Economic Review

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GOVERNMENT OF LESOTHO PLANS TO INTRODUCE TREASURY BONDS: IMPLICATIONS ON ECONOMIC GROWTH

In a move towards capital market development, treasury bonds are going to be issued for the first time in Lesotho in October 2010……………

Introduction

The Government of Lesotho is continuing in its endeavour to develop Lesotho's capital market through development of the Government securities market. It is anticipated that the first issue of Treasury bonds will be in October 2010. The introduction of this instrument will serve as a catalyst for broader development of the capital market in Lesotho and the next step will be the development of the equity market, which involves the establishment of a stock exchange, to be achieved in two years time.

Treasury bills are short-term debt instruments (backed by the government) with maturity of at most one year, whereas, a treasury bond is a long term marketable debt instrument issued by the government to domestic and foreign investors (individuals and businesses) at a certain market determined interest rate. The inception of the Treasury bond market, amongst others, will raise funds for infrastructure development, create alternative avenues for savings and investment, stem the capital flight to SA and close the financing gap of the Government.

Evolution of the Money Market in Lesotho

In 1988, the Government of Lesotho made a policy to develop money markets in Lesotho with the following objectives: to improve financial intermediation by expanding and creating alternative investment and borrowing instruments; to broaden participation in short term financial instruments; and to create a vehicle through which monetary policy decisions of the Central Bank could be effected. However, the decisive steps to implement this decision were only taken in the early 1990s.

In 1992, the Central Bank of Lesotho introduced an English Auction System for issuance of treasury bills with the nominal value of M154.1 million. This value was broken down into three series of 91-treasury bills. Of the objectives mentioned above, the second objective is the only one that was achieved under this system. Following the non-accomplishment of other objectives under this system, the Central Bank then restructured the securities market in such a manner that the unrealized and other additional objectives are addressed.

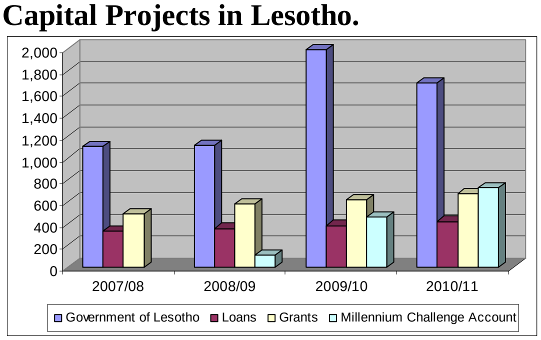
In 1999, the Government issued five and ten year special purpose treasury bonds which were redeemed in 2004 and 2009 respectively. These bonds were not issued in a formal treasury bond market but were issued primarily to facilitate liquidation of state owned banks in Lesotho: Lesotho bank as well as Lesotho Agricultural Development Bank.

In September 2001, two types of instruments, 91-day and 182-day Treasury bills were issued under the Dutch Auction System. In September 2008, the 273-days and 365-days Treasury bills were launched for the first time in Lesotho. These longer term instruments were introduced to encourage savings and to suite liabilities of investors with longer term maturity profiles. Despite this vibrancy in the primary market, there is no trading in the secondary market, particularly due to tendency of funds to flow to more sophisticated financial markets in SA as a result of limited avenues and alternatives for savings and investments opportunities that are long-term in nature.

Justification for Introduction of Treasury Bonds

The Government of Lesotho, through domestically generated revenue, has been the main financier of capital projects in Lesotho. To supplement that, much reliance has been on donor funding, external borrowing and lately SACU revenue. Figure 1 below, presents a financing structure of capital projects in Lesotho with Millennium Challenge Compact (MCC) as a separate financing entity following resumption of its operations in 2008/09 financial year.

Figure 1: Sources of Financing for Capital Projects in Lesotho.

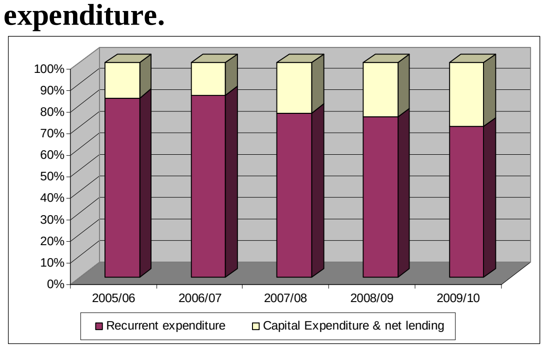


Source: CBL

Donor funding has its problems as it depends on how much donors are willing and able to donate, which may not be sufficient for the purpose for which it is sought. MCC on the other hand will only support development projects for only five years. SACU revenue has declined drastically in the current fiscal year and has become unsustainable as a result of the global economic downturn and the general movement towards free trade areas, regionally and internationally. This led to a fiscal deficit of about 10 per cent of GDP being budgeted in 2009/10. All these call for alternative sources of revenue for raising capital for financing infrastructure development projects, Treasury bonds are one such alternative source of revenue.

Figure 2 shows that the bulk of the budget allocations is directed towards recurrent expenditure and less than one out of three is allocated to capital projects. In 2008/09, the share of capital expenditure to total expenditure including net lending was recorded at 26.5 per cent and 74.5 per cent was allocated to the recurrent expenditure. This is a small share by all standards and shows that the share of capital expenditures needs to increase in order to drive the development agenda in Lesotho.

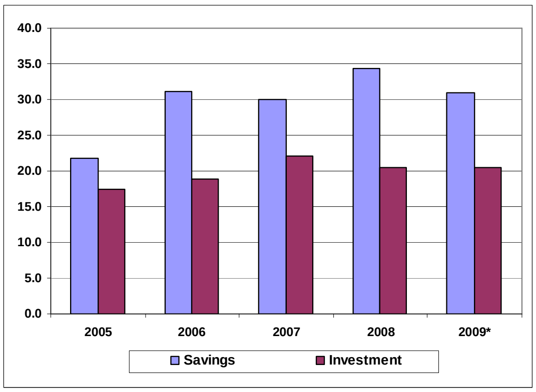
Figure 2: Shares of Recurrent and Capital Expenditures on total expenditure.



Source: CBL

Savings as a share of GNI in 2009 is projected at 31.0 per cent and much of it found its way into the SA capital markets rather than being turned into investment for Lesotho. Investment as a share of GNI remained low at 20.5 per cent in 2009. Government bonds will provide an alternative investment instruments that are long term for local investors and could reduce the flight of capital to South Africa where the capital market and financial sector are more developed and offer an array of more sophisticated investment opportunities.

Figure 3: Share of Savings and Investment



Source: Bureau of Statistics
*CBL Projections

It is against this background that the Government intends to develop Treasury bond market in Lesotho. The main objective of introducing Government bonds is to develop a bond market that will provide an alternative domestic source of funds for the Government of Lesotho. These funds can be used for infrastructure development in the country. Prudent liquidity and sustainable economic development is another important objective for introduction of Government bonds. The development of the bond market will bring about efficiency in financial intermediation which will boost investment and sustainable economic growth and development.

The role of Capital Markets in Economic Development

Efficient and effective capital markets provide an important alternative source of long-term finance for productive investments. Finance for productive investments is acquired through equity, long dated bonds and asset backed securities. Finance acquired through these means have strong socio-economic benefits in the form of roads, water and sewer systems, housing, energy, telecommunications, public transport, etc. These benefits are essential for rapid industrialization and hence economic growth.

Amongst the projects that are earmarked for financing with funds raised through treasury bonds is improvement of roads, construction of Metolong Dam and extension of 'Muela hydropower station. These projects have potential to promote long term economic growth. Infrastructure can have a direct impact on growth by increasing aggregate demand during construction and maintenance phases. In addition, infrastructure is a factor of production, for example, electricity generation infrastructure is an input in almost all production processes for goods and services and water is a significant input in the production process of the wet industries in Lesotho. Infrastructure also lowers the cost of production and the role of transport infrastructure in this regard cannot be overemphasized.

Capital markets encourage broader ownership of productive assets by small savers to enable them benefit from economic growth and equitable distribution of wealth which is key in poverty reduction. They also provide avenues for investment opportunities that encourage a thrift culture critical in increasing domestic savings and investment ratios.

Capital markets enable contractual savings industry (pension and provident funds, insurance companies, medical aid schemes, collective investment schemes, etc) to mobilize long-term savings from small savers and channel them into long-term domestic investments. Currently, the majority of these funds and schemes are managed in South Africa. The typical example is the M600 million portfolio raised under the Government's defined contributory pension scheme which also followed the trend and fled to South Africa immediately. This pattern tends to break the link between savings and investment in Lesotho but rather enhances investment and development in South Africa.

Well functioning capital markets promote and encourage public-private sector partnerships. They also assist the Government to close resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project based capital. Again, they improve the efficiency of capital allocation through competitive pricing mechanism and they open broader gateway for global and foreign portfolio investors.

Developed capital markets increase access to financial resources, which could facilitate private sector growth. It presents the opportunity to existing firms to borrow and expand their operations and can encourage emergence of new ones. It also increases liquidity which, in turn, increases the willingness of firms to make permanent investments that are necessary for development. In addition, it could stimulate diversification of financial instruments, which could promote mobilization of domestic savings that can be used in various investment initiatives.

Operational and Institutional Requirements for the Treasury Bond Market

In order for the bond market to be a success, proper market infrastructure need to be in place, in particular, systems governing auctions, secondary market trading, clearing and settlement. In this regard, new automated systems that are safer, faster and easier to process transactions have been introduced by the Central Bank and shall all be interfaced to assure safety. Regulations under the 2001 Loans Act only dealt with Treasury bills and not Treasury bonds. However, these regulations were reviewed and new ones that include Treasury bonds were published in April 2009.

Institutionally, the Ministry of Finance and Development Planning, through the Department of Economic Policy and Debt Office shall work hand in hand with the Central Bank in forecasting the short falls between Government expenditures and revenue to determine the amount to be issued. Other supporting structures will include the Debt Management Technical Committee, the Capital Market Development Committee and the High Level Debt Policy and Financial Sector Development Committee. The latter shall be tasked with the responsibility of formulating and coordinating the national debt strategy and policy.

Treasury bonds will work more or less like Treasury bills. They will be sold at auction, whereby the total face value of bonds to be auctioned will be set and announced. The difference between the two is in the term until maturity whereby Treasury bills are issued for terms less than a year while bonds are invested for much longer, for example, 3 and 5 years in the case of Lesotho[1]. Another difference relates to the use of the instrument particularly in Lesotho's case. On one hand, Treasury bills are mainly used as monetary policy instruments for mopping up and/or injecting liquidity into the economy and hence controlling inflation. The funds accumulated from Treasury bills auctions are saved in a blocked account and not spend for any purpose. On the other hand, the funds that will be collected through the issuance of bonds will be used on Government's development projects.

With regard to the issue amount, M250.00 million is available for launching the market and operating until the end of the current fiscal year in March 31st 2011. The responsible authorities will decide on the number of auctions, amounts to be offered at each auction and the time between auctions

[1] The length until maturity differs from country to country and in the US 2, 3, 5 and 10 years are for what are called treasury notes while bonds are issued in terms of 30 years.

taking into consideration factors such as operation of the market on a continuous basis to ensure development of the market. Competitive and non competitive investors will participate in the market with the threshold for non-competitive investors ranging from M5,000.00 to M99,900.00 while competitive investors will require minimum face value bid of M100,000.00.

Central to the Treasury bond market, is the need for the augmentation of the yield curve, particularly, to price debt securities and to measure and understand all the market risks and expectations based on the prevailing macroeconomic conditions. The yield curve is a graphical representation of the relationship between yields of similar debt instruments and maturity – it is a representation of the relationship between market remuneration rates and the remaining maturity time of debt securities. The yield curve is therefore developed and shall be used as one of the benchmarks for the pricing of treasury bonds in Lesotho.

To ensure the smooth development of the market, bonds will be introduced gradually, starting with the short end and later on moving towards the longer end. In the beginning, bonds in maturities of 3 and 5 years will be issued, forming the short end of the market. Longer term maturity bonds, for example, 10 and 15 year bonds would be introduced at a later stage. To ensure proper information dissemination and broad participation, the Central Bank is also embarking on a campaign to sensitize and educate the nation about the issuance of bonds.

Conclusion

Development of the capital market is a commendable milestone towards economic development and the introduction of government bonds is therefore a big step in the right direction. If implemented well, it shall pave a smooth transition to the establishment of the corporate bonds and the formation of the equity market. Nonetheless the introduction of bonds will increase government domestic debt, therefore, it should be well managed to assure sustainability.

Theory argues that government debt is a burden for the next generations. This occurs in a case where the debt issued does not finance projects that yield social and economic returns for the next generations. Therefore, there is need for Government to prioritise development projects that yield the best economic and social returns for the future generations.

2. Road Infrastructure Development: Implications for the economy of Lesotho

Introduction

The Government of Lesotho (GoL) has prioritised construction and development of roads as a catalyst for economic growth and development in recent years. It is regarded as a springboard upon which other developments can be made. Roads are a very convenient vehicle upon which the transportation system depends. Inadequate and poor roads access increase high cost of transportation thereby limiting uses of local and international markets to the sales of necessary products and constrain access to social infrastructures such as education and health facilities. On the other hand, improvement of roads, especially rural ones where a large population lives seems to be a clear means by which large numbers of people might acquire the opportunity to participate in the market economy, pulling themselves out of poverty.

The role of road infrastructure on economic growth

Road infrastructure development is an important vehicle in the development process of any country given that it is a component of larger national development strategy. In theory, the relationship between road infrastructure and output (a standard measure of economic growth) is well articulated. It argues that investment in physical capital increases the marginal productivity of capital, thereby impacting positively on economic growth as measured by output growth. In addition, capital accumulation and/ or expansion furnish workers with better and time-saving equipment, leading to an increase in output per worker. As both output per worker and total output increase, the economy grows.

Nonetheless, physical investment does not by itself increase the level and the rate of economic growth but needs to be complemented by other economic inputs. It is also very important to note that the rate and level of capital development in a country are very essential elements for complementing road infrastructure's role in the economic development process of a country.

The state of road infrastructure in Lesotho

In Lesotho, road infrastructure has improved markedly since independence when gravel roads mostly dominated the country. At independence in 1966, there was only one paved road. In 2009, the road network comprised of 1350 kilometres of paved roads and 1021 kilometres of unpaved roads, *Lesotho Review 2010 Edition*. During the same period, the main road network improvement focused on trunk roads between Likalaneng and Thaba-Tseka. Reconstruction of trunk roads also took place between Oxbow and Mokhotlong. There are other roads that the GoL deemed it necessary to realign, expand and rehabilitate. This comprise of the road from Lejone to Lekhalong la Tlaeeng near Katse Dam, Roma and Semonkong, Qacha's Nek to Sehlabathebe, Sani pass to Sehlabathebe and Katse to Thaba-Tseka and roads between Ha Kome and Ha Baroana.

Institutional Structure and Reforms of Roads Network

Prior to 2008, the management of roads was under the auspices of Department of Rural Roads (DRR) and Roads Branch under Ministry of Public Works and Transport, Maseru City Council (MCC) and Ministry of Local Government and Chieftainship (MoLGC). The Roads Branch is responsible for major trunk roads formulating and implementing policy relating to road infrastructure, while The DRR is charged with the responsibility of constructing, upgrading and maintenance of secondary and tertiary gravel roads. Its primary object is to provide a functional platform for rural road network to improve access to services and markets to rural communities.

However, in 2008, the road network system took a reform and the Roads Directorate was born. The Directorate has been established as an umbrella over the Roads Branch and the DRR. It does not eliminate the original structure but acts as body that oversees the roles of the DRR and the Roads Branch. The Directorate main functions include: implementation of Government of Lesotho policy on roads-related issues; Planning, designing, implementation of roads programs for all roads; preparation of strategic road network development plans; and promotion and support of the development of road construction Industry in Lesotho

Sources of Funds for Roads Construction in Lesotho

The Government of Lesotho (GoL) has sourced funds both locally and abroad for the construction of roads and their maintenance. The International organisations such as European Commission have been vital in funding some portion of construction in Lesotho recently. Locally, the Roads Directorate will be funded from monies from consolidated fund and funds from Road Fund, The funds are distributed through budget that is prepared by the

Ministry of Finance and Development Planning.

Current Trends in Roads infrastructure Development

Throughout the country the road network is being upgraded, maintained and rehabilitated. The Lesotho's Transport Infrastructure Policy governs the overall maintenance, upgrading and rehabilitation of the existing network of roads, inter alia. In line with current donor programmes, namely, the European Commission, which has provided M212.0million for upgrading paved roads, especially in the main sub-towns of the Maseru City, the MoLGC has an ongoing initiative of expanding the network of rural roads, especially in the more isolated and mountainous parts of the country.

Currently, the GoL through its departments and ministries concerned with road infrastructure is massively investing in the development of roads across the country. In Maseru, the streets' roads connecting various parts of Upper Thamae are being paved; the Main North One (A1) stretching from Maseru to Butha-Buthe is also being upgraded and maintained between Maseru town and Maqhaka in Berea district. The maintenance work, construction and upgrading of roads in Teyateyaneng also marks an important milestone in road infrastructure development on the country. This will also include street lights installation, construction of parking bases and furrows which is envisaged to channel water.

Implications for the economy of Lesotho

The current road sector development in Lesotho is a welcome development goal in recent years. This is because improved and better-quality infrastructure has a number of important economic benefits. First, developing the road network that would link Lesotho's economic sectors like manufacturing sector to the South Africa's transport infrastructure can boost investment in the manufacturing sector.

Second, the construction of rural roads is a vital tool for economic growth as it would enhance establishment of smaller businesses with access to markets, either locally or in South Africa. This is likely to impact positively on the income levels and reduce poverty levels in the country.

Third, improving and upgrading roads throughout the country can act as a magnet to tourists. Due to the beautiful mountain scenery of the Kingdom of Lesotho, the tourism sector is likely to be boosted significantly by improvements in road infrastructure.

Fourth, the impact of road construction, maintenance and upgrading has created employment for the urban poor and this has also affected their income levels positively.

Conclusion

The current road infrastructure development comes at the time when the recent global financial crisis has ravaged the country's macroeconomic stability. The government of Lesotho is on the right track by ensuring that the planned construction is undertaken.

Table 2: Selected Monetary and Financial Indicators

	2010		
	June	July	Aug
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	*11.17*	*11.25*	*11.25*
1.2 Prime Lending rate in RSA	*10.00*	*10.00*	*10.00*
1.3 Savings Deposit Rate	*2.03*	*2.03*	*2.03*
1.4 Interest rate Margin(1.1 – 1.3)	*9.14*	*9.22*	*9.22*
1.5 Treasury Bill Yield (91-day)	*6.64*	*6.64*	*6.62*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*6198.76*	*6379.73*	*6508.01*
2.2 Net Claims on Government by the Banking System	*-2779.13*	*-2884.34*	*-3394.31*
2.3 Net Foreign Assets – Banking System	*10043.99*	*10298.56*	*10320.55*
2.4 CBL Net Foreign Assets	*7201.15*	*7131.76*	*7180.24*
2.5 Domestic Credit	*-835.84*	*-899.20*	*-1304.66*
2.6 Reserve Money	*852.79*	*826.56*	*870.61*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	*7.6467*	*7.5442*	*7.3008*
4. Inflation Rate (Annual Percentage Changes)	*3.8*	*3.4*	*3.3*
5. External Sector (Million Maloti)	***2009***	***2010***	
	QIV	***QI***	***QII***
5.1 Current Account Balance	*-331.42*	*-275.57*	*-936.12*
5.2 Capital and Financial Account Balance	*1303.29*	*-59.24*	*387.38*
5.3 Reserves Assets	*-368.88*	*216.18*	*928.04*

+Preliminary Estimates.

**Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities*

Table 3: Selected Economic Indicators

	2006	2007	2008	2009+
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	*6.6*	*2.3*	*4.4*	*2.6*
1.2 Gross National Product – GNI	*2.4*	*1.7*	*11.4*	*0.7*
1.3 Per capita –GNI	*2.3*	*1.6*	*11.3*	*0.7*
2. Sectoral Growth Rates				
2.1 Agriculture	*18.4*	*-14.0*	*6.3*	*1.1*
2.2 Manufacturing	*9.1*	*1.2*	*3.2*	*-1.3*
2.3 Construction	*-1.3*	*5.1*	*7.7*	*7.9*
2.4 Services	*5.7*	*2.5*	*4.0*	*2.7*
3. External Sector – Percent of GNI				
3.1 Imports of Goods	*80.5*	*87.8*	*82.8*	*78.7*
3.2 Current Account	*3.5*	*11.0*	*11.1*	*3.2*
3.3 Capital and Financial Account	*0.8*	*5.9*	*7.6*	*8.7*
3.4 Official Reserves (Months of Imports)	*1.2*	*5.0*	*8.9*	*10.4*
4. Government Budget Balance (Percent of GDP)	*42.8*	*43.1*	*43.3*	*48.1*

+Preliminary Estimates