



THE LOTI-RAND PEG: BENEFITS AND COSTS

There are several exchange rate regimes that different countries adopt. The Government of Lesotho (GoL) operates a fixed exchange rate regime under which the loti is pegged one to one to the South African (SA) rand ...

Background

The existence of the parity between the rand and the loti stems from the Common Monetary Area (CMA) arrangement. Indeed several features of the CMA Agreement represented merely a codification of the *de facto* monetary union that existed among its signatories- Lesotho, Swaziland, Namibia and South Africa (SA). The Agreement provides for circulation of a single currency, the rand, throughout the entire area, but also allows for the parallel issue of national currencies by the three smaller members for circulation within their own territories. In addition, there is unrestricted transfer of funds within the monetary area and a substantially uniform exchange control regime against the rest of the world. However, the smaller countries are responsible for approving all external transfers in their territories, because national exchange control regulations have been modified to suit local conditions.

One of the important decisions in the design of macroeconomic policies in any country is the choice of currency exchange rate regime. The attainment and maintenance of economic and social stability leans on, amongst others, the accuracy and precision of this decision. It is interesting to look at the framework of each of the various regimes and their implications in the context of Lesotho.

Types of exchange rate regimes

The fixed exchange rate regime represents a commitment to a single fixed exchange rate quoted against an anchor currency or a basket of currencies. In this regime, the government guarantees the exchange rate and defends the peg by way of holding adequate reserves of foreign currency. Typically, when the central bank believes that its reserves would soon run out, it would raise the price of foreign currency, that is, devalue the domestic currency. Another extreme type of a regime is the floating exchange rate regime under which the exchange rate is determined by the forces of demand and supply in the foreign exchange market on a daily basis. The interplay between demand and supply yields an equilibrium price at which the market clears.

In between these two extremes, are intermediate regimes such as the crawling peg and managed float regimes. Under a crawling peg regime, the exchange rate is fixed, but only for a specific, relatively brief period. The nominal exchange rate is changed periodically and remains fixed at the new rate until the next scheduled adjustment. The monetary authorities may or may not announce in advance when and by how much they will change the exchange rate. A managed float refers to a situation under which the authorities define an exchange rate band above and below the exchange rate target. The rate is allowed to fluctuate within this band. Bands may be superimposed on a fixed exchange rate or on a crawling peg, and may be narrow or wide depending on the primary intention of the authorities. Clearly, these

regimes are a compromise between a fixed exchange rate and a flexible exchange rate. That is, countries using a band guarantee the exchange rate between the limits of the band, but let the market determine what the rate will be within the band from day to day.

The decision to fix or float depends on whether having an independent exchange rate provides a country with a means to stabilise its economy as the external economic circumstances it faces change.

Important Issues when choosing a regime

There are three important considerations that guide policy makers on which regime to adopt. The first one is monetary stability. A highly volatile domestic money supply would require a floating exchange rate regime because the Central Bank would need independent tools to manage it so that it does not exert inflationary pressures in the economy. Second, the degree of openness of the domestic economy to the economy of the anchor currency is critical. Relatively high volumes of trade between the home and anchor countries allow for a high degree of inflation pass-through to the home economy and favour a fixed exchange rate regime. Another vital issue to examine is the welfare implications of such a regime. If the degree of imported inflation is high, it destabilises prices in the home economy, and this results in welfare erosion in the home country. The option for the authorities under such a case is a floating exchange rate regime because the automatic adjustment of the exchange rate due to the interplay between the demand and supply of the home currency would reduce the impact of such high foreign inflation on the home economy.

Following the consideration of these factors, if a country decides to peg, the next relevant questions concern the degree of the fixity of the peg and whether or not the anchor currency should be allowed to circulate freely in the home country.

The degree of a peg, the duality of a monetary system

There are a few types of pegs which differ on the degree of fixity. For instance, under a standard peg a country would fix the value of its currency to that of another currency or basket of currencies. It would have an option of changing the rate as economic circumstances changed. It would then need sufficient stock of foreign exchange reserves to support this system. Another type of a peg is a currency board, in which the country would have its currency's value fixed to that of another currency and would have to back each unit of its currency in circulation with reserves of the target currency. This mechanism would automatically tie the country's interest rates to those of a target country. In reality, the country's interest rates would most likely be higher than interest rates of a target country because of the risk premium. Another option for the country may be to dollarise its economy. Under this option, the currency of the target economy may be officially used in that country. The country's exchange rate is permanently fixed to that of the target country.

The context of Lesotho

The case of Lesotho is quite peculiar because it combines both a currency board with dollarisation. According to section 5 of the CBL Act no.2 of 2000, the primary objective of the Bank is to achieve and maintain price stability in the economy. The first line of action in pursuing this objective was to choose a country with a history of price stability, in this case South Africa (SA), and link the value of the loti to the value of the rand. Admittedly, there were other issues that were considered at this level. For instance, these could have included the proximity of the Lesotho economy to SA, the volume of trade between the two countries, and the degree of interdependence of the Lesotho economy and SA. The second step was to ensure that the value of the loti is maintained at parity with that of the rand. CBL achieves this by holding an adequate level of Net International Reserves (NIR). The Bank's monetary policy operations which employ open market operations (OMO) as an instrument enable it to realise the ideal level of NIR. The Bank uses the treasury bill rate as an intermediate instrument to influence the decisions of agents. Auction amounts are varied accordingly depending on whether the objective is to attract funds from abroad or not. In this way, CBL is able to defend the parity. It may therefore be interesting to examine the prospective effects of this arrangement on the development of the economy, and to also trace its possible implications.

Implications for the Lesotho Economy

There are benefits and costs associated with pegging the loti to the SA rand. Therefore, the decision to review Lesotho's CMA membership, which provides for the loti-rand peg, should be based on net benefits or costs expected from the arrangement. The parity has several positive implications for the economy of Lesotho:

- ? Firstly, it eliminates transaction costs and foreign exchange rate risk: Due to the trade links between Lesotho and South Africa, particularly Lesotho's heavy reliance on imports from SA, the peg reduces foreign exchange transaction costs and eliminates the risk due to adverse currency movements. Under the current arrangement, the rand in circulation in Lesotho eliminates the need and costs for individuals and businesses to convert currency. The arguments on foreign currency risk also apply to Basotho miners' remittances from SA, which are one of Lesotho's major sources of foreign currency earnings.
- ? In addition, the arrangement minimises foreign exchange rate risk against other world currencies as the local currency is linked to a relatively stable currency (i.e. the SA rand).
- ? Currently, the peg also enables Lesotho to benefit from the low inflation environment in SA, which is conducive to macroeconomic stability.
- ? Moreover, as a result of price stability, investors gain confidence in the economy and this has a potential to attract foreign direct investment

Since the peg is maintained in a dollarised economy, this yields additional gains to Lesotho, namely; that:

- ? Under the current arrangement, SA compensates Lesotho and other CMA members for lost seignorage revenues; SA pays Lesotho for the rand currency that circulates in the country. To highlight the importance of this issue, in 1986, Swaziland stopped the use of rand as legal tender. But, the move was futile because economic agents on the ground still continued to use the rand and the Government of Swaziland forfeited compensation for lost seignorage revenues. As a result, Swaziland was forced to reverse its policy decision. Hence, Lesotho should use this as an important lesson when deciding on the future of the arrangement.
- ? The arrangement would act as a launch pad for greater regional integration given the current momentum towards regional cooperation on monetary and financial issues.

Needless to say, the arrangement is not costless. It imposes three major costs on the economy. First, it results in a loss of monetary policy autonomy. If capital is mobile and the country chooses a fixed exchange rate, then it has to accept the interest rates of the country to which it fixes its currency. In this case, the authorities lose their discretion to set interest rates. Consequently, monetary policymaking in Lesotho essentially involves reacting to monetary policy changes in SA. Typically, if SA decides to increase rates, the CBL would intervene in its domestic money market in order to steer interest rates in the same direction with SA. This simply means that CBL reacts and responds to the SA monetary policy stance. The inflation rate and economic cycle, in Lesotho, will tend to converge to that of the target economy. Second, the maintenance of the peg may not be sustainable in a case where there is a speculative attack on the currency. Fortunately, there is no parallel market for rand in Lesotho and loti continues to be converted into rand at the official rate of one to one in shops, petrol stations, and other public trading places.

Conclusions

In conclusion, the current economic situation and practice are relevant because it is pertinent to limit the costs and difficulties associated with the transition from one exchange rate regime to another. Considering the benefits derived from the current arrangement, it would be costly to de-link. It is worth noting, however, that the sustainability of the peg hinges on sound macroeconomic management and the absence of speculative attacks in the economy.

Table 1. Monetary and Financial Indicators+

	Feb.	Mar.	Apr
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	11.50	11.50	11.50
1.2 Prime Lending rate in RSA	10.50	10.50	10.50
1.3 Savings Deposit Rate	1.24	1.24	1.24
1.4 Interest rate Margin(1.1 – 1.3)	10.36	10.36	10.36
1.5 Treasury Bill Yield (91-day)	6.90	6.90	6.80
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	2587.9	2566.93	2610.78
2.2 Net Claims on Government by the Banking System	-1196.48	-1027.20	-1694.13
2.3 Net Foreign Assets – Banking System	4396.27	4377.47	5035.30
2.4 CBL Net Foreign Assets	3873.20	3803.31	4364.59
2.5 Domestic Credit	-381.91	-191.48	-882.79
2.6 Reserve Money	437.98	461.05	429.78
3. Spot Loti/US\$ Exchange Rate (monthly average)	6.1221	6.2537	6.1064
4. External Sector (Million Maloti)	2005		
	QII	QIII	QIV
4.1 Current Account Balance (Excl. LHWP)	-122.41	34.71	-51.90
4.2 Capital and Financial Account Balance (Excl. LHWP)	187.88	-102.54	102.73
4.3 Reserves Assets	-94.55	26.53	-86.9
5. Inflation rate	3.1	3.2	3.5

+These indicators are for 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

	2002	2003	2004	2005*
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	3.5	3.1	3.1	1.2
1.2 Gross Domestic Product Excluding LHWP	2.9	2.9	3.7	1.1
1.3 Gross National Product – GNI	1.6	6.0	6.1	0.3
1.4 Per capita –GNI	-0.2	3.7	3.9	-0.9
2. Sectoral Growth Rates				
2.1 Agriculture	-4.2	-1.8	1.2	1.8
2.2 Manufacturing	6.9	5.2	5.9	-8.3
2.3 Construction	6.9	4.3	0.4	2.0
2.4 Services	2.2	3.9	4.4	4.2
3. External Sector – Percent of GNI Excluding LHWP				
3.1 Imports of Goods	93.9	80.1	81.3	76.0
3.2 Current Account	-11.6	-5.8	1.0	0.5
3.3 Capital and Financial Account	6.4	3.8	1.4	0.4
3.4 Official Reserves (Months of Imports)	6.2	5.8	5.2	5.8
4. Government Budget Balance (Percent of GDP)	-2.8	-0.3	8.4	1.5

* Preliminary estimates