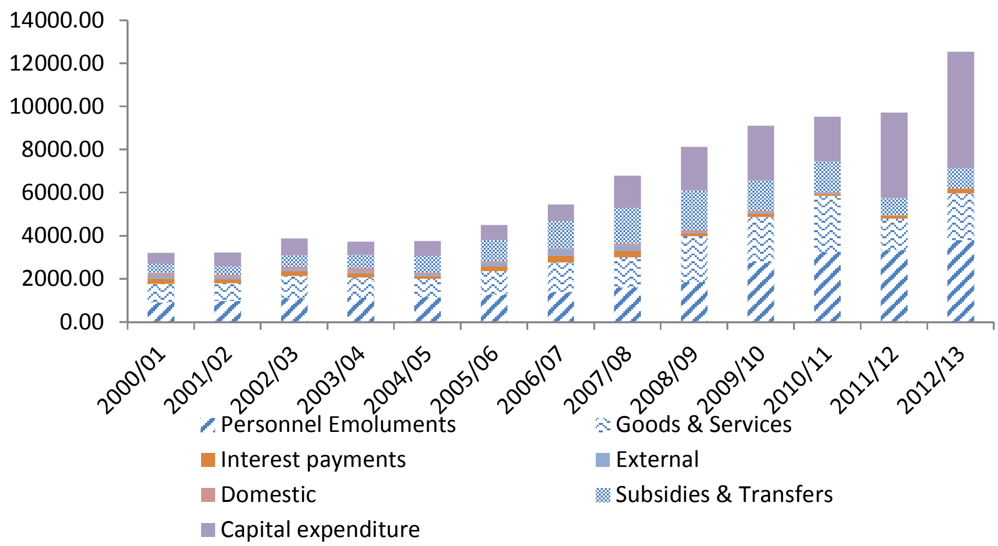


The structure of revenues bears testimony to the fact that customs revenues account for the largest share of total revenue. It had also been increasing quite rapidly over the years 2003/04 to 2009/10. The non-customs revenue had also been on an upward trajectory since 2003 following some major fiscal reforms including the establishment of the Lesotho Revenue Authority (LRA), an autonomous body charged with overseeing tax collections in Lesotho.

Figure 2: Revenue Structure 2000-2012 (Million Maloti)

Expenditures also depict a similar trend to the revenues. Since the 2005/06 fiscal year, they have also assumed an upward trend, with the largest component over the period being compensation of employees. The expansion in compensation for employees largely reflected the growth in the public sector over time. Another major contributory factor to the growth in expenditures was a constant increase in expenditures on goods and services up until 2010/11. Capital expenditures, which have remained quite mediocre between the fiscal year 2000/01 and 2006/07, have also increasing since 2007/08 fiscal year. This reflected Government efforts to channel resources towards sectors that have a potential to accelerate economic growth. Capital expenditure allocations were directed towards; construction of roads in the rural and urban areas, building of bridges and footbridges in the lowlands and highlands, and erection of school buildings.

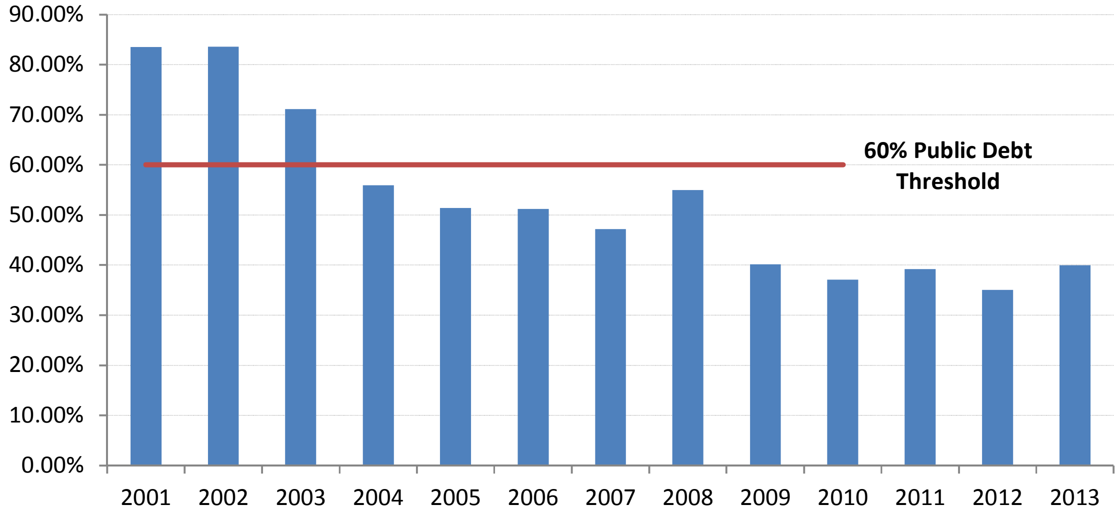
Figure 3: Expenditure Structure 2000-2012 (Million Maloti)



1.3 Sustainability of Lesotho's Fiscal Policy

Having discussed the evolution of fiscal policy in Lesotho, as well as the structure of revenues vis-à-vis expenditures, the next relevant question is whether Lesotho's fiscal policy is sustainable in light of its economic performance in recent years and the likely performance going forward. Fiscal policy is said to be sustainable if the ratio of public debt to GDP is stable and declining over time. Figure 4 below shows that the public debt as a percentage of GDP has been declining overtime and remains below the 60 percent sustainability threshold. Although the public debt to GDP ratio has been on a decline, it is important to identify the determinants of changes in the debt to GDP ratio in order to assess the likely risks to fiscal sustainability. The following determinants of changes in the debt to GDP ratio are analyzed with a view to gauge the sustainability of Lesotho's fiscal policy; the primary balance, the differential between the interest payments and the economic growth and the stock-flow adjustments.

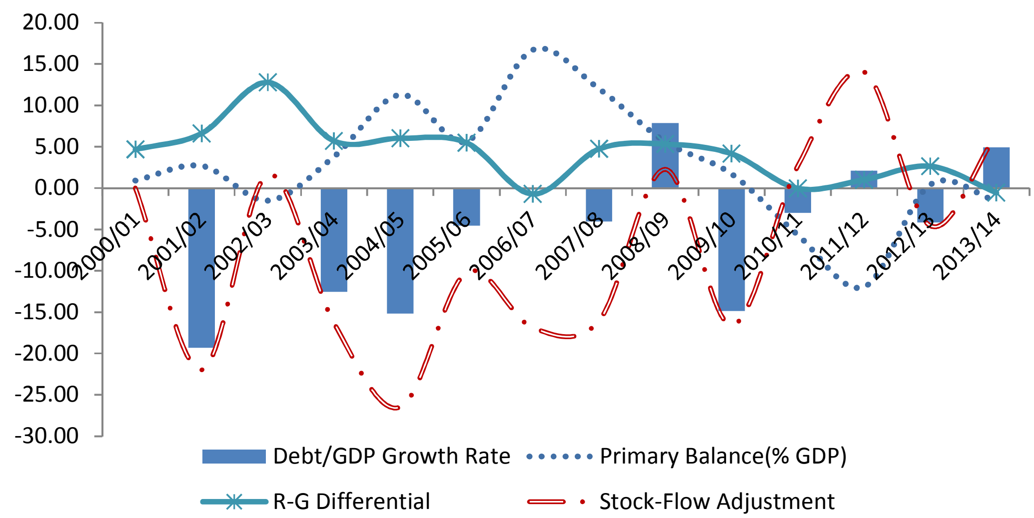
Figure 4: Public Debt to GDP Ratio



Primary Balance

As explained above, the primary balance refers to the overall deficit excluding interest payments and is a major determinant of fiscal sustainability. As can be observed in figure 5 below, the primary balance has been in surplus between the fiscal years 2003/04 and 2009/10. The primary balance was bolstered by the constant increase in SACU receipts. This also explains the decline in the debt to GDP ratio over time. However, in the 2011/12 fiscal year, the primary balance deteriorated to a low of -11.9 per cent as a share of GDP and this was underpinned by a drop in SACU revenue. However, an immediate increase in the public debt was not observed as Government continued to rely heavily on its deposit buffer to finance the deficit. Had the situation persisted, a huge increase in the debt to GDP ratio could have been observed. As explained earlier, SACU revenues account for the largest share of expenditures and a slight change in SACU revenue is mirrored in the fiscal balance. Therefore, the major risk to the fiscal sustainability is the high dependence on SACU revenue whose performance can be highly volatile. In 2012/13 fiscal year, SACU revenue is estimated to account for 45.6 per cent of total expenditures.

Figure 5: Decomposition of the Debt Accumulation 2000/01-2013/14



Interest rate – Growth Differential

The interest rate growth (R-G) differential refers to the difference between the interest rates and output growth rates. High interest rates raise the debt GDP ratio by pushing up the overall deficit, while higher output growth rates reduce the debt to GDP ratio through the denominator effect. Thus positive domestic interest rate-growth differential, imply the growth of the debt to GDP ratio. As can be observed on figure 5 above, the interest rate-growth differential has been positive, implying that the interest rates on domestic debt have been growing at a faster pace than the rate of growth of the economy. Since the majority of the Lesotho's debt is foreign and highly concessional the debt to GDP ratio did not respond accordingly. However, the domestic debt has been increasing lately especially since Lesotho experienced a shock on the revenue side. A widening of the interest rate-growth gap could pose a major threat to the debt to GDP ratio and ultimately fiscal sustainability.

Stock-Flow Adjustments

Stock flow adjustments refer to the changes in the debt to GDP ratio not associated with the primary deficit. Changes in stock-flow adjustments mostly reflect acquisition or reduction in financial assets and valuation changes. As can be observed in figure 5 above, the debt GDP ratio has largely responded to the stock flow adjustments. The stock flow adjustment was negative over the period 2000/01 and 2010/11 implying that public debt has been declining driven by exchange rate. Since the majority of Lesotho's debt is foreign and highly concessional, it is subject to exchange rate changes. Government also repaid some of the non-concessional debt during the period of fiscal surpluses. Therefore, negative stock flow adjustments reflect the exchange rate movements and the reduction in government debt.

1.4 Lessons for the Future

Lesotho's fiscal policy remains sustainable when observing the debt to GDP ratio in recent years and for the foreseeable future. However, a stable debt to GDP ratio is insufficient to give conclusive remarks concerning fiscal sustainability. The major risks to fiscal sustainability remain the heavy reliance on SACU revenue as a dominant source of revenue as it is highly vulnerable to external shocks that hit the SACU region. Therefore it is imperative that Lesotho continues to build up its deposits with banking system to create a buffer against such shocks. The buffer that Lesotho had built over the years has proven to be very helpful during the crisis. Another major risk is the widening interest rate-growth differential. For fiscal policy to be sustainable, the gap should be narrowing and negative, especially in light of the increasing domestic debt. It is also important that resources be directed towards sectors that have potential to accelerate economic growth.

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

2.1 Introduction

Global economic activity weakened significantly in 2011 in comparison with 2010. Recovery was threatened by intensifying strains in the euro area and fiscal fragilities in other economies. Global output grew by 3.8 per cent in 2011 following 5.2 per cent observed in 2010. The slowdown reflected the sovereign debt and banking sector problems in the euro area; supply chain disruptions caused by the Great East Japan earthquake and tsunami; social unrest in the Middle East and North Africa (MENA) region; fiscal consolidation problems in the United States (US); and a surge in oil prices. Real GDP in advanced economies showed a modest growth of 1.6 per cent in 2011, underpinned by the reassertion of the supply chain disruptions. Economic activity in emerging and developing economies remained robust at 6.2 per cent. This growth was however, dampened by slow foreign demand, capacity constraints and policy tightening. This reflected an inadequate transition from public to private demand in advanced economies and from external demand driven growth to domestic demand driven growth in emerging and developing economies.

2.2 Industrialised Countries

2.2.1 The United States (US)

Economic growth in the US continued to be slow in 2011. The US economy grew by 1.7 per cent in 2011 in comparison with 3.0 per cent in 2010. The deceleration in economic activity reflected the slowdown in exports, private inventory investment, as well as federal government spending. The economy grew at a rate of 1.6 per cent in the quarter ending December 2011 compared with the 1.5 per cent growth realised in the third quarter of 2011. Growth was supported by an increase in consumption as consumers unexpectedly lowered their savings. Positive contributions were also gained from personal consumption expenditures, private inventory investment and exports. The insufficient progress in developing medium term fiscal consolidation plans in the US remained a downside risk to growth.

In line with the recovery in the US during the second half of 2011, the unemployment rate declined to 8.7 per cent in December 2011 compared with 9.4 per cent registered in 2010. More jobs were gained in retail trade, manufacturing and mining.

The US inflation rate rose to 3.0 per cent in 2011, from 1.4 per cent in 2010. The acceleration in inflation was driven by food and energy prices which rose by 6.6 per cent and 4.7 per cent, respectively in 2011. Moderate growth, stable inflation expectations and low rates of resource utilisation warranted the Federal Reserve Bank's Open Market Committee to maintain its benchmark lending rate at a record low of 0.25 per cent throughout December 2011.

The revival in consumer demand in the US augurs well for Lesotho's exports as the domestic exports of manufactured goods, in particular clothing and textiles, are destined to the US market.

2.2.2 The Euro Zone

According to the IMF projections, the Euro Zone[2] was expected to grow by 1.6 per cent in 2011 following a 1.9 per cent growth registered in the previous year. The slowdown reflected the effects of the sovereign debt crisis in the euro area. The crisis led to banking sector losses and caused fiscal sustainability problems that widened sovereign spreads. Domestic demand generally lagged behind economic growth in most advanced European economies, reflecting mainly sluggish household consumption. Even as the negative effects of high commodity prices and supply disruptions from the Japanese earthquake diminished, the on-going financial turbulence slowed down economic activity through lower confidence and financing. Real GDP growth was expected to slow down to 0.3 per cent in the second half of 2011 from 2.0 per cent in the first half of 2011.

The inflation rate in the Euro Zone, measured by changes in the Harmonised Index of Consumer Prices (HICP) rose from 1.6 per cent in 2010 to 2.7 per cent in 2011. This upsurge in consumer price inflation was attributable to the rise in commodity and food prices. As a result, the European Central Bank (ECB) maintained its benchmark lending rate at 1.0 per cent at the end of the review year.

The economic slowdown in the Euro Zone does not bode well for Lesotho as most of diamond exports are destined for the region.

2.3 Emerging Market Economies

In emerging economies, economic activity remained strong in the review year. However, growth decelerated from 7.3 per cent in 2010 to 6.2 per cent in 2011. The strong growth was mainly on account of strong labour markets; firm consumer and business sentiment; solid growth in credit and asset prices; as well as buoyant domestic demand supported by relatively accommodative policies. Growth was dampened by weak external demand due to the persistent financial shocks from the euro area and US which might eventually impinge on domestic demand and regional financial stability.

Inflationary pressures appeared to be disparate across emerging economies. The average annual inflation rate in emerging economies was estimated at 5.3 per cent for 2011, assuming stable commodity prices. Inflationary

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

pressures were expected to be high in economies with sustained strong credit growth, positive output gaps and accommodative policies, while they were relatively lower for other emerging economies.

The main downside risk in emerging and developing economies was the possibility of a hard landing, especially in the context of slowing and uncertain potential output. This could be caused by the possibility of unwinding of the strong credit and asset growth which would trigger loss in confidence, demand and, therefore, a decline in economic activity. Furthermore, it could also be triggered by materialisation of the upside risks to inflation which would attract tighter policies and provoke a hard landing in output.

Increased inflation in the Asian economies would mean that Lesotho's export competitiveness would be hurt through increased production costs as raw materials for the textile manufacturing sector are sourced from the Asian economies.

2.4 South Africa (SA)

According to the IMF, economic activity in South Africa was estimated to increase marginally in 2011. Real GDP was estimated to grow by 3.1 per cent compared with the 2.8 per cent growth realised in the previous year. Economic activity in South Africa has benefited from robust private consumption and reinvigorated investment, supported by a low interest rate environment and a return to the issuance and renewal of mining licenses. However, growth continued to be threatened by low capacity utilisation, high unemployment rate, and weak global developments.

The inflation rate, measured by changes in the consumer price index, recorded an annual average of 5.0 per cent in 2011, and was within the 3.0 per cent to 6.0 per cent target range, in comparison with 4.3 per cent observed in 2010. Food prices remained the major driver of inflation. The impact of the rand depreciation in the review year, in response to the changes in global risk aversion, was evident in inflation. Though it is expected that exchange rate would be stable for a protracted time, it would depend mainly on global sentiment and developments.

In line with the deteriorating growth outlook for the economy, modest domestic demand as well as the cost-push nature of inflationary pressures, the South African Reserve Bank's (SARB) Monetary Policy Committee (MPC) decided to keep the key interest rate at 5.5 per cent throughout 2011.

Through the trade links, the moderate inflation has translated into moderate inflation in Lesotho as large proportion of Lesotho's inflation is imported from SA. The expected growth in economic activity in SA is expected to have a positive effect on growth in Lesotho.

Table 1

SELECTED ECONOMIC INDICATORS, 2007-2011*
(Percentage changes unless otherwise stated)

Indicators	2007	2008	2009	2010	2011*
World Output	5.2	3.0	-0.6	5.2	3.8
Advanced Economies	2.7	0.6	-3.4	3.2	1.6
Of which:					
United States	2.1	0.4	-2.6	3.0	1.7
Euro Area	2.7	0.7	-4.1	1.9	1.6
Japan	2.3	-0.7	-6.3	4.4	-0.9
United Kingdom	2.6	0.7	-4.9	2.1	0.9
Emerging and Developing Economies					
Of which:					
Africa					
Sub Saharan	7.0	5.6	2.8	5.3	4.9
South Africa	5.1	3.1	-1.7	2.9	3.1
Developing Asia					
China	13.0	9.6	9.2	10.4	9.2
India	9.4	7.3	5.7	9.9	7.4
Consumer Prices					
Advanced Economies	2.2	3.4	0.1	1.6	2.7
Of which:					
United States	2.9	3.8	-0.3	1.4	1.4
Euro Area	2.1	3.3	0.3	1.6	3.0
Japan	0.0	1.4	-1.4	-0.7	-0.4
United Kingdom	2.3	3.6	2.1	3.3	4.5
Emerging and Developing Economies					
Of which:					
Africa	6.0	10.3	9.0	7.1	7.1
Sub Saharan	6.8	11.9	10.4	7.5	8.4
South Africa	7.1	11.5	7.1	4.3	5.9
Developing Asia					
China	4.8	5.9	-0.7	3.3	5.5
India	6.4	8.3	10.9	12.0	10.6
World Trade Volume (Goods and Services)	7.3	2.8	-10.7	12.7	6.9
Exports					
Advanced Economies	6.3	1.9	-11.9	12.2	5.5
Emerging and Developing Economies	9.8	4.4	-7.5	13.8	9.0
Imports					
Advanced Economies	4.7	0.5	-12.4	11.5	4.8
Emerging and Developing Countries	13.8	9.4	-8.0	15.0	11.3

Source: IMF World Economic Outlook September 2011.
* IMF Projections

2.5 Commodity Price Developments

2.5.1 Gold Prices

The annual average price of gold rose by 27.8 per cent to US$1 570.6 per ounce during the review year, compared with an increase of 26.2 per cent recorded in 2010. The rise in gold prices mirrored an upsurge of global demand for gold during the year, since investors shifted to gold as it is regarded as a 'safe haven' investment during the turbulence economic times. This was caused by the uncertainty and volatility in the global financial markets related to the impact of the sovereign debt crisis in the euro zone. Gold prices reached the respective minimum and maximum levels of US$1 313.9 per ounce and US$1 900.2 per ounce in the year under review. In rand terms, the annual average price of gold increased by 27.5 per cent to M11 441.2 per ounce in 2011, from M8 974.7 per ounce registered in the previous year.

2.5.2 Platinum Prices

The annual average price of platinum increased by 6.1 per cent to US$1 720.5 per ounce in 2011 from US$1 622.0 per ounce observed in 2010. It registered minimum and maximum levels of U$1 369.2 and US$1 903.7 per ounce, respectively, during the review period. In rand terms, the annual average price of platinum rose by 4.8 per cent to M12 437.3 per ounce in the period under review, from M11 868.6 per ounce in the previous year.

2.5.3 Oil Prices

In 2011, the price of crude oil accelerated as a result of an increase in global demand, largely influenced by China and India. Moreover, the political turmoil in MENA region disrupted supply side and exerted upward pressure on crude oil prices. On an annual average, crude oil grew by 38.7 per cent to US$107.4 per barrel in the review year, from US$77.4 per barrel observed in 2010. During the review period, it registered minimum and maximum levels of US$89.3 and US$120.0 per barrel, respectively. In maloti terms, , it rose by an annual average of 37.6 per cent to M779.6 per barrel in 2011, following M566.4 per barrel recorded in the previous year. Acceleration of oil prices exerted upward pressure on global inflation rates.

In line with the global developments in petroleum products, there were several revisions of fuel prices in Lesotho during the year. Price of petrol in Lesotho closed the review year at M9.55 per litre, while those of diesel and illuminating paraffin closed the year at M10.80 per litre and M7.90 per litre, respectively. During the year, minimum levels of M7.40 per litre for petrol, M7.75 per litre for diesel and M5.40 per litre of illuminating paraffin were registered, while the maximum levels recorded were M9.70 per litre for petrol, M10.80 per litre for diesel and M7.90 per litre for illuminating paraffin.

2.5.4 Maize Prices

The annual average spot prices of white and yellow maize grew by 58.2 per cent to US$260.3 and 51.6 per cent to US$262.4 per tonne, respectively, in 2011, compared with their respective declines of 0.5 per cent and 0.6 per cent in the previous year. The observed increases in prices were underpinned by adverse weather conditions and supply shocks coupled with strong demand for cereals during the year. In maloti terms, white and yellow maize accelerated to annual average spot prices of M1 900.8 and M1 914.2 per tonne in 2011, from M1 200.4 and M1 262.7 per tonne, respectively, in the previous year.

2.5.5 Wheat Prices

The annual average spot price of wheat rose by 42.0 per cent to US$312.4 per tonne during the review period, from US$220.0 per tonne recorded in the previous year. In maloti terms, the average spot price of wheat increased by 41.2 per cent to M2 255.2 per tonne in 2011, following a decline of 14.1 per cent observed in the previous year.

2.6 Lesotho in the Context of Regional Economic Integration

Lesotho continued to demonstrate strong commitment to economic cooperation throughout 2011 by actively participating in activities of regional economic organizations such as the Southern African Customs Union (SACU)[3], Southern African Development Community (SADC)[4] and the Common Monetary Area (CMA)[5].

During the review year, SACU continued with the implementation of the 2002 SACU agreement and negotiated various free trade agreements (FTA) with the major trading blocs. The review of the SACU Revenue Sharing Arrangement, which began in 2010, continued into 2011. The review was done so as to evaluate issues relating to the operations of the current revenue sharing arrangement and to develop possible options on an equitable revenue sharing arrangement.

With regard to the SACU-World Customs Organization (WCO), the customs development programme continued. This programme was presented at the WCO capacity building meeting in Belgium on May 2011 targeting the global customs audience. The following were identified from the meeting as important for SACU towards building a regional center of customs:

- Closer collaboration with WCO in various technical areas;
- Access of SACU Secretariat into WCO members resources;
- Closer collaboration with the WCO for capacity building activities that will sustain and support the activities of the customs development programme.

[3] SACU comprises: Botswana, Lesotho, Namibia, South Africa, and Swaziland.
[4] SADC comprises: Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.
[5] CMA comprises: Lesotho, Namibia, South Africa and Swaziland.

The SACU Council of Ministers adopted the SACU customs policy framework which sets trade facilitation, economic protection and social protection as the three pillars for customs cooperation in the region. Moreover, in an effort to establish regional connectivity between member states, SACU has launched an information technology connectivity project. In accordance with the 2002 SACU Agreement, which requires that member states apply the same legislation with respect to customs and excise duties, SACU has directed that member states review their customs legislation using the South African draft bill as a model.

Trade agreement negotiations between SACU and European Free Trade Area (EFTA), United States of America (USA), India, World trade organization (WTO) Doha Development Round and *Mercado Comun del Sur* (MERCOSUR) continued. Thus, indicating commitment to integrate with the rest of the world, thereby advancing economic development. Trade negotiations work began on an impact assessment study of the proposed COMESA/EAC/SADC Tripartite FTA.

With regard to SADC, efforts towards implementing the Protocol on Finance and Investment, which is aimed at improving the investment climate in each member state; attracting more investment in SADC; as well as enhancing cooperation, coordination and harmonization in the finance sector, were ongoing. Progress made thus far, showed that simpler-to-achieve country level commitments have not all been achieved. In respect of the harder-to-achieve regional level country commitments little progress has been made. The SADC resource mobilization strategy which is aimed at prioritizing, planning, selecting projects, broadening resource channels and co-operating with member states and international partners for effectively utilizing resources was drafted. The strategy would fulfill the following objectives:

- Ensure that there is a clear, systematic and well-coordinated approach to soliciting, acquiring, managing, reporting and evaluating assistance from international cooperating partners.
- Expand the resource base to ensure sustainable resource availability for implementation of SADC programmes in support of regional integration and millennium development goals.
- Enhance the effectiveness of development assistance.
- Improve structures and systems to facilitate better management of resources.
- Improve relations and dialogue between SADC and the international cooperating partners.

The deeper regional integration that Lesotho has embarked upon is expected to have positive implications for Lesotho. This will be manifested in trade gains, attraction of more foreign direct investment as well as diversified markets for Lesotho's exports. Employment prospects, the external position, investment and ultimately growth would improve with enhanced regional integration.

PART III DOMESTIC ECONOMIC DEVELOPMENTS

3.1 Real Sector Developments

3.1.1 Trends in Output and Income

Domestic economic growth was estimated to have slowed down in 2011 following a robust expansion in 2010. This mainly reflected varying patterns of subdued performance in all the main sectors of the economy. The secondary and tertiary sectors recorded 6.3 per cent and 2.9 per cent, respectively, while the primary sector registered 3.9 per cent in 2011. Real GDP growth was estimated at 4.3 per cent in 2011 compared with a revised 5.6 per cent in 2010.

The primary sector continued to grow, driven mainly by robust performance of the mining and quarrying sub-sector. The mining and quarrying sub-sector was supported by high international demand for diamonds, hence the high diamond prices. Nonetheless, the primary sector grew at a slower rate compared with last year mainly because of the contraction in the agriculture, forestry and fishing sub-sector. The deceleration in the secondary sector was at the back of slower growth of the manufacturing sub-sector, especially textiles and clothing. The slump in the secondary sector was somewhat moderated by the stronger performance of the building and construction sub-sector. The tertiary sector growth slowed down due to negative growth in wholesale and retail trade, as well as hotels and restaurants sub-sectors.

Real Gross National Income (GNI) was estimated to have expanded by 3.0 per cent in 2011 from a contraction of 3.8 per cent in 2010. Moreover, GNI per capita was estimated to have grown by 2.8 per cent compared with a contraction of 4.0 per cent in 2010. The increase in GNI mainly reflected a slight increase in net factor income from abroad following a decline in the previous year. The moderation in the rate of decline in factor income received from abroad was at the back of an increase in migrant worker remittances.

Table 2

AGGREGATE ECONOMIC INDICATORS
(Percentage Change, 2004 = 100)

	2007	2008	2009	2010	2011*
Constant 2004 Prices					
GDP	4.6	5.4	2.8	5.6	4.3
GNI	1.7	11.4	5.1	-3.8	3.0
GDP Per Capita	4.5	5.3	2.8	5.4	4.3
GNI Per Capita	1.6	11.3	5.0	-4.0	2.8

Source: Bureau of Statistics
* CBL Projections

3.1.2 Sectoral Performances

(a) Developments in the Primary Sector

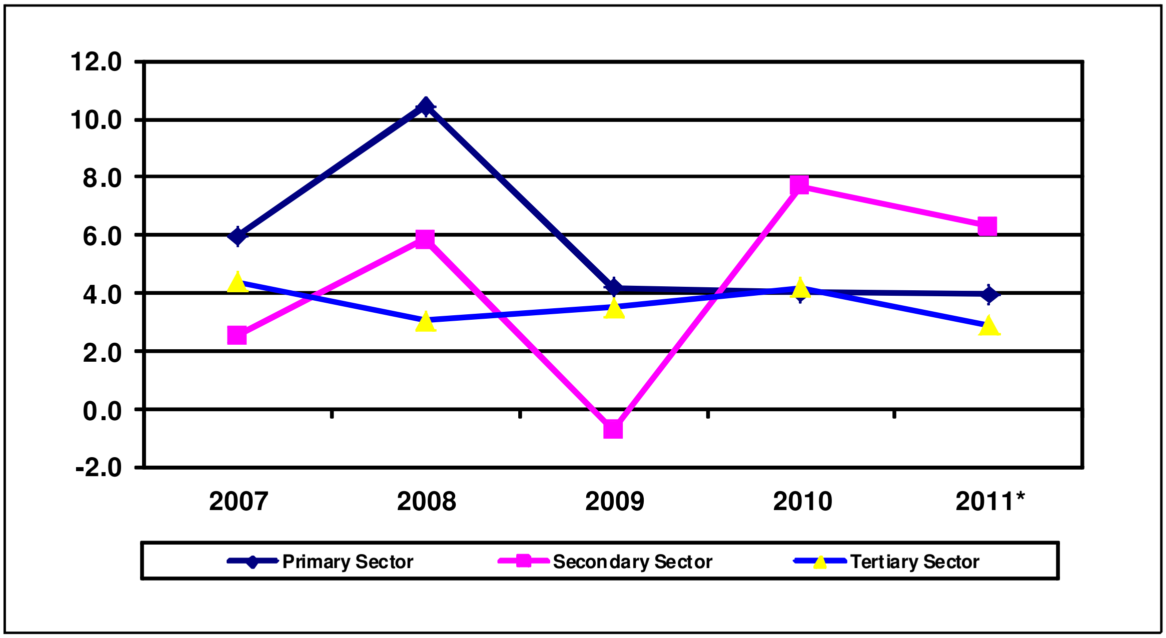
The primary sector grew at a slower rate of 3.9 per cent in 2011 compared with 4.0 per cent in 2010. The growth of the industry was largely underpinned by the strong recovery of the mining and quarrying sub-sector at the back of the surge in diamond prices during the year. The strong performance of the mining sub-sector was offset by contraction in agriculture, forestry and fishing sub-sector, hence the deceleration in the growth rate of the primary sector.

The agriculture, forestry and fishing sub-sector contracted at an estimated rate of 1.8 per cent in 2011 compared with a strong growth of 10.9 per cent in the previous year. The contraction resulted from poor performance of the crops sub-sector, which was largely affected by heavy rains, floods and storms experienced during the 2010/2011 agricultural year. Maize and sorghum yields were estimated to have declined in 2011 because of the heavy rains that ravaged the country from December 2010 to February 2011.

The mining and quarrying sub-sector grew by a robust 14.5 per cent in 2011 compared with a contraction of 6.7 per cent in 2010. The strong global demand for diamonds, evidenced by the increase in diamond prices, supported the recovery of the diamond mining industry in Lesotho in 2011. The Liqhobong and Kao mines that had closed operations since the third quarter of 2008 resumed operations during the year. In addition, a new mine, Lemphane was opened during the year. The depreciation of loti against major currencies in 2011 also helped boost export earnings.

Figure 6: Sectoral Real Growth Rates

(2004 = 100)



Source: Bureau of Statistics
* CBL Projections

BOX 1: The 2009/2010 Agricultural Census for Lesotho

The findings of the 2009/2010 Agricultural Census indicate that agriculture production, particularly production of major crops and livestock, deteriorated quite significantly in 2009/2010 compared to the previous two census years. With regard to crops, some improvement was observed in 1999/2000 compared with 1989/1990 and all crop types except wheat and peas, registered an increase. The 2009/2010 census results indicate quite a substantial decline in the production of crops, with all types of crops registering a decline compared with their levels in 1999/2000, except wheat, which rose by 56.7 per cent.

The livestock ruminant population also declined in 2009/2010 compared with the previous two census years. There was a moderate decline of 0.4 per cent in the total livestock population in 1999/2000 compared with 1989/1990. This resulted mainly from the fall in the number of sheep and goats while all other livestock types realized an increase. The 2009/2010 census results indicated a much higher fall of 4.0 per cent in the total livestock population compared with the previous census findings. Only sheep registered an increase during the period.

Table 3: Lesotho's Agricultural Production

Census Period	1989/1990	1999/2000	2009/2010
Type of Agricultural Product			
Crops Produced in Metric Tones			
Maize	171,600	277,626	128,213
Wheat	19,000	12,841	20,119
Sorghum	36,100	26,807	23,830
Beans	8,400	17,024	8,899
Peas	2,900	2,863	1,373
Total	**238,000**	**337,161**	**182,434**
Animals in Numbers			
Cattle	523,000	755,134	626,343
Sheep	1,377,000	1,109,107	1,228,557
Goats	994,000	937,600	875,184
Pigs	66,500	103,700	83,976
Horses	55,300	98,933	69,842
Total	**3,015,800**	**3,004,474**	**2,883,902**

Source: Lesotho Agricultural Census Reports

The deterioration in production over the years has resulted in a situation where Lesotho produces only 30.0 per cent of its food requirements and the deficit has to be imported. Food aid also plays a significant role in closing the gap. There are a number of factors constraining agricultural production in Lesotho. Amongst others, these include, limited availability of arable land, declining soil fertility, erratic and unfavorable climatic conditions, particularly rain fall, poor agricultural production technologies and practices, uncontrolled grazing and the associated deterioration in the quality of rangelands, theft of livestock and crops, high production costs, lack of capital and lack of irrigation facilities and disease outbreak in case of livestock production.

The largest share of Lesotho's population resides in the rural areas and the majority of them, estimated at 80.0 per cent, rely heavily on agriculture for their livelihoods. Improved agricultural production/agricultural growth could contribute to poverty reduction in several ways. These include income growth for farmers, including small holder farmers residing mainly in the rural areas, increased employment brought about by increased demand for labour per hectare due to increased area cultivated and/or frequency of cropping, the positive impact of production links brought about by the demand for inputs and services by farmers and the demand for processing, storage and transportation of produce. At the macro level, increased agricultural output could lead to lower food prices, increased export earnings and reduced import bill, thus contributing to GDP growth.

Lesotho's agricultural sector needs to be revived to enable it to make meaningful and sustainable contribution to poverty reduction and economic growth. Properly controlled grazing could make rangelands much more productive, improved input supply, better access to capital, better technology and well managed water resources could result in proper utilization of the arable land that lie fallow every year. Promotion of green agriculture, which has the potential to increase food production without depleting the earth's resources or polluting the environment, could be an option for consideration. It minimizes production costs because it involves the use of location specific organic resource inputs and natural biological processes to restore and improve soil fertility. This could make food production more sustainable, improve food security and reduce poverty. Green agriculture presents an opportunity for Lesotho to commercialise agriculture and move away from subsistence farming. It involves production of organic food products for which global demand has risen substantially in recent years, thus presenting an opportunity for Lesotho to increase its export earnings.

(b) Developments in the Secondary Sector

The secondary sector, which comprises manufacturing, electricity and water, and building and construction sub-sectors, remained relatively strong in 2011, despite growing at a slower rate of 6.3 per cent compared with 7.7 per cent in 2010. The manufacturing sub-sector decelerated 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 64.0 per cent; food products and beverages, which accounted for 17.0 per cent and other manufacturing at 19.0 per cent of the manufacturing sub-sector's output. The sub-sector was estimated to have registered a lower growth rate of 4.6 per cent in 2011 compared with 7.9 per cent in the previous year. This could be attributed to the slow recovery of the US economy and the associated slow consumer demand, especially for the manufactured textiles and clothing. Consequently, the sector had to readjust its activities in order to cope with these pressures that were compounded by some firms that closed operations during the year, increased competition from East Asian countries and the appreciation of the loti against the US dollar in the first half of the year.

The electricity and water sub-sector was estimated to have rebounded from a contraction of 0.2 in 2010 to an expansion of 1.3 per cent in 2011. The high level of activity in this sub-sector is consistent with the good performance of building and construction sub-sector. The projects in the water sub-sector and electricity are expected to have given the sub-sector an impetus.

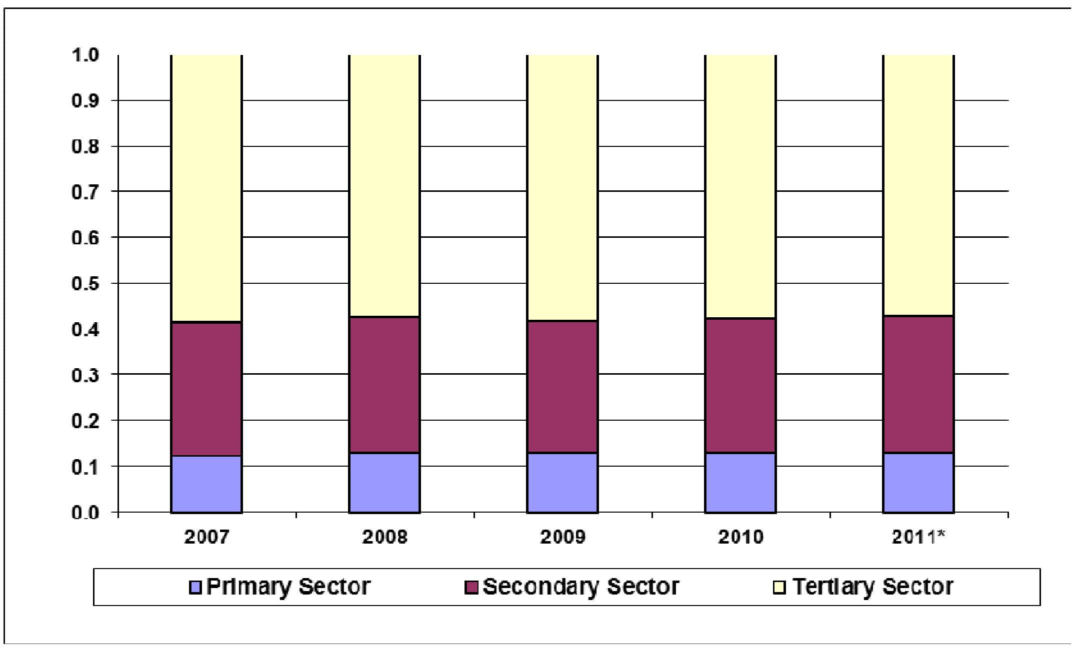
The building and construction sub-sector was estimated to have expanded by 16.9 per cent in 2011 compared with a growth rate of 13.4 per cent in 2010. The performance of the sub-sector was largely supported by building and construction projects that were implemented during the year. These included, refurbishment of filter clinics under the Millennium Challenge Account (MCA); commencement of construction of the Metolong Dam; upgrading, renovation and construction of roads infrastructure throughout the country and reconstruction of bridges that were damaged by heavy rains and floods that were experienced throughout the country from December 2010 to February 2011. Commercial as well as residential property development that appears to have gained momentum in the country also boosted the sub-sector.

(c) Developments in the Tertiary Sector

The tertiary sector was estimated to have grown at a moderate rate of 2.9 percent in 2011 compared with a higher growth rate of 4.2 per cent recorded in 2010. This reflected declines of 2.6 per cent and 0.4 per cent in the wholesale and retail trade, and hotels and restaurants sub-sectors, respectively, while the real estate and business services sub-sector decelerated. The declines in the 'wholesale and retail trade' and 'hotels and restaurants' sub-sectors reflected the low level of demand in the economy in 2011 and could be a result of the decline in Government expenditure during the year. However, the strong growth in output by the transport and communication sub-sector helped sustain the industry. The transport and communication sub-sector expanded by 11.5 per cent in 2011, from 10.2 per cent in the previous year. This was mainly attributable to good performance by the communication sub-sector. Communications services providers have introduced a wider range of products and services on the market, in response to increased competition. Consequently, consumers have enjoyed improved quality of communications services at reduced prices.

Figure 7: Sectoral Shares in GDP at Factor Cost

(Percentages)



Source: Bureau of Statistics
*CBL Projections

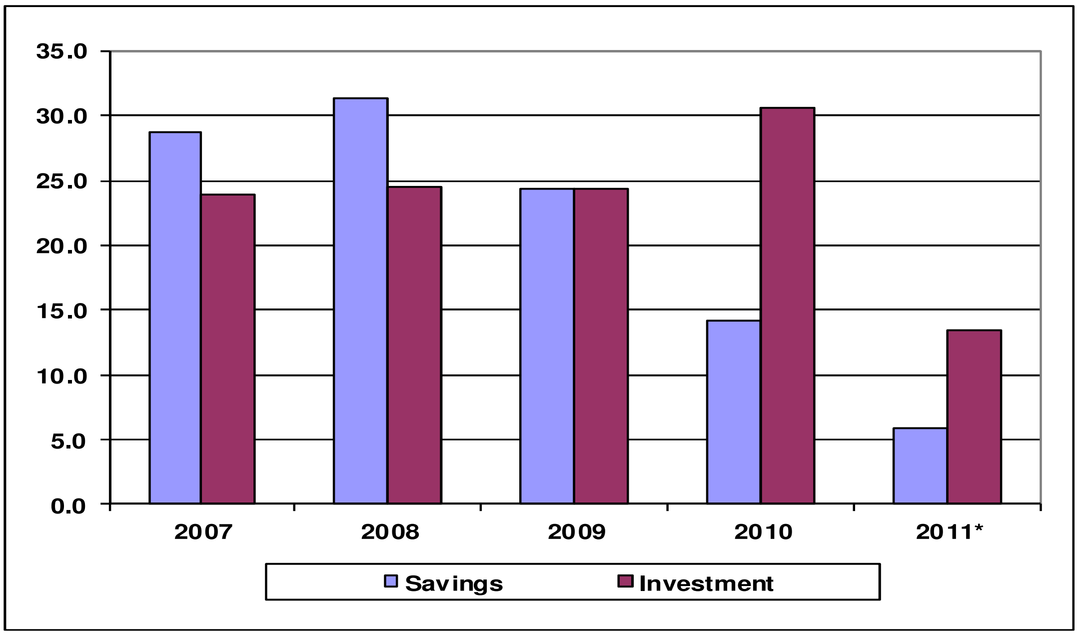
3.1.3 Savings and Investment

The saving-investment gap, as a share of GNI, was recorded at negative 7.5 per cent in the year under review compared with negative 16.5 per cent in 2010. The negative saving-investment gap is indicative of lower gross national savings relative to national investment. Gross national savings was estimated at 6.0 per cent of GNI in 2011 compared with 14.2 per cent of GNI in 2010. Total investment as a share of GNI was recorded at 13.5 per cent in 2011 compared with 30.7 per cent in the previous year.

The saving-investment gap narrowed in 2011 compared with 2010, mainly reflecting a higher decline of 58.0 per cent in gross national savings compared with a decline of 56.0 per cent in national investment. The major contributor to the decline in gross national savings was government savings, which fell from 14.7 per cent of GNI to 3.9 per cent of GNI while private savings increased. The low government savings were in line with the fiscal deficit for 2011/2012 fiscal year.

Figure 8: Savings and Investment

(As a percentage of GNI)



Source: Bureau of Statistics
* CBL Projections

Savings as a ratio of Gross National Disposable Income (GNDI) was projected at 7.1 per cent in the review year compared with 13.8 per cent recorded in 2010. The moderation in the savings ratio emanated from subdued performance of net current transfers due to the decline in SACU revenue.

3.2 Employment, Wages and Prices

3.2.1 Employment

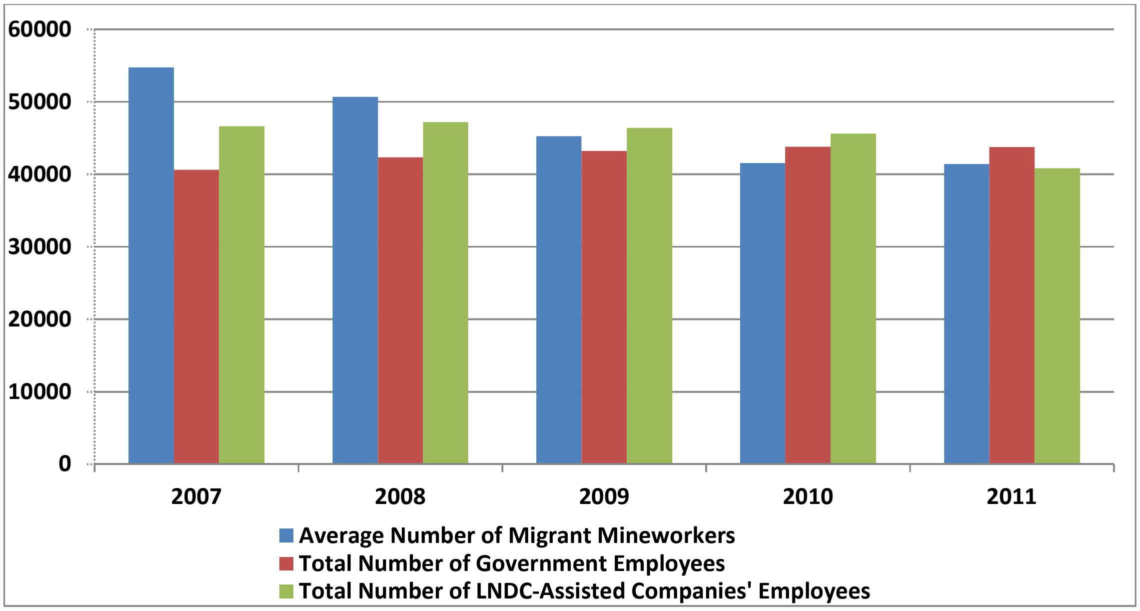
Employment by LNDC-assisted companies[6] fell to 40861 in December 2011 from 45,595 registered at the end of December 2010. The decline was equivalent to 10.4 per cent in 2011. This decline was in line with the slowdown in the manufacturing sub-sector as explained in Section 3.1.2 above. The manufacturing sector activity, especially textile and clothing responded to the industrial actions that occurred during the review period and the subdued consumer demand coupled with lackluster labour market recovery in the US.

Employment by the public sector declined moderately by 0.1 per cent in 2011 from 43,781 employees at the end of December 2010. This was mainly driven by a fall of 0.8 per cent in the number of teachers in 2011 from 15,139 employees in the previous year and the number of daily paid workers which fell by 0.15 per cent.

The number of migrant mineworkers continued to decline, albeit at a slower rate in 2011. The number of migrant mineworkers stood at 41,427 employees in December 2011 from 41,555 registered in December 2010. This represented a moderate decline of 0.3 per cent, significantly lower than 8.2 per cent recorded in the previous year. The moderation in the rate of decline was mainly attributable to high commodity prices, particularly gold and platinum during the review year. In addition, the depreciation of rand against major currencies, especially the US Dollar, on an annual basis, increased export earnings in rand terms and hence the profitability of the SA mining sector.

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

Figure 9: 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 7.4 per cent during the review year, higher than 5.0 per cent effected in 2010. The hotels, motels and lodges as well as funeral parlours sub-sectors realized higher increments relative to the rest of the sectors. The rise in the minimum wages was in line with expected inflation in 2011/2012 fiscal year. In addition, government employees' salaries were increased by 3.0 per cent in the 2011/2012 fiscal year, lower than salary increase of 3.5 per cent for the 2010/2011 fiscal year.

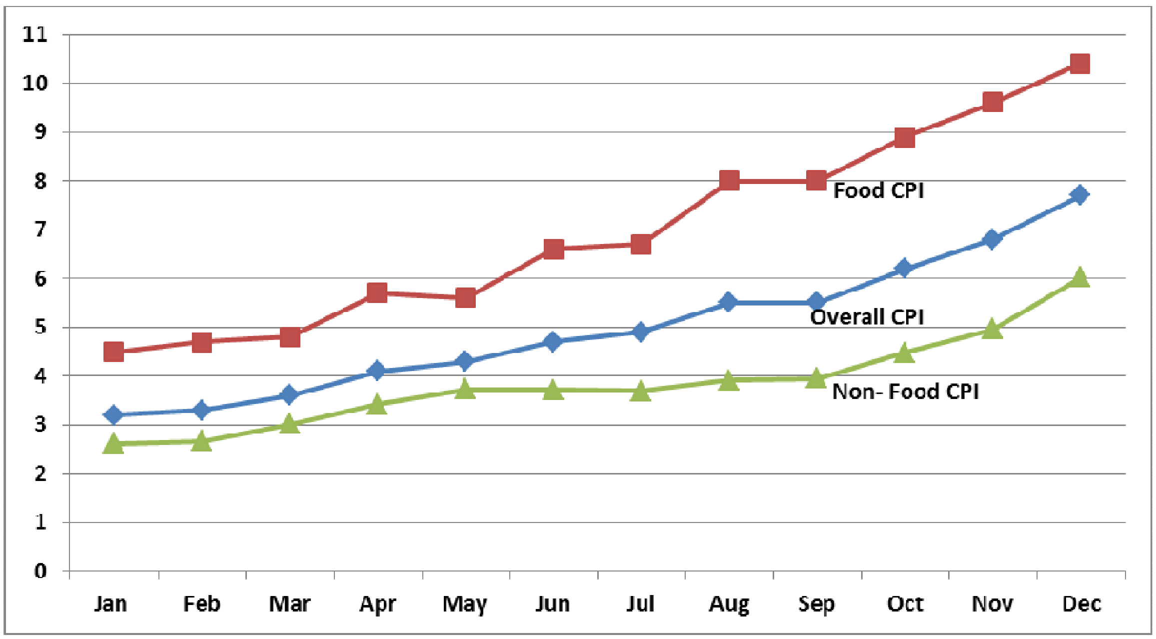
3.2.3 Price Developments

The rate of inflation, measured by the change in the Consumer Price Index (CPI), accelerated to an average of 5.0 per cent in 2011 from an average of 3.3 per cent in 2010. Categories that reflected inflationary pressures were food and non-alcoholic beverages and housing, electricity, gas and other fuels. The rise in the general price level was mainly attributable to exogenous factors, particularly the surge in international food and fuel prices. The weakening of the rand against major currencies resulted in higher imported inflation in SA, which was transmitted to Lesotho because of the latter's heavy reliance on imports of goods and services from SA. The inflation rate started the year at 3.2 per cent and went on an upward trend during the course of the year. It closed the year at 7.7 per cent.

Lesotho's inflation continued to move in line with that of SA during the year. For the large part of the year, SA's inflation was higher than that of Lesotho. This trend changed in the second half of the year, when Lesotho's inflation rate surpassed that of SA. This mainly reflected much higher increases in the food prices, which carry a much higher weight in Lesotho's inflation basket than in SA's basket. For example, as depicted in figure 6 below, food inflation rose rapidly from October 2011 and this category takes a much higher weight of 37.0 per cent in Lesotho's inflation basket compared with 14.3 per cent in SA. SA's inflation rate was 6.1 per cent in December 2011, 1.6 percentage points lower than Lesotho's inflation rate.

Figure 10: Lesotho Consumer Price Index

(Annual Percentage Change)



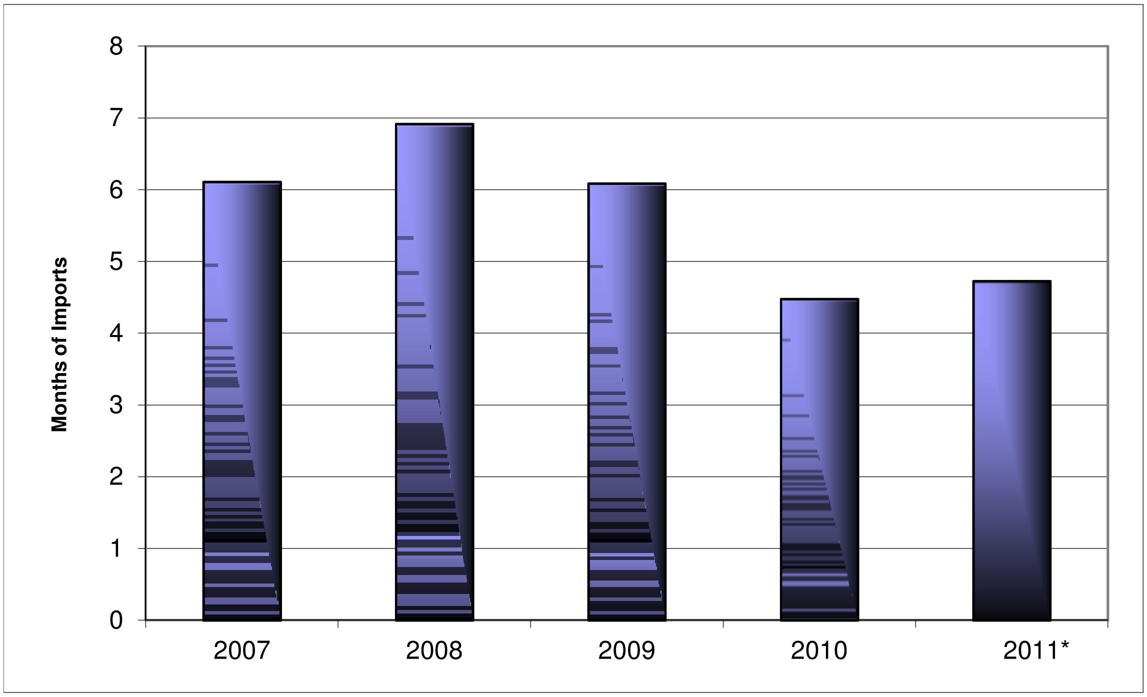
Source: Bureau of Statistics

3.3 Balance of Payments (BOP)

3.3.1 Overall Balance

Preliminary estimates of external sector position showed some recovery during the year under review, despite the moderate performance of global economic activity during the period. The overall balance of payments registered a surplus of M512.2 million, equivalent to 3.0 per cent of GDP in 2011, in contrast with a deficit of M1.6 billion or 10.1 per cent of GDP realised in the previous year. The surplus reflected improvements in the current account and capital and financial account. In addition, the surplus was supported by valuation adjustment, due to the depreciation of the local currency against the major trading currencies in which country's foreign reserves were held during the period. The transactions balance, which represents overall balance excluding the movements of exchange rates, recorded a deficit of 1.2 per cent of GDP in 2011, following a deficit of 6.7 per cent of GDP in the previous year. The import coverage of gross official reserves increased to 4.7 months in the year under review, from 4.5 months in the previous year.

Figure 11: Reserves in Months of Imports



** Preliminary estimates*

Table 4

SUMMARY OF BALANCE OF PAYMENTS
(As percentage of GDP)

	2007	2008	2009	2010	2011*
Current account	5.54	8.31	0.03	-16.44	-9.10
Goods	-42.45	-39.78	-49.45	-50.69	-35.20
Services	-21.48	-20.30	-20.58	-22.40	-22.70
Income	25.82	25.95	27.84	25.68	22.42
Current transfers	43.65	42.44	42.22	31.03	26.38
Capital and Financial account	-3.58	-3.52	1.34	-0.37	10.70
Transactions balance	17.65	9.52	3.59	-8.45	-1.19

** Preliminary estimates*

3.3.2 Current Account

The current account deficit narrowed to 9.1 per cent of GDP during the year under review, from a revised deficit of 16.4 per cent of GDP recorded in the previous year. The improvement in the current account balance resulted largely from trade in goods, boosted by increased exports of diamond, textiles and clothing as well as water exports. However, balances in other components of current account – *services, income and current transfers* declined, and counterbalanced the positive performance in the trade account during the period.

A large increase in merchandise exports was due to 97.3 per cent rise in diamond exports during the year. The observed performance in diamond exports was underpinned by, firstly, the recovery in the global demand for diamond. Secondly, the growth in global diamond prices during the year, particularly in the European market where a large portion of Lesotho's diamond exports are destined for, despite the on-going uncertainty in the Euro Zone financial markets. Lastly, an increase in diamond production by Letšeng and other diamond mines coupled with re-opening of Liqhobong diamond mine during the review period. Merchandise exports were also supported by the recovery in the textiles and clothing, which rose by 11.8 per cent together with an increase of 20.7 per cent of water exports. The increase in the value of water export resulted from revenue correction in water export which was under estimated in 2010. However, a rise of 0.6 per cent in merchandise imports, as a result of an increase in domestic activity, partly offset the improvement in the current account in 2011.

As a percentage of GDP, merchandise exports amounted to 49.2 per cent, which was higher than a 40.5 per cent realised in the previous year. Merchandise imports declined to 84.4 per cent of GDP in 2011, from 91.2 per cent of GDP recorded in 2010.

As already mentioned, payments for services acquired abroad increased, while income and current transfers deteriorated during the year under review. The services account deficit widened to 22.7 per cent of GDP in 2011, from 22.4 per cent of GDP recorded in 2010, as a result of a rise in payments for transportation services, communication services and Basotho students studying abroad. The income account balance fell by 4.8 per cent to M3.8 billion, from M4.0 billion registered in the previous year, as returns on CBL portfolio investments coupled with interest earned on commercial banks' investments abroad dropped, due to lower global interest rates during the period. Current transfers also fell by 7.4 per cent to M4.5 billion in 2011, following M4.9 billion realised in 2010. The decline in current transfers largely emanated from the reduction in SACU receipts which plummeted by 22.0 per cent in 2011.

3.3.3 Capital and Financial Account

The net inflow of M1.8 billion, equivalent to 10.7 per cent of GDP, was registered in the capital and financial account in the period under review, in contrast with an outflow of M58.6 million or 0.3 per cent of GDP recorded in the previous year. The observed performance reflected an increase in both capital and financial account inflows. The capital account net inflows rose to M1.3 billion in 2011, from M990.8 million in the previous year, which indicated sustained donor support for the country. The financial account also registered a net inflow of M486.4 million during the period, compared with a net outflow of 1.0 billion in the previous year, as a result of a decline in commercial banks' foreign assets holdings.

3.3.4 Foreign Exchange Rates

During 2011, the loti appreciated at an annual average rate of 0.8 per cent against the US Dollar. Nonetheless, it depreciated against the Pound Sterling, the Euro and Special Drawings Rights (SDR), by 2.8 per cent, 3.9 per cent and 2.6 per cent, respectively. However, there had been volatility throughout the year, as the rand, to which the loti is fixed at par, tends to be sensitive to uncertainties surrounding developments in the US and European debt markets. During the first half of 2011, the rand/loti strengthened against the major currencies, due to among other factors, strong commodity prices, narrowing of SA current account deficit and resumption of portfolio flows to SA. During the same period, it appreciated by an average of 2.9 per cent against the Pound Sterling, 8.2 per cent against the US Dollar, 3.1 per cent against the Euro and 4.4 per cent against the Special Drawings Rights (SDR).

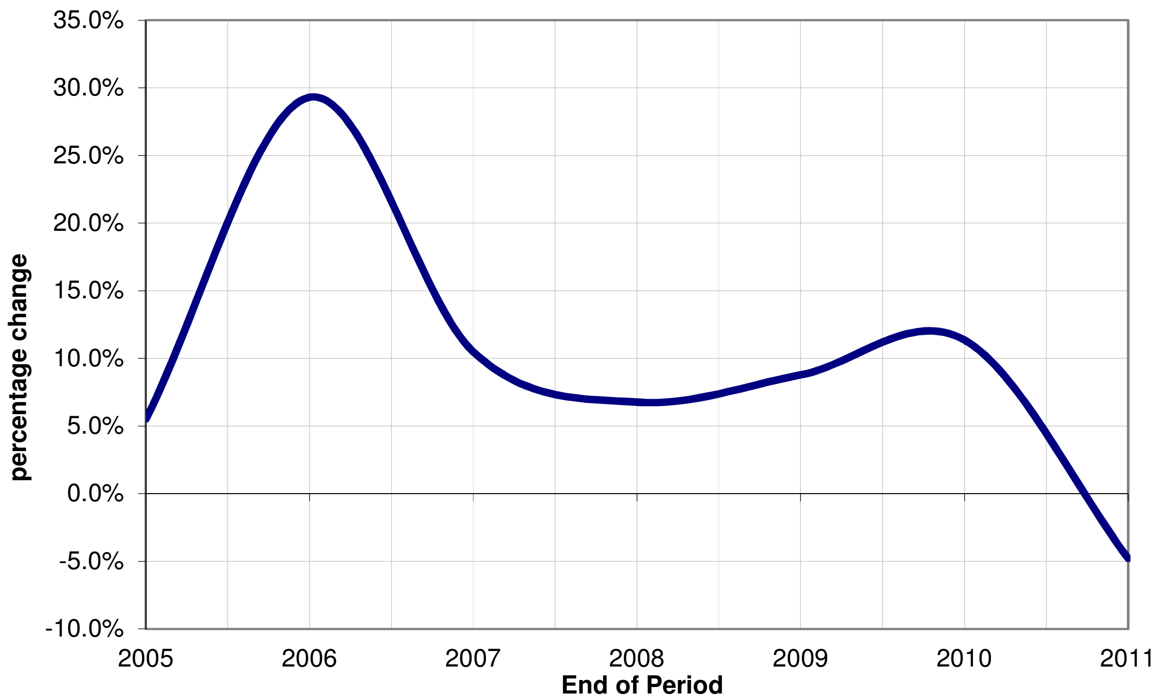
In the second half of 2011, the rand/loti weakened against all major currencies. It depreciated by an average of 8.7 per cent, 7.3 per cent, 11.5 per cent and 9.9 per cent against the Pound sterling, the US Dollar, the Euro and SDR, respectively. The depreciation of the loti, on the one hand, poses an upside risk to the inflation outlook, while on the other hand benefits the export sub-sector.

3.4 Money and Banking

3.4.1 Money Supply

Nominal money supply slowed from a 14.8 per cent expansion in December 2010 to a modest 2.9 per cent increase in December 2011. The growth in money supply was largely a result of 166.9 per cent jump in domestic credit including net claims on government which was moderated by a 1.3 per cent decline in net foreign assets. The lower growth in nominal money supply against a much higher rate of inflation resulted in a contraction in real money supply. Real growth in money supply, measured by the change in M2 excluding the change in the general price level, declined by 4.8 per cent at the end of 2011 after increasing by 11.4 per cent in 2010. As already noted, inflation closed the year high at 7.7 per cent compared to 3.1 per cent recorded in 2010.

Figure 12: Real Money Supply Growth



Source: CBL Monetary Survey, December 2011

Changes in money supply can also be observed through the movement in components of money supply. On the one hand, narrow money (M1) rose by 4.4 per cent following a 19.4 per cent surge observed in the previous year. The growth in M1 was largely driven by a 27.8 per cent jump in currency with public and 2.1 per cent rise in demand and call deposits. On the other hand, quasi money contracted by 1.8 per cent after increasing by 1.4 per cent in the previous year.

3.4.2 Domestic Credit

Domestic credit, including net claims on government, expanded further by 166.9 per cent in 2011 following a 53.1 per cent jump in the previous year. The large expansion in domestic credit was driven by the increase in both net claims on government and credit to the private sector. Net claims on government rose by 36.5 per cent while credit to the private sector increased by 23.0 per cent. The upsurge in net claims on government reflected the reduction in government deposits with the central bank. The continued drawdown in government deposits was for financing of the fiscal deficit. Government deposits are however expected to recover following the strong recovery in SACU revenues and hence a lower fiscal deficit for 2012/13.

Table 5

DOMESTIC CREDIT

Million Maloti: End of period

	2007	2008	2009	2010	2011
Claims on Government (Net)	-3324.3	-3950.7	-3996.0	-3197.6	-2029.7
Claims on Private Sector	1207.4	1463.2	1859.8	2193.8	2698.2
Claims on Official entities	51.5	43.8	0.00	3.0	1.4
Domestic Credit	-2065.5	-2443.8	-2136.2	-1000.8	670.0

Credit to the private sector rose by 23.0 per cent in 2011 after increasing by 18.0 per cent in 2010. Credit extended to households increased by 32.7 per cent while credit to business enterprises rose by 12.9 per cent at the end of 2011. The growth in credit to the private sector continues to be fuelled by the current low cost of borrowing. The growth in credit extension to the private sector is quite encouraging given the critical role the private sector plays in stimulating the economy. Credit extension to the private sector is expected to expand further in the short to medium term given the on-going reforms in the financial sector, including plans to develop a national identification card system and to establish a credit bureau.

Although the amount of credit extended to statutory bodies declined, its impact was negligible given that its very low level. At the end of 2011, credit extended to statutory bodies stood at M1.37million.

3.4.3 Net Foreign Assets

The net foreign assets (NFA) of the overall banking system fell further by a modest 1.3 per cent at the end of 2011 following a 6.7 per cent decline in the previous year. The fall in NFA was at the back of the decrease in net foreign assets of the commercial banks which was moderated by the increase in net foreign assets of central banks. On the one hand, net foreign assets of the commercial banks shrank by 19.5 per cent following a 27.2 per cent surge observed in the previous year. On the other hand, net foreign assets of the central bank jumped by 10.0 per cent. The increase in net foreign assets of the central bank was mainly as a result of higher SACU transfers exacerbated by exchange rate revaluation gain.

Table 6

BANKING SYSTEM'S NET FOREIGN ASSETS
Million Maloti: End of period

	2007	2008	2009	2010	2011
Commercial banks	2200.3	2921.1	2986.7	3799.8	3060.7
Assets	2273.7	3013.7	3297.2	3917.5	3242.1
Liabilities	-73.4	-92.7	-310.5	-117.7	-181.4
Central Bank	6177.3	8251.6	7664.9	6138.9	6752.2
Assets	6786.3	8989.2	8345.4	6749.5	7297.6
Liabilities	-609.0	-737.7	-680.5	-610.6	-545.4
Net Foreign Assets	8377.7	11172.6	10651.6	9938.7	9812.9

3.4.4 Commercial Banks' Liquidity

The liquidity ratio[7] measures banks' ability to sufficiently honour customers' demands in making withdrawals. At the end of the review period, the ratio dropped from 75.6 per cent recorded at the end of December 2010, to 71.4 per cent at the end of 2011. The decline in the ratio, at the end of the review year, reflected a smaller decline of 2.1 per cent in deposits held by the private sector vis-à-vis a much larger 7.5 per cent decline in other borrowings. Despite the decline in the liquidity ratio, the banking sector remained highly liquid.

The credit to deposit[8] ratio rose by 8.2 percentage points from 34.1 per cent recorded at the end of 2010 to 44.1 per cent in the period under review. The expansion in this ratio was indicative of a faster growth in credit extension relative to deposits mobilised from the private sector.

[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
[8] This ratio seeks to establish how much credit is extended to the private sector and statutory bodies using these sectors' deposits with the banking system. It thus assesses the degree to which the financial sector mobilises deposits from surplus sectors of the economy, and allocates these funds to deficit sectors.

BOX 2: Financial Sector Reforms in Lesotho During 2011

Countries undertake financial sector reforms with the general objective of enhancing the sector's efficiency, hence its contribution to economic growth and development, which are necessary for poverty eradication in countries like Lesotho. In 2011, the Central Bank of Lesotho continued to undertake measures aimed at reforming the financial sector in Lesotho.

The review of the Financial Institutions Act 1999 (FIA 1999), which was intended to result in its repeal by the FIA 2012, led to the tabling of the Financial Institutions Bill before the Parliament of Lesotho by the Minister of Finance and Development Planning in April 2011. The main objective of the whole process was to strengthen supervision and regulation of Lesotho's financial sector. Amongst other things, the review was intended to address the major shortcomings of the FIA 1999 by:

- Broadening coverage, catering for both banking and non-banking financial institutions, thus taking cognisance of the increasing demand for non-bank financial institutions.
- Protecting investors from fraudsters, by granting the CBL, Commissioner of financial institutions, adequate authority and mandate to deal with investigation of unlawful financial activities.
- Enhancing provisions on control of repayment of unlawfully acquired assets, and ensuring compensation in favour of investors against whom the illegal conduct would have been carried out.
- Revising penalties upwards to match the committed offence, so that they could carry the desired deterrence against perpetrators.
- Strengthening corporate governance structures in domestic financial institutions as a necessary condition for preventing financial crisis, by strengthening conditions for appointment of auditors for financial institutions, improving the requirements for composition of audit committee structures and appointment of directors and principal officers of financial institutions as well as on the scope of responsibility of the boards of directors of financial institutions.
- Enhancing supervision by granting the Commissioner the authority to allow foreign supervisory authorities and to make use of external experts to conduct examinations.

By strengthening regulation and supervision of the financial sector, the FIA 2012 could minimise Lesotho's vulnerability to banking and financial crisis. Strong regulation and supervision could help ensure that financial institutions take adequate steps to manage risks that are inherent in their business, thus ensuring that the financial system is always in a position to meet its financial obligations and satisfy the needs of customers. Appropriate financial sector policies could also facilitate modernisation of the financial sector and diversification of financial services. This is particularly a problem in developing countries like Lesotho, where the range of financial services is limited and products that are high in demand are not available in the market. By empowering the authorities to swiftly and firmly take the necessary legal action against criminality in the sector, the new Act could prevent the emergence and growth of pyramid schemes and enhance confidence in the stability of Lesotho's financial system.

The process of developing a legal instrument on credit reporting, Credit Reporting Act 2012, also continued and culminated in the passage of the Credit Reporting Bill by Parliament in October 2011. The Act would provide for regulation of credit reporting in Lesotho and facilitate regulation of credit information by credit providers, credit bureau operators and authorities, thus supporting establishment of a credit bureau in Lesotho. The credit bureau would provide creditors with information for assessing credit worthiness of borrowers, thus enhancing access to credit, which was viewed as one of the hindrances of private sector development.

3.4.5 Interest Rates

The market interest rates in Lesotho generally followed a downward trend or otherwise maintained a flat rate. These movements were in line with interest rate developments in the Common Monetary Area (CMA). Despite rising inflation in recent months, the monetary authorities in SA maintained the repo rate unchanged at 5.50 per cent since the last quarter of 2010. The MPC was of the view that the underlying inflation pressures were of a cost-push nature, particularly, exchange rate fluctuations and international food and oil prices. Furthermore, the seemingly loose monetary policy stance by the Reserve Bank of South Africa was a result of heightened uncertainty concerning the debt stricken Euro area and weak global economic growth outlook.

The Lesotho 91-day treasury bill rate dropped by 24 basis points from 5.52 per cent in December 2010 to 5.28 per cent in December 2011. The South African counterpart rate also fell by 14 basis points from 5.60 per cent at the end of 2010 to 5.46 per cent at the end of 2011.

The average prime lending rate in Lesotho at the end of December 2011 remained constant at 10.50 while its SA counterpart also remained unchanged at 9.00 per cent. The wedge between the two rates could reflect amongst others, the fact that level of competition in the banking industry and clientele risk profiles in the two economies differ considerably. That is, South African rates are likely to be lower than Lesotho's rates because of a highly competitive South African banking sector and lower risk profile clients compared to Lesotho.

Similarly, commercial banks' deposit rates in Lesotho remained flat while their SA counterpart increased marginally. For instance, the 1-year deposit rate in Lesotho was unchanged at 2.78 per cent at the end of 2011. On the contrary, the South African 1-year deposit rate increased slightly from 5.85 per cent in 2010 to 6.03 per cent at the end of 2011. As a consequence, the real deposit rate was negative in both Lesotho and South Africa as inflation soared above the deposit rates. This implies that deposits are earning a rate of return that is too low to compensate for the loss in purchasing power.

3.5 Government Finance

3.5.1 Fiscal performance in 2011/12

The fiscal position improved during the 2011/12 fiscal year. The fiscal balance for 2011/12 was estimated at a deficit equivalent to 4.5 per cent of GDP. Total revenue and grants were estimated to have increased by 4.0 per cent on an annual basis, while total expenditure fell by 2.7 per cent. The deficit was financed through the issuance of domestic bonds, foreign sources and the use of government deposits with the central bank.

3.5.1.1 Revenue

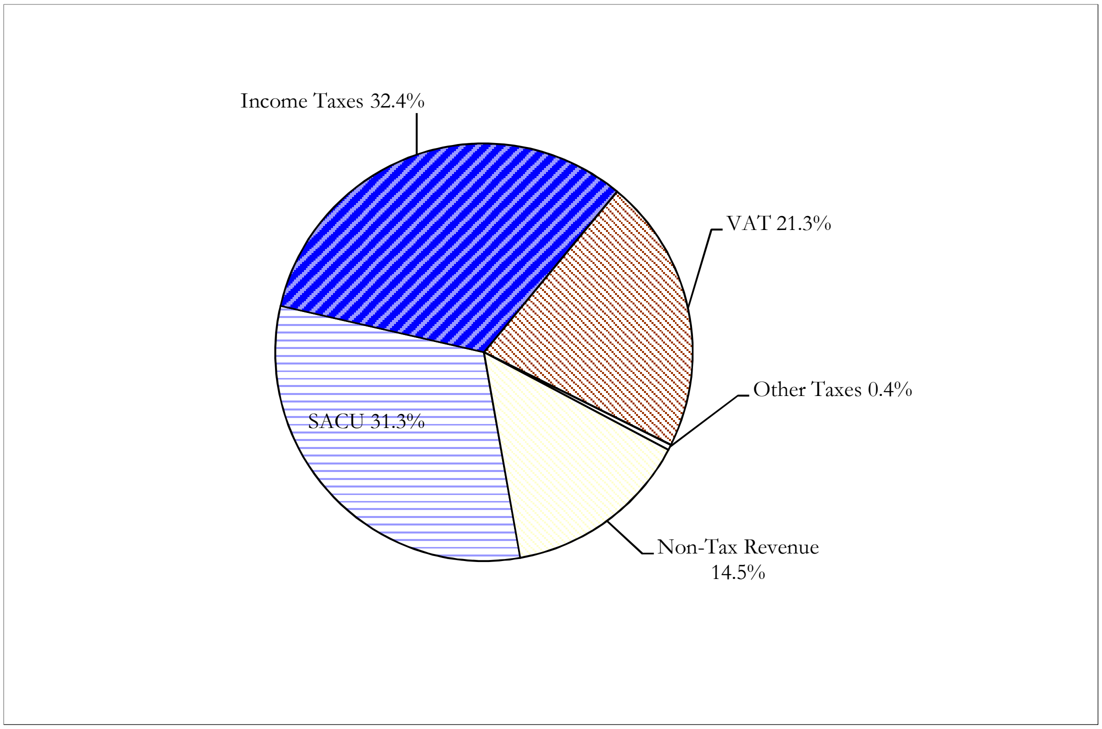
Preliminary estimates indicate that total revenue and grants increased by 4.0 per cent during the 2011/12 fiscal year. This was attributable to an 8.4 per cent rise in tax revenue and a 15.4 percent increase in grants. SACU receipts rose by 4.8 per cent during the review period in comparison with a drop of 46.6 per cent recorded during the previous fiscal year while income tax and tax on goods and services increased by 14.1 per cent and 13.5 per cent, respectively. As depicted in figure 13 below, income taxes were the main source of revenue contributing32.4 per cent of total revenue, while SACU and value added tax (VAT) contributed 31.3 per cent and 21.3 per cent respectively..

Non-customs receipts were estimated to have increased by 11.3 per cent, mainly as a result of a 45.3 per cent rise in individual income tax which more than offset the 16.3 per cent contraction in company tax and 31.6 per cent fall in other income taxes. Other income taxes mainly include withholding tax, gaming levy and fringe benefit tax. VAT collections fell by 1.6 per cent reflective of a slowdown in economic activity, following a 23.3 per cent increase observed in 2010/2011 fiscal year.

Non-tax revenue includes dividends from operations of organisations with public ownership, royalties from Lesotho Highlands Water Project, rand compensation and other revenues. It was estimated to have declined by 26.6 per cent in the review period, following an increase recorded in 2010/2011 fiscal year. Notwithstanding, water royalties rose by 4.9 per cent compared with 58.9 per cent increase recorded in 2010/11.

Capital grants increased by 15.4 per cent during the period under review due to large disbursements targeted at financing infrastructure projects including construction of urban and rural roads.

Figure 13: Sources of Government Revenue



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

3.5.1.2 Expenditure

Total government expenditure was estimated to have dropped by 2.7 per cent during 2011/12. The contraction was driven by a 6.4 per cent decline in recurrent expenditure, while capital spending increased by 22.8 per cent. In view of the importance of infrastructure development in accelerating economic growth, the Government has steadily been increasing its allocation towards capital projects while restraining recurrent expenditure. This will not only spearhead economic growth but most importantly, ensure Lesotho's long term fiscal sustainability. Recurrent expenditures constituted 84.0 per cent of overall expenditures at.

Purchases of goods and services fell by 8.3 per cent, in contrast with an increase of 24.9 per cent observed in 2010/2011 fiscal year. These expenses constitute amounts payable to contractors and self-employed workers for services rendered to Government. Total interest payments are expected to have increased by 54.9 per cent during the period under review due to a rise in the debt stock. The debt stock increased as a result of disbursements towards Metolong projects during the review period.

Capital expenditure as a share of overall expenditures stood at 16.0 per cent during the review period, in contrast to a 12.7 per cent share realised in the 2010/11 fiscal year.

Table 7

SUMMARY OF BUDGETARY OPERATIONS
(Million Maloti)

	2007/08	2008/09	2009/10	Revised 2010/11	Projections 2011/12
Total Receipts	7512.33	8265.30	9089.03	8684.00	9033.90
Revenue	7264.05	8076.20	8185.13	7327.70	7468.50
Customs	4097.68	4635.20	4918.00	2628.10	2752.80
Grants	248.28	189.10	753.90	1356.40	1565.40
Total Expenditure	6484.07	7653.40	8546.70	10050.80	9777.30
Recurrent expenditure	4973.76	5975.44	6014.20	8775.70	8211.90
Purchases of Goods & Services	3002.34	3996.54	4456.10	6789.40	6224.00
Capital Expenditure & net Lending	1510.31	2029.20	2532.50	951.40	1268.10
Surplus/Deficit Before grants	779.98	422.80	-762.00	-2723.10	-2308.80
Surplus/Deficit after grants	1028.26	611.90	-8.10	-1366.70	-743.40
Government Savings	2290.29	2448.30	586.90	-1771.70	-1040.70
Financing					
Foreign, net	-4.49	57.6	8.1	134.90	154.50
Domestic	-1023.76	-669.70	40.90	1231.87	588.90
Bank	-998.51	-648.30	-14.80	1227.07	590.30
Non-Bank	-25.26	-21.40	55.70	4.80	-1.40
In per cent of GDP (unless indicated otherwise)					
Revenue (excluding Grants)	61.80	59.30	55.50	45.30	45.6
Customs (in % of revenue)	54.55	56.08	54.00	30.86	30.47
Grants	2.10	1.40	5.10	8.40	9.60
Total Expenditure	55.20	56.20	61.70	62.20	59.70
Surplus/Deficit Before grants	6.60	3.10	-5.17	-16.80	-14.10
Surplus/Deficit after grants	8.70	4.50	-0.10	-8.50	-4.50
Government Savings	19.50	18.00	4.00	11.00	-6.40
Memorandum item:					
GDP in current prices	11753.00	13612.8	14736.30	16171.80	16364.80

Source : MoFDP and CBL Projections

The overall budget balance and financing

The budget outturn is projected to result in an overall deficit equivalent to 4.5 per cent of GDP during the period under review. The deficit was financed primarily through the drawdown of government deposits with the banking system and the issuance of treasury bonds. The draw down in deposits was facilitated by the cushion of deposits that Government had built between 2003/04 and 2008/09 when fiscal surpluses were being realized.

3.5.2 Recurrent Expenditure by Functions of Government

Community and social services accounted for 39.9 per cent of the overall recurrent expenditure during the review period. Of this, education and health constituted 56.3 per cent and 31.5 per cent of expenditure respectively. Expenditure on education was directed towards building of schools, bursaries and subventions to institutions of higher learning. This reflected Government's commitment to provision of quality education from primary through tertiary level. A large proportion of expenditure on health went to health care services, improvement and refurbishment of clinics and other activities aimed at addressing the effects of HIV and AIDS.

General government services continued to be the second largest spending category at 33.4 per cent of total recurrent expenditure. About half (50.4 per cent) of this expenditure was channeled towards the general public service while, public order and safety accounted for 37.2 per cent and the remaining 12.7 was spent on defense.

Expenditure on economic services stood at 9.0 per cent of recurrent spending. Transport & communications constituted the largest share of this category at 31.7 percent, followed by agriculture at 21.8 per cent. The remaining 17.6 per cent of recurrent spending was unclassified expenditure, which comprised, amongst others, other transfers and public debt

BOX 3: Lesotho's Progress on the International Monetary Fund's Extended Credit Facility

On June 2, 2010, the Executive Board of the IMF approved concessional lending to the tune of SDR 41.88 under the Extended Credit Facility (ECF) for Lesotho. This amount, which would be disbursed over a period of three years, would assist Lesotho to minimize fiscal and external risks emanating from the debilitating effects of the global economic crisis. The global economic crisis led to a sharp drop in revenues from SACU and a decline in exports of textile and clothing as well as in workers' remittances. These funds would support implementation of a medium-term macroeconomic program under which the broad objectives behind IMF's assistance would be pursued. These would include undertaking measures to contain public expenditure while protecting the poor and vulnerable groups; strengthening non-SACU revenues; strengthen public financial management to improve spending efficiency and public service delivery; improve the business climate to facilitate private sector expansion; and strengthen the regulatory framework for the financial sector while also enhancing access to financial services.

Implementation of the program would be monitored through a set of semi-annual quantitative performance criteria and structural benchmarks. For the first year of the program, performance criteria were set for end-September 2010 and end March 2011. In the following year they were set for end September 2011 and end March 2012. Lesotho's performance on the benchmarks would be the basis for subsequent disbursements under the ECF program. In addition, compliance with the benchmarks would enable Lesotho to attain projected levels of fiscal balances deemed adequate to move the country to fiscal sustainability in the medium-term.

The set program targets on quantitative performance criteria for end March 2011and end September 2011were all met as depicted in the Table 7 below, indicating strong overall performance. Preliminary indications were that this performance largely reflected success by Government in its endeavours to achieve fiscal consolidation. As discussed in Section 3.5 above, the fiscal deficit was estimated to have narrowed down to 4.5 per cent of GDP for the 2011/12 fiscal year compared with 8.5 per cent in the previous fiscal year.

With regard to the structural benchmarks, eight benchmarks were envisaged to be achieved before end-September 2011. Reforms that were successfully implemented and achieved on set dates were the preparation of a plan for capacity building in line ministries to strengthen preparation of medium term economic framework (MTEF), submission of the new Financial Institutions Bill to Parliament and submission of the National Leasing Finance proposal to Cabinet. The submission of a review of the Cooperatives Societies Act to Cabinet and the launch of a partial credit guarantee scheme were met with some delays. In addition, completion of an audit of domestic arrears and preparation of a plan for their elimination, implementation of the front office revenue receipting system and ensuring that all revenues are captured in the IFMIS as well as submission of the Industrial Licensing Bill to Parliament were not met.

Table 8: Lesotho's Performance on Quantitative Benchmarks in 2011

	March		September	
	Target/ Performance Criteria	**Actual Attained**	**Target/ Performance Criteria**	**Actual Attained**
	(In millions of Maloti)			
Ceiling on domestic financing requirements of the central government	1,670	1,231	1,383	482
Ceiling on the net domestic assets of the Central Bank of Lesotho	1,551	1,397	1,262	9
Floor on the central government social expenditures	170	205	170	170
	(In millions of US Dollars)			
Floor on the stock of Net International Reserves	776	897	641	892
Ceiling on the stock of external payments arrears	0	0	0	0
Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector				
Maturity of less than one year	0	0	0	0
Maturity of one year or more	182	182	182	182

3.6 Public Debt

3.6.1 Overview

The level of outstanding public debt, which comprises external and domestic debt, rose by 16.0 per cent during 2011, following a 2.4 per cent increase recorded in the previous year. The increase was mainly attributable to disbursements by Metolong project and the expansion in both domestic and foreign borrowing. External debt continued to constitute a greater proportion of overall debt at 83.2 per cent of total public debt while domestic debt was 16.8 per cent.

As a ratio of GDP, public debt stood at 39.2 per cent, in contrast to 37.1 per cent recorded in the previous year. External debt accounted for 32.6 per cent of GDP, while domestic debt constituted 6.6 per cent of GDP. Domestic debt was mainly issued for monetary and fiscal policies purposes. The ratio of public debt to GDP remained below the 60 per cent sustainability threshold[9]. The high concessionality and long term nature of the bulk of external debt implies that the total debt remains sustainable.

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

Table 9

PUBLIC DEBT INDICATORS FOR END OF YEAR
(Percentages)

	2007	2008	2009	2010	2011
Total debt as % of GDP	45.5	54.0	38.3	37.1	39.2
External debt as % of GDP	39.7	49.0	34.9	31.4	32.6
Domestic debt as % of GDP	5.7	5.0	3.5	5.7	6.6
External debt as a % of total	87.4	90.7	91.0	84.6	83.2
Domestic debt as a % of total	12.6	9.3	9.0	15.4	16.8
Concessional as % of External debt	93.6	97.0	94.6	93.7	92.2
Debt service ratio(1)	6.8	3.3	2.6	1.1	1.5
Debt service ratio(2)	11.5	5.3	4.7	1.8	2.5

Source: MoFDP

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

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

3.6.2 External Debt

Lesotho's external debt continued to comprise, loans from bilateral and multilateral sources, financial institutions as well as supplier's credit. The primary source of external debt was multilateral institutions which constituted 91.4 per cent of external debt, followed by supplier's credit at 4.7 per cent while loans from bilateral creditors contributed 4.2 per cent of foreign debt. Loans from bilateral creditors rose by 12.0 per cent while loans from multilateral creditors and supplier's credit increased by 16.0 per cent and 17.6 per cent respectively. However, these increases were mainly offset by a 5.9 per cent decrease in loans from financial institutions.

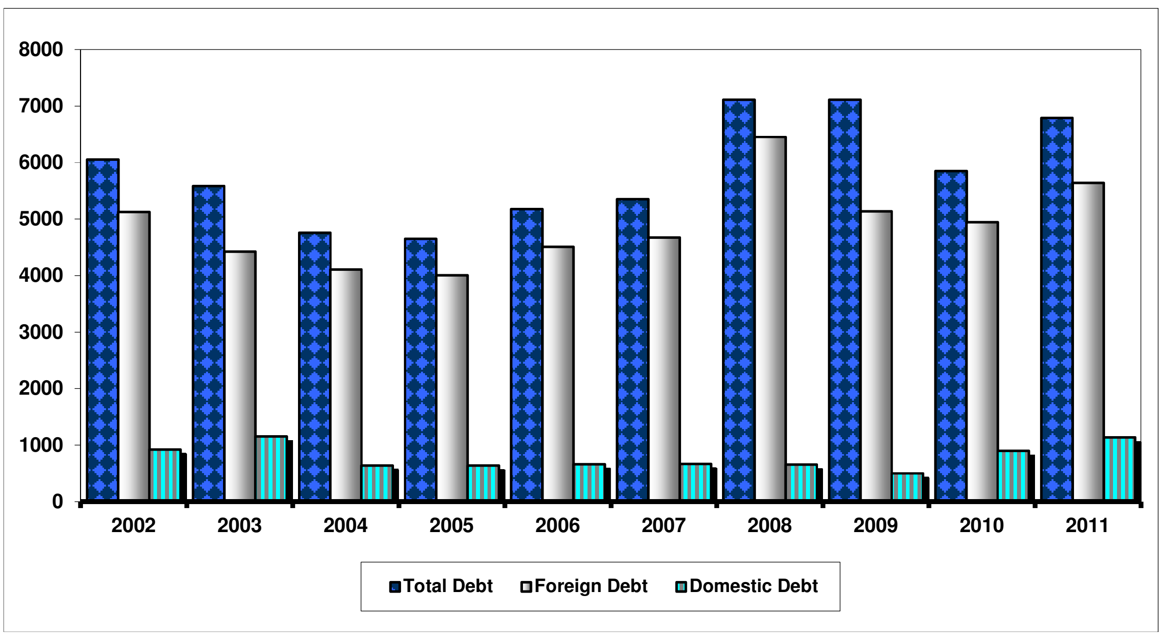
Concessional debt as a proportion of external debt dropped to 92.2 per cent at the end of 2011 from 93.7 per cent a year ago. External debt indicators suggest that Lesotho's external debt remained within the sustainability guidelines. The external debt to GDP ratio increased from 31.4 per cent in 2010 to 32.6 per cent in 2011. The ratio of debt service to exports of goods and services including factor income rose to 1.5 per cent from 1.1 per cent observed in the previous year. Excluding factor income, the debt service ratio was recorded at 2.5 per cent in contrast to the 1.8 per cent recorded in the previous year.

3.6.3 Domestic Debt

Domestic debt comprises treasury bills which are issued for monetary policy purposes and treasury bonds which are issued for fiscal purposes. Domestic debt increased by 26.5 per cent in the period under review, and this was largely a result of the issuance of treasury bonds in the review period. Treasury bonds were introduced as a step towards development of the capital market in Lesotho and to provide the Government with an alternative source of funds.

Short-term debt, constituted 54.1 per cent of total domestic debt while long-term debt amounted to 45.9 per cent. At 89.5 per cent, the banking sector continued to dominate the holding of domestic debt.

Figure 14: Outstanding Public Debt
(Million Maloti)



PART IV: REPORT OF THE BANK'S OPERATIONS

4.1 Supervision Department

4.1.1 Supervision of Banks

In an effort to strengthen the soundness of the banking sector, the Central Bank of Lesotho undertook reforms which included among others, implementation of Risk Based Supervision approach. During the period under review, a pilot examination of three banks was undertaken, using this new methodology. Feedback from banks indicated that the approach was well accepted as it placed emphasis on the risk management systems.

Despite the unstable economic conditions at global level, the banks continued to perform fairly well partly due to effective management of costs. Banks were generally in compliance with the statutory and regulatory requirements. In order to increase their outreach to the public, new branches were opened by some banks and new automated teller machines (ATMs) were installed in different areas across the country. However, some of the challenges still exist. They include high cost of transacting; lending which is still concentrated on the top clients with low entrepreneurial lending and, insufficient transparency and little disclosure of information for clients.

The long awaited review of the Financial Institutions Act 1999 was completed and the new Bill was passed by the two houses of Parliament, namely, the National Assembly and the Senate. At the end of the year, the Bill was awaiting Royal Assent to be enacted into law.

Under the Credit Bureau Project, a lot of work was done in 2011. In tandem with the review of the Financial Institutions Act, the Credit Reporting Bill and the Lesotho Data Protection Bill were promulgated. The Credit Reporting Bill seeks to give the Central Bank of Lesotho power to license and regulate the Credit Bureau service providers. The expectation is that when the legislation is in place, the lending level in Lesotho will increase as the exchange of credit information will be easily facilitated. At the end of the year, the two bills were also awaiting Royal Assent. The two pieces of legislation had been drafted under the Millennium Challenge Corporation assistance programme to Lesotho.

In an effort to sensitize the public on the new developments, outreach activities in the form of radio programs and newspaper inserts continued in earnest during the course of the year. These efforts were meant to increase public awareness mainly about the Credit Bureau.

4.1.2 Supervision of Non-Bank Financial Institutions

In line with the Central Bank of Lesotho (CBL)'s Strategic plan 2010-2014, the Non-Banks Supervision Division (NBSD) is charged with supervisory and regulatory role of monitoring and examining performance of the non-bank sector, through onsite and offsite surveillance. The sector comprises all non-bank institutions with the exclusion of institutions offering insurance and pensions.

During the period under review, the institutions under the purview of CBL through NBSD included money lenders, asset managers of Collective Investment Schemes (CIS), Ancillary Financial Institutions (AFI) comprising Money Transfers and Forex Bureaux and Credit Only Institutions. The microfinance sector is in its early stages of development continuing from the last reporting period and incorporated in the Financial Institutions Bill 2011 (FI Bill). As at the reporting period, moneylenders reported a fractional increase from 69 in 2010 to a total of 70 as at December, 2011. This is attributed to a decline in active lenders due to non-compliance and deregistration by some while new members almost matching these numbers portray an **insignificant change** resulting in a stagnant position when the balance is offset for the two periods.

Implementation of the new Credit Only Regulations 2010 started during the review period under the Financial Institutions Act 1999 which allowed for public companies to register as credit only institutions with flexibility from conditions of the Moneylenders Act 1993 as amended. This was meant to be an avenue to accommodate some of the large moneylenders that would qualify. Two institutions were licensed in this category. Compared with the previous period, the numbers of CIS and AFI remained the same at two each. Expression of interest has, however, been received through enquiries and applications. The high penetration of 91% in the money lending business in comparison with other non-banking business at 9% is underscored. Even though this depicts a winning position for moneylenders quantitatively, their asset portfolio quality versus that for (CIS) portrays a different picture with the former claiming M90m (only 10% of M950m) held by the latter.

Pursuant to legislation guiding the non-banks institutions, licenses issued are subject to annual renewal. Licensing of institutions continued during the year. However, only 20 new licenses for moneylenders were issued, 50 renewed and 49 not renewed. No revocations were made though non-compliance by small lenders ultimately rendered them non-existent. As reported above, numbers of AFI's and CIS have remained unchanged. A problem of inactivity by these newly licensed institutions has been observed. This status calls for revocation of licenses save for one Forex Bureau which is in the process of changing its name in consonant with change in shareholding following the resignation of some of its directors.

4.1.3 Supervision of the Insurance Industry

In order to strengthen the sector, the Central Bank of Lesotho took measures to enhance the regulatory framework for the insurance sector in line with international best practice. The bank also continued to hold quarterly meetings with the insurers to discuss issues of mutual interest. These meetings are intended to improve communication and understanding of matters requiring attention. This would assist in mitigating regulatory and supervisory risk and seek to improve the market conduct and practices in Lesotho.

The Bank continued to attend the International meetings hosted by the International Association of Insurance Supervisors (IAIS) and Regional meetings hosted by the Committee of Insurance and Securities and Non-Banks Authorities (CISNA). These meetings are intended to discuss international and regional regulatory issues with an effort to harmonizing the regulatory and supervisory frameworks in an effort to strengthen the financial stability and regulatory framework which complies with both international and regional standards.

The Offsite Surveillance analysis of quarterly returns; audited financial statements submitted by the insurance companies and Onsite Inspections disclosed non-compliance issues by some of the insurance companies and insurance brokers. Some of the non-compliance issues were very serious and posed high market, operational and regulatory risks. The Central Bank of Lesotho has issued directives to each of the concerned institutions to rectify all non-compliance issues within specified time periods.

Due to non-existence of retirements and pension legislation, the Bank has received technical assistance from first initiative to assist in the drafting of both the policy and legislation from the supervision and regulations of retirements and pension funds. The Draft Policy was discussed with the stakeholders in the workshop.

4.1.3 Rural Finance

During the period under review, the Bank continued with the Rural Finance activities with the aim of linking the rural groups engaged in various financial activities of their choice with the formal banking sector. In this regard, 12 groups guaranteed under the Rural Savings and Credit Guarantee and financed through the two commercial banks (Standard Lesotho Bank and Nedbank Lesotho) continued to be monitored. Out of the 12 groups, 11 fully paid up their loans and only 1 defaulted while a group that had performed extra ordinarily well reapplied for refinancing in October 2011; and its new loan is currently performing very well.

Ideally, the promotion and monitoring of rural finance activities is not the role of a central bank. Negotiations with the Ministry of Agriculture are therefore under way for the handing over of this activity.

4.1.4 Policy and Exchange Control

Lesotho acceded to the IMF Article VIII in 1997 as a result of which it embarked on a substantial but gradual abolishment of many restrictions over current account transactions. Many restrictions on the capital account transactions have also been relaxed.

Despite the abolishing of controls on current account transactions and relaxation of many restrictions over capital account transactions, indicative limits are retained on certain current account transactions. These include items like monetary gifts, maintenance and travel allowances. These are limits above which approval has to be sought and obtained from the Central Bank of Lesotho (the Bank) before the Authorised Dealers can effect the transactions. Other transactions have to be approved by the Bank more as a formality and a direct monitoring tool than an instrument to prohibit such transactions.

The Bank is responsible for the administration of Exchange Control laws under powers delegated by the Minister of Finance and Development Planning. In addition to administration of Exchange Control laws in pursuance of Ministerial delegation, the Bank carries out this mandate as specific functions in terms of Section 7 of the Central Bank of Lesotho Act 2000. It also administers Anti-Money Laundering Legislation, namely Financial Institutions (Anti Money Laundering) (AML) Guidelines 2000 and Financial Institutions (Know Your Customer) (KYC) Guidelines 2007. As part of the country's efforts in fighting Money Laundering (ML) and Financing of Terrorism (FT) it partakes in the implementation of the Money Laundering and Proceeds of Crime Act, 2008.

Applications to sell Foreign Currencies

During 2011, a total of one hundred and thirty one (131) applications were submitted by Authorised Dealers to Exchange Control for approval. This number is lower than the number approved in 2010. However, the value of the applications approved stood at M 988.4 million compared to M463.9 million in 2010. The payments were in respect of professional services, management fees, dividends, royalties, insurance premiums and off shore investments by institutional investors. As in previous years, the largest number of applications was in respect of repatriation of dividends to non-resident shareholders by manufacturing companies, the mining sector, insurance companies and loan repayments by construction companies and some corporates.

Capital Account Liberalisation

There was a decrease in Foreign Currency Accounts (FCA) held by residents from eight in 2010 to five in 2011. The small number still reflects lack of interest on the part of individuals for this type of service because it brings little reward by way of interest earned. There was also a marked decrease in amounts processed through FCA from M4.5 million in 2010 to M355 thousand in 2011. The decrease was largely due to decrease of FCA held by staff of foreign diplomatic missions in Lesotho.

On the contrary, interest in accounts held by corporates and international agencies, namely Customer Foreign Currency Accounts (CFCs) remained high. There were fifty one (51) accounts in 2011 compared to forty three (43) in 2010. During the year under review, an approximate amount of M1, 018,033 was processed through CFC accounts. This was still subject to the policy that amount that has been held for 180 days in the CFC account would be converted to Maloti.

Despite the minimal interest paid on these accounts the main attraction remains the hedge against fluctuations in exchange rates. The manufacturing companies which constitute the bulk of CFC account holders manage exchange rate risk through these accounts when they make payments for raw materials and related trade expenses.

Export Declarations

In spite of the global financial and economic crises the export sector, mainly the mining and manufacturing industries, performed reasonably well under the circumstances. The authorised dealers attested exports worth USD715.7 million in 2011, compared to USD450.5 million in 2010. This was a big increase over the figure for 2010 which signalled a change for the better in overseas markets where most of the products are sold.

Cross-Border Foreign Exchange Transactions Reporting System

After several years of unsatisfactory implementation of the Cross Border Foreign Exchange Transactions Reporting System (CBFETRS), the commercial bank that was the largest contributor to the challenges, finally made a concerted effort to improve its performance. By the end of 2011 the occurrence of errors in reported transactions had been reduced to acceptable levels.

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

Suspicious Transactions and Large Cash Transactions Reports

The Bank has also been mandated to enforce compliance with Anti-Money Laundering measures in terms of the Financial Institutions (Anti-Money Laundering) Guidelines 2000. Seven suspicious transactions reports (STR) were received during 2011 compared to three in 2010. The cases are still under police investigations.

As the regulator and supervisor of financial institutions, the Bank has the responsibility to ensure that law enforcement agencies, especially the police, carry out necessary investigations into any STR received by them from the financial institutions.

The Bank also received thousands of Large Cash Transactions reports from commercial banks in terms of sections 17(1) of the Anti-Money Laundering Guidelines. In terms of this section, all transactions above the threshold of M100, 000 have to be reported to the Bank.

Money Laundering and Related Issues

The Anti-Money Laundering / Combating Financing of Terrorism (AML/CFT) Regime

At the end of 2010, Lesotho underwent a Mutual Evaluation by inspectors of the Eastern and Southern African Anti-Money Laundering Group (ESAAMLG). During 2011, the assessment team took the report through appropriate structures to assess Lesotho's compliance with international standards to determine whether there were Laws and structures that could prevent money laundering and financing of terrorism and related activities. The Mutual Evaluation Report was adopted by the council of Ministers in Mauritius in September 2011.

National Cooperation

The National Task Team on Anti-Money Laundering (Task Team) was set- up with the mandate to develop legislation on Anti-Money Laundering measures. This mandate has since been completed. There is a proposal to elevate the National Task Team to the National Coordination and Advisory Committee through legislation. The Committee shall serve as a forum for discussing policy issues on AML/CFT. The task of establishing the National Coordination and Advisory Committee formally was completed in 2011. Its proposed terms of reference and governance structure have been submitted to the Minister of Finance for onward transmission to Cabinet for approval.

The Task Team held several workshops to discuss, among others, the implementation of the National strategy and to address the core and key recommendations that came out of the Mutual Evaluation report as rated by the relevant structures of ESAAMLG.

Central Bank AML/CFT Initiatives

The Central Bank had been a driving force behind the anti-money laundering initiatives since the very beginning. It issued the Financial Institutions (Anti-Money Laundering) and Financial Institutions (Know Your Customer Guidelines 2000 and 2007, respectively. With the enactment of the Money laundering and Proceeds of Crime Act, 2008, the Bank's challenges as the regulator and supervisor of most of the financial institutions has been to put in place regulations, policies, guidelines and directives in order to align them with the Act.

Regional Meetings

- **ESAAMLG**

The Eastern and Southern African Anti-Money Laundering Group (ESAAMLG) has two statutory meetings per annum. Policy and Exchange Control Division, on behalf of the Bank, attended both the March and August meetings held in Zanzibar and Mauritius, respectively. It participated in AML/CFT issues, representing the financial sector, to network and exchange invaluable information with other members in the region.

- **CMA**

Policy and Exchange Control Division continued to represent the Bank, hence the country, at the CMA Exchange Control Quarterly meetings.. These are consultative meetings held in each member country, on a rotational basis.

4.3 Operations Department

4.3.1 National Payment System

Introduction:

For the year under review, the central Bank of Lesotho, in collaboration with the commercial banks and other stakeholders, continued to implement the National payment systems modernisation project which started in 1999. The project is spearheaded and implemented by the National Payment Systems division of the CBL, with the aim to achieve its vision in 2015.

Strategies:

Among the strategies implemented to achieve the vision, progress has been made as reflected below.

Legal and regulatory Framework

The National Payment Systems Draft Bill was finalised and submitted in 2007, and it is currently with the Office of Parliamentary Committee (OPC), and awaiting enactment.

Real Time Gross Settlement System (RTGS)

In August 2006, the process let to the implementation of the RTGS system called Lesotho Wire, which is a wholesale payments system, processing large value and time critical payments equal to and above M100, 000.

Automated Clearing House (ACH) Project

The ACH processes retail payments, being payments of small value but large volumes**.** The implementation process is at an advanced stage, as progress is quite noticeable.

- Most of the Infrastructure connectivity issues or requirements have been addressed.

- The Electronic Funds Transfer (EFT) payment streams went Live in October, 2011, between CBL and Standard Lesotho Bank only, as the other banks were still trying to come on board.

- The other two banks, Nedbank Lesotho and FNB Lesotho, are currently testing their transactions, and the plan is that the whole industry is going to achieve a "smooth" full cycle of events for both inwards and outwards items (Outgoing EFTs and Unpaids); and going Live date is planned for the 18th February, 2012.

4.3.2 Currency Management

The Division has responsibility for administering all functions of currency management, a core function of the Central Bank of Lesotho in terms of the Central Bank of Lesotho Act, 2000. Currency Management essentially relates to issue of notes and coins and retrieval of unfit notes from circulation. In an effort to accomplish this function, the Bank through Currency Operations Division introduced a new set of banknotes in 2010 with improved quality and security features.

In 2011, the Bank commenced a massive campaign to educate the public about the new series of re-designed banknotes. The emphasis was on **"The know Your Money"** viewpoint, the program that entailed quality of the notes and improved security features. The new set was made available for public use during the first quarter of 2011. The Public reception and confidence on the new set has so far remained a success.

4.4 Financial Markets Department

The Department of Financial Markets is charged with efficient and prudent management of the foreign exchange international reserves for the support of the peg between the loti and the rand as well as a strong balance of payments position in line with the investment management framework approved by the Board of Directors. The department is also responsible for the enhancement and advancement of the domestic market operations for efficient monetary policy and financial intermediation.

4.4.1 Reserves management

The reserves management activity was challenged by the difficult investment environment following the recession in the global economy. However, strict adherence to the set benchmarks and the Strategic Asset Allocation that the Bank adopted on joining the World Bank Reserves Advisory Management Program (RAMP) minimized the impact of the global recession on the reserves. The continuous adoption of new skills by personnel in the Department through RAMP is expected to enhance reserves management activity in order to further assist efforts by the Government to increase international reserves.

4.1.2 Securities Trading and Domestic Market

The domestic market operations continue to be focal point of development in the country's nascent money and capital markets. Since the successful introduction of Government Bonds in 2010, efforts are now directed to leveling the field for the establishment of the stock exchange. On securities trading, the Bank continued to re-open some of the securities that were launched in 2010 and further introduced new ones. Treasury Bills in tenors of 91,182,273 and 364 days were auctioned as per the auction calendar for the purpose of monetary policy.

4.5 Administration Department

The Human Resources Division had three sections, namely Recruitment and Training section, Personnel and Administration Section and Safety, Health and Environment Section. The division continued to carry out its functions though out the year as mandated.

(a) Recruitment and Training

A total of number of sixteen (16) staff was employed in 2011. These staff members were placed in various departments of the Bank.

(b) Training

Most policies of the Bank, including the Training Policy, are presently being revised. It is anticipated that the exercise will the completed before the end of the year. A total of twenty (29) staff were approved for long term training. Out of this number, one (1) is pursuing PhD, eleven (11) are pursuing Master degrees, three (3) undertaking other post graduate degrees, eight (8) are pursuing first degree while seven (7) are pursuing diplomas and certificates in various fields of study.

(c) Separation

Three members of staff separated with the Bank in the form of resignation. While three employees including the Governor lost their lives. Vacant positions came as a result of promotions/lateral transfers and newly created positions.

(d) Safety, Health and Environment

Our incident/accident statistics reflected zero percent no disabling accidents for the entire Bank during the year. As part of our employee wellness program, the Bank conducted the Health day. This event was for all staff and their dependents. All members were given a free opportunity of checking their health on life threatening diseases such as cholesterol, high blood, vision, HIV and others.