Economic Review **October 2006**

LESOTHO SOVEREIGN RATING FOR 2006

Lesotho's long term foreign currency credit rating by Fitch Rating Agency remains unchanged at BB- while local currency rating is downgraded from BB+ to BB .....

Background

Fitch sovereign credit ratings refer to the capacity and willingness of a sovereign government to service its debt within the maturity dates and in accordance with the conditions agreed upon with the creditors at the time the loans were contracted. Regarding the currency in which the debt is denominated, the ratings refer to financial obligations denominated either in national or foreign currency. Furthermore, as for the maturity terms involved, the ratings reflect long-term and short-term obligations. A short-term rating refers to obligations maturing in less than 12 months and thus places greater emphasis on the liquidity necessary to meet financial commitments in a timely manner.

Investors use credit ratings as indications of the likelihood of getting their money back in accordance with the terms on which they invested. The ratings are variations of the scale A, B, C or D. On the scale employed by Fitch, the top rating is 'AAA' and the bottom is 'D'. The lower the rating, the bigger the probability of default, and vice versa. Governments rated above 'BBB' are known as 'investment grade' while those rated below fall into the 'speculative grade' category. In determining the payment capacity and willingness to repay debt, Fitch considers macroeconomic indicators such as the available stock of foreign currency reserves, balance of payments flows, economic growth prospects and capacity to generate revenue and a variety of political and social factors.

Lesotho Credit Rating

For three consecutive years, Lesotho's Long Term Foreign Currency (LTFC) rating has been left unchanged at BB-. It received the same rating as Nigeria, Indonesia, Serbia, Turkey, Ukraine and Vietnam. This rating is on the lower end of the 'BB' rating, thus implying that there is a possibility of credit risk developing, particularly as a result of adverse macro economic changes over time. However, this 'speculative' credit rating shows that capacity for continued payment is dependent on a sustained, favourable business and economic environment. As in the previous year, Lesotho's ability to pay off its short-term foreign currency loans is rated 'speculative (B)'. This means that the country has 'minimal capacity for timely payment of financial commitments, plus vulnerability to near-term adverse changes in financial and economic conditions'. However, Fitch has downgraded the local currency rating from BB+ to BB due to concerns about the Government's ability to cope with the decline in SACU revenues when they eventually occur given the fast rising expenditure over

the medium term. However, Lesotho was rated better at ‘BB’ for long-term local currency commitments.

The rating process identified strengths as well as weaknesses to the rating of Lesotho. SACU revenue windfalls, balance of payments position, net external creditor, strong integration with South Africa and efforts to reverse trends in the textile sector were identified as strengthens to the rating. However, low economic growth and GDP per capita, high reliance on the textile sub-sector, weak public expenditure management were identified as major weaknesses in the rating of Lesotho.

Strengths

Strong Fiscal Consolidation

Lesotho continued to achieve strong fiscal consolidation as a result of strong fiscal revenue due to amongst others, additional revenues from SACU. The 2005/06 budget achieved a surplus equivalent to 3.9 per cent of GDP. Additional SACU revenues were from two sources, the transitional adjustment from the old formula to the new formula, which came into effect in April 2005 and the windfall added to SACU revenues in 2005/06 and 2006/07. In addition, higher revenues are a result of higher-than-expected revenue pool due to an import boom in South Africa.

Integration within the South African Economy

Lesotho’s currency, the loti, is pegged to the South African rand in the Common Monetary Area (CMA). South Africa’s integration into the global financial market makes the currency vulnerable to global sentiment. For example in May and June there was a depreciation of the rand and hence the loti. This was due to a reversal in global investor sentiment. The currency depreciation had a positive impact on the performance of the textile sub-sector, as exports increased.

Strong International Liquidity

Due to large official reserves and a rise in banks’ foreign assets, Lesotho has been a net external creditor since 2004, which is a major rating strength. This followed the easing of capital controls in 2003, which caused a substantial increase in the foreign assets held abroad by the banking system. As a result of the huge build-up of official reserves in 2006 owing to a projected large balance of payments surplus, Fitch expects Lesotho’s net public external debt ratios to fall to almost zero and Lesotho to become a net public sector creditor in 2007.

Structural Reforms in the Textile Sub-Sector.

The end-2004 expiry of the MFA has turned out to have had a less severe impact on Lesotho’s textiles industry than originally anticipated. Following the closure of a number of factories in December 2004 and early 2005 due to a decline in number of orders, (which resulted in job losses for a number of people) the sub-sector stabilised in 2005 and has gradually been recovering in 2006. This is attributable largely to Government interventions to arrest the decline. The authorities, trade unions and foreign investors employed a number of short-term measures to reduce the losses, including lobbying congressmen in the US and holding bi-lateral meetings with the buyers. Furthermore, an interdepartmental taskforce holds bi-monthly meetings with exporters and trade unions. In addition, Government has improved competitiveness

by upgrading the infrastructure and the reliability of services of utility providers. Furthermore, as of 2006, the Lesotho government substantially reduced company tax rates, including a zero company tax rate for companies that export outside Southern African Customs Union (SACU).

Weaknesses

Low Economic Growth and GDP per capita

Lesotho's low economic growth was cited as a major rating weakness, particularly in view of the need to alleviate high unemployment and poverty and therefore to improve the country's economic performance. Growth was expected to improve gradually to 2.5 per cent by 2008 from 1.2 per cent in 2005 as a result of the recovery of the textiles sub-sector. These growth rates are far lower than the BB- rating median of around 5.0 per cent. In addition, low GDP per capita relative to rating peers was cited as another weakness.

Public Expenditure Management

The downgrade of the local currency rating reflects concerns about the governments' ability to control expenditure and cope with a decline in SACU revenues when it eventually occurs. The expenditure side of the budget has represented a relative weakness for the rating. Expenditure as a share of GDP rose sharply in 2006/07 and remains very high over the medium term. Given the uncertainties regarding SACU receipts, it is a concern that the authorities are not putting aside more in the form of reserves of the current windfall. Therefore, the quality and effectiveness of expenditure also need to be addressed through the on-going public-sector reforms.

Conclusion

Lesotho continued to maintain its foreign currency rating at the same level as in the last three years (BB-). With regard to the local currency rating, Lesotho was rated at BB down from BB+. Lesotho's rating was reflective of the stabilisation of the textile sector and a significant improvement in the external sector outlook. The continued rise in official reserves and commercial banks' foreign assets, allowed Lesotho to become a net external creditor. Furthermore, a strong fiscal position mostly driven by strong SACU revenues was also considered a major rating strength coupled with intensive efforts to bring stability in the clothing and textile sub-sector. Nevertheless, the country is faced with quite a number of challenges. First, the weak economic growth remains the major medium-term challenge. Second, high reliance on the textile sub-sector, which is facing increased competitive pressures from other textile exporters. Last, efforts to improve public expenditure management are necessary.

Table 1. Monetary and Financial Indicators+

	August	Sept	Oct
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	12.25	12.33	12.69
1.2 Prime Lending rate in RSA	11.50	11.50	11.50
1.3 Savings Deposit Rate	1.32	1.32	1.84
1.4 Interest rate Margin(1.1 – 1.3)	10.93	11.01	10.85
1.5 Treasury Bill Yield (91-day)	6.86	6.86	6.76
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	3128.2	3121.46	3387.38
2.2 Net Claims on Government by the Banking System	-1492.36	-1396.16	-1986.82
2.3 Net Foreign Assets – Banking System	5814.9	5934.44	6358.55
2.4 CBL Net Foreign Assets	4249.4	4885.89	5328.61
2.5 Domestic Credit	-712.1	-520.50	-1113.62
2.6 Reserve Money	439.14	427.84	436.14
3. Spot Loti/US$ Exchange Rate (Monthly Average)	6.9483	7.7795	7.4085
4. Inflation Rate (Annual Percentage Changes)	6.8	6.8*	6.8*
5. External Sector (Million Maloti)	**2006**		
	QI	**QII**	**QIII**
5.1 Current Account Balance (Excl. LHWP)	26.67	105.84	406.57
5.2 Capital and Financial Account Balance (Excl. LHWP)	99.88	52.28	-132.32
5.3 Reserves Assets	-86.90	-177.17	-641.50

+These indicators refer to the end of period. Prime and deposit (savings) 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.

Table 2. Selected Economic Indicators

	2003	2004	2005	2006*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	2.7	4.0	2.7	4.8
1.2 Gross Domestic Product Excluding LHWP	4.3	4.5	3.2	5.1
1.3 Gross National Product – GNI	6.0	6.1	3.4	5.7
1.4 Per capita –GNI	3.7	3.9	2.2	4.4
2. Sectoral Growth Rates				
2.1 Agriculture	0.3	13.5	20.0	10.7
2.2 Manufacturing	5.7	2.1	-8.0	1.2
2.3 Construction	-4.9	-4.4	2.5	2.8
2.4 Services	6.1	2.6	3.5	2.8
3. External Sector – Percent of GNI Excluding LHWP				
3.1 Imports of Goods	84.0	84.5	69.5	77.7
3.2 Current Account	-6.3	-1.2	-1.0	8.6
3.3 Capital and Financial Account	3.9	1.5	2.0	2.3
3.4 Official Reserves (Months of Imports)	5.6	5.2	6.4	7.1
4. Government Budget Balance (Percent of GDP)	-0.4	5.6	4.4	9.3

* Preliminary estimates