CHAPTER 2

AN OVERVIEW OF THE ECONOMY

2.1 INTRODUCTION

The basic aim of this chapter is to provide a background to the economy of Lesotho over the sample period with a view to highlight the major elements and state of the economy and the policy developments over that period. The background is presented in two parts. The first part presents and discusses the developments in the economy during the study period. The second part of the review highlights the monetary and fiscal policy environment during the period under review and slightly beyond. The analysis made here is based primarily on Annual Reports of the Central Bank of Lesotho (CBL), Reports of Government of Lesotho (GOL) and Ministries of Finance and Economic Planning and Statistical Bulletins of the Bureau of Statistics (BOS).

2.2 AN OVERVIEW OF THE ECONOMY OF LESOTHO

For the economy of Lesotho, the 1980s were in general characterised by low levels of economic growth and internal and external economic imbalances. The end of the 1980s marked a major structural and macroeconomic policy transition in the economy. The launching of the Lesotho Highlands Water Project (LHWP) in 1987/88 and the implementation of the structural adjustment programmes in 1988/89 brought significant changes in the structure of the economy. Specific targets of the adjustment policies included increasing domestic output, reducing the government budget and balance of payments deficits as well as achieving price and monetary stability.

While the structural rigidities and its peculiar geographical position are still considered a major impediment to economic growth and development, significant improvements, though erratic, were observed in the performance of the economy during the 1990s. From a depression in the 1980s, the economy began recovering almost immediately following the commencement of adjustment programs in 1988/89. Table 2.1 gives a summary of selected macroeconomic indicators. The 1990s began with a modest growth rate of 6.4 per cent in 1990, reaching a peak of 10 per cent in 1996. Notable improvements were observed with the inflation rate falling from 16.5 per cent in 1981 to 6.1 per cent in 2000. Fiscal discipline and hence a budget surplus, is one of the major highlights of the 1990s. Because of the progressive improvements in the fiscal position, the debt burden remained at relatively low levels with a debt service ratio of less than 5 per cent in the mid-1990s.

Table 2.1 Selected Macroeconomic Indicators (Percentages)

	1981	1985	1988	1990	1992	1994	1996	1998	2000
GDP growth	0.7	4.9	10.6	6.4	4.6	3.4	10.0	-4.6	4.1
GNP growth	2.9	-2.5	7.8	4.8	6.8	1.1	4.4	-9.0	-3.2
CPI inflation	16.5	15.1	11.4	11.5	17.0	7.2	9.1	7.8	6.1
Gross savings ratio	15.8	22.8	20.9	23.5	29.0	24.9	17.4	11.2	16.9
Budget def/sup to GDP	-3.0	-2.6	-6.7	-1.8	1.8	4.6	4.5	-2.4	-5.6
Current acc to GDP	-2.4	-1.5	-8.4	-11.6	-22.9	-22.2	-36.3	-36.8	-26.5
Total debt to GNP	-	-	48.8	45.3	38.7	48.5	47.2	53.1	66.1
Debt service ratio	-	-	-	-	3.5	3.5	4.1	7.2	8.4

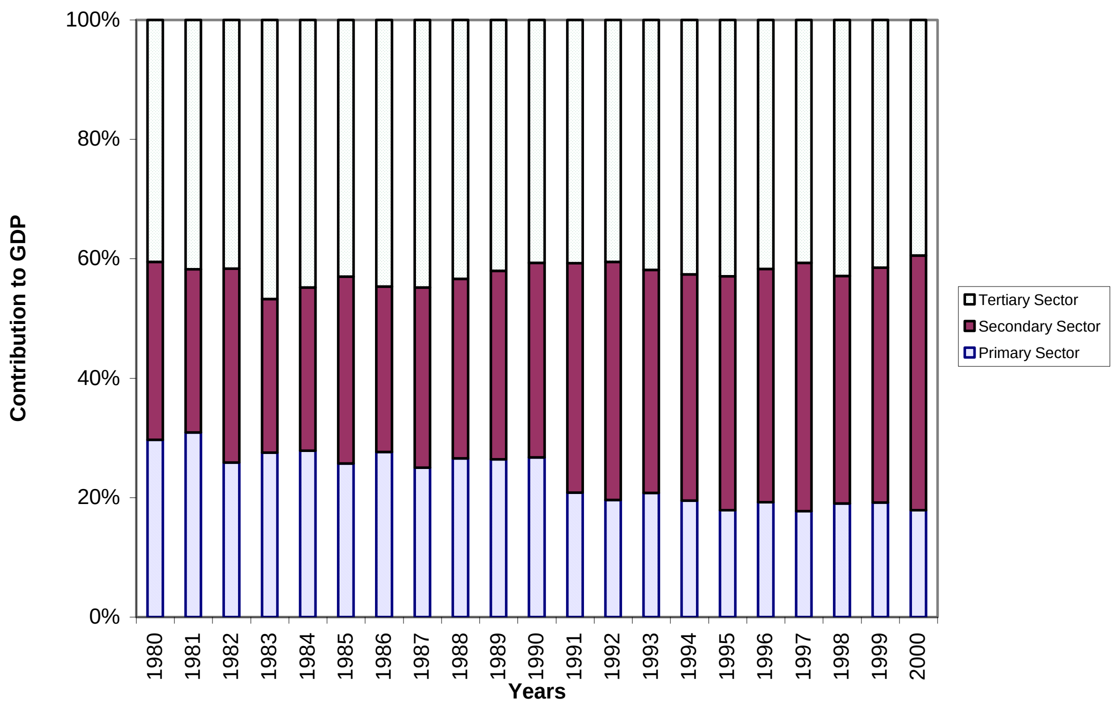
Source: Central Bank of Lesotho Annual Reports and Database

2.2.1 Supply sectors

Three major productive sectors, namely the primary (predominantly agriculture), the secondary (including manufacturing and construction) and tertiary sectors, make up the real sector of the economy. Higher growth rates of output during the 1990s were attributed to a large extent to the satisfactory performance of the construction sector led by the LHWP related activities, especially a surge in capital expenditures at that time, and the rapidly growing export-oriented manufacturing sector following intensified campaigns to attract investors. The contribution of the construction sub-sector towards the secondary sector was however offset by the near-stagnant growth in the manufacturing sector in 1994 owing to industrial actions that disrupted productivity within that sector.

Like many developing countries, the agricultural sector has traditionally played a pivotal role in the economy of Lesotho. The end of the 1980s was characterised by a marked fall in the growth of real GDP largely attributed to a decline in agricultural value added and a slack growth rate of value added in the manufacturing sector. In the early 1990s favourable weather conditions resulted in higher crop and livestock production and hence an increase in value added of the agricultural sector. On the other hand, modest developments in the tertiary sector, which consists largely of services, have largely been linked with improved government service as well as the expansion of wholesale and retail trade and other services. Figure 2.1 portrays value added by different aggregate sectors during the review period.

Figure 2.1 Value added by major production sectors (Million Maluti, 1995=100)

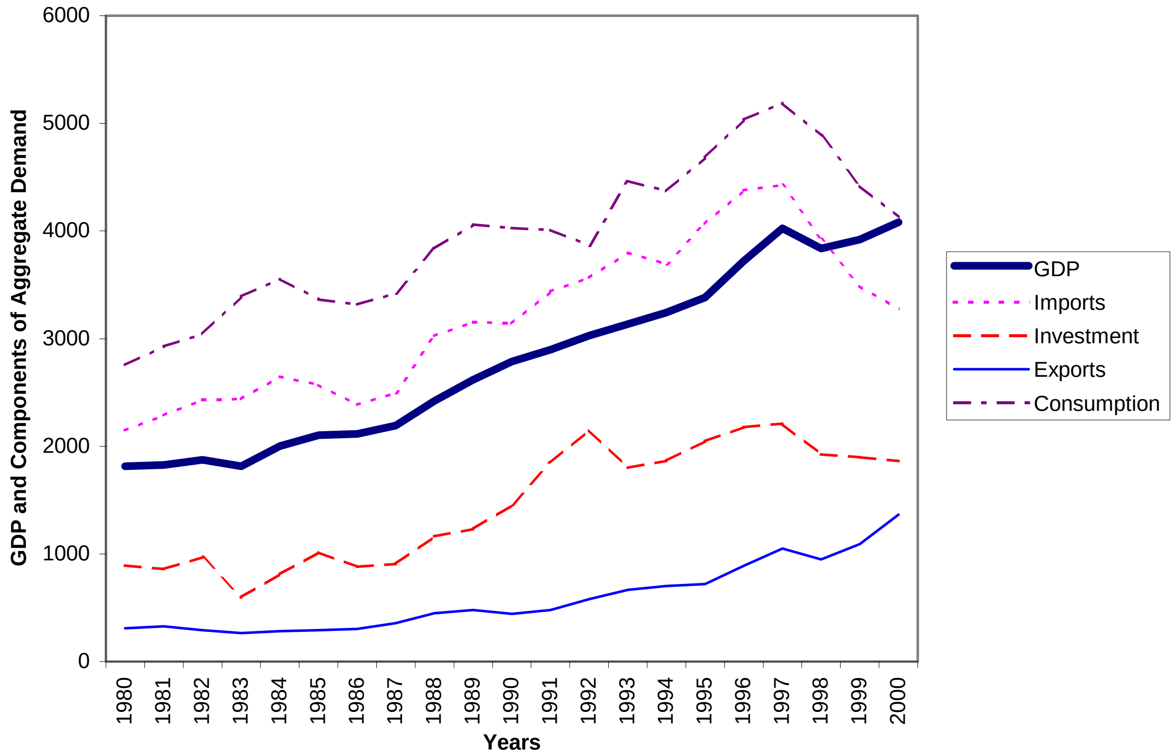


Since 1990 the primary sector has on average contributed about 20 per cent to GDP owing to the decline in agricultural output in the 1980s, while the secondary sector and the tertiary sector seem to have each accounted for approximately 40 per cent of total output.

2.2.2 Aggregate demand components

Viewed from a broader perspective, the national accounts reveal an interesting feature of the economy. A comparison of economic activities from the supply side and the demand side shows quite clearly that the economy is supply constrained and demand driven. Throughout the 1990s, consumption expenditure exceeds GDP (see figure 2.2) by an average of 75 per cent. This indicates dissaving and the fact that most of the domestic demand is satisfied from abroad. Imports of goods and services actually exceed GDP for most of the time and constitute about 60 per cent of total supply.

Figure 2.2 GDP and aggregate demand components
(Million Maluti, 1995=100)



Consumption expenditure dominates other components of aggregate demand. In 1990 it constituted 68.9 per cent of total demand and 138.4 per cent of domestic supply. It has increased steadily above GDP for the entire period. This means that more than a third of total resources have invariably been allocated to consumption annually. The second largest component of aggregate demand is imports of goods and service making up for 54.7 per cent of total supply in 1990. The increase in the size of imports has been linked to the activities of the LHWP. According to the CBL (1996:10), imports related to the LHWP project increased on average by 32.4 per cent in the five-year period ending 1996. The financing of imports has been covered to a large extent by inflows of remittances and transfers.[2] This suggests that the stability of the economy is highly susceptible to external shocks. Since 1998 imports have fallen below GDP. This has been associated with the winding up of the activities of LHWP phase 1A.

Investment is the third largest component of demand. It accounted for 23.5 per cent and 24.9 percent of total demand in 1990 and 1999 respectively. An impressive growth in investment of 45.8 per cent was recorded in 1991. Again this has been attributed largely to increases in LHWP related capital expenditures. With the contraction of the LHWP construction activities in the mid-1990s, the growth of investment waned to 24.2 per cent in 1995. Lower growth rates of 16.8 per cent in 1999 and -8.4 per cent in investment in 2000 can, to a large extent, be related to the after-effects of the political unrest during the third quarter of 1998.

Exports, a large portion of which comes from textile manufacturing, make up the smallest portion of overall demand.[3] The large gap between exports and imports shows the extent of the deficit on the current account. From 7.5 per cent in 1990, the share of exports and non-factor services receipts in total resources rose to 12.6 per cent in 1999. This represents a surge in export earnings of manufactured goods which have increased overall during the 1990s owing to promotional efforts in the form of tax and financing incentives, low wages in the sector and preferential access to international export markets in European Union (EU), United States of America (USA) and Japan.[4] In contrast, the

[2] Net factor income from abroad has contributed up to 50 per cent to GNP in the past. In 2000, its share in GNP had dropped to 19.6 per cent because of the continuing retrenchments in the South African mining industry.

[3] Because of different adjustments made by the BOS and the CBL, export statistics are notorious for discrepancies.

[4] Lesotho has enjoyed preferential treatment for its exports in major international markets through the Lome convention, Southern African Customs Union (SACU) and other arrangements, and lately, African Growth Opportunity Act (AGOA).

export earnings of the agricultural sector, mainly from exports of wool and mohair declined substantially during this period. This has been a result of the decline in productivity in the agricultural sector due to unfavourable weather conditions. Because of the decline in the quantity and quality of agricultural products, they have failed to attract decent earnings in international markets. In contrast, the former benefited furthermore from the depreciation of the Rand against major currencies in recent years. The following table displays the distribution of domestic output and expenditures.

Table 2.2 Shares of expenditures in GDP and GNP (Percentages)

	1980	1985	1988	1990	1992	1994	1996	1998	2000
Final consumption to GNP	88.68	89.83	91.82	91.02	85.08	92.3	100.6	101.47	91.05
Final consumption to GDP	151.93	160.08	158.38	144.59	127.57	134.8	135.28	127.41	101.21
Shares to final cons.									
Private sector	87.17	88.02	88.99	89.37	88.05	87.8	88.1	84.69	82.41
Government	12.86	11.98	12.0	10.63	11.95	12.19	11.89	15.31	17.59
Gross investment to GNP	49.28	48.25	48.02	52.19	71.01	57.50	58.52	50.13	45.60
Gross investment to GDP	28.77	27.07	27.84	32.86	47.36	39.37	43.51	39.93	41.02
Shares to gross investment									
Private investment	13.61	18.92	24.59	40.57	49.62	51.87	53.32	57.13	57.11
Government investment	82.71	81.57	74.03	59.57	48.78	50.95	46.43	46.61	49.32
Total exports to GNP	9.99	7.81	10.72	10.03	12.78	14.81	17.76	19.69	30.11
Total exports to GDP	17.13	13.93	18.49	15.93	19.16	12.62	23.88	24.73	33.47
Total imports to GNP	69.08	68.6	72.4	70.96	78.53	78.0	87.5	81.45	72.22
Total imports to GDP	118.34	112.25	124.89	112.71	117.74	113.92	117.67	102.26	80.28
Factor income from abroad to GNP	37.88	44.32	42.18	39.76	34.15	31.26	25.96	21.96	19.62

Source: CBL Annual Reports and Database

2.2.3 Employment and wages

Though labour market statistics are quite scanty, a few pointers can be made on the basis of surveys conducted by the statistical office from time to time. Given an estimated population growth of 2.6 per cent per annum, labour force growth of 2.8 per cent and an annual average growth of per capita GDP of 1.6 per cent in the 1990s, it is not surprising that poverty alleviation has been one of the main focuses of government since the beginning of the 1990s. Employment statistics show that the unskilled and low-skilled labour force grows at a higher rate than the capacity of the economy to create employment despite the recent growth in the export-manufacturing sector. Since 1990, employment growth rates have lagged behind the rate of growth of GDP causing the employment-GDP elasticity to fall below unity. Within the formal sector, government is the largest employer, taking up 60 per cent of the 7.8 per cent of the labour force that was employed in the formal sector in 1994. The manufacturing sector and the LHWP accounted for 31 per cent and 8.4 per cent, respectively. However, because of the restraints, the growth of government employment has fallen from 27.7 per cent in 1990 to 0.02 per cent and 0.2 per cent in 1993 and 2001 respectively. The following table shows employment by sector and employer in 1991 and 1999.

Table 2.3 Employment by sector and employer (Percentages)

By sector	1991	1999
Primary	53.1	58.4
Secondary	14.7	13.2
Of which:		
Manufacturing	29.9	44.5
Construction	65.9	50.8
Other	4.2	4.7
Tertiary	32.2	28.4
By employer		
Government and parastatals	-	13.1
Private	-	35.6
Subsistence farming	-	51.3

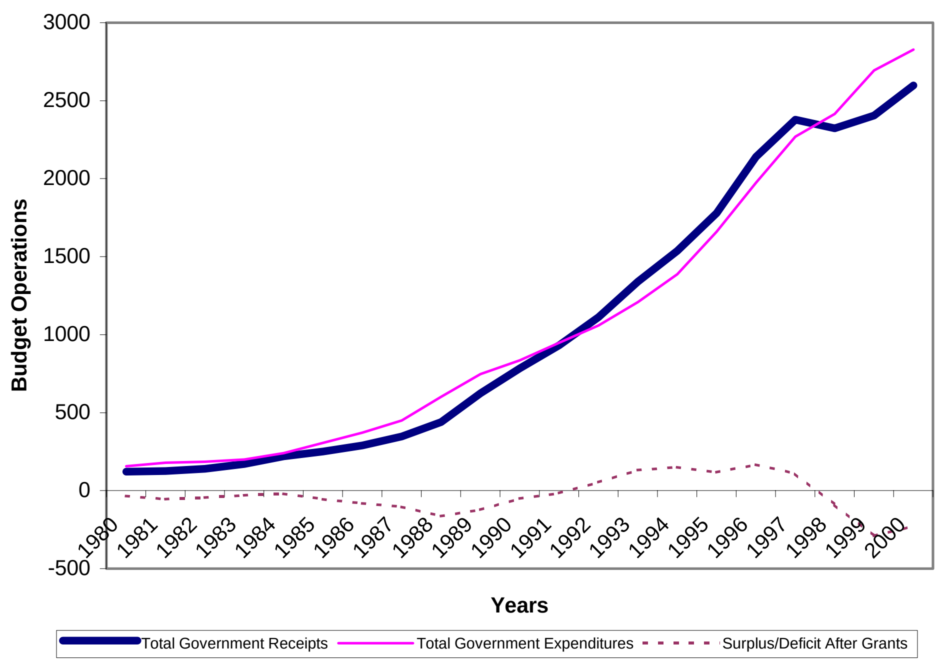
Source: BOS Labour Force Surveys and CBL Annual Reports

On the basis of these statistics, the primary sector is the largest employer in the economy followed by the tertiary sector and the secondary sector. Within the secondary sector, the construction sub-sector takes the lead. Although with scanty information, it can be inferred from the statistics that while the secondary and tertiary sectors are leaders in terms of output (see table 2.2), they lag behind the primary sector in terms of employment.

2.2.4 Fiscal developments

Evidently there has been a remarkable improvement in the government budget since the implementation of the stringent measures that accompany the structural adjustment policies. This reflected efforts of government to curb expenditure and improve administration and coverage of the tax system. Fiscal control has always been a major policy option for Lesotho notwithstanding the slight loss of sovereignty through the common tariff of the SACU arrangement. Since 1992, total receipts have been in excess of total expenditures although the margin narrowed from 1994. This improvement is reflected in the growth rate of expenditure relative to receipts as well as their relative shares in GDP. Figure 2.3 shows a summary of the position of government finances from 1980 to 2000.

Figure 2.3 Summary of government budgetary operations
(Current Million Maluti)



Government receipts are composed mainly of customs revenue and different taxes. Of these, customs revenue is the largest source of revenue. Prior to 1990 it constituted more than half of total government receipts. In the early 1990s, the increase in customs revenues was made possible mainly by the growth of imports related to the LHWP. Official statistics show that the share of customs revenue in total receipts was 43.5 per cent in 1990 while that of tax revenue was 24.1 per cent. Towards the mid-1990s customs revenue declined because of the slowdown of the growth of imports related to the LHWP. From a growth rate of 13 per cent in 1994, a lower rate of growth of customs revenue of 8 per cent was realised in 1995. Although the rate of growth of tax revenue fell between 1990 and 1993, there was a remarkable recovery in 1994, offsetting the fall in customs revenue. This followed a range of tax reform measures undertaken during the 1990s. It is notable that water royalties, though not much, emerged in 1996 towards the completion of the first phase of LHWP.

Recurrent expenditure feature predominantly in government expenditure. Their share has ranged from 55 per cent to 83 per cent during the 1990s. The early 1990s were characterised by a slowdown in the growth of recurrent expenditure due to the reduced wage bill following restructuring. However, government efforts to contain expenditure since the late 1980s seem to have been successful only up to 1996 after which resurgence was experienced. This is reflected by the experience of a budget deficit starting from 1998 and can be explained by increased expenditure during and after the political unrest experienced in 1998. It is noteworthy that the ratification of the European Union-South Africa (EU-SA) free trade agreement in recent years has been perceived as a threat to the customs revenue given that it renders imports from the EU tariff free. However, there are prospects for recovery beyond 2001 given the lower rate of growth of expenditures relative to receipts. It is noteworthy that while the government managed to contain the growth of expenditure to some extent, there has not been much change in its composition. Recurrent expenditure still account for the largest share of total expenditure.

2.2.5 The monetary sector

Because of developments in the fiscal sector, the government has assumed the position of net creditor throughout the 1990s and has since maintained a policy of financing its overall budget from external borrowing on concessional terms. Significant government deposits with the domestic banking system eased government borrowing from the banking sector and have helped to shift domestic financial resources in favour of the private sector which was previously marginalised by a government policy of subsidising holdings of government debt by commercial banks. Treasury bills have since become the main instruments for monetary policy and government short-term financing.

Table 2.4 A summary of monetary aggregates and their statistical counterparts, 1980 - 2000 (Million Maluti)

	1980	1985	1990	1992	1994	1996	1998	2000
Net Foreign assets	93.2	216.6	360.9	768.6	1609.0	2230.8	3646.7	3585.3
Net Domestic credit	48.5	178.8	426.6	235.3	-256.5	-503.3	-944.3	228.6
Of which:								
Government	22.8	87.9	206.6	-140.8	-840.9	-1320.6	-2011.1	-733.6
Statutory bodies	9.2	11.3	26.2	28.9	30.9	141.3	225.5	79.2
Private sector	16.8	79.6	193.8	347.2	553.5	676.0	841.2	883.0
Of which:								
Mortgages (%)			-	-	14.0	1.6	9.4	11.5
Business enterprises (%)			75.5	78.3	67.4	63.9	44.4	38.4
Households (%)			24.5	21.7	18.6	34.5	46.2	50.2
Money supply (M2)	117.1	306.0	619.2	821.0	1132.2	1334.0	1768.8	1700.9
Other items	7.5	77.2	184.4	182.1	220.3	393.5	933.6	2112.9
Money supply (M2) growth	22.1	15.1	11.1	17.5	16.3	17.2	15.5	1.4

Source: CBL Annual Reports and Database

Although the growth of total domestic credit has been declining, the share of credit to the private sector has been increasing. It is also clear that the composition of total credit has changed significantly over the years. This is clearly indicated by the higher growth of credit to private sector relative to the growth of credit to the public sector. It is important to note that private investment has grown at a faster rate than public investment during the same period[5].

On the other hand, the growth of Maluti denominated money supply (M2) had been moderate in the 1980s until 1991. In 1992 the growth of broad money increased to 17.5

[5] See table 2.2.

per cent, after which it stabilised somewhat. This was a reflection of notable increases in net foreign assets, inclusive of funding related to LHWP. It is noteworthy that net foreign assets contribute the largest share to money supply. The stability of money supply growth can partly be attributed to the budgetary surpluses that the government has maintained over a large part of the 1990s (see figure 2.3). Because of this and the fall in domestic credit, there has been a slight dampening effect on the growth of money supply.

2.2.6 Price developments

The 1980s were almost invariably characterised by a double-digit inflation rate. The inflation rate declined from 16.5 per cent in 1981 to 9.1 and 6.1 per cent in 1996 and 2000, respectively.[6] This improvement was explained by the decline of the annual growth rates of individual indices from which the CPI is compiled. According to the CBL (1996), approximately 75 per cent of a combination of goods and services from which the CPI is computed comprise imports from South Africa (SA). This implies that imported inflation and exchange rate movements in SA that pass through to domestic prices explain most of the changes in prices. This, however, does not rule out the influence of pressure from aggregate demand despite efforts to curb inflation through wage restraints and tight monetary policy. Though the authorities have not had much leverage with respect to monetary policy, it is notable that the general price developments also match the stable growth of money supply during the 1990s.

2.2.7 The balance of payments

The external position of the economy is summarised by the balance of payments. While the economy has enjoyed a positive capital balance, the current account has remained in deficit over the entire period since 1990. The margin between exports and imports shows the extent of current account deficit (see figure 2.2). The deficit in the current account has however been offset by the observed surplus in the capital account resulting in an overall surplus in the balance of payments for most of the period. The position of the balance of payments is summarised in figure 2.4.

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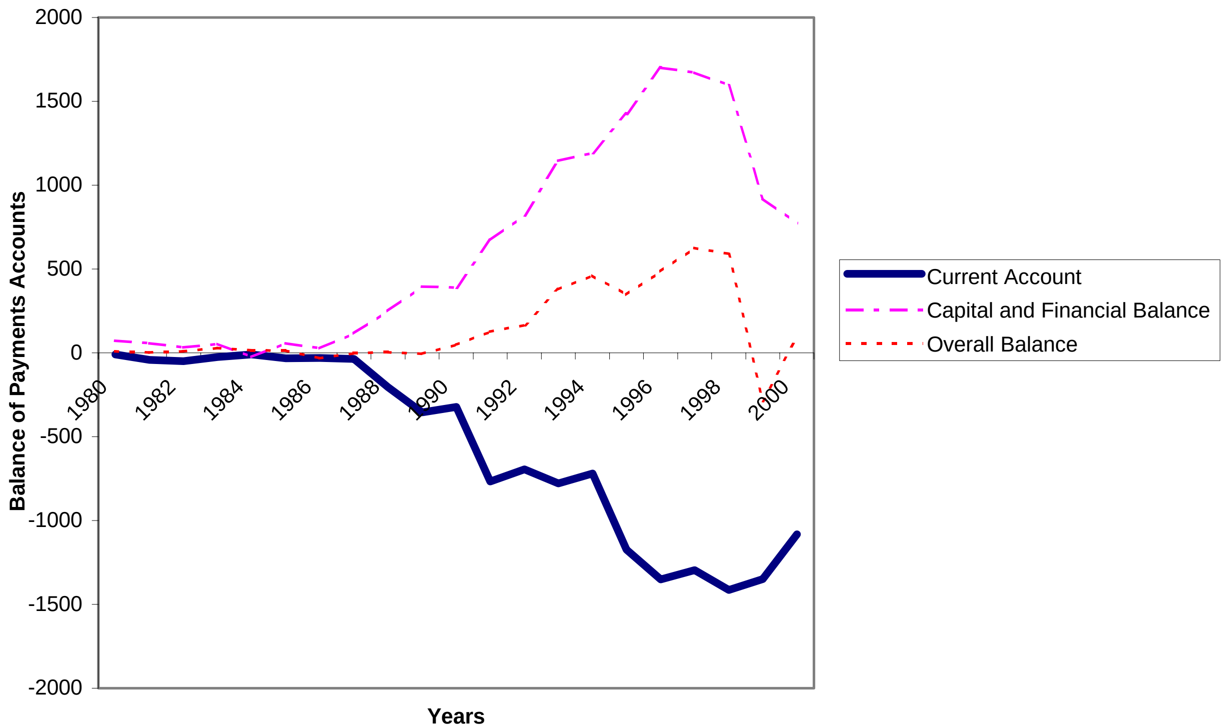
[6] See table 2.1.

Figure 2.4 Summary of major accounts in the balance of payments (Current Million Maluti)



In all years, merchandise imports have the highest value as compared to other components of the current account. In 1991 this item exceeded the current account deficit by 293 per cent.[7] Of these, LHWP related merchandise imports alone accounted for only 35 per cent of the current account deficit (CBL 1994). This trend continued to the mid-1990s. Exports also grew substantially during the same period. Manufactured exports account for about 80 per cent of total exports. In 1992 exports grew by an impressive 67 per cent as compared to the growth of 12 per cent in 1991 (see table 2.5). The steady expansion of the export oriented manufacturing sector played a major role in this development. This was also accounted for by the sharp depreciation of the Rand and hence the Loti during that time. Imports remain significantly higher than exports in absolute terms notwithstanding their growth of only 14.3 per cent during the same period.

[7] This represents the share of merchandise imports in the current account balance.

Remittances and unrequited transfers play a major role in financing imports. In 1994 workers' remittances financed about 40 per cent of imports. Their role fell to 32 per cent in 1996 and 30 per cent in 2000 owing mainly to the continuing retrenchments in the South African mining industry. However, overall the shortfall in net exports continues to grow more rapidly than income. This fact is depicted in table 2.5. Because of this, the external position of the economy remains vulnerable, particularly in the light of the anticipated decline in the remittances and SACU revenues.

Table 2.5 Summary of balance of payments 1980-2000 (Current Million Maluti)

	1980	1985	1990	1992	1994	1996	1998	2000
Current account	-8.7	-32.3	-321.8	-695.0	-719.4	-1350.6	-1413.7	-1083.8
Goods, servs & income	-	-225.3	-635.9	-1162.6	-1368.6	-2154.8	-2255.9	-2019.9
Goods	-285.3	-672.1	-1574.5	-2253.6	-2491.2	-3490.9	-3589.6	-3582.2
Of which:								
Exports	46.6	50.0	166.9	310.9	509.3	812.1	1109.6	1468.4
Imports	-331.9	-722.1	-1741.4	-2564.5	-3000.5	-4303.0	-4699.	-5050.5
Net services balance	-	-39.9	-39.9	-54.2	-31.9	-86.9	-58.1	-1.2
Income	205	486.7	978.5	1145.2	1154.5	1422.9	1391.8	1563.6
Of which:								
Labour income	205	471.4	1000.5	1226.1	1206.1	1390.2	1409.6	1553.8
Transfers	63	163.8	314.1	467.6	649.2	804.2	842.2	936.1
Of which:								
SACU receipts	35.2	96.2	195.1	328.5	532.7	682.6	709.8	803.2
Capital & fin. acc.	71.9	57.7	389.9	820.9	1192.3	1699.9	1595.8	773.6
Of which:								
Capital account	20.4	15.7	110.6	173.2	142.9	194.2	122.6	150.7
Financial account	51.5	42.0	279.3	647.7	1049.4	1505.7	1473.2	622.9
Overall balance	10.2	13.8	47.3	165.9	461.6	487.4	589.1	92.0

Source: CBL Annual Reports and Database

Private foreign investment dominates the long-term capital transactions and has grown rather steadily over time. This follows a range of incentives such as income tax holidays for a given period, export financing schemes and establishment of more efficient investor advisory services to attract foreign investment. On the other hand, LHWP related financing dominates the financial account of the balance of payments. A combination of these major accounts has produced and maintained a surplus in the capital account over the 1990s. However, overall the balance of payments remains in deficit because of a huge shortfall on the current account.

2.3 SUMMARY OF MACROECONOMIC DEVELOPMENTS

The end of the 1980s and the beginning of the 1990s were characterised by major changes in both the structure of the economy and macroeconomic policy. Firstly, the inception of the LHWP in 1987/88 represented significant changes in the structure of the economy directly through elevated investment and capital inflows as well as imports. These have had great implications for the real sector of the economy as well as the balance of payments. Secondly, the adjustment programs in 1988/89 marked major policy changes for the economy. The ultimate outcomes of these have been observed and felt to a large extent in the public sector. Thirdly the decline in labour income, which has historically played a pivotal role in national income, was a major milestone during the review period.

Having gone through a recession in the 1980s, an analysis of the performance of the economy in the 1990s reveals mixed outcomes. On the fiscal front, a combination of fiscal restraints, tax reforms and increased imports and hence SACU receipts, seem to have jointly benefited the fiscal stance directly. Through stringent revenue raising and expenditure cutting policies, government has managed to secure a surplus position in its budget for a series of years. Increased LHWP capital expenditures and the improved fiscal discipline have tended to propel investment expenditures, while the fall in labour income has led to a decline in aggregate consumption expenditures. From the supply side, the former changes have jointly increased domestic output through the increased value added of the manufacturing and construction sub-sectors in particular. A view from the demand side reveals a rise in investment expenditures and a fall in consumption expenditures, though consumption remains significantly higher than investment in absolute terms.

Developments in the balance of payments seem to have been driven predominantly by LHWP related activities rather than the policy changes and changes in labour income combined. The current account deficit has been worsened by increased total imports of which the LHWP imports take a large part, as well as the decline in labour income, which has traditionally played a major role in financing imports. It is notable, however, that the decline in labour income has been partly offset by the rise in LHWP related SACU receipts and transfers. On the other hand, the capital and financial accounts have benefited from increased foreign investment, due to government policy especially with respect to the manufacturing sector and LHWP activities. Overall, the balance of payments remains in deficit. The monetary sector is linked to the system by the growth of net foreign assets in the balance of payments of which transfers and grants are a part. A large part of grants are related to the funding of LHWP. Though the growth of money supply has remained stable, it feeds directly into prices.

Uncertainties in both the external and domestic economic environment threaten both the implementation and effectiveness of policies. Because of the degree of openness of the economy, any major changes in South Africa tend to have repercussions for Lesotho. There is evidence of instability in the external position of the economy resulting mainly from faster growth of merchandise imports and those that are related to the LHWP, as compared to exports. Although the growth of imports and hence the worsening of the external position as well as the growth of private investment may be related to LHWP activities, which may be considered a temporary shock to the system, it is also evident that the economy is susceptible to external shocks. It is anticipated that this trend will continue, given the large volume of imports of the continuing LHWP and the fall in the mineworkers' remittances, which finance a large percentage of the current account deficit. At present the erosion of remittances and SACU receipts pose a major challenge to the maintenance of a stable macroeconomic environment.

2.4 THE CONDUCT OF MACROECONOMIC POLICY

Lesotho has ample, but not complete flexibility in the conduct of fiscal policy as compared with monetary and other policies. The inflexibility and lower potency of economic policy can be attributed, to a large degree, to existing institutional arrangements. In particular, its membership of the Common Monetary Area (CMA) and SACU effectively imply that it cannot have independent monetary and fiscal policies, the principal tools of economic management.

2.4.1 Monetary policy

The primary objective of pursuing monetary policy in Lesotho is to achieve and maintain price stability (CBL 2000). Lesotho is a member of the CMA, which replaced the Rand Monetary Area (RMA) of 1974 in 1986. It is noteworthy that the potency of monetary policy is to a large extent restricted by this arrangement. Since the Loti is pegged to the Rand, which also circulates in the economy, Lesotho has limited control over money supply, and none over the exchange rate.[8] To the extent that the Loti is fully backed by the Rand, the CBL can issue Maluti only if it has sufficient backing Rand deposits.

2.4.1.1 Monetary policy developments in the 1980s

Monetary and general economic policy developments in Lesotho are closely linked to those in SA. According to CBL (2001:5), the objective of price stability is achieved if the inflation rate does not deviate significantly from that of SA. The CMA provides for free mobility of financial resources among member countries.

The tradition has been to keep interest rates in Lesotho very close to those prevailing in the CMA region and in particular in South Africa where investment opportunities are usually more attractive than elsewhere in the region. The rationale for this has been to avoid large differentials in interest rates between members that would trigger undesirable and destabilising capital flows. The CBL has relied more on the use of direct controls as

[8] One of the problems that the agreement poses is the estimation of the total money supply with precision. In recent years, the problem has been aggravated by the fact that both individual residents and business enterprises perform the bulk of their banking activities in SA (GOL 1996). Furthermore the banking structure, which can be classified as ologopolisitic in nature, the inherent problem of excess liquidity in the economy, and the common problem of a relatively underdeveloped money market, restrict the extent of administration and or potency of monetary policy.

instruments of monetary policy. These included rather flexible bank to bank credit ceilings, minimum deposit rates, the setting of a ceiling for the prime lending rate, restrictions on foreign asset holdings by banks, reserve requirements and a liquidity asset ratio differentiated by maturity of liability which banks have to observe.

A policy of administrative determination of some principal interest rates has been pursued in the economy.[9] Although interest rates in general move together with SA rates, there is some time lag in setting the rates. In general, the borrowing and lending rates in Lesotho are slightly lower than in South Africa because of the deliberate policy of the central bank to keep lending rates lower to stimulate demand for bank credit.[10] The monetary authorities have however continued to manoeuvre within this framework as fully as possible in order to adjust monetary trends to the specific needs of the economy. In the face of low economic activity in the mid-80s the central bank kept interest rates for bank lending down and encouraged the banking system to lend a higher proportion of its funds locally. The main policy instruments used were moral suasion and the variation of interest rates that the Central bank pays on the commercial banks' deposits with itself (CBL 1983:8).[11]

In an attempt to encourage lending to local investors, the government instituted capital controls in the form of the minimum local asset requirement (MLAR) in 1981. By this requirement, commercial banks are required to hold domestic assets equal to at least 85 per cent of their liabilities to the public plus their required paid-up capital and reserves.[12]

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[9] These include the prime lending rate, the minimum deposit rate, the Treasury bill rate and the rates on bank's deposits with the CBL.

[10] For example, the rate paid by the Central bank on commercial banks' surplus funds follows the call rate on large deposits in South Africa to avoid penalizing the commercial banks for complying with the legal minimum asset requirement (CBL 1985:9).

[11] Negative real rates of interest were a result of this policy and implied severe erosion in the real value of savings. A trend of declining rates continued into the early 1990s. This was followed by a rise in the mid to late 1990s induced by a similar trend in the discount rate of the South African Reserve Bank (SARB). Corresponding to the rise in interest rates, the rate of inflation also declined to less than 8 per cent during the same period resulting in low real deposit rates. In 2000, inflation in Lesotho and neighbouring countries remained under control despite pressure from rising international rates and the depreciation of the Rand mainly owing to the policy efforts of the larger neighbour in curbing inflation. For this reason, interest rates remained relatively stable.

[12] This policy has not attained much success since it was put in place. It is argued that its effectiveness was hindered by the problems of both supply and demand. Regarding the supply side, the argument is that the

The CBL also maintained a high variance between the lending rates and the deposit rates in the economy during the 1980s. This policy is also blamed for the high cost of banking in the economy. According to the estimates of the GOL (1996), the spread of the lending rate from the deposit rate in the period 1990 to 1995 averaged 7 to 8 per cent as compared to 4 per cent in SA.

2.4.1.2 The policy environment during the reform period - 1990s

A realization that direct controls tend to be ineffective and distortionary and encourage inefficient use of financial resources, among others, led to the adoption of reforms in the financial sector. Since the implementation of the structural adjustment program in 1988/89, a number of reforms have been undertaken in the financial system. At the inception of the program, the broad objective of government towards the financial sector was to enhance financial intermediation by way of broadening the range of money market instruments available for policy consideration.

Mobilization of savings into equity holding was envisaged as a starting point towards establishing a capital market. Although at a very young stage, Lesotho Investment Holdings was established to encourage savings to be channelled into holdings of equity. Moreover, the sale of treasury bills and government bonds was initiated as a way of developing a securities market. In an attempt to encourage competition and participation of the non-bank private sector and individual savers in the market, the CBL issued securities in smaller denominations since 1992. The frequency of auctions has also been increased from quarterly to monthly since 1993. Later, the CBL began to issue its own securities owing to the lack of supply of treasury bills, as government debt repayments became rapid. This would pave way for market determination of interest rates and add to

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rate on the CBL deposits are too high and therefore provide a disincentive to lending to the private sector. On the other hand, the demand is constrained by the ill-defined property rights on real estate and land, which constitute major holdings of wealth by residents and could provide collateral. Identification of convincing and feasible projects by the private sector poses a further problem due to lack of relevant expertise.

the range of monetary instruments. This policy has indeed increased participation in the market substantially, although it is believed to have crowded out private savings to some extent.

To promote further financial integration and competition and to facilitate this development, it seemed conducive for the Central Bank to maintain conditions for entry of new participants in the market while adhering to prudential regulations and minimum capital requirements. This called for the review of the legal and regulatory frameworks that govern the operations of financial institutions as contained in the Financial Institutions Act of 1973. It is anticipated that provision shall be made in the revision of the regulations for the future administration of reserve and liquidity ratios. The gradual reduction of the MLAR would facilitate and enhance flexibility of the market. In view of this, in 1998 the MLAR was reduced from 85 per cent to 60 per cent. This implies that commercial banks were now allowed to keep up to 40 per cent of their assets abroad. The envisaged changes were to assist in encouraging lending to the private sector by commercial banks.

2.4.1.3 New and proposed monetary strategies - beyond 2001

Although some major steps have been taken to move away from direct policy instruments, the CBL perceives that the existence of a variety of indirect instruments is essential to exercise greater flexibility in monetary policy. It is with the view of a more efficient allocation of financial resources that this strategy is envisaged. In view of this, new instruments to control inflation and maintain a favorable balance of payments position are being considered for implementation. At the core of these are the open market-type operations (CBL 2001:2). These are already operative through the competitive auctions of treasury bills. The repurchase order system (repo system) in which all transactions will be fixed for a maximum period of six weeks and the cash reserve requirements without interest is earmarked to complement the former. It is perceived that the latter calls for an active interbank and money markets to facilitate the exploitation of the indirect instruments. Therefore, complementary policies proposed for the promotion of effective financial intermediation and removal of distortions include, non-payments of interest on commercial banks' surplus funds, abolition of the MLAR and introduction of an overnight lending facility for commercial banks in the form of a Lombard facility[13].

2.4.2 Fiscal policy

The medium to long term aim of fiscal policy, as an economic management tool is to maintain fiscal stability and to stimulate sustainable economic growth (GOL 1997). Though the government's flexibility with fiscal policy is somewhat limited, it remains the most important option for the economy of Lesotho as it has a relatively high degree of flexibility in its use. With membership to SACU, Lesotho cannot exercise independent policy decisions with regard to trade-related fiscal policy.

2.4.2.1 Fiscal policy developments in the 1980s

In the late 1970s to early 1980s the government undertook fiscal reforms that entailed curtailing capital expenditure and strengthening its financial position in the light of rising deficits and the much less predictable foreign aid. The deterioration of the government's budgetary position had stemmed from rapid increases in capital expenditures in the 1977/78 fiscal year and increased recurrent expenditures as a result of the rise in the wage bill in the 1978/79 fiscal year (WB 1983).[14] This situation continued into the 1980s. By 1980/81 the government's revenues could not cover even the recurrent expenditures.[15] In 1981/82, the granting of a tax relief by government with the belief that the tax burden was too high by international standards worsened the situation. The introduction of a five

[13] The Lombard facility is the overnight lending facility by commercial banks from the central bank. At the inception of this facility, the Lombard rate was set at a 2.5 per cent margin above the Treasury bill rate. The facility is intended for commercial banks to meet their clearing requirements and the rate is viewed as a penality to encourage banks to seek funds elsewhere before approaching the Central Bank (CBL 2001).

[14] This increase was caused by political developments that culminated in the necessity for government to invest in infrastructure.

[15] During this time, the gap in the government budget was financed, to a large extent, by grants and external loans. During 1980/81 government revenues remained virtually stagnant. Customs revenue did not increase and even though income tax revenues rose, they were offset by a fall in non-tax revenues. On the other hand, a 50 per cent rise in wages and salaries in the public sector caused a sharp surge in recurrent expenditures.

per cent retail sales tax in December 1982 helped to alleviate the situation. This tax became the major source of revenue at that time. The establishment of an internal audit mechanism that monitored the day-to-day operations of the ministries was also effective. At the same time, the government reduced capital expenditures by about 18 per cent and froze public sector employment to keep the wage bill in check. The budget deficits continued to be a major problem for government despite a 43 per cent increase in customs revenue brought about by the revision of the revenue sharing formula in 1983/84 (WB 1983).

Since 1985 the government undertook substantial non-concessional borrowing to accommodate the decline in remittance revenue that resulted from increasing retrenchments in the SA mining industry. At this time, the government monetised part of the deficits indirectly through borrowing from the domestic banking system and other financial institutions as well as the Central Bank.

It is against this background of fiscal imbalances and the unstable fiscal stance that dominated the major part of the 1980s that government adopted the IMF and World Bank’s structural adjustment programmes in 1988/89. The basic aim of the programmes was to improve the macroeconomic situation and to establish a framework that would encourage and receive the development of a sound private sector. Specific targets for the adjustment policies included increasing domestic output, reducing the government budget and balance of payments deficits as well as achieving price and monetary stability. Expenditure restrictions and revenue raising measures dominated the operations of government at this time. Improved administration and a wider coverage of income and sales tax ensured increased customs and other revenues. This was of great assistance in easing the pressure on borrowing from the banking sector and non-bank financial institutions.

2.4.2.2 The policy environment in the 1990s

The implementation of the structural adjustment programmes in the late 1980s introduced a shift in the government policy regime that was carried through into the 1990s. Following their adoption a budget surplus was realised in the early 1990s. Moreover, the government assumed the position of a net creditor the financial system while domestic debt declined steadily. In 1994 the privatisation and parastatal reform programme was officially launched with the aim of further easing the financial burden on the budget, improving efficiency in production, encouraging and improving domestic investment by local residents and attracting foreign investment into the economy.

Against a background of fiscal and balance of payments deficits in the late 1990s, the government implemented the IMF Staff Monitored Programme (SMP) in 1999 and the Poverty Reduction and Growth Facility (PRGF) with the IMF at the end of 2000. The focus of these was to ensure prudent management of government finances (CBL 2001). Specific objectives of the programme were to lay the basis for strong economic growth, curb the decline the foreign assets and restrict the budget deficit to two per cent of GDP (CBL 2000). Within the confines of the PRGF, the government's budgetary position was to be safeguarded by setting a ceiling on the net domestic financing requirement of the government. Two strategies have dominated the improvements in tax administration and compliance under the PRGF so far. These are the establishment of the Lesotho Revenue Authority (LRA) and the introduction of value-added tax (VAT). Under the LRA, notable improvements have been made in the sales and income tax departments. Moreover, significant improvements have been made in border surveillance with the aim of strengthening the valuation of imports for tax purposes. Expenditure control and rationalization focused on the elimination of off-budget spending to allow for a prudent and efficient budget making process.

2.5 CONCLUSION

This chapter has outlined the developments in the economy of Lesotho for each of the major sectors for the sample period, 1980 to 2000. One of the major conclusions from this review is that while economic growth has been impressive for most of the review period, this position is hardly sustainable as it is attributable, in most cases, to transitory structural changes such as the LHWP-related activities. This position is also made fragile by the low prospects of growth in the agricultural sector, on which most of the population depends, but which faces major challenges. It is evident that while the government, through policy, has contained problems of budget deficits and inflation, problems of unemployment and external imbalances are still at large.

This review has highlighted the intricate features of the economy ranging from its structural framework to the historical and current policy stance. This is useful in the modelling process as it gives an indication of the relationship between certain groups of variables and policy variables and targets in the economy. It is in turn used as a guide in the formulation of the different interrelationships in the specification of the model.