CENTRAL BANK OF LESOTHO

ANNUAL REPORT

2010

Maseru
March 2011

BOARD OF DIRECTORS

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

MANAGEMENT

M. P. Senaoana	-	Governor
R. A. Matlanyane	-	Deputy Governor I
Vacant	-	Deputy Governor II
T. Namane	-	Director of Operations
M. Mofelehetsi[2]	-	Director of Supervision
L. Kirstein[3]	-	Director of Administration
M.G. Makenete	-	Director of Financial Markets
M. S. Mahooana[4]	-	Director of Information and Communication Technology (acting)
M. P. Makhetha	-	Director of Research
M. Malope	-	Director of Corporate Affairs
F. Morokole[5]	-	General Manager – Lehakoe Recreation and Cultural Centre (acting)
M. Mohasoa	-	General Manager – Lehakoe Recreation and Cultural Centre (acting)

DIVISIONAL HEADS

Governor's Office

P. Letlela	-	Internal Audit
L. Khaka	-	Accounts and Budget
T. Malataliana	-	Currency
C. Chidyamoto	-	Security

[1] Until end June 2010
[2] Until end August 2010
[3] Until end August 2010
[4] November 2010
[5] Until August 2010

Administration

M. Molekane	-	Human Resources
M. Phate	-	General Services and Maintenance

Information and Communications Technology

M. Sekoati	-	Business Solutions Development
T. Mpheteng	-	Infrastructure and 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 and Exchange Control (acting)
N. Bereng	-	Non-Bank Supervision

Financial Markets

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

Research

T. Bereng	-	Real Sector
L. M. Lephoto[6]	-	Finance
R. Masenyetse	-	Macroanalysis

Corporate Affairs

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

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[6] On secondment until October 2010

Central Bank of Lesotho
P O Box 1184
MASERU 100
Lesotho

March 31, 2011

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 2010, 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, 2010, certified by Deloitte and Touché; and

   ii) a report on the Bank's operations and statement of affairs during 2010.

Yours faithfully

A. R. Matlanyane (PhD)
ACTING GOVERNOR

PART I GLOBAL ECONOMIC IMBALANCES AND EXCHANGE RATE MOVEMENTS: IMPLICATIONS FOR LESOTHO

1.1 Introduction

In the aftermath of the global financial crisis, economic recovery continued across the world during 2010. However, the speed and strength of this recovery remained uncertain, due mainly to persistent sluggishness in the advanced economies. However, prospects for recovery remained strong among a number of emerging and developing countries, boosted mainly by strong commodity prices and exports. Capital also continued to flow into the emerging markets, in search of higher rates of return, causing appreciation of currencies in receiving economies.

1.2 Overview of Global Economic Developments

Economic activity in countries such as the United States (US), United Kingdom (UK) and the Euro area was characterised by low consumer confidence and aggregate demand, and higher than normal unemployment rates. In addition, the threat of sovereign debt crisis in some of the Euro zone member countries negatively affected prospects of recovery. Monetary policy in these economies remained accommodative, throughout the year, so as to support the fragile economic recovery.

Growth in many emerging market and developing economies continued to be strong, led by China, India and Brazil. The Sub-Saharan Africa (SSA) region also maintained a relatively strong economic recovery. According to the International Monetary Fund[7] (IMF), output in SSA was projected to increase by 5 per cent, supported mainly by exports and strong commodity prices. In South Africa (SA), the region's largest economy, output expanded by 2.8 per cent in 2010, in contrast with a contraction of 1.7 per cent in 2009. This recovery was driven mainly by the mining and manufacturing sectors, which grew by 5.8 per cent and 5 per cent, respectively, despite persistent appreciation of the rand that threatened export competitiveness.

Meanwhile, capital continued to flow into many emerging and developing economies. In the face of weak economic recovery in the major developed countries, stronger growth prospects in the emerging markets offered superior rates of return on capital, attracting investors due to favourable

[7] World Economic Outlook, October 2010

interest rate differentials. In addition, concerns of inflationary pressures kept nominal interest rates relatively high in these markets. In contrast, nominal interest rates remained near-zero in most of the advanced economies, due to aggressive and persistent monetary policy easing intended to stimulate economic activity.

1.3 Emerging Exchange Rate Developments

The relentless imbalances in economic activity and growth prospects between the advanced and emerging market economies led to strong exchange rate appreciation in the emerging market economies. In some cases, countries that experienced currency appreciation sought measures to weaken their currencies in order to preserve or boost their export competitiveness. However, for small open economies such as Lesotho, the main drivers of the ensuing exchange rate developments remained entirely exogenous although affecting trade flows.

1.4 Factors Influencing the Rand/Loti Exchange Rate

Stronger prospects for economic recovery tended to attract capital inflows into SA and thus strengthened the value of the rand in the following ways:

- Relatively stronger growth prospects attracted investors, in search of superior yields in emerging markets. This exerted upward pressure on the rand;

- As one of the major producers of commodities, such as gold and platinum, a commodity boom boosted the value of the rand in SA. In particular, investors typically raise demand for gold, as a safe haven, whenever economic activity is sluggish in the developed economies, especially in the US;

- Interest rates in the advanced economies remained at historically low levels during 2010, as authorities continued to stimulate these economies out of recession. In contrast, rates of interest in the developing countries and emerging market economies remained much higher due, in part, to structural factors. Concerns about a build-up in inflationary pressures in most of the emerging markets, including SA, also kept rates relatively high. This kept interest rate differentials considerably favourable, in real terms, to developing and emerging market economies.

As demonstrated in Figure 1, below the loti appreciated strongly throughout 2010. At the same time, the international price of gold rose considerably in both US dollar and loti terms. In addition, the difference between inflation-adjusted rate of return on SA and US government bonds ranged between 1.9 and 3.3 percentage points since the fourth quarter of 2009.

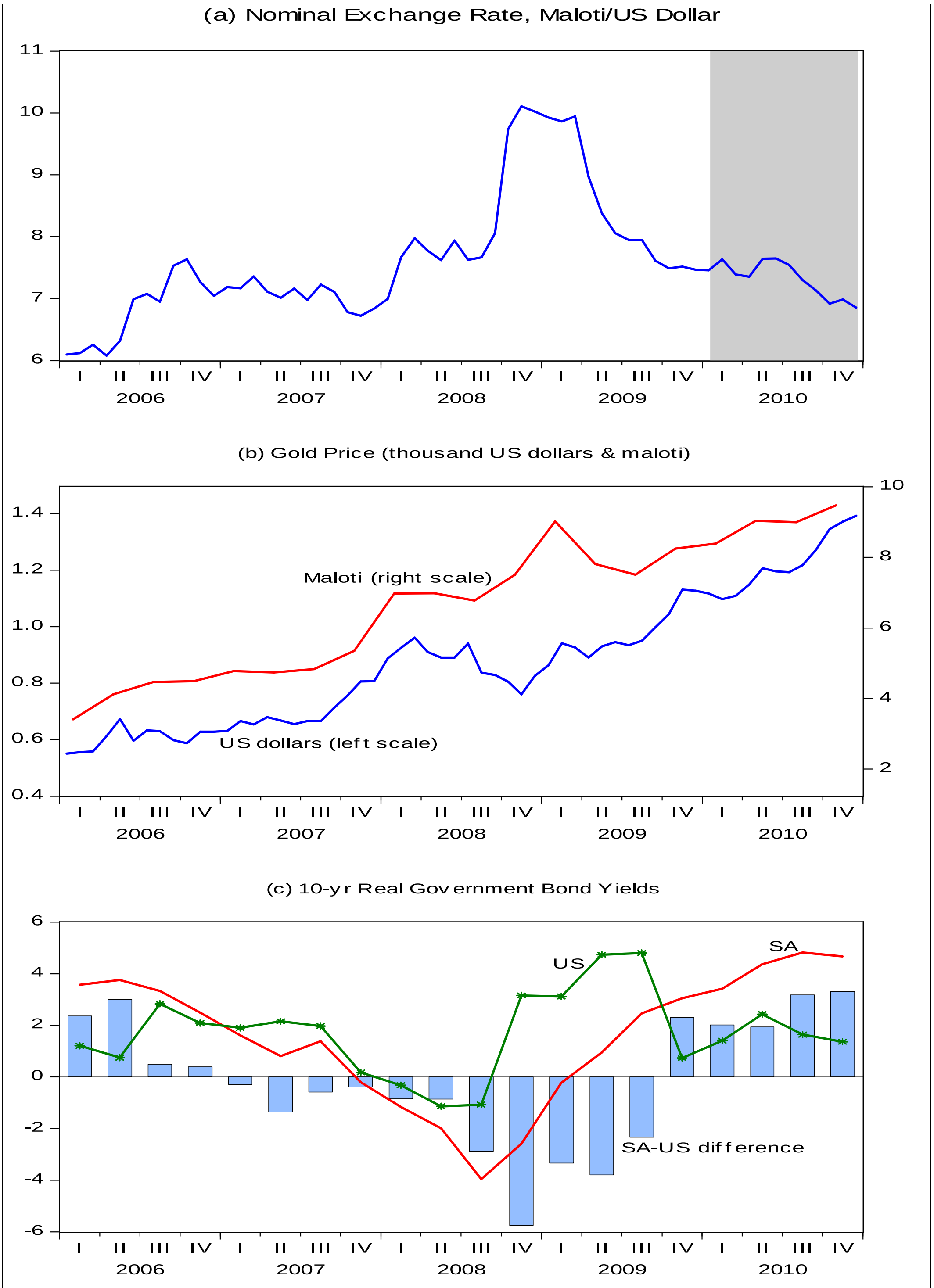
1.5 Implications and Prospects for Lesotho

As a small open economy, Lesotho is susceptible to the effects of global economic developments. The second round effects of the global financial crisis affected the Lesotho's economy in two main ways. First, demand for Lesotho's exports was reduced as economic recovery in developed economies remained slow. Finally, persistent currency appreciation adversely affected the competitiveness of Lesotho's exports.

Since the inception of the African Growth and Opportunity Act (AGOA) in 2000, Lesotho's manufacturing subsector, in general, and exports of clothing and textiles, in particular, have become a major source of economic growth and employment. The manufacturing subsector is currently the country's single largest employer with over 40,000 employees. However, during the review period, manufacturing production and employment slowed down due to weak global demand, particularly, in the US, coupled with the appreciation of the local currency. However, strong global demand for diamonds, one of Lesotho's major exports, increased the international price of diamonds, and slightly dampened the adverse effect of currency appreciation on the profitability of the subsector.

In terms of policy responses, there are limited options for small economies, such as Lesotho's, given the nature and scope of the existing global economic imbalances. On the positive side, however, are indications of a relatively stronger growth prospects in the major world economies for 2011. Economic activity is expected to improve, albeit moderately, in economies such as the US and the Euro area. A sustained recovery in most of the major developed economies would obviate the need for costly but unsustainable policy interventions.

Figure 1: Exchange Rate, Gold Prices and Bond Yields



Sources: Bloomberg Financial Markets; IMF International Financial Statistics (IFS); Organisation for Economic Cooperation and Development (OECD); South African Reserve Bank (SARB); and CBL staff calculations.

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

2.0 Introduction

The global economic recovery in 2010 was rather skewed towards the emerging market economies, emerging market economies outperformed advanced economies considerably. Preliminary estimates suggest that the world economy expanded by about 5 percent during the first half of 2010, underpinned by continued policy support and a stronger than anticipated recovery in emerging economies. Emerging market and developing economies were estimated to have grown by 7.1 per cent, while advanced economies grew by 3.0 per cent. Growth in emerging economies appeared increasingly self-sustained at the back of robust domestic demand, just when the push from inventory rebuilding and the policy stimulus began to lose steam. In addition, capital inflows into emerging economies with good fundamentals remained strong, partly in response to easy monetary conditions in advanced economies and a combination of improving risk environments in emerging countries and changing perceptions of investors towards the risk of investing in these markets. The main downside risks included high unemployment and a slow pace of growth in developed economies. The recovery was led more by revival in consumption and investment, than the fiscal stimulus which drove the recovery in 2009. However, volatility in the financial, currency and commodity markets remained elevated in 2010.

According to the latest IMF projections, the global economy grew by 4.7 per cent in the fourth quarter of 2010. This growth was supported by an increase in manufacturing and global trade emanating from a surge in inventory and fixed investment, and strong consumption in the US and Japan in response to stimulus measures. However, the sovereign debt crisis in the Euro area during the second half of 2010, threatened the sustainability of the world economic recovery.

2.1 Industrialised Countries

2.1.1 The United States (US)

Economic growth in the US remained relatively slow in 2010. IMF projections indicated that the US economy grew by 2.8 per cent in 2010 in comparison with a fall of 2.6 per cent in 2009. The US economy expanded at a rate of 1.7 per cent in the quarter ending June 2010, slower than 3.7 per cent growth realised in the first quarter of 2010. However, during the second half of 2010, there was a strong expansion in consumption which led to 2.9 per cent growth in economic activity, compared to growth of 1.7 per cent in the second quarter. The stronger than expected growth in personal consumption, which accounts for about 70 per cent of the increase in economic activity, was a direct result of the stimulus packages that were passed by the US government in the second half of 2010. Despite this, the unemployment rate remained high at 9.7 per cent of the total workforce. The rate of inflation in the US remained subdued at 1.4 per cent in 2010, from a fall of 0.4 per cent in 2009. The low consumption demand, weak labour market and easing consumer prices posed a threat of deflation. On the upturn, the rebound in business investment could lead to a rise in inflation.

Sluggish growth, muted inflation and financial strain warranted the Federal Reserve Bank's Open Market Committee (FOMC) to maintain its benchmark lending rate at a record low of 0.25 per cent in 2010.

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 for the US market.

2.1.2 The Euro Zone

According to the IMF's projections, the Euro Zone[8] grew by 1.8 per cent in 2010 following a contraction of 4.1 per cent in 2009. The recovery in the Euro Zone seemed to be gradual and uneven mainly due to the financial turmoil that shook the periphery of the Euro Zone in the first half of 2010. The sovereign debt contagion that was triggered by Greece's public debt problems and fiscal sustainability problems quickly spread in the Euro Zone. Economic growth occurred mainly during the second half of 2010, mostly driven by the robust growth in Germany, buoyed by an expansionary budget. The pickup in exports and targeted austerity measures also contributed to the rise in GDP growth.

Growth prospects were dampened by, among others, private consumption that was weakened by high unemployment and the withdrawal of stimulus packages; planned fiscal consolidation which weakened private demand; and competitiveness imbalances which limited the scope for export growth.

[8] Euro zone comprises: Austria, Belgium, Germany, Greece, Finland, France, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Spain and Slovakia. Estonia became the 17th Euro-zone member country with effect from January 01, 2010.

The inflation rate in the Euro Zone, measured by changes in the Harmonised Index of Consumer Prices (HICP) rose to 1.6 per cent in 2010 compared to 0.3 per cent increase in 2009. This uptick in consumer price inflation was attributable to the rising 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 modest recovery in the Euro Zone bodes well for Lesotho as most of diamond exports are destined for the region.

2.2 Emerging Markets

Economic activity in emerging economies remained buoyant in the review year. IMF projections show that real GDP expanded by 9.3 per cent compared with a 7.0 per cent increase registered in the previous year. Growth in Emerging Markets was supported by the well entrenched private demand, accommodative policy stance and resurgent capital inflows. The domestic-demand-driven economies; China, India and Indonesia; were set to grow particularly rapidly and would lead the Asian recovery.

Signs of overheating have become apparent in some economies through rapid credit growth or rising asset prices. The annual inflation rate in emerging economies grew to 6 per cent in 2010 on account of both the oil and non-oil prices, which rose considerably in 2010, in response to increased global demand and supply shocks for selected commodities.

The current account surplus as a proportion of the region's GDP narrowed down to 3 per cent of GDP in 2010 from 3.5 per cent of GDP in 2009, reflecting developments in major economies in the region. China's (as one of the major economies) current account surplus is expected to fall by 1.5 per cent of GDP in 2010. The narrowing of the current account surplus in emerging Asia was largely on account of the regional growth which translates into a faster pickup in imports rather than exports, as income from investment outside the region falls with lower growth in the rest of the world.

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 Asian economies.

2.3 South Africa (SA)

As projected by the IMF, economic activity in South Africa continued on its recovery path in 2010. Real GDP grew by 2.8 per cent compared to a fall of 1.7 per cent realised in the previous year. South Africa has benefited from continued strong demand for commodities from emerging Asia and from a recovery in demand for manufactures in its largest export market, the Euro Zone. There are also signs that the monetary easing pursued in 2009 was supportive of recovery in domestic demand.

The annual average rate of inflation, measured by changes in the consumer price index (CPI), fell from 7.1 per cent in 2009 to 4.3 per cent in 2010. The slowdown in inflation during the review period resulted mainly from subdued domestic and international demand and the relatively strong rand exchange rate.

In line with improved growth outlook, sustained domestic demand and moderate price increases, the South African Reserve Bank's (SARB's) Monetary Policy Committee (MPC) kept the key interest rate unchanged at 5.5 per cent in the quarter ending in December 2010. This was 1.5 percentage points lower than in the first quarter of the review year.

Low inflation in SA augurs well for price developments in Lesotho given that the bulk of Lesotho's imports derive from SA. Similarly, improved economic activity in SA has positive spill-over effects into Lesotho's economy.

Table 1					
Indicators	**2006**	**2007**	**2008**	**2009**	**2010***
World Output	5.1	5.2	3.0	-0.6	5.0
Advanced Economies	3.0	2.7	0.6	-3.4	3.0
Of which:					
United States	2.7	2.1	0.4	-2.6	2.8
Euro Area	2.9	2.7	0.7	-4.1	1.8
Japan	2.0	2.3	-0.7	-6.3	4.3
United Kingdom	2.9	2.6	0.7	-4.9	1.7
Emerging and Developing Economies					
Of which:					
Africa	6.1	6.3	5.2	1.8	3.9
Sub Saharan	5.7	7.0	5.6	2.8	5.0
South Africa	5.3	5.1	3.1	-1.7	2.8
Developing Asia					
China	11.6	13.0	9.6	9.2	10.3
India	9.8	9.4	7.3	5.7	9.7
Consumer Prices					
Advanced Economies	2.4	2.2	3.4	0.1	1.5
Of which:					
United States	3.2	2.9	3.8	-0.3	1.4
Euro Area	2.2	2.1	3.3	0.3	1.6
Japan	0.3	0.0	1.4	-1.4	-1.0
United Kingdom	2.3	2.3	3.6	2.1	3.1
Emerging and Developing Economies					
Of which:					
Africa	6.4	6.0	10.3	9.0	7.1
Sub Saharan	7.3	6.8	11.9	10.4	7.5
South Africa	4.7	7.1	11.5	7.1	5.6
Developing Asia					
China	1.5	4.8	5.9	-0.7	3.5
India	6.2	6.4	8.3	10.9	13.2
World Trade Volume	9.3	7.3	2.8	-10.7	12.0
(Goods and Services)					
Exports					
Advanced Economies	8.4	6.3	1.9	-11.9	11.4
Emerging and Developing Economies	11.0	9.8	4.4	-7.5	12.8
Imports					
Advanced Economies	7.5	4.7	0.5	-12.4	11.1
Emerging and Developing Countries	14.7	13.8	9.4	-8.0	13.8

Sources: IMF World Economic Outlook, October 2010; and IMF World Economic Outlook Update, January 2011.
* IMF Projections

2.4 Commodity Price Developments

2.4.1 Gold Prices

Gold prices soared in 2010 reflecting an upsurge global demand, mainly in emerging markets. The price of gold rose by 26.2 per cent in the year under review to US$1 228.43 per ounce from an annual average of US$973.54 per ounce in 2009. The jewellery sector in Asia enjoyed a strong demand in 2010, with annual demand increasing by 17 per cent from 1760.3 tonnes in 2009 to 2059.6 tonnes in 2010. Gold closed the year at US$1 370.45 per ounce in comparison with US$1 101.01 per ounce at the end of 2009. In rand terms, the average annual price of gold increased by 10.2 per cent to R8 974.66 in 2010 from R8 144.47 per ounce observed in the previous year.

2.4.2 Oil Prices

Oil prices increased in 2010 reflective of the general trend of rising global commodity prices. The minimum and maximum levels of crude oil prices were recorded at US$68.21 and US$90.73 per barrel respectively, compared to US$35.58 and US$77.88 per barrel registered in 2009. By the end of the review year, the price of crude oil per barrel was US$88.99 compared with US$77.16 at the end of 2009.

On average, the loti price of crude oil increased by 13.4 per cent in 2010 to M568.59 per barrel from M501.38 per barrel in 2009. In line with the global developments, there were several upward revisions of fuel prices in the economy during the year. Price of petrol in Lesotho closed the review year at M7.10 per litre, while that of diesel and illuminating paraffin closed the year at M7.55 per litre and M5.25 per litre, respectively. These compare with M6.90 per litre of petrol, M7.20 per litre of diesel and M5.25 per litre of illuminating paraffin at the end of 2009.

2.4.3 Platinum Prices

The annual average price of platinum also increased in line with prices of other commodities. It increased by 34.2 per cent to US$1 622.02 per ounce in 2010 from US$1208.56 registered in 2009. In Rand terms, the average price of platinum rose by 18.0 per cent to M11 868.60 per ounce in the period under review from M10 059.77 per ounce in the previous year.

2.4.4 Maize Prices

In US dollar terms, the average spot price of white and yellow maize, in the first half of 2010 was US$153.66 and US$160.41 per tonne, respectively. However, in the second half of 2010, the average spot price of both white and yellow maize rose to US$175.53 and US$185.82 per tonne, respectively. The increase was mainly due to the adverse weather conditions that were experienced globally; shrinking global supplies, as well as high energy prices which led to high production costs. In maloti terms, the price of white and yellow maize, in the first half of 2010, increased to M1 245.38 and M1 2318.18 per tonne, respectively, compared with M1 156.30 and M1 207.46 per tonne observed in the second half of 2010. The pickup largely reflected the local currency appreciation against major trading currencies.

2.4.5 Wheat Prices

The average spot price of wheat rose from US$184.98 per tonne in the first half of 2010 to US$253.56 in the second half of 2010. The increase was triggered by the downgraded harvest expectations resulting from poor weather conditions. In maloti terms, the average spot price of wheat increased by 14.1 per cent to M1 1787.87 per tonne in the second half of 2010 from M1 392.69 per tonne realised in the first half of 2010, reflecting the appreciation of the local currency against the major trading currencies.

2.5 Lesotho in the context of Regional Economic Integration

Lesotho remained strongly committed to economic cooperation throughout 2010. In particular, Lesotho maintained active participation in the activities of regional economic organizations such as the Southern African Customs Union (SACU)[9], the Southern African Development Community (SADC)[10] and the Common Monetary Area of Southern Africa (CMA)[11] .

During the review year, SACU continued with the implementation of the 2002 SACU Agreement and to negotiate various free trade agreements with the major trading blocs. In April, 2010, the commemoration of SACU's 100 years of existence was launched to reflect on the achievements and challenges, as well as to deliberate on the future

[9] SACU comprises: Botswana, Lesotho, Namibia, South Africa, and Swaziland.
[10] SADC comprises: Botswana, Democratic Republic of Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.
[11] CMA comprises: Lesotho, Namibia, South Africa and Swaziland.

strategic direction of SACU, in view of recent regional and global developments. A new vision and mission, which was signed by all Member States, was adopted. This would be translated into a strategic work programme of SACU and would allow SACU to serve as an engine for deeper development integration both within itself and within the Southern African region. This initiative was aimed at pursuing an economic community with equitable and sustainable development, dedicated to the welfare of its people for a common future.

Challenges that needed immediate attention were identified as:

- Developing deliberate initiatives to promote intra-SACU trade;
- Strengthening the capacity in the Secretariat;
- Exploring the possibility of a review of the 2002 SACU Agreement;
- Consideration of the sharing of SACU Revenue;
- Defining a roadmap for moving towards an Economic Community and Monetary Union and;
- Investigating financing options for cross-border projects.

SACU Member States signed the Memorandum of Understanding between the World Customs Organization (WCO) and SACU. The programme was intended to contribute to the development of sustainable and improved economic activity in SACU, with regard to trade, security and social protection, through development of the Customs Authorities that would act as fair and effective trade management partners. The Swedish International Development Cooperation Agency (SIDA) had also partnered with SACU in embarking on a comprehensive regional Customs Development Programme.

SACU continued its trade agreement negotiations during the review period. In particular, negotiations were held under the SACU Trade Protocol, the European Free Trade Area (EFTA) and the World Trade Organization (WTO) Doha Development Round; and with *Mercado Comun del Sur* (MERCOSUR), India and the United States (US). These indicated SACU's commitment to integration with the rest of the world, thereby advancing economic development.

With regard to SADC, efforts towards implementing the Protocol on finance investment which is aimed at the establishment of a regional common market, where there would be free movement of capital, labour and services, were continued. Against the backdrop of the Confederation of African Football (CAF) Africa Cup of Nations held in Angola and the FIFA World Cup that was held in South Africa, efforts were intensified to raise awareness about SADC and to promote sustainable investment in the region. The main focus was on:

- Spatial Development Initiatives/ Transport Corridors;
- Regional Infrastructure and related Water projects;
- Energy Infrastructure System Development;
- Trade and Industrial Development;
- Information and Communication Technologies and;
- Trans-Frontier Conservation Areas.

The deeper regional integration that Lesotho has embarked upon is expected to bear fruits for Lesotho. With the revival in global consumer demand and commodity prices, the Lesotho-based producers would have access to new and increased markets. Diversified markets for Lesotho's exports would improve on the employment prospects in the economy and therefore economic growth. Furthermore, broader economic integration would attract foreign direct investment. Having increased access to international markets, the country's export earnings would increase and hence improve the Balance of Payments position.

BOX 1: STUDY OF THE FUTURE OF THE SOUTHERN AFRICAN CUSTOMS UNION

The global economic crisis has had a number of adverse effects on the economy of Lesotho, the most devastating of which has been the decline in government revenue, particularly, the customs revenue from Lesotho's membership of the Southern African Customs Union (SACU). The low global demand resulted in a fall in imports of goods and services to SACU member countries and hence contributions from import duties into the SACU revenue pool. Consequently, SACU revenue share for Lesotho declined from M4918.00 million in 2009/10 to M2627.90 million during the 2010/11 fiscal year. This has presented formidable challenges for the economy, particularly because of Lesotho's heavy reliance on this source of revenue, which has historically financed up to 50.0 per cent of the national budget. Furthermore, long term reliability and sustainability of SACU as the major source of revenue for Lesotho is threatened by a number of trade negotiations that SACU countries are involved in at the multilateral, regional and bilateral levels. Completion and implementation of a substantial trade agreement will have a significant debilitating effect on SACU tariff revenues. The possibility of an expansion in the membership of SACU to include other countries (Mozambique and Angola) could reduce the share of revenue to Lesotho. To this end, the Central Bank of Lesotho commissioned an independent firm of consultants to conduct a study on the "Future of the Southern African Customs Union".

The study assessed the possible directions that SACU is likely to take, going forward, and evaluated the possible impact of such possibilities on the economy of Lesotho. On the basis of internal and external developments that had taken place, the study developed four possible scenarios for the future of SACU. The **status quo or baseline scenario** which considers the possibility that SACU continues to function 'as is' with no changes to the revenue sharing or tariff setting arrangement. While it is true that the process of reforming the SACU revenue sharing formula has begun, it is likely that it will take a few years before the changes are implemented as negotiations could be complex and lengthy. The second scenario is that of **dissolution**, where an assessment of what the region might look like in the absence of SACU is made. This is followed by the **reform** scenario, which captures the apparent commitment from all SACU members to work towards an improved revenue sharing formula. The **expansion** scenario which considers the possibility of the expansion of SACU as an alternative to or first step in the formulation of the proposed SADC Customs Union and the speculation that other countries like Mozambique and Angola could also join SACU on their own.

The study also took into consideration some external and internal developments that are likely to have a bearing on the future of SACU and used them to define some trade, budget and growth assumptions. These assumptions were in turn incorporated in each of the four scenarios through sensitivity analysis. Among these are tariff liberalisation under a multilateral World Trade Organisation (WTO) agreement; the gradual global economic recovery; the likely performance of SACU imports; and Fiscal reforms in Lesotho.

The results of the study indicate that Lesotho would stand to benefit more from the reform scenario, followed by the status quo while dissolution would be disastrous for Lesotho as it would result in massive loss of revenue. Under the status quo, SACU revenues are likely to recover over time, though payments to Lesotho are not likely to return to the pre-crisis levels. In addition, with the current revenue sharing formula, SACU revenue receipts remain subject to massive volatility arising from changes in imports, the exchange rate and tariffs.

The reform scenario appears to hold significant benefits for Lesotho. This is because it seems likely that a reformed SACU revenue arrangement will provide for the creation of a more substantive development component including a structural fund. As the only least developed country in the customs union, Lesotho would have a strong claim to the largest share of such a fund. Moreover, if this fund could be financed independently of customs duties, it would be more stable and sustainable than under the current arrangement.

PART III DOMESTIC ECONOMIC DEVELOPMENTS

3.1 Real Sector Developments

3.1.1 Trends in Output and Income

Growth in domestic economic activity improved slightly in 2010, reflecting an accelerated increase in value added by both the primary sector and the secondary sector, which outweighed the slow down in value added by the tertiary sector. Real GDP growth was estimated at 2.5 per cent in 2010 compared with 2.4 per cent in 2009.

The performance of the primary sector improved on the back of the recovery of the diamond mining sector which regained its vigour during 2010 as diamond prices, along with prices of other commodities surged. The recovery in demand for jewellery by some economies, such as the US, China and India, contributed to the increase in the prices of rough diamonds. The secondary sector was boosted by relatively high building and construction activity, which offset the negative impact of the subdued activity in the textiles and clothing manufacturing industry.

Real Gross National Income (GNI) is estimated to have deteriorated by 6.3 per cent in 2010 from a growth of 1.6 per cent in 2009, reflecting a fall in both miners' remittances and investment income from abroad. Miners' remittances declined on account of the negative impact of the global economic recession on the South African mining sector, particularly the gold mines. Meanwhile, investment income fell as a result of lower interest rates in Lesotho's major trading and investment partners. As a result, GNI per capita is estimated to have declined by the 6.5 per cent in 2010, compared with a growth of 1.6 per cent in 2009.

Table 2					
AGGREGATE ECONOMIC INDICATORS (Percentage Change, 2004 = 100)					
	2006	**2007**	**2008**	**2009**	**2010***
Constant 2004 Prices					
GDP	6.5	1.7	5.1	2.4	2.5
GNI	2.4	1.7	11.4	1.6	-6.3
GDP Per Capita	6.5	1.7	5.1	2.4	2.5
GNI Per Capita	2.3	1.6	11.3	1.6	-6.5

Source: Bureau of Statistics
* CBL Projections

3.1.2 Sectoral Performances

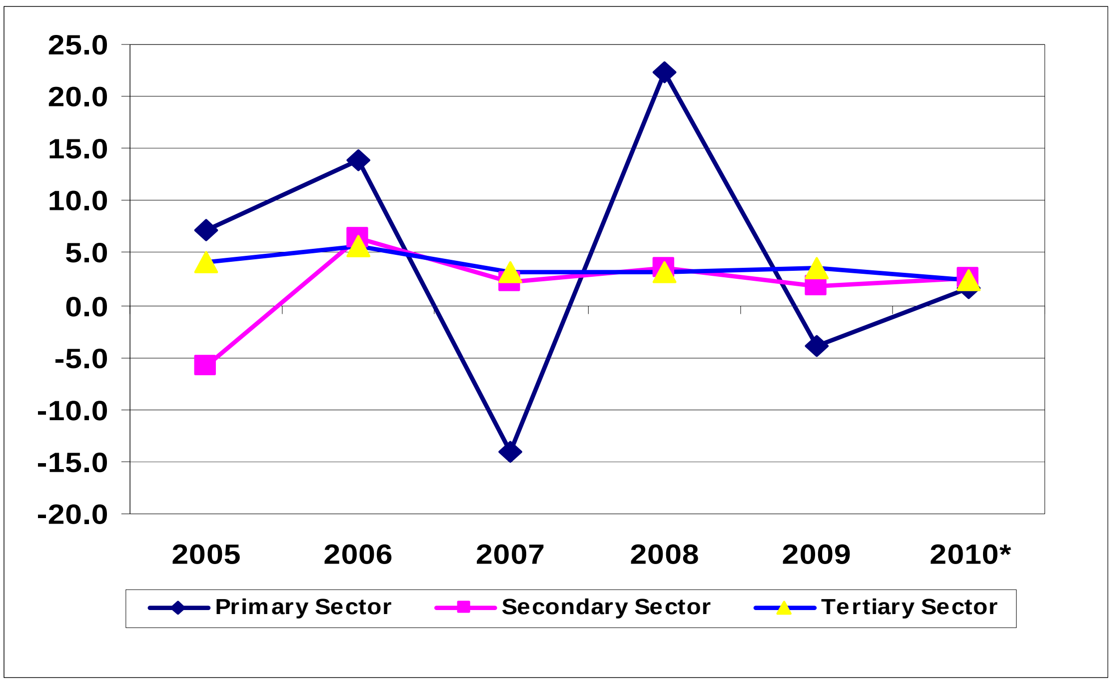
(a) Developments in the Primary Sector

The primary sector registered a positive growth of 1.7 per cent in 2010 compared with the contraction of 4.0 per cent in the previous year. This was largely underpinned by the rebound in the mining and quarrying sub-sector, which was supported by the global economic recovery and the improvement in the international commodity prices. In addition, the agriculture, forestry and fishing subsector recovered moderately in 2010 following a slump in the previous year.

Having contracted by 3.3 per cent in 2009, the mining and quarrying subsector is estimated to have rebounded and increased at a rate of 3.7 per cent in 2010, signaling increased diamond mining production. Global demand for diamonds recovered substantially leading to acceleration in the price of rough diamonds throughout 2010. The positive impact of increased diamond prices outweighed the negative impact of the exchange rate appreciation on mining production.

The agriculture, forestry and fishing subsector is estimated to have grown by 0.8 per cent in 2010 compared with a contraction of 4.3 per cent in the previous year. The modest growth resulted from an improvement in livestock production, the largest subsector in the primary sector. The more significant contribution came from the crops subsector, which benefited from relatively good rains during the 2009/10 agriculture year. It grew by an estimated 2.0 per cent in 2010 following a lower expansion of 1.8 per cent in 2009, mainly reflecting good performance in maize, sorghum and wheat production. According to the preliminary report on crop forecasting, maize production increased by a projected 77.0 per cent while sorghum is expected to have grown nearly two-fold in 2009/10 agriculture year.

Figure 2: SECTORAL REAL GROWTH RATES



Source: Bureau of Statistics
* CBL Projections

(b) Developments in the Secondary Sector

The secondary sector, which comprises manufacturing, electricity and water as well as building and construction subsectors, is estimated to have accelerated further to 2.6 per cent in 2010 following an increase of 1.9 per cent in 2009. This sector benefited largely from improved performance in the construction sub-sector, which was boosted by the construction of the new public referral hospital and new clinics as well as the refurbishment of a number of filter clinics in the country. In addition, the construction of a number of rural and urban roads, bridges and the increase in construction activity related to residential and commercial property development, particularly in Maseru, contributed significantly to the subsector's performance.

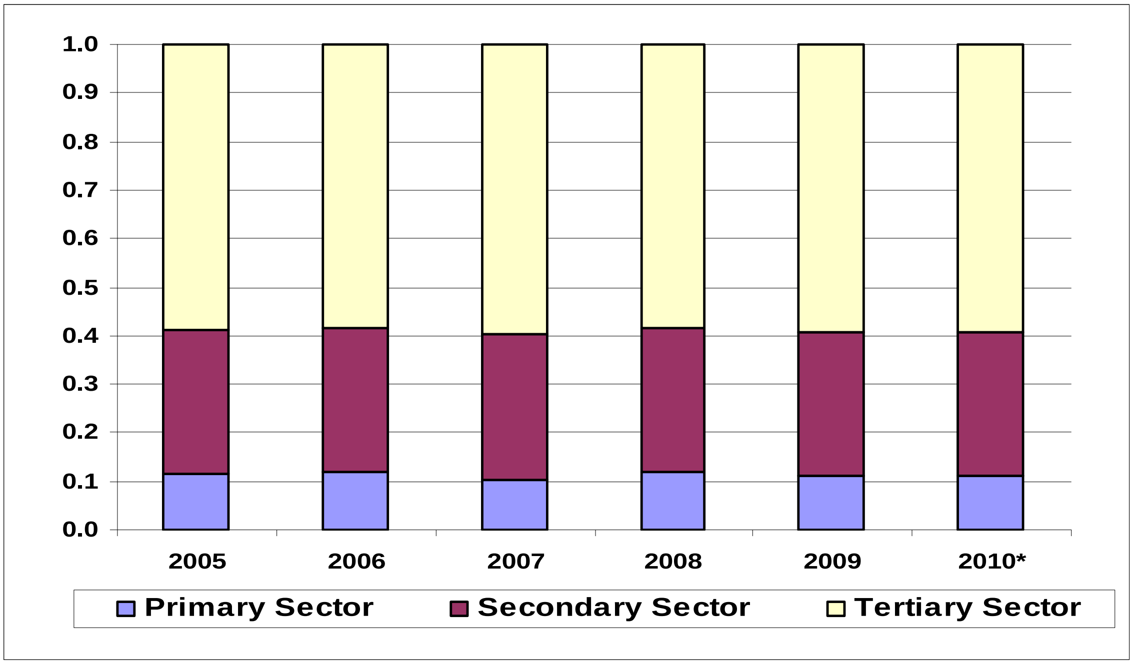
Lesotho's manufacturing subsector comprises textiles, clothing, footwear, and leather, which account for 61.8 per cent; food products and beverages which account for 20.6 per cent and other manufacturing at 17.8 per cent. The subsector recovered modestly in 2010, registering a growth of 0.5 per cent compared with a decline of 1.3 per cent in the previous year. The recovery was boosted mainly by other manufacturing, while textiles, clothing, footwear and leather declined at a slower pace than in the last year. The fragile global economic recovery coupled with high and sticky unemployment rates and low consumer confidence in the US, in the first half of 2010, did not bode well for the Lesotho-based textile and clothing industry because their exports are destined for the US market. Some of the firms had to cease operations because insufficient demand for their products rendered their operations unprofitable.

In line with these developments, the electricity and water subsector is estimated to have grown by 4.3 per cent in 2010 from 5.3 per cent in 2009. This deterioration resulted from low activity in the wet industries, in particular, the garment sector.

(c) Developments in the Tertiary Sector

The tertiary sector is estimated to have increased at a lower rate of 2.0 per cent in 2010 compared with 3.6 per cent in 2009, on account of a deceleration in the growth of the transport and communication subsector to 5.0 per cent in 2010 from 11.5 per cent in the previous year. The slowdown in transport and communication was mainly attributable to the sluggish global demand and international trade. Nonetheless, the wholesale and repair subsector boosted the sector during the review period. Restaurants and hotels subsector slowed down during the review period.

Figure 3: **SECTORAL SHARES IN GDP AT FACTOR COST**
(Percentages)

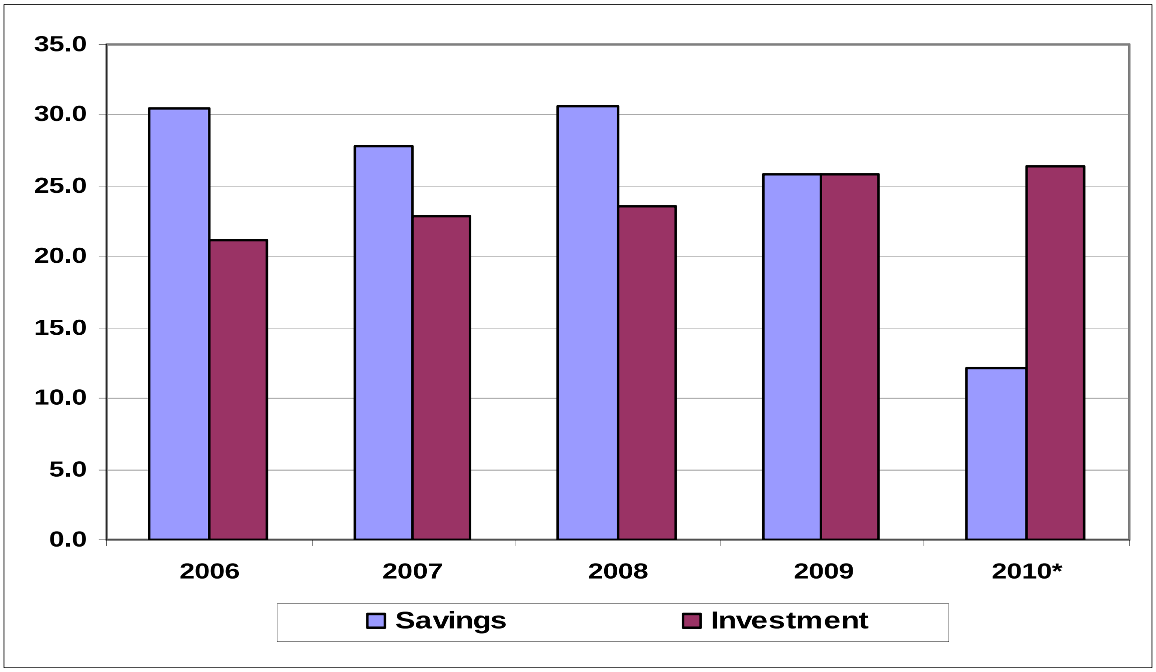


Source: Bureau of Statistics
*CBL Projections

3.1.3 Savings and Investment

The Saving-Investment gap as a share of GNI was recorded at 14.3 per cent in the year under review. Gross national savings alone were estimated at 12.2 per cent of GNI in 2010 compared with 25.8 per cent of GNI in 2009. The decline in savings mainly reflected lower private sector savings as household disposable income fell during the year. The global financial crisis and the consequent recession have impacted negatively on the household income through declines in migrant mineworkers' remittances. Private savings declined from 12.7 per cent of GNI in 2009 to a dissaving of 2.2 per cent in 2010. In addition, the share of saving to Gross National Disposable Income (GNDI) was estimated at 9.9 per cent in the review year compared with 19.4 per cent recorded in 2009, following a dramatic decline in net current transfers, mainly, as a result of a steep reduction in SACU revenue. Total investment as a share of GNI was recorded at 26.5 per cent in 2010 compared with 25.8 per cent in 2009.

Figure 4: SAVINGS AND INVESTMENT
(As a percentage of GNI)



Source: Bureau of Statistics
* CBL Projections

3.2 Employment, Wages and Prices

3.2.1 Employment

The manufacturing sector remained the single largest employer in the economy in 2010. Employment in LNDC-assisted companies[12] fell to 45 595 in December 2010 from 46 386 registered at the end of 2009, owing to a decline in production activity in the manufacturing subsector, particularly textiles and clothing firms. The continued fall in employment in this subsector was mainly attributable to the sustained strain in the US labour market and slow global economic recovery, which curtailed export orders and led to reduced production activity. The employment situation worsened as one firm accidentally burnt down towards the end of 2010.

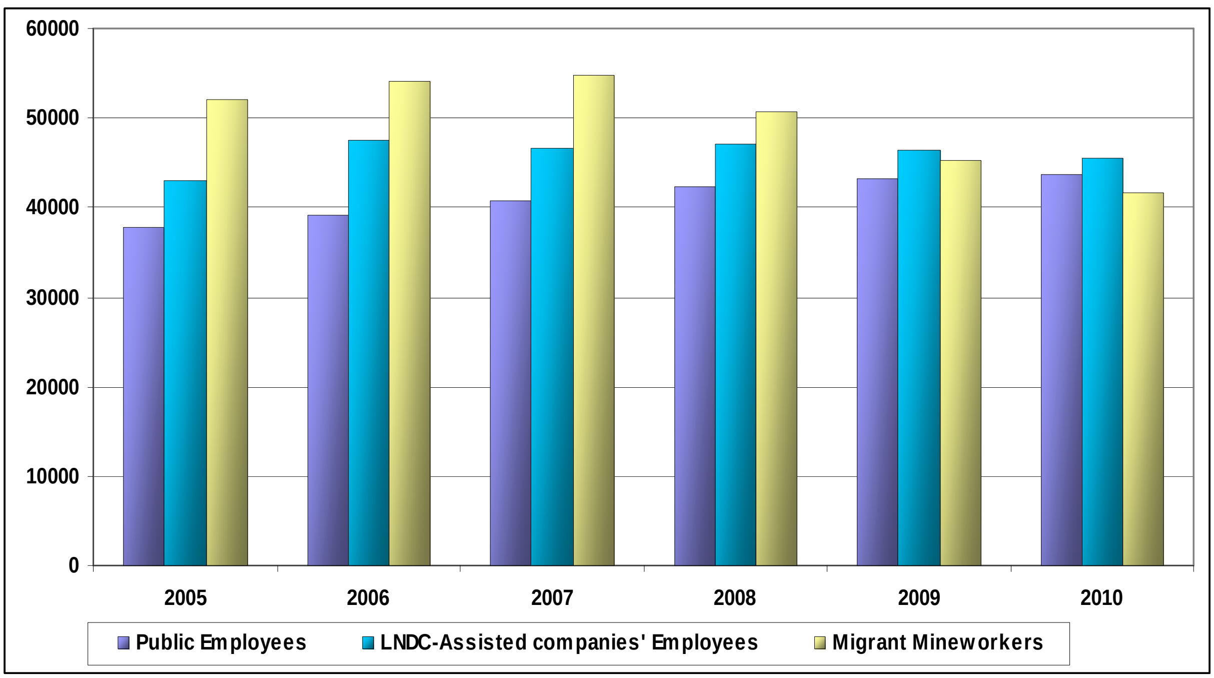
Employment in the public sector increased by 1.2 per cent from 43 259 employees at the end of 2009 to 43 781 employees at the end of the

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

review period. The increase was mainly influenced by categories of general teachers and civil servants which rose by 1.1 and 1.0 per cent, respectively. The category of daily paid employees on the other hand showed a decline of 4.3 per cent in December 2009.

The number of Basotho employed in SA mines continued to follow a downward trend in 2010. The average number of migrant mineworkers stood at 41 555 employees in December 2010 from 45 276 registered in December 2009. This represented a lower decline of 8.2 per cent compared with the 10.7 per cent reduction recorded in the previous year, mainly reflecting economic uncertainties prevailing in the global financial markets as well as the increased costs of the mining activities. Nonetheless, the prospects for the mining industry are expected to improve in 2011.

Figure 5: EMPLOYMENT TRENDS



Sources: The Employment Bureau of Africa Limited (TEBA), Lesotho National Development Corporation and the Ministry of Finance and Development Planning.

3.2.2 Wages

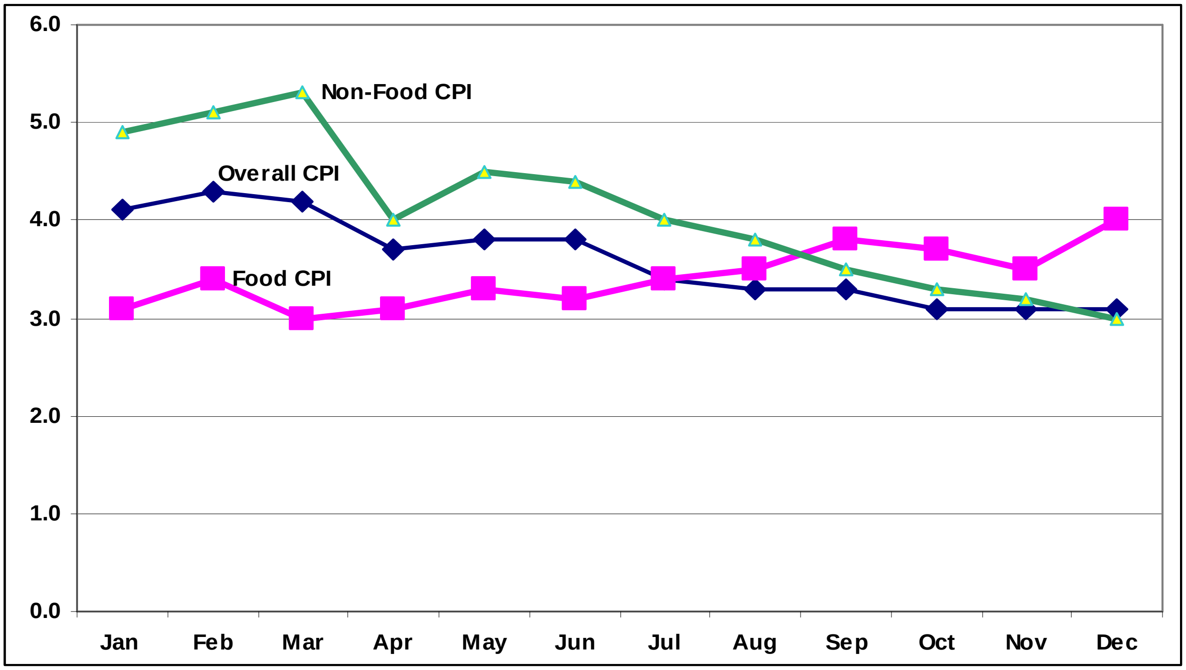
The general minimum wage as determined by the Wages Advisory Board increased by an annual average of 5.0 per cent during the review year. This increase was lower than the 8.1 per cent increase that was effected by the Board in the previous year, consistent with the lower level of inflation and currently reduced inflationary expectations. In addition, government employees benefited from an across-the-board salary increase of 3.5 per cent in the fiscal year 2010/2011.

3.2.3 Price Developments

The rate of inflation, measured by the rate of change in the CPI, slowed to an average of 3.3 per cent in 2010 from 7.3 per cent recorded in 2009 as a result of relatively weak demand conditions in SA and a strong rand. Inflation opened the year under review at a rate of 4.1 per cent in January and decelerated throughout the year to close at a lower rate of 3.1 per cent in December.

The annual inflation rate in South Africa closed the year at 3.5 per cent, which was higher than that of Lesotho. This can be explained by differences in the respective consumer baskets, particularly, relating to the category of food and non-alcoholic beverages. Although the inflation rate in Lesotho is expected to increase when South African domestic demand improves in 2011, it is projected to remain in single digits throughout the year. The low inflation rate augurs well for consumers as it reduces the rate at which their purchasing power is eroded.

Figure 6: LESOTHO CONSUMER PRICE INDEX
(Annual Percentage Change)



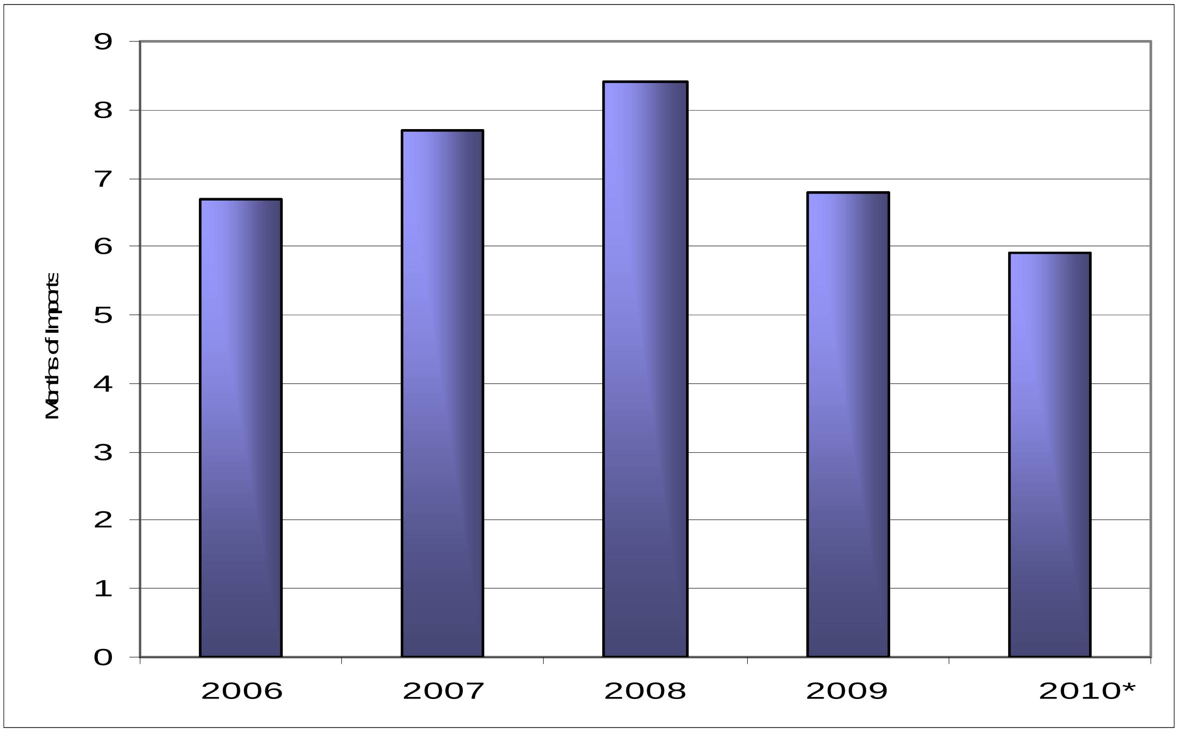
Source: Bureau of Statistics

3.3 Balance of Payments (BOP)

3.3.1 Overall Balance

Preliminary indications are that Lesotho's external sector position continued to deteriorate in 2010. The overall balance of payments (BOP) deficit widened from M643.9 million in 2009 to M1.6 billion in 2010. This resulted from a deterioration in the current account position because of disappointing current transfers as well as the unfavourable income account and the trade balances. The transactions balance, which measures the overall balance excluding the effects of currency fluctuations, also registered a deficit estimated at M1.58 billion, equivalent to 10 per cent of GDP. This followed a surplus of M516.8 million or 3.5 per cent of GDP that was registered in 2009. The worsening BOP position resulted in a reduction of gross official reserves, from 6.8 months of import cover in 2009 to 5.9 months in 2010.

Figure 6: Reserves in Months of Imports



* Preliminary estimates

Table 4

SUMMARY OF BALANCE OF PAYMENTS
(As percentage of GDP)

	2006	**2007**	**2008**	**2009**	**2010***
Current account	8.10	15.90	13.10	-1.00	-17.40
Goods	-43.80	-49.30	-47.70	-54.00	-54.50
Services	-2.50	-2.10	-2.70	-2.20	-1.30
Income	26.90	27.20	31.50	24.10	18.80
Current transfers	27.50	40.10	32.00	31.10	19.60
Capital and Financial account	0.80	6.60	1.70	7.80	7.20
Transactions balance	9.73	18.04	9.65	3.51	-10.00

* Preliminary estimates

3.3.2 Current Account

The current account deficit widened from M130.0 million, in the previous year, to M2.7 billion or 17.5 per cent of GDP in 2010. Almost all major components of the current account – trade in goods, the income account, and current transfers, contributed to this deterioration. The largest source of the decline was current transfers, which fell by 32.5 per cent, followed by the income and trade accounts, which declined by about 16 per cent and 7 per cent, respectively.

The large decrease in current transfers emanated from a 40 per cent reduction in customs receipts from the Southern African Customs Union (SACU) revenue pool. The income account balance also declined, as labour income fell by 12 per cent, reflecting a steady downward trend, which started during the mid-1990s, in the number of Basotho employed in South African mines.

Despite a modest recovery in diamond exports, merchandise exports fell by 2.6 per cent in 2010. The poor performance of the country's export sector was explained by weak demand in Lesotho's major export markets, particularly, in the US, which continued to suffer from the ripple effects of the recent global financial crisis. Nevertheless, Lesotho's dependence on imports has resulted in a moderate positive growth in imports of goods in nominal terms. In addition, demand for imports is envisaged to have benefited from the Metolong Dam pre-construction activities.

As a share of GDP, merchandise exports fell from 40.5 per cent in 2009 to 36.6 per cent in the review period. At the same time, merchandise imports declined by 3 percentage points to 91.5 per cent of GDP.

Meanwhile, the deficit on the services account narrowed to M213.0 million, from M320.3 million registered in the previous year, as growth in receipts overshadowed that of payments for cross-border services.

3.3.3 Capital and Financial Account

The surplus on the capital and financial account increased, marginally, to M1.2 billion during the review year, from M1.1 billion observed in 2009. This reflected net inflows on the capital account, while the financial account realised net outflows. The capital account inflows rose to M1.3 billion from M633.7 million in the previous year, due to an increase in grants to the government, which indicated continued donor support for the country. However, the financial account registered an outflow of M125.1 million in 2010, in contrast with an inflow of M520.1

million in 2009, as commercial banks increased their foreign asset holdings. As a percentage of GDP, the capital and financial account registered a surplus of 7.2 per cent in 2010, compared with 7.8 per cent recorded in 2009.

3.3.4 Foreign Exchange Rates

The rand, to which the local currency, the loti is fixed at par, remained volatile but appreciated strongly against the major world currencies during the review year. The main factors behind the strengthening of the domestic currency unit included:

- High real interest rates in SA compared to those prevailing in the developed economies, which attracted portfolio investment flows into the SA market;
- Strong commodity prices, in particular, gold and platinum, in the international markets. This continued to benefit the rand, as SA is one of the major commodity-exporting countries; and
- Positive investor sentiments due to the expectation that emerging market economies were becoming major drivers of global economic recovery.

In nominal terms, the rand, hence the loti, appreciated by 13.1 per cent against the US dollar in 2010 compared with a depreciation of 1.8 per cent observed in 2009. Against the Pound sterling, the Euro and Special Drawings Rights (SDR), it appreciated by 13.4 per cent, 16.7 per cent and 13.8 per cent, respectively.

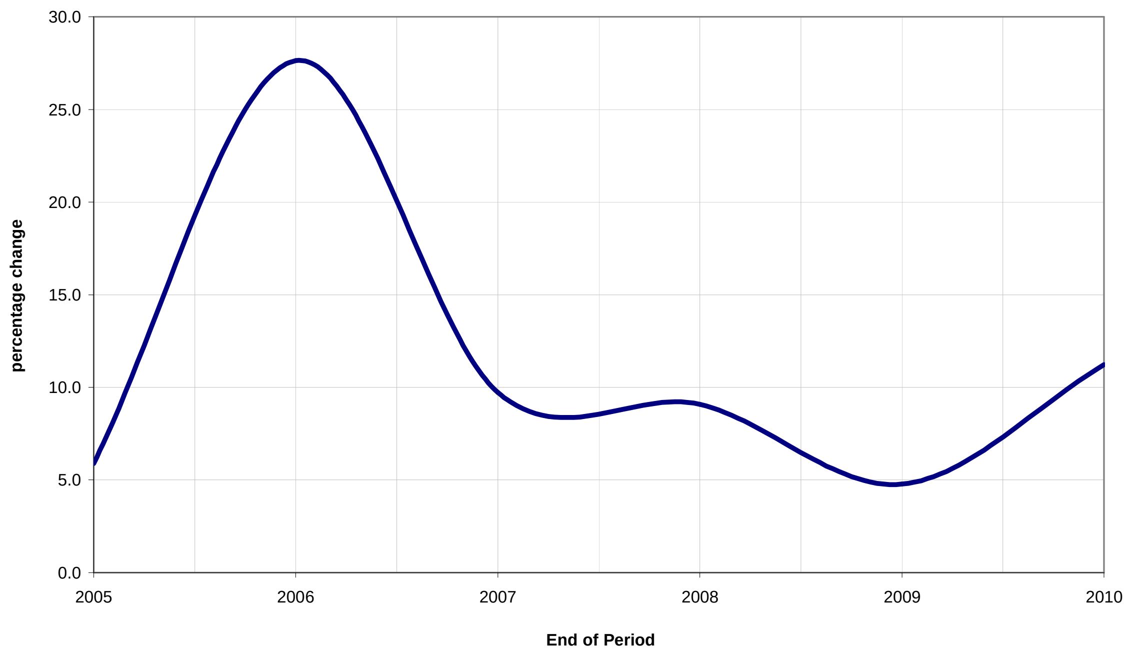
3.4 Money and Banking

3.4.1 Money Supply

The growth in money supply, measured by the change in M2, rose by 11.2 per cent at the end of 2010 following an increase of 9.9 per cent in 2009. The acceleration in money supply took place at the back of the rise in domestic credit including net claims on government. However, net foreign assets of the overall banking system dropped for the second consecutive year.

The expansion in money supply can also be observed through the movement in components of money supply. On the one hand, narrow money (M1) rose by 19.4 per cent following a 7.8 per cent increase in the previous year. The growth in M1 was largely driven by a 10.6 per cent rise in currency with public and 22.3 per cent jump in demand and call deposits. On the other hand, quasi money rose by 2.6 per cent following an increase of 35.5 per cent in the previous year.

Figure 8: Real Money Supply Growth



Source: CBL Monetary Survey, December 2010

3.4.2 Domestic Credit

Table 4

DOMESTIC CREDIT

Million Maloti: End of period

	2006	2007	2008	2009	2010
Claims on Government (Net)	-1498.8	-3324.3	-3950.7	-3996.0	-3197.6
Claims on private sector	897.2	1184.2	1463.2	1859.8	2193.8
Claims on Official entities	17.4	51.5	43.8	0.00	2.9
Domestic Credit	-576.8	-2071.1	-2443.8	-2136.2	-1000.8

Domestic credit including net claims on government rose by 53.1 per cent in 2010 following a 12.6 per cent increase in the previous year. The expansion in domestic credit was driven by the increase in net claims on government as well as credit to the private sector. Net claims on government rose by 20 per cent while credit to the private sector increased by 18.0 per cent. The upsurge in net claims on government reflected the deterioration in government deposits with the central bank. It is noteworthy that the drawdown in government deposits was aimed at financing the government fiscal deficit following a sharp reduction in SACU revenue which normally accounts for more than 50.0 per cent of total government revenue.

Credit to the private sector rose by 18.0 per cent in 2010 after increasing by 27.1 per cent in 2009. Credit extended to households increased by 13.0 per cent while credit to business enterprises rose by 23.7 per cent at the end of 2010. The growth in credit to the private sector was fuelled by the reduction in borrowing costs as interest rates continued on a downward trend. The growth in credit extension to the private sector is quite encouraging given the critical role the private sector plays in stimulating economic growth. The on-going reforms in the financial sector, such as plans to establish a credit bureau in 2011, are expected to facilitate further expansion of credit to the private sector. Establishment of the credit bureau is central in assessing creditworthiness of clients by commercial banks.

Although the amount of credit extended to statutory bodies increased, it remained relatively low. At the end of 2010, credit extended to statutory bodies stood at M2.97 million.

3.4.3 Net Foreign Assets

The net foreign assets (NFA) of the overall banking system fell by a further 6.7 per cent at the end of 2010 following a 4.7 per cent decline in the previous year. The fall in NFA was at the back of the decrease in net foreign assets of the Central Bank of Lesotho which offset the increase in net foreign assets of commercial banks. Net foreign assets of the Central Bank of Lesotho shrank by 19.9 per cent following 7.1 per cent decrease observed in the previous year. However, the net foreign assets of the commercial banks jumped by 27.2 per cent.

The decline in net foreign assets of the Central Bank of Lesotho reflected a revaluation loss due to the strengthening of the rand, hence loti; and the dip in SACU receipts. The rise in net foreign assets of the commercial banks reflected an increase in net transfers abroad, in search of better returns on investment.

Table 5

BANKING SYSTEM'S NET FOREIGN ASSETS

Million Maloti: End of period

	2006	2007	2008	2009	2010
Commercial banks	1772.5	2200.3	2921.1	2986.7	3799.8
Assets	1845.4	2273.7	3013.7	3297.2	3917.5
Liabilities	-72.9	-73.4	-92.7	-310.5	-117.7
Central Bank	4377.2	6177.3	8251.6	7664.9	6138.9
Assets	4918.7	6786.3	8989.2	8345.4	6749.5
Liabilities	-541.5	-609.0	-737.7	-680.5	-610.6
Net Foreign Assets	6149.7	8377.7	11172.6	10651.6	9938.7

3.4.4 Commercial Banks' Liquidity

The liquidity ratio[13] measures banks' ability to sufficiently honour customers' demands in making withdrawals. At the end of the review period, the ratio dropped from the 78.0 per cent that was recorded at the end of December 2009, to 75.6 per cent. The decline in the ratio reflected the increase in deposit holdings by the private sector coupled with an increase in other borrowings. The contraction occurred despite the increase in holding of South African short-term securities by commercial banks.

The credit to deposit[14] ratio rose marginally, from 34.1 per cent to 35.8 per cent at the end of 2010. The expansion in this ratio was indicative of a faster growth in credit extension relative to deposits mobilised from the private sector. As indicated earlier, growth in credit extension to the private sector was enhanced by lower borrowing costs as interest rates reached historic low levels. The ratio improved despite the strong growth in private sector deposits.

3.4.5 Interest Rates

Major money market rates in Lesotho generally followed a downward trend in line with interest rate developments in the Common Monetary Area (CMA) region. Specifically, the rates reflected relatively low interest rates in South Africa, where authorities continued to loosen monetary policy. Subdued inflation enabled the South African monetary authorities to cut interest rates. As explained earlier, the low level of inflation prevailed at the back of the strengthening of the rand vis-à-vis other foreign currencies.

The average prime lending rate in Lesotho dropped by 117 basis points, from 11.67 per cent in 2009 to 10.50 per cent in 2010. Similarly, the SA prime lending rate fell by 150 basis points, from 10.50 per cent to 9.00 per cent at the end of 2010. The margin between the two rates could reflect amongst others, the fact that level of competition in the banking industry in the two economies differs considerably. That is, South African rates are likely to be lower than Lesotho rates because the South African banking sector is more competitive.

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[13] 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

[14] 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.

Similarly, commercial banks' deposit rates followed a downward trend. For instance, the one year deposit rate declined from 2.05 per cent, at the end of 2009, to 1.21 per cent at the end of 2010. The real deposit rate was negative throughout the year as inflation rate remained above the deposit rate. The South African one-year deposit rate fell from 8.09 per cent in 2009 to 5.85 per cent. However, the real deposit rate in South Africa was positive.

The 91-day Treasury bill rate dropped by 19 basis points, from 6.66 per cent in December 2009 to 5.52 per cent in December 2010. The South African counterpart rate fell from 7.14 per cent in 2009 to 5.60 per cent in 2010. The margin between the two rates seemed to be slowly converging. It narrowed from 14 basis points observed at the end of 2009 to 8 basis points at the end of 2010.

BOX 2: Treasury Bonds are introduced in an Endeavour to Deepen the Money and Capital Market in Lesotho

In the year 2010, the Central Bank of Lesotho (CBL) maintained its gradual approach towards development of the money market. As the fiscal agent of Government, the CBL issued Treasury bonds in October, 2010. During the introductory issuance, M125.00 million worth of treasury bonds were issued, with M50 million allocated to three-year bonds while the remainder was allocated to five-year bonds. This was followed by an auction of M62.00 million in December, 2010.

The primary objective behind the introduction of treasury bonds is to develop capital market in Lesotho. The funds raised through the treasury bonds would close the financing gap of government, created by the sharp decline in SACU revenue. The intention of the Government is to use the funds raised from the sale of bonds for financing capital projects. This is important for infrastructure development in Lesotho. Issuance of bonds will also create alternative avenues for savings and investment which will, in turn, stem capital flight to South Africa. In addition, the development of the domestic bond market will help establish a benchmark yield curve, which is important for signaling the future course of real economic activity. It will also deepen the securities market in Lesotho.

The development of the money and capital market has several potential benefits for the economy of Lesotho. It is an important alternative source of funds for financing productive investments which is critical for high and sustainable economic growth and development. Issuance of treasury bonds will provide an additional channel, to the treasury bills, through which the Government can borrow funds domestically to finance capital projects. The projects that are earmarked for financing with funds raised through treasury bonds in Lesotho include improvement of roads, construction of Metolong Dam and extension of ‘Muela hydropower station.

These projects have the potential to promote long term economic growth. Infrastructure development can have a direct impact on economic growth by increasing aggregate demand during construction and maintenance phases. In addition, good infrastructure enhances productive investment. For instance, electricity that will be generated through the extended hydropower station will be used as an input in almost all production processes for goods and services and water is also a significant input in the production process in wet industries in Lesotho. Good infrastructure also lowers the cost of production; the role of transport infrastructure in this regard cannot be overemphasized.

Money and capital market development also has the potential to reduce capital flight to South Africa because it increases the pool of savings and investment options available to investors. Lesotho is a member of the Common Monetary Area (CMA) with Namibia, South Africa and Swaziland, the area in which there is free movement of capital. Therefore, each member state has to be creative to ensure that capital, which is necessary for economic development, does not flee to other member states. This can be achieved by developing the capital market to provide alternative investment opportunities with different combinations of risk and return. It is also likely to stimulate competitive behaviour among investors, which could stir interest rates within the economy in a downwards direction. Low interest rates have the potential to stimulate economic growth as they encourage both consumption and investment.

3.5 Government Finance

3.5.1 Fiscal reforms in recent years

In 2010/2011, the Government of Lesotho (GoL) continued building on the progress made in reforming the Public Financial Management (PFM) system. In this regard, it made efforts to address the deficiencies in the functioning of the Integrated Financial Management Information System (IFMIS) in order to enhance its effectiveness. Improving the functionality of the IFMIS included actions to prevent over-commitment of resources and to strengthen internal controls.

The global economic slowdown has led to a huge decline in SACU revenues, which threatens the Lesotho's fiscal and external stability. In response to this, the government undertook to implement, starting in 2010/11, measures aimed at restoring macroeconomic stability and entered into an Extended Credit Facility (ECF) arrangement with the IMF to support the government's program of economic policies in this regard.

Cognisant of the need for a large fiscal adjustment to restore macroeconomic stability, the government has implemented fiscal consolidation measures. These include measures to significantly reduce expenditures, by containing growth in recurrent spending and enhancing domestic revenue while, at the same time, protecting critical investment and social spending. Efforts to strengthen tax revenues, by improving tax administration and compliance were also made.

3.5.2 Fiscal performance in 2010/11

Fiscal performance for the 2010/11 fiscal year was adversely affected by the large and unprecedented decline in SACU revenues. Following several years of surpluses, the fiscal balance is estimated to have deteriorated to a deficit equivalent to 6.4 per cent of GDP, as a result of the slump in SACU receipts. Total revenue and grants were estimated to have declined by 7.0 per cent while total expenditure was estimated to have risen by 10.6 per cent. The deficit was financed by the issuance of domestic bonds and the use of government deposits held at the Central Bank of Lesotho.

3.5.2.1 Revenue

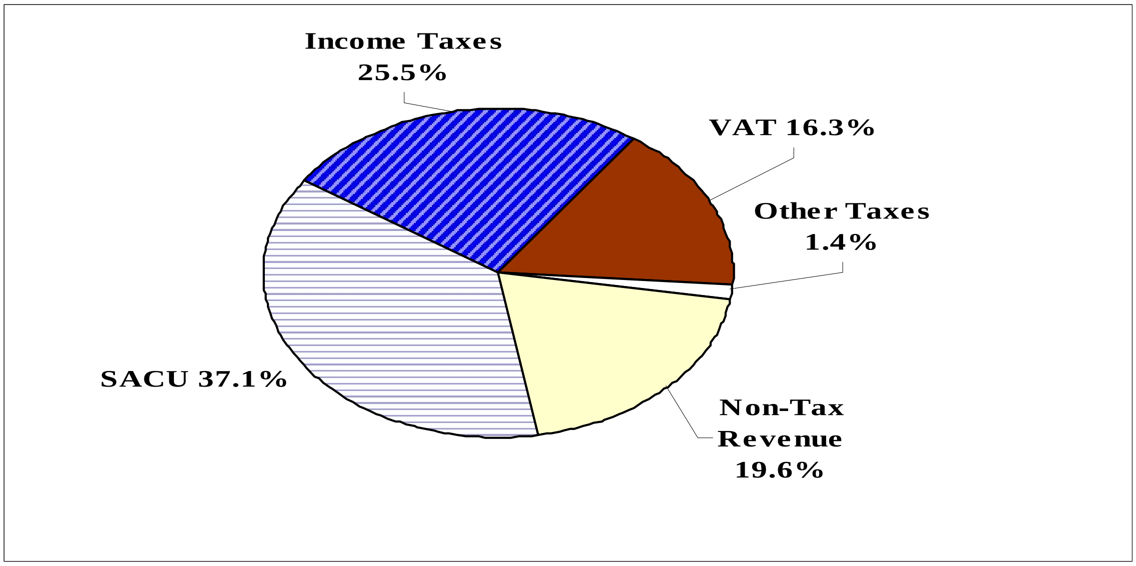
Revenue performance is estimated to have deteriorated significantly during the 2010/11 fiscal year. Total revenue, including grants, is estimated to have declined by 7.0 per cent. This was attributable to a 46.6 per cent slump in SACU revenue. The effect of the fall in SACU receipts was slightly moderated by an increase in both income and value added taxes (VAT) which rose by 5.7 per cent and 16.6 percent, respectively. As depicted in figure 8 below, the share of SACU receipts in overall revenue fell from 60.1 per cent realised in 2009/10 to 37.1 per cent in 2010/11. Nevertheless, SACU continued to be the main source of revenue to GOL, followed by income taxes at 25.5 per cent and non-tax revenue at 19.6 per cent of total revenue.

Income tax receipts were estimated to have grown by 5.6 per cent, mainly as a result of a 40.4 per cent upsurge in individual income tax which more than offset the 20.9 per cent plunge in company tax and 36.7 per cent fall in other income taxes. VAT collections increased by 16.6 per cent, following a 2.3 per cent decline observed in 2009/2010. The increase was driven by an increase in consumer demand.

Non-tax revenue increased twofold in the review period. The increase emanated primarily from a rise in property income which includes dividends from operations of organizations with public ownership like the Central Bank of Lesotho, royalties from Lesotho Highlands Water Project and diamond mines, rand compensation paid by Reserve Bank of South Africa in respect of rand in circulation in Lesotho and other departmental revenues. Water royalties increased by 26.4 per cent compared with 3.1 per cent recorded in the previous period.

Capital grants doubled during the period under review due to large disbursements targeted at financing infrastructure projects including construction of several urban and rural roads.

Figure 8: Sources of Government Revenue



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

3.5.2.2 Expenditure

Total government expenditure is estimated to have risen by 10.6 per cent during the fiscal year 2010/11. This was attributable to an increase in recurrent expenditure by 22.7 percent. Capital spending declined by 18.0 per cent.

Recurrent expenditure constitutes a significant portion of government spending at 78.0 per cent. The growth in recurrent spending was largely influenced by purchases of goods and services which grew by 31.5 per cent, compared with an increase of 11.5 per cent observed in 2009/2010 fiscal year. These expenses reflected, among others, amounts payable to government employees, contractors, and self employed outworkers for services rendered to the Government. Personnel emoluments rose by 17.4 per cent as a result of increase in government employment and the 3.5 percent salary adjustment awarded to civil servants during the fiscal year. Total interest payments are estimated to have dropped by 34.5 per cent during the period under review due to a decline in the maloti value of the public debt stock.

The share of capital expenditure stood at 22.0 per cent of overall expenditure during the review period, in contrast to 29.6 per cent observed in the 2009/10 fiscal year. This reflected, amongst others, a reduction in disbursements from Millennium Challenge Account Lesotho (MCA-L).

Table 6

SUMMARY OF BUDGETARY OPERATIONS

(Million Maloti)

	2006/07	2007/08	2008/09	Revised 2009/10	Projections 2010/11
Total Receipts	6431.9	7512.3	8616.8	9089.0	8455.3
Revenue	6339.5	7264.0	8427.7	8185.1	7079.0
Customs	3943.2	4097.7	4901.0	4918.0	2627.9
Grants	92.4	248.3	189.1	753.9	1376.3
Total Expenditure	5137.9	6484.1	8004.6	8546.7	9452.3
Recurrent expenditure	4363.2	4973.8	5975.4	6014.2	7376.5
Purchases of Goods & Services	2777.6	3002.3	3996.5	4456.1	5860.27
Capital Expenditure & net Lending	774.7	1510.3	2029.2	2532.5	2075.8
Surplus/Deficit Before grants	1201.7	780.0	423.0	-361.6	-2373.20
Surplus/Deficit after grants	1294.1	1028.3	612.1	542.3	-996.9
Government Savings	2068.8	2538.6	2641.3	3074.8	1078.8
Financing					
Foreign, net	-28.8	-4.5	57.6	2.7	97.0
Domestic	-1265.3	-1023.8	-669.7	-545.0	899.94
Bank	-1248.0	-998.5	-648.3	-605.4	716.74
Non-Bank	-17.2	-25.3	-21.4	60.4	183.2
In per cent of GDP (unless indicated otherwise)					
Revenue (excluding Grants)	60.8	60.0	62.7	57.0	45.2
Customs (in % of revenue)	62.2	56.4	58.2	59.0	37.1
Grants	0.9	2.1	1.4	5.3	8.8
Total Expenditure	49.3	53.6	59.5	59.1	60.3
Surplus/Deficit Before grants	11.5	6.4	3.2	-2.52	-15.1
Surplus/Deficit after grants	12.4	8.5	4.6	3.78	-6.4
Government Savings	19.8	21.0	19.6	21.4	-1.9
Memorandum item:					
GDP in current prices	10429.5	12101.9	13443.5	14358.1	15668.5

Source : MoFDP and CBL Projections

3.5.3 The overall budget balance and financing

The budget outturn is projected to result in a deficit equivalent to 6.4 per cent of GDP during the period under review. The deficit would be financed primarily from drawdown of government deposits with the banking system and the issuance of treasury bonds. It is important to mention that the deficit would be financed from both foreign and domestic sources, at 9.7 per cent and 90.3 percent of total financing, respectively.

3.5.4 Recurrent Expenditure by Functions of Government

Community and social services accounted for 46.0 percent of recurrent expenditure during the review period. Education and health constituted 58.6 per cent and 29.9 per cent of expenditure on community and social services, respectively. Expenditure on education was directed to building of schools, bursaries and subventions to institutions of higher learning. This share reflected Government's commitment to provision of quality education from primary through tertiary level. Health was the second highest in spending on social services. A large proportion of expenditure was on the improvement and refurbishment of clinics.

General government services continued to be the second largest spending category at 35.3 per cent of total recurrent expenditure. Out of the total allocation to general government services, 42.4 per cent was spent on general public service, 36.3 per cent financed public order and safety, while 21.3 per cent funded defense operations.

Expenditure on economic services stood at 9.8 per cent of recurrent spending. Mining and industry constituted the largest share of this category at 37.0 percent, followed by agriculture at 36.6 percent.

The remaining 8.9 per cent of recurrent spending was unclassified expenditure, which comprised, amongst others, other transfers and public debt.

BOX 3: Lesotho under the Extended Credit Facility (ECF)

Lesotho entered into a three-year arrangement with the IMF under the ECF. The ECF is one of the concessional lending facilities through which the IMF provides loans to low-income countries to tackle balance of payments (BOP) problems, stabilize economies and restore sustainable economic growth. An amount equivalent to Special Drawing Rights (SDR) 41.88 million, to be disbursed over a period of three years would assist Lesotho to tackle the challenges that emanated from the global economic crisis.

The global economic crisis had debilitating effects on Lesotho. The low global demand resulted in a decline in Lesotho's exports of textiles and diamonds and employment by the domestic manufacturing sector. The number of Basotho migrant mineworkers in South Africa also fell, resulting in a decline in remittances. In addition, imports into the Southern African Customs Union (SACU) plummeted, leading to a sharp reduction in SACU revenues. The consequences of all these have been slow economic growth and a significant deterioration in the fiscal and external balances.

Financial assistance by the IMF under the ECF is intended to support implementation of the medium-term macroeconomic program, which outlines macroeconomic policies, structural and quantitative reforms that Government needs to undertake to restore fiscal and external sustainability, attain sustainable and broad-based growth for poverty reduction and strengthen the financial sector. This program is in line with Lesotho's Interim National Development Framework. Lesotho has committed to restore macro-economic stability while, at the same time, ensuring that the impact of fiscal consolidation, on the poor and vulnerable Basotho in the face of a protracted decline in revenues is, minimized.

The Government has set itself objectives and policy targets, to be pursued over the medium-term, in support of the broad objectives of the program. To restore fiscal sustainability, total government expenditure will be reduced by cutting non-priority expenditures while protecting spending on critical social programs. This will create fiscal space to increase development spending, particularly spending on capital projects. Recurrent expenditure would be reduced by containing the wage bill through restricting new recruitment to high priority areas such as health and education, freezing the number of existing positions and reducing the size of the public service, and eliminating posts that have remained vacant for more than 12 months. In addition, expenditures on goods and services would be reduced by rationalizing diplomatic missions, reducing international travel and cutting spending on goods and services.

Implementation of macroeconomic and structural reforms that are aimed at increasing competitiveness, improving the business climate and achieving diversification of products and markets lays the basis for broad based economic growth and external sustainability. These reforms will make it easy to start, operate and expand businesses, thus enabling private sector activities to support growth. The reforms, which are supported by development partners, mainly the Millennium Challenge Corporation (MCC), include modernizing civil legal procedures to expedite resolution of commercial disputes; undertaking land reform to facilitate use of land as an economic asset; introducing national identification cards; establishing a credit reference bureau; developing an automated payments and settlement system; and reforming the Postbank to expand access to financial services in the rural areas. In addition, effective implementation of the World Bank's Private Sector Competitiveness Program should help reduce the cost of doing business and boost Lesotho's regional and global competitiveness.

Implementation of the program is monitored through a set of semi annual quantitative performance criteria and structural benchmarks. The following structural benchmarks were set to be achieved on the specified dates. Firstly, an audit of user access rights to the Integrated Financial Management Information System (IFMIS) was supposed to be completed and users assigned access rights on a "need-to-use" basis by end-June 2010. The following were to be achieved by end-September 2010: preparation of monthly monitoring reports assessing the impact of modification to the IFMIS to prevent over-commitment; submission to Cabinet of a comprehensive review of all on-going capital projects, assessing their desirability and making recommendations on projects to be retained or eliminated; submission of the Companies Bill to Parliament; Submission of the amended Financial Institutions Act to Parliament. Finally, the issuance of domestic bonds was conducted by end-December 2010. A few of these were not met. These include an audit of user access rights to the IFMIS, which was completed in July 2010; the submission of the review of capital projects for which the new date was changed to end-January 2011; and submission of the amended Financial Institutions Act to Parliament, which is set to be done by end-March 2011.

Table 7

Quantitative Benchmarks and Performance Criteria June – September 2010

	June Benchmarks	**September Perf. Criteria**	**Level as at end-September**
	(In millions of Maloti)		
Ceiling on domestic financing requirements	-217.50	311.50	620.00
Ceiling on the net domestic assets	1170.00	1884.00	1408.30
	(In millions of US Dollars)		
Floor on the stock of NIR	992.00	956.00	933.00
Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector			
Maturity of less than one year	0.00	0.00	0.00
Maturity of one year or more	182.00	182.00	182.00
Floor on the central government social expenditures	170.00	170.00	253.00
Ceiling on gross cumulative payments of domestic arrears	200.00	200.00	199.00

The specific quantitative targets for the 2010/11 fiscal year were mainly aimed at addressing and ensuring sustainability of the inevitable large fiscal deficits, estimated at 20.0 per cent of GDP (excluding outlays for the Metolong dam) in 2010/11, emanating from the decline in SACU revenue. Table 7 above shows such quantitative performance criteria, benchmarks and indicative targets for June 2010 to September 2010. Lesotho has displayed good performance on these targets. All performance criteria through end-September 2010 were met except for the floor on the stock of NIR, which was missed by a small margin.

3.6 Public Debt

3.6.1 Overview

Outstanding public debt comprises external and domestic debt. It increased by 5.1 per cent during 2010 following a 19.7 per cent drop recorded in the previous year. The increase was attributable to the issuance of treasury bonds during the quarter ending December 2010. External debt continued to constitute a greater proportion of overall debt. It constituted 85.9 per cent of total public debt compared with a share of 14.1 per cent of domestic debt.

As a ratio of GDP, public debt stood at 36.8 per cent, in contrast to 38.3 per cent recorded in the previous year. As a proportion of GDP, external debt constituted 31.6 per cent of GDP, while domestic debt amounted to 5.2 per cent of GDP. Domestic debt was mainly issued for monetary and fiscal policy purposes. The ratio of public debt to GDP remained below the 60 per cent sustainability threshold[15]. Lesotho's public debt continues to be sustainable due to the high concessionality and long term nature of the bulk of external debt.

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

Table 8 PUBLIC DEBT INDICATORS FOR END OF YEAR (Percentages)					
	2006	**2007**	**2008**	**2009**	**2010**
Total debt as % of GDP	51.2	45.5	54.0	38.3	36.8
External debt as % of GDP	44.6	39.7	49.0	34.9	31.6
Domestic debt as % of GDP	6.6	5.7	5.0	3.5	5.2
External debt as a % of total	87.2	87.4	90.7	91.0	85.9
Domestic debt as a % of total	12.8	12.6	9.3	9.0	14.1
Concessional as % of External debt	84.4	93.6	97.0	94.6	93.7
Debt service ratio(1)	4.2	6.8	3.3	0.7	0.4
Debt service ratio(2)	7.0	11.5	5.3	1.1	0.5

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 public debt continued to comprise, loans from bilateral and multilateral financial institutions as well as supplier's credit. The primary source of external debt was multilateral institutions which constituted 89.7 per cent of external debt, followed by supplier's credit at 4.6 per cent, while loans from bilateral creditors contributed 4.0 per cent of foreign debt. The maloti value of external debt decreased by 3.7 per cent during the review period, mainly reflecting the appreciation of the loti against major world currencies in which the bulk of foreign debt is denominated. Loans from bilateral creditors fell by 10.8 per cent while loans from multilateral creditors fell by 4.2. These declines were mainly offset by an increase of 16.2 per cent from supplier's credit.

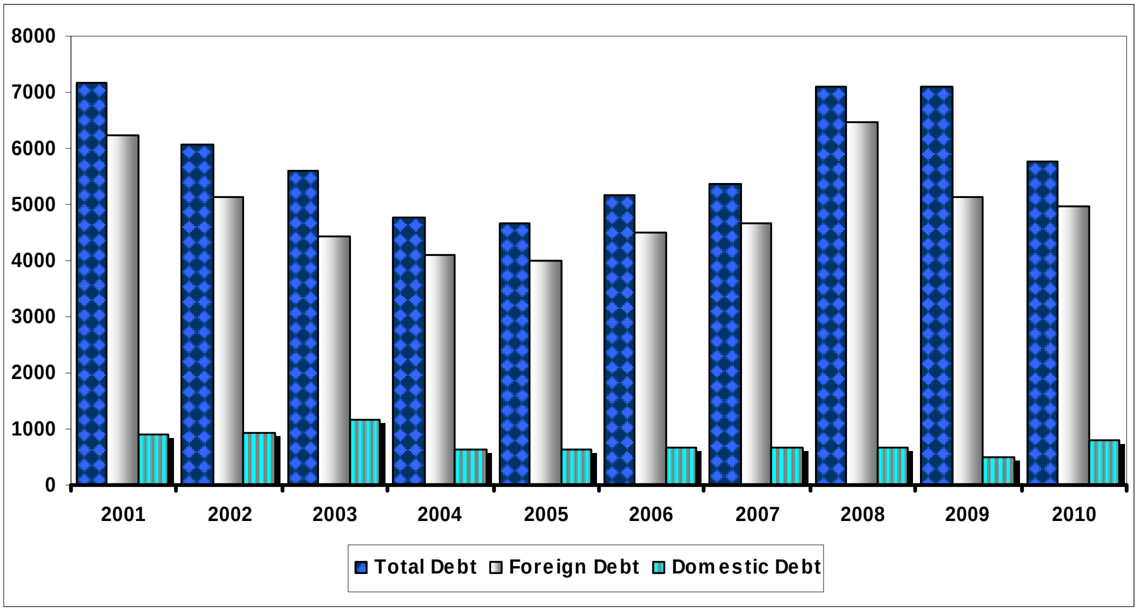
Concessional debt as a proportion of external debt, dropped to 93.7 per cent at the end of 2010 from 94.6 per cent a year before. External debt indicators suggest that Lesotho's external debt remained within the sustainability guidelines. The external debt to GDP ratio improved to 31.6 per cent compared with 34.9 per cent in 2009. The ratio of debt service to exports of goods and services including factor income, declined to 0.4 per cent from 0.7 per cent observed in the previous year. When factor income is excluded, debt service ratio was recorded at 0.5 per cent in contrast to the 1.1 per cent observed in 2009.

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 22.3 per cent in the period under review, and this was largely a result of the introduction and issuance of 3-year and 5-year treasury bonds in the third quarter of 2010. Treasury bonds were introduced as a step towards the development of the capital market in Lesotho and to provide government with an alternative source of borrowing, should the need to cover a financing gap arise.

Short-term debt, constituted 76.9 per cent of total domestic debt while long-term debt amounted to 23.1 per cent. At 76.9 per cent, the banking sector continued to dominate the holding of domestic debt.

Figure 9: Government Outstanding Debt
(Million Maloti)



PART IV REPORT OF THE BANK'S OPERATIONS

4.1 Supervision Department

4.1.1 Supervision of Banks

The function of the Financial Institutions Supervision Division is to enhance and maintain a financially sound and healthy banking sector that stimulates economic activity to the betterment of the welfare of the public. During the review period, the Division continued to perform this function through on–site examinations and off-site surveillance. Banks were generally in compliance with the statutory and regulatory requirements. In addition, the banks improved their coverage by opening new branches and ATMs throughout the country.

In 2010, the Division continued with its planned activities designed to implement risk-based supervision. The risk management framework was completed. With the assistance of MEFMI, a pilot examination of one of the largest banks was conducted towards the end of the year.

A local bank that was initially licensed to accept deposits only, but given a fully-fledged banking licence in May 2009, started to extend credit in February 2010 on a pilot basis, at its main branch. The bank has not yet ventured into other areas of banking.

Under the credit bureau project, a lot of ground work has been achieved towards implementation of the project. Following the engagement of a consultant to draft the laws and regulations that will govern the credit bureau activities, two draft bills, namely, the Credit Reporting Bill and the Lesotho Data Protection were submitted to the Central Bank. At the beginning of 2010, stakeholder workshops were held to solicit inputs from them. The draft bills are currently being drafted in the Office of Parliamentary Counsel.

Another milestone achieved was the engagement of a consultant who will train the Supervision Staff of the Central Bank on the supervision of a credit bureau. A contract was signed at the beginning of December 2010 but the actual work will commence in 2011.The training was found necessary because the concept of a credit bureau is new to Lesotho.

The Division continued to undertake public outreach activities in an effort to inform and educate the public about the establishment of the credit bureau, its benefits to them, the lenders and the economy at large. Training workshops were held throughout the country where the business community was trained. Press conferences were also held to educate the media because it is a good platform for spreading the message and reaching a large audience. Progress on the project was continuously monitored throughout the year by Millennium Challenge Account-Lesotho.

4.1.2 Supervision of Non-Bank Financial Institutions

The Non-Bank financial sector comprises all financial institutions excluding banks, insurance companies and pension funds. The supervised entities within this industry include Moneylenders, Asset Managers in the form of Collective Investment Schemes (CIs), Ancillary Financial Institutions (AFIs) through Money Transfer services and Foreign Exchange Bureaux, Microfinance sector, which is still at infancy stage. Moneylenders, in comparison with the two CIs, are numerous, about 69 in all (large, medium and small). However, in monetary terms, Collective Investment Schemes hold the largest proportion of assets, averaging M735 million compared to M 60 million for Moneylenders.

During the review period, the sector has experienced serious problems especially on the money lending business due to a weak regulatory framework. FIRST Initiative Consultants were commissioned to develop policy and regulatory framework for the sector. However, there has not been much progress in this regard. In respect of NBFI, policy has been finalized, awaiting submission to Cabinet for adoption. Moreover, development of its legal framework was started in the review period and will continue in 2011. The absence of adequate legal framework may have contributed to a situation where Money Lenders were sued by clients for illegal interest charges. The court case was adjudicated in favour of the clients, resulting in a decline in the overall performance of Moneylenders' loan portfolios. A downward trend during the period was observed, portfolios shrunk from an estimated figure of M190 m in September 2009 to M103 m as at December 2010. The year under review also saw a reduction in the number of money lenders who either closed shop or suspended loan disbursements only concentrating on collections. This reduction was, however, commensurate with the small new entrants in the business.

Licensing and supervision of CIs under Regulation 2001 and AFIs continued during the period. The number of CIs remained constant at two while a new Foreign exchange Bureau (FB) and Money Transfer Service (MTS) were licensed under AFIs regulation 2003, increasing the number of registered FBs to 2. Under same, licenses for a Money Transfer Service Provider and a Forex Bureau were renewed.

Even though a decline in the number of Moneylenders has been reported above, there are 27 new small moneylenders who were licensed during the year under review, while 42 have been renewed. There were 14 non-renewals and revocations.

Challenges facing the sector during this period included:

- Continued lack of requisite legislation to regulate the sector
- The final appeal court judgement against Moneylenders favouring borrowers which destabilised the Money lending business therefore
- reducing access to financial services
- Continued lack of requisite skills by the regulatory personnel while training is awaited

Developments are however reported in the area of gazetting of a new regulation meant to open a window for public company lenders running concurrently with the Money Lenders Act 1993 as amended. A Financial Institutions (Credit Only Institutions) Regulation 2010 is now in place with different conditions. Contrary to the contents of the above Act under this Regulation, interest rates are left to the market to promote competition which would deepen the intermediation base.

In an effort to facilitate development of the financial sector in Lesotho, Central Bank of Lesotho, through the Non-Banks Division, embarked on a countrywide study on demand and supply of financial services. The study will assist in identifying obstacles and improving policies for a sound and responsive regulatory and supervisory framework. Finmark Trust, an NGO supported by DFID with vast experience in undertaking surveys regionally, has therefore been commissioned by the Bank to conduct a Finscope study which started in November 2010.

4.1.3 Supervision of the Insurance Industry

The central Bank of Lesotho, through its Supervision Department, continued to interact with the industry by holding quarterly meetings. In these meetings the industry and the Regulator discuss issues pertinent to the operation and regulation of the industry. During the period under review, the industry comprised of 6 insurance companies, of which four were life, one (1) non-life and one (1) composite. The insurance brokers and agents were the only insurance intermediaries in 2010. The total number of intermediaries was 232 of which 13 were insurance brokers and 219 were agents.

The insurance companies continued to submit returns on a quarterly basis. The analysis reports that were prepared from the returns indicated that the insurance companies complied with the insurance Act and its implementing Regulations. The on-site inspections of the insurance companies were carried out during the period under review. The main objective was to determine the financial soundness of the insurance companies with respect to the risk exposures. The inspections revealed that the insurance companies were exposed to various risks which they were able to manage. There was however, an observation that the insurers needed some risk management guidelines which will assist them to prepare comprehensive risk management policies and procedures.

4.1.4 Policy and Exchange Control

4.1.4.1 Introduction

Lesotho acceded to the IMF Article VIII in 1997. As a result, 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 abolishment 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 Exchange Control Division before the Authorised Dealers can effect the transactions. Other transactions have to be approved by the Central Bank of Lesotho (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 effort 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.

4.1.4.2 Applications to sell Foreign Currencies

During the year under review one hundred and sixty four (164) applications were submitted by Authorised Dealers to Exchange Control for approval. This number is higher than the number approved in 2009. The value of the applications approved stand at M 463.9 million compared to M353.4 million in 2009. The payments were in respect of professional services, management fees, dividends, royalties, insurance premiums and offshore 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.

4.1.4.3 Capital Account Liberalisation

There was a marginal increase in Foreign Currency Accounts (FCAs) held by residents from seven in 2009 to eight in 2010 The small number reflects lack of interest on the part of individuals for this type of service because it brings little reward by way of interest earned. However, there was a 50 per cent increase in amounts processed through the FCA from M2.2 million in 2009 to M4.5 million in 2010. The twofold increase was largely due to increase of FCA's held by staff of foreign diplomatic missions in Lesotho.

On the contrary, interest in accounts held by Corporate and International Agencies, namely Customer Foreign Currency Accounts (CFCs) remained high. There were forty three (43) accounts in 2010 compared to forty four (44) in 2009. During the year under review, an approximate amount of M1, 187,717,133.00 was processed through CFC accounts. This was still subject to the policy that an amount that has been held for 180 days in the CFC account would be converted to maloti.

4.1.4.4 Export Declarations

In spite of the global financial and economic crises, the export sector, mainly mining and manufacturing, performed reasonably well under the circumstances. The authorised dealers attested exports worth USD450.5 million in 2010, compared to USD422.9 million in 2009. This was a moderate increase over the figure for 2009 which signalled a change for the better in overseas markets where most of the products are sold.

4.1.4.5 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. The Bank received three suspicious transactions reports (STRs) during 2010 compared to two in 2009 from two commercial banks in the country. However, on further investigations by the Police, two transactions were found to be genuine. The other case constituted a criminal offence whereby the suspect was prosecuted and convicted by a court of law.

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 Guidelines.

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

Following the enactment of the Money Laundering and Proceeds of Crime Act of 2008, the Financial Intelligence Unit (FIU) was established. This new entity was housed at Central Bank of Lesotho during the year 2010. The interim structure is composed of the FIU Director and three other members to kick start the process of the setting up a functional FIU. The unit is one of the most crucial institutions as it shall receive, request, analyse and disseminate to the investigatory and supervisory authorities financial information at its disposal where necessary.

During the year 2010, the AML/CFT National Strategy was approved. The strategy's main objective is to establish an effective anti-money laundering program in order to:

- Create a comprehensive and effective legislation
- Built effective enforcement structure and resources
- Put in place regulations for accountable institutions
- Enhance awareness and appreciation of AML/CFT system
- Assess money laundering and terrorist financing risks and vulnerabilities and make appropriate recommendations to the authorities.

National Cooperation

The National Task Team on Anti-Money Laundering 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.

AML/CFT legislation

The Money Laundering and Proceeds of Crime Act, 2008 criminalises money laundering and financing of terrorism, the law provides for confiscation of proceeds of all serious crimes. The Act establishes two institutions being the Anti-Money Laundering Authority and the Financial Intelligence Unit.

The Directorate on Corruption and Economic Offences (DCEO) is the Anti-Money laundering Authority in terms of Section 11 of the Money Laundering Act. It is mandated to administer the Anti-Money Laundering issues.

Central Bank AML/CFT Initiatives

The Central Bank has 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 challenge 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.

4.1.4.7 *Regional Meetings*

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

4.2 Currency Management

The Central Bank of Lesotho, through Currency Operations Division, continued its obligation in accordance with the Act to "***issue, manage and redeem the currency of Lesotho"*** by way of handling bulk deposits and withdrawals, sorting of Maloti notes and coins and systematic issuance of new and re-issuable currency.

In an effort to combat the high rate of counterfeit incidences, in the past few years, the Bank commenced a process of re-designing a new set of currency banknotes with improved security features in 2009. The new set was launched in November 2010 during the celebration of 30 years of the existence of the Bank. The roll out and issuance of the new currency was successfully done in the first quarter of 2011.

The table below indicates values of maloti banknotes and coins in circulation for the past five (5) years.

Table 9

MALOTI CURRENCY IN CIRCULATION
(Million Maloti: End of Period)

	2006	**2007**	**2008**	**2009**	**2010**
Maloti notes issued	366.2	390.1	532.4	583.8	621.1
Maloti coins issued	11.8	13.01	14.1	14.8	17.1
TOTAL	378.0	403.1	546.5	598.6	638.2

4.3 Operations Department

4.3.1 National Payment Systems

Automated Clearing House (ACH) Project Progress Report

Introduction

The Central Bank of Lesotho in collaboration with the commercial banks and other relevant stakeholders embarked on the National Payment Systems modernization process in 1999. The project is spearheaded and implemented by the National Payment systems Division of CBL. Thus far, the process led to the implementation of the Real Time Gross Settlement (RTGS) system (Lesotho Wire), which is a wholesale payment system, processing large value and time critical payments, e.g. (amounts equal and above M100,000).

In accordance with the NPS Blue Print, following the RTGS, the Automated Clearing House (ACH) was the next payment system to be implemented. ACH processes retail payments (payments of small values but large volumes). The ACH implementation project is one of the seven projects funded under the Millennium Challenge Corporation (MCC). The ACH project has been identified as one of the strategies to modernize the payment system under the broader initiative of the Lesotho National Payments Systems (LNPS) Modernization Project, and the Bank is working on the implementation of this phase of the project.

4.4 Financial Markets Department

The Department is responsible for the management of the country's reserves in accordance with the Reserves Management Policy. It is also responsible for management and development of the domestic money and capital markets.

4.4.1 Reserves Management

For the year under review, the Department continued to manage the country's reserves against the prescribed benchmarks. The overall performance of the portfolio tracked closely those of selected benchmarks in respective markets as per the Strategic Asset Allocation (SAA). The performance was fair given the hostile economic environment in global markets.

Through continuous engagement of the World Bank under the Reserves Advisory Management Program (RAMP), acquired new skills helped in managing the reserves prudently.

The Department spearheaded the introduction of Government Bonds which were launched in October, 2010. This saw the Bank issue, on behalf of the Government, the three (LS 303) and the five year bonds with coupons of 8.25 and 9 percent, respectively.

Since the development of the financial markets was phased, the focus of the Department for 2011 and beyond will be to level playing fields for the introduction of the Stock Exchange and to continue educating prospective market participants. However, the process is curtailed by challenges such as the development of the secondary market for both bills and bonds.

4.4.2 Securities Trading

The Bank continued to auction Treasury bills in four tenors of 91,182, 273 and 364 days. These were issued bi-weekly throughout the year. In October 2010, the Treasury bonds were successfully issued as evidenced by oversubscriptions observed in both the maiden and subsequent auctions. The bond issues will be reopened in February 2011 as a last offering in the series LS303 and LS305. The Bank will continue to auction Treasury bonds every other month in line with the Government's program.

Another highlight for the year was the introduction of the Central Securities Depository (CSD), which automated the bidding, trading and settlement processes for both bills and bonds. It also serves as a depository for government and corporate securities.

4.5 Research Department

4.5.1 Research and Publications

The primary mandate of the Central Bank of Lesotho is to achieve and maintain price stability. To achieve this objective, the Bank disseminates information on Lesotho's economic environment and its relationship with the international community through its publications such as: Monthly Economic Reviews, Quarterly Reviews and Annual Reports. The following research papers were produced by the department:

- Determinants of Demand for Holding Net International Reserves
- Modeling the Yield Curve
- Appropriate Measure of the Competitiveness of the Treasury bill Market

- Government Intervention In The Financial Sector: Is Bailout A Panacea?
- The Impact of Anti-Money Laundering Legislation on Investment: An Application of an Overlapping Generations (OLG) Model

The Monetary Policy Committee (MPC) met on a quarterly basis to decide on the appropriate level of foreign reserves that the Bank should hold in order to defend the 1-1 peg between the loti and the rand. Moreover, the Bank continued to conduct annual Private Capital Flow's (PCF) survey in order to improve the Balance of Payments and International Investment Position.

4.6 Administration Department

4.6.1 Human Resources Management

Human Resources Management

The Human Resources Division has 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 thought the year.

(a) Recruitment

The Recruitment policy has been implemented as approved by the Board of Directors.

A total of fifteen new members of staff joined the services of the Bank in 2010. All positions from the level of Section Heads and above required candidates who have passed the oral interview to under go psychometric tests. Vacant positions came as a result of promotions / lateral transfers, newly created positions, retirements and resignation. A total of fifteen members of staff were promoted in accordance with the Bank Staff Rules and Regulations.

(b) Separations

Four members of staff separated with the Bank in a form of retirement. They all have served the Bank for a period of more than 15 years. While the other three members of staff separated with the Bank at the end of their five year term contracts.

Three professionals and three middle management staff resigned from the services of the Bank. While two members of staff lost their lives.

(d) Social Activities

The Bank continued to participate in the SADC inter-central-bank activities during 2010. In-house sporting teams continued to challenge and to be challenged by other teams from various organizations including local commercial banks on friendly competitions.

Three schools, namely, ‘Matikoe High School, Lithabaneng High School, and St. Peter Paul High School were assisted with used computer as contribution to their Computer Literacy Programmes.

Financial assistance was also distributed among the following beneficiaries:

- Taele Primary School
- Cenez Primary School
- ‘Mamoeketsi Community Primary School
- Father Denis O’Callagan Fund for the Poor and the Sick
- ‘Mamohau Support Group
- Phomolong Support Group
- Seboche Mission Hospital
- Samaria Parish

(e) Safety, Health and Environment (SHE)

SHE section continued to address the safety, health and environmental issues in the Bank throughout the year. The main focus was on housekeeping and reporting of injury on duty incidents/accidents. Our incidents/accidents statistics reflects zero fatalities and one case of disabling injury on duty. The Bank introduced the new life cover for both staff on contract and permanent employment called Group Life Assurance (GLA), and updated its HIV/AIDS policy to an Employee Wellness programme.