

Economic Review September 2004

ESTABLISHMENT OF THE MONETARY POLICY COMMITTEE OF THE CENTRAL BANK OF LESOTHO

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Background

The Central Bank of Lesotho (CBL) Monetary Policy Committee (MPC) was established on 28th April 2004 in accordance with section 18 of the Bank's Bye-laws. The MPC, which shall meet once in a quarter, has the responsibility to: (a) review international and domestic economic developments and their likely impact on the Bank's ability to achieve and maintain price stability; (b) consider and formulate appropriate monetary policy responses in order to achieve and maintain price stability in Lesotho; and (c) regularly review CBL's monetary policy framework and adopt changes as and when necessary.

Role of MPC in conducting Monetary Policy in Lesotho

Monetary policy, being an important component of macroeconomic policy, must be implemented effectively in order to achieve the goals of economic development. An explicit monetary policy strategy will enhance the transparency of monetary policy implementation by establishing a framework for policy analysis and to explain monetary policy actions to the public. Such a framework is built upon the important role of money and an assessment for price developments and stability based on economic and financial indicators. Experience with different monetary policy regimes suggests that transparency and accountability are crucial for monetary policy to achieve desirable long-run outcomes.

The CBL has been taking steps to conduct the monetary policy in a more transparent and accountable way. The Bank has also resolved that changes in monetary policy stance and related reasons must be clearly announced and explained. In addition, the Bank intends to upgrade its public commentary on the economic outlook and issues bearing on monetary policy setting, through quarterly monetary policy statements (MPS) and its regular quarterly report on the economy. It is intended that these statements will include information on the outlook for inflation. The CBL acknowledges that to fast track and sustain economic development, it is essential to maintain a stable exchange rate vis-à-vis the rand, adequate external reserves, non-inflationary growth in money and credit aggregates, prudent fiscal policy, certain level of donor assistance inflows, and monitor developments in the global economy.

Accordingly, the MPC would be guided by the following when framing the monetary policy and releasing the periodical monetary policy statement:

- The goal of monetary policy is to achieve price stability that would promote sustainable economic growth, full employment and a sustainable pattern of international payments. Through monetary policy, the CBL is able to maintain stable prices, thereby promoting economic growth and maximum employment and favourable external balance.
- As a member of the Common Monetary Area (CMA), Lesotho's monetary policy stance is expected to be consistent with that of the other member countries. It is also essential that the monetary policy stance must incorporate all commitments made under the CMA agreement.
- CBL recognises the effectiveness of market friendly indirect monetary policy instruments in enhancing the role of price signals in the economy. The Bank also recognises that, under current economic environment in Lesotho, direct instruments of monetary policy are ineffective and inefficient and might lead to an overhang of liquidity, financial

repression and disintermediation. Being fully aware of these adverse impacts of direct tools, CBL is unlikely to use such direct instruments, unless exigencies warrant. The Bank shall continue to use market based indirect tools to conduct monetary policy.

- The CBL has developed a series of monetary sector models. These models will be used as an input in making monetary policy decisions.

- The CBL is also in the process of reformulating the macroeconomic model of Lesotho to use for various macro-econometric simulation studies to measure the impacts of policies on target variables (such as employment, income and prices) and, more importantly, to set the monetary policy rules. Monetary policy rule, rather than discretion, shall enhance transparency and accountability in conducting monetary policy.

- Price stability, as the target, does not provide simple and mechanical instructions as to how the central bank should conduct monetary policy. It requires that the central bank uses all available information to determine the appropriate policy actions to achieve price stability.

- Monetary policy affects the economy with considerable and variable lags. The CBL therefore recognises that monetary policy should be forward-looking and preemptive: that is, depending on the lags from monetary policy to inflation (transmission period), monetary policy needs to act well before inflationary pressures appear in the economy.

- The CBL would continually monitor and analyse current and expected future economic and financial conditions, paying particular attention to any signs of emerging price pressures. This assessment involves comprehensive analysis of external and domestic economic activity, financial conditions and price and wage developments. The assessment of economic and financial conditions provides the Bank with a view of the extent of inflationary pressures and the likely evolution of inflation over the next year. This information is conveyed to the MPC periodically by the Research Department of the CBL.

- The MPC recognises that there must be a sound interplay between fiscal policy and monetary policy to ensure sustainability of economic developments. It would be advantageous if fiscal policy could be used to counter fluctuations in demand and output.

- The CBL agrees that structural problems leading to higher inflation in some sectors of the economy, stagnation or poor growth and growing unemployment cannot be solved exclusively or in isolation by the monetary policy. The MPC shall assess the required structural measures and present to the Government of Lesotho its recommendations on addressing the structural problems.

- The MPC recognise that a sound banking system is an essential prerequisite for the efficient implementation of monetary policy. This is more relevant under a rule-based monetary policy regime contemplated. The MPC will announce the rules clearly to the players in the market with an expectation that they will follow them efficiently and fairly.

- The MPC will issue a MPS to inform the public, both local and overseas, of the outlook for monetary developments in Lesotho and to ensure the Bank is more accountable and transparent in deciding the key monetary policy objectives to be pursued during the year.

Net international reserves (NIR) target

At its first meeting held on the 1st September 2004, at CBL, the MPC decided that the target range for CBL net international reserves (NIR) for the period to December 2004 will be US\$400 to \$450 million. The target range for the NIR is at the same level as that which was maintained from 2003 to the end of August 2004. The Committee is satisfied that the NIR position of this magnitude is sufficient to cope with the demands of the economy.

Economic developments

The MPC's decisions were informed mainly by a consideration of domestic inflation and balance of payments (BOP) developments. On domestically generated inflation, the Committee noted that costs of factor inputs contributed to a downward trend up to March 2004. However, substantial increases in the costs of important inputs exerted upward pressure on overall price levels during May and June 2004. The MPC further noted that there were no immediate inflationary pressures from the demand side of the economy. As such, measures to combat excess aggregate demand were not necessary.

The Committee also looked at the BOP developments and noted that the medium term prospects are favourable. As such, it decided to leave the NIR target unchanged until December 2004. The Bank will, however, continue to monitor developments, particularly, on the BOP side.

Members of the Committee

The members of the Committee are Mr. E. M. Matekane (Governor and Chairman), Mr. T. Foulo (Deputy Governor II), Mrs. M. L. Moiloa (non-executive member of the Board), Dr. M. Majoro (Principal Secretary for the Ministry of Finance and Development Planning), Mr. E. R. Mapetla (representative of the business community), and one non-executive member of the Board who is an economist and yet to be appointed to the Board.

Conclusion

The CBL among other functions, being mandated with the maintenance of price stability in the economy, will be able to achieve this objective through an effective monetary policy framework to be determined by the MPC. These meetings for the CBL are scheduled to take place immediately after those of the South African Reserve Bank (SARB). This emanates from the fact that SARB is the key driver of monetary policy in the CMA region and the decisions taken there will ultimately filter into the other member countries with a lapse of time. Consequently, appropriate monetary policy responses in order to achieve and maintain price stability in the country would be formulated by this committee.

Table 1. Monetary and Financial Indicators@

	June	July	August
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	12.5	12.5	12.42
1.2 Prime Lending rate in RSA	11.5	11.5	11.00
1.3 Savings Deposit Rate	2.31	2.31	1.49
1.4 Interest rate Margin (1.1 – 1.3)	10.19	10.19	10.93
1.5 Treasury Bill Yield (91-day)	9.31	9.27	8.91
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2353.47	2424.2	2448.60
2.2 Net Claims on Government by the Banking System	-539.52	-552.4	-696.38
2.3 Net Foreign Assets – Banking System	3858.72	4031.3	3973.33
2.4 CBL Net Foreign Assets	2831.31	2911.5	2877.35
2.5 Domestic Credit	73.98	60.58	18.32
2.6 Reserve Money	289.522	356.4	330.51
3. Spot Loti/US\$ Exchange Rate (monthly average)	6.4476	6.2050	6.6793
	2003	2004	

	Q4	Q1	Q2
4.1 Current Account Balance	-299.8	-193.2	-161.64
4.2 Capital and Financial Account Balance	320.0	-23.5	181.73
4.3 Reserve Assets	-156.6	257.5	-251.39

Table 2. Selected Economic Indicators

	2000	2001	2002	2003
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	1.3	3.2	3.5	3.3
1.2 Gross Domestic Product Excluding LHWP	0.0	3.5	3.3	3.2
1.3 Gross National Product – GNP	-3.2	0.2	1.6	6.3
1.4 Per capita –GNP	-5.2	-1.9	-0.4	4.1
2. Sectoral Growth Rates				
2.1 Agriculture	2.8	0.5	-4.2	-1.9
2.2 Manufacturing	4.4	7.8	6.9	5.2
2.3 Construction	9.7	1.4	6.9	4.3
2.4 Services	-0.9	2.2	2.2	4.4
3. External Sector – Percent of GNP Excluding LHWP				
3.1 Imports of Goods	64.4	68.2	82.8	74.5
3.2 Current Account	-21.3	-17.4	-24.5	-21.1
3.3 Official Reserves (Months of Imports)	8.9	11.7	6.4	5.5
4. Government Budget Balance (Percent of GNP)	-4.9	-1.0	-2.7	-2.5

@ These indicators refer to the end of period. Prime lending and savings deposit rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities.