Global Current Account Imbalances and Trends in the Current Account in Lesotho

Background

The current account reflects the totality of residents' transactions with non-residents in the markets for goods and services. The current account balance also determines the evolution over time of a country's stock of net claims on (liabilities to) the rest of the world, reflecting the behaviour of residents and non-residents with respect to saving, investment and the fiscal position. Therefore it is necessary for policy makers to focus on the current account as an important macroeconomic variable, to endeavour to explain its movements, to assess its sustainability, and to seek to induce changes in the current account balance through policy actions. Primarily an area for concern is the financing of the current account, where in most cases is through capital inflows.

When countries run large current account deficits for a number of years, concerns often arise about their sustainability. Both theoretical and empirical evidence suggest that current account deficits of about 5 per cent of gross domestic product (GDP) raise an alarm, especially when the deficit is financed with short-term debt and foreign reserves and reflects high consumption spending. Thus a current account deficit in excess of 5 per cent of GDP is viewed as unsustainable.[1] It is however noted that current account deficits may not matter if other internal policies are appropriate and sound. An imbalance in the current account deficit may reflect an imbalance in the income and expenditure patterns of either the private or the government sectors. Equally, a current account imbalance may also emanate from a discrepancy between savings and investment.

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Global Experience and Lessons on the current Account Deficit

It has been widely noted that developing countries have at least four reasons that warrant the monitoring of capital flows as a financing component of current account deficits. These are globalization and liberalization, increasing capital flows; lessons from international financial crises; and the need to harmonise policies. Therefore a comprehensive understanding of these flows is highly beneficial in informing policy by providing information on investor perceptions.

[1] see Summers, 1996

The movement in capital flows is also one of the explanations why the United States attracts a variety of assets from the rest of the world. This highlights how non-residents finance the current account deficit. This is demonstrated by the foreign account of about US$2.2 trillion of the total of US$4.3 trillion in the US Treasury securities held by the rest of the public in 2006.

The US capital markets are some of the largest and highly liquid markets, and this is observed in the size of foreigners' acquisition of US assets. In the period 1985 to 2005 foreign holding of assets was estimated at 75 percent of the overall treasuries. The US current account deficit grew from US$850 billion to US$875 billion during 2006 alone. This is equivalent to 7 percent of US GDP. It represented an annual average increase of US$100 billion in four years. Demand analysis indicates that the US is in a position to attract at least US$3 billion to US$4 billion capital flows daily, in order to satisfy its minimum financial requirement.

It has been noted that other countries have experienced surpluses overtime. For example, Germany realised a surplus of US$120 billion and Japan recorded US$170 billion in 2005. A similar scenario holds in developing countries where most Asian countries recorded a current account surplus above US$200 billion.

A similar pattern prevails elsewhere. South Africa (SA) as an emerging market drifts in line with the international financial markets. The SA financial markets experienced an overall asset price increase for the period 2005 and 2006, though there was some moderation in the latter part of 2006. This movement in prices has been influenced mainly by strong commodity prices and investor interest in emerging markets. The stock exchange all-share index increased by 43 per cent in 2005, and accelerating further by 16 percent in 2006.

Estimates indicate that the current account may have widened in the fourth quarter of 2006, as a result of a deficit in the trade account. In addition non-residents have purchased South African bonds and equities to the total of R108 billion in 2006. This compares with R41 billion for 2005, which implies that non-residents have been net buyers of bonds and equities in South Africa.

South Africa has been able to attract a sizable proportion of foreign savings. This in turn may present a challenge of negative foreign shock in the event that the international environment drifts contrary to emerging markets development. It is however noted that South Africa's current account is periodic than structural and therefore can easily be corrected. It is however cautioned that suppressing domestic demand in an attempt to reduce imports may be counterproductive to economic growth.

Policy Options on the Global Imbalance

A possible shock to the world economy can be an abrupt reversal of capital flows to the US, resulting in changes in US asset prices, with filtering effect felt in interest rates and exchange rate. A similar impact would be felt in the rest of equity and housing markets. To the US, any corrective measure on markets and current account can be in the improvement of the government budget. It is nonetheless noted that contrary to the theoretical proposition of the problem of twin deficits, the US seemed to have historically experienced them without major shocks. It is emphasised that in the case of developing countries, running an unsustainable current account deficit with a government budget deficit can be detrimental to the economy.

One of the policy options advocated for by among others, the International Monetary Fund, World Bank and United Nations has been the need for policy coordination. The global imbalance has emerged within the

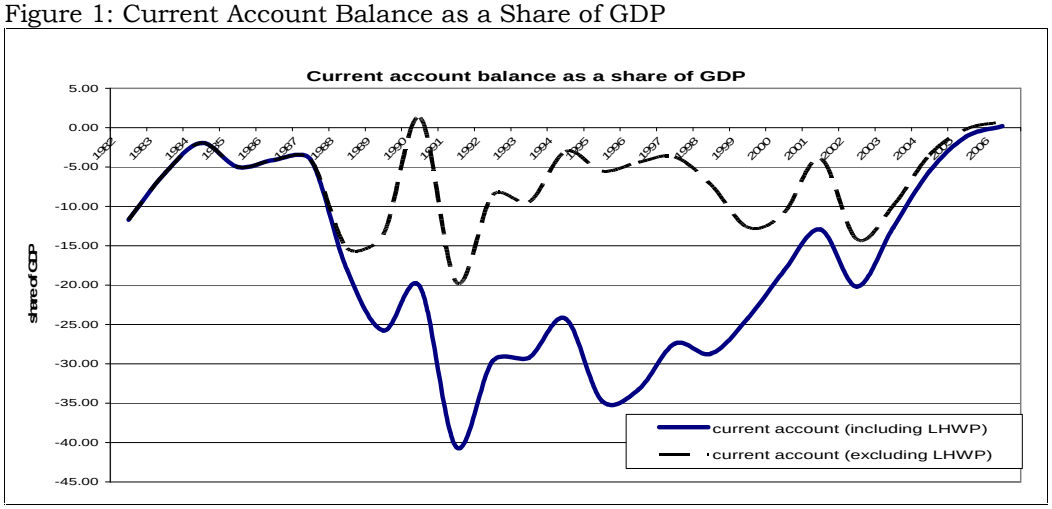
context of lack of harmonisation in the national policies. It is observed that the current lack of policy coordination is due to conflict of interest, disagreement on the urgency of the need to correct the imbalance, especially from surplus countries such as China and Russia.

Trends in the Current Account Balance in Lesotho

In Lesotho, the current account, as a share of GDP, has been running on a deficit for most years. It widened and reached a high of 40.6 per cent of GDP in 1991. However, this observed trend was on the back of increased imports of the Lesotho Highlands Water Project (LHWP) which started in the early 1990s. Figure 1 below shows that the current account deficit has since been recovering and narrowing since 1996 when the project reached a peak.

In 2001, after the implementation of the Africa Growth and Opportunities Act (AGOA), there was an influx of FDI related to textiles and clothing manufacturing firms into the country. This led to the increase in the value of exports to the United States (US) and hence the narrowing of the current account deficit by a significant margin. It is further noted that from 1998, the widening of the current account coincided with a decline in labour income in the BOP. The migrant mine workers income in Lesotho is classified under labour income and this has historically been a significant income injection. Subsequent correction in the Lesotho current account has been on the back of an improvement in exports.

Figure 1: Current Account Balance as a Share of GDP



A. Savings –Investment Gap

Indicators of Current Account Sustainability

Current account sustainability can be analysed by various indicators, but the following four are emphasised; Saving-investment gap, economic growth, openness to trade and debt sustainability.

As already indicated, the current account balance is determined by the difference between national savings and investment. Therefore, for a given level of current account balance, the levels of domestic savings and investment can have implications for the sustainability of the external position. A low saving-investment gap can also signal creditworthiness to international investors because it shows the level of commitment to higher future output and thus raises the perception that the country will be

able to service and reduce external debt. When investment exceeds saving, the country must borrow the difference from abroad. Table 1 below shows that in the case of Lesotho, the saving-investment gap has been narrowing. This signals the commitment to higher future output, assuming that investment is growth enhancing and strengthens the ability to repay external debt in the future. Therefore, according to this indicator alone, Lesotho's current account deficit is sustainable.

Table 1: Saving -Investment Gap

	2000	2001	2002	2003	2004	2005	2006*
National Savings	**27.6**	**25.7**	**24.9**	**23.8**	**29.2**	**32.6**	**41.2**
Government	3.7	7.7	6.7	8.0	14.2	13.0	21.0
Private	23.9	18.0	18.2	15.8	14.9	19.7	20.2
National Investment	**45.9**	**38.4**	**45.4**	**36.8**	**34.9**	**39.3**	**40.9**
Government	8.0	10.5	11.0	8.6	7.3	7.7	9.8
Private	37.9	27.9	34.4	28.2	27.6	31.6	31.1
Savings-Investment Gap	**-18.3**	**-12.7**	**-20.6**	**-13.0**	**-5.7**	**-6.7**	**0.3**

NB: * denotes CBL Projections

B. Economic Growth

Rapidly growing countries can sustain persistent current-account deficits without increasing their external indebtedness relative to GDP. Table 2 below shows growth of real GDP for Lesotho from 2000-2006. Real economic growth has always been above 1.5 per cent throughout the review period. The growth rates seem to be sufficient to finance the current account balance. However this indicator does not seem to integrate a situation where population growth is higher than the benchmark of 1.5 per cent.

Table 2: Real Economic Growth

	2000	2001	2002	2003	2004	2005	2006*
Real GDP growth rate (year-on-year)	2.6	1.8	2.8	2.7	4.0	2.9	6.2

C. Debt Sustainability Indicators

In evaluating the sustainability of current account deficit, it is also important to look at the debt sustainability indicators. This set of indicators assess the solvency of a country. Table 3 below shows Lesotho total debt as a share of GDP. It is worth noting that most of Lesotho's debt is on concenssional terms. External debt, which accounted for about 43.52 per cent of total debt in the year 2006, has been sustainable over the period.

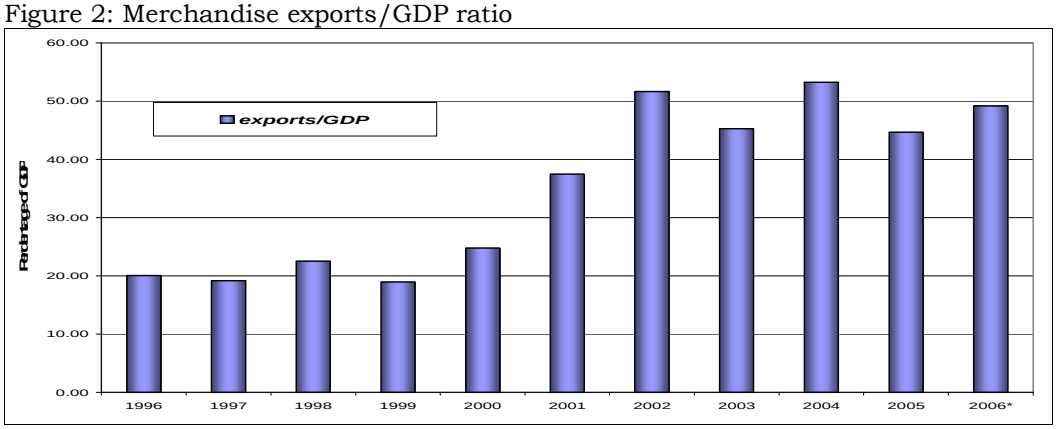
Table 3: Debt Sustainability Indicators

	2001	2002	2003	2004	2005	2006
Total Debt/GDP	110.45	83.65	71.12	55.89	50.27	49.93
External debt/GDP	96.46	70.82	56.37	48.29	43.31	43.52
Debt Service/Exports	6.60	2.04	3.32	7.13	6.70	2.81

D. Openness to trade

The degree of openness of an economy can be measured as the ratio of exports to GDP. In order to service and reduce external indebtedness, a country needs foreign exchange. Clearly, as depicted in figure 2 below, Lesotho's exports have increased tremendously since 2001 and after the inception of the Africa's Growth and Opportunities Act (AGOA) initiative. Furthermore, the country's diamond exports have also increased in recent years due to the opening of the Lets'eng and Liqhobong diamond mines. This has increased the potential for Lesotho to raise foreign exchange to service its external debt.

Figure 2: Merchandise exports/GDP ratio



Conclusion and Recommendations

It is noted that Lesotho's external position is sustainable given the measures discussed. It is however cautioned that Lesotho is still susceptible to external shocks just as most developing countries. The immediate challenge is reliability of its export base from a narrow manufacturing sector. The emergence of diamond and sandstone mining, and bottled water export, among others, offer new avenues for export diversification.

Nevertheless, Lesotho is still confronted with the issue of expanding its export base which will boost economic growth.

2. Monetary Policy Operations in January

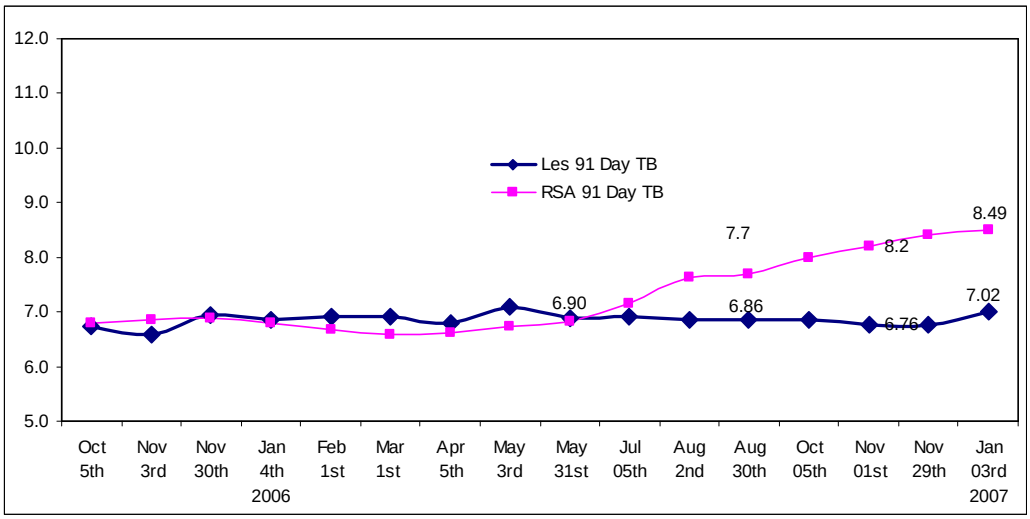
Table 4 below shows amounts of treasury bills auctioned and discount rates that prevailed for each of the auctions. The January auction was fully subscribed and as a result, the whole auction amount to the tune of M160.0 million was issued. The level of competitiveness in the market, as estimated by the number of participants in an auction, declined during the recent auction. In January, there were 7 bidders who submitted 13 bids for the auction and all bidders became partially successful.

Although the Lesotho 91-day treasury bill is still below its SA counterpart rate, the margin between the two rates is beginning to narrow. In January, the Lesotho 91-day treasury bill increased by 26 basis points to 7.02 per cent in January. The counterpart South African rate continued to rise from its previous level of 8.41 per cent in December to 8.49 per cent in January. Hence, the margin between the two rates narrowed from 165 basis points to 147 basis points at the end of the review period.

Table 4: Treasury Bill Auctions

Type of Security	Auction Date	Auction Amount (million)	Amount Issued (million)	Discount Rate
91-day TBs	01Nov 2006	M170.0	M170.0	6.76%
182-day TBs	08Nov 2006	M50.0	M16.5	7.00%
91-day TBs	29 Nov 2006	M170.0	M170.0	6.76%
91-day TBs	03 Jan 2007	M160.0	M160.0	7.02%
182-day TBs	09 Jan 2007	M50.0	M50.0	7.30%

Figure 3. Measuring the Success of Monetary Policy Objectives:



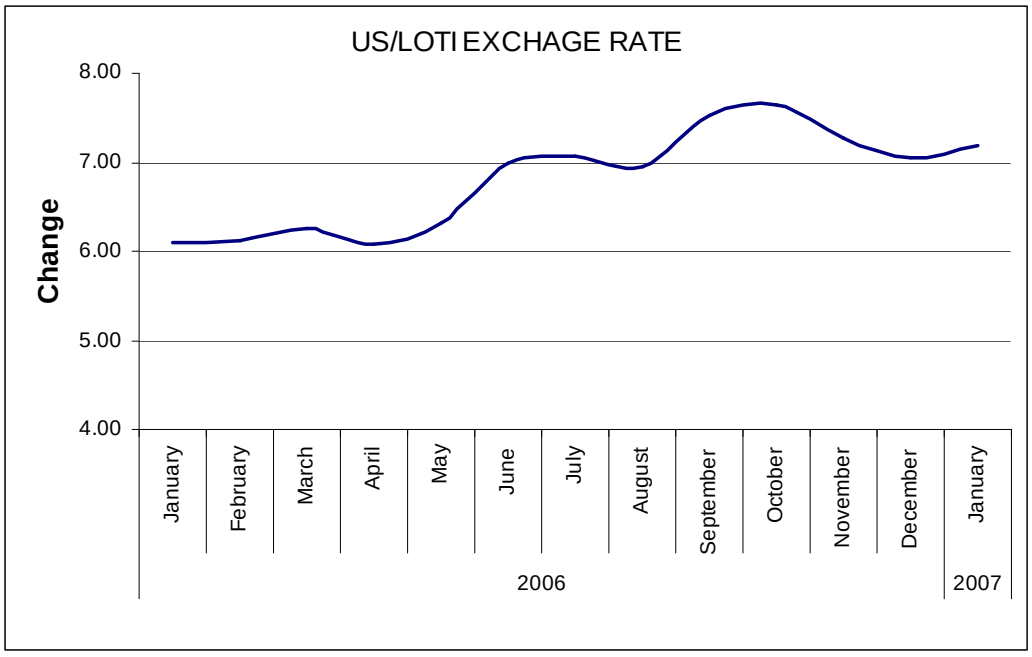
3. Foreign Exchange Markets in January

The Rand opened the month trading at 6.9146 against the US Dollar as the price of precious metals surged, hitting a low of R7.3228 on the 29th of January and closed the month trading at R7.2222. On the first day of trade this year South African shares rose to a record high, tracking gains in Europe and Asia. Some South African gold mines led the advance in Johannesburg as gold climbed to a three-week high. Towards the middle of the month the Rand gained strength and traded around R7.1542 against the US Dollar. This advance in the Rand was due to consumer spending and credit extension that continued to surge boosting the chances of an interest rate hike.

However during the third week of the month the Rand dropped against the US Dollar after government released data showing lower than expected inflation data as at end of December. The cost of goods leaving factories and mines rose to an annual 9.3 percent in December. The rate was expected to rise to a four-year high of 10.2 percent, from 10 percent in November according to Statistics SA. After the release of the report there were mixed views regarding the possibility for further increases in interest rates. Domestically, the currency responded to lower expectations of interest rate increases. During the month under review the Rand also slumped against the US Dollar on speculation that the yield premium offered by local assets may shrink. On the last day of the month the Rand was boosted by better than expected trade data, with a small R388million surplus in December following deficits in the previous two months.

During the month under review, the Rand opened trading at R9.1733 against the euro and closed at R9.3162, while it traded at R13.6423 against sterling at the beginning of the month and closed the month trading at R14.1195

Figure 4. SA Rand against the US Dollar



4. Selected Monetary and Financial Indicators+

	2006		
	Oct	**Nov**	**Dec**
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	12.69	12.69	13.50
1.2 Prime Lending rate in RSA	11.50	12.00	12.00
1.3 Savings Deposit Rate	1.84	1.84	2.68
1.4 Interest rate Margin(1.1 – 1.3)	10.85	10.16	9.32
1.5 Treasury Bill Yield (91-day)	6.76	7.16	7.05
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	3387.38	2532.40	3505.80
2.2 Net Claims on Government by the Banking System	-1986.82	-1751.00	1498.76
2.3 Net Foreign Assets – Banking System	6358.55	6376.99	6149.69
2.4 CBL Net Foreign Assets	5328.61	4460.29	4377.24
2.5 Domestic Credit	-1113.62	-839.21	-576.82
2.6 Reserve Money	436.14	465.51	490.92
3. Spot Loti/US$ Exchange Rate (Monthly Average)	7.4085	7.2400	6.9930
4. Inflation Rate (Annual Percentage Changes)	6.9	6.9	6.4
5. External Sector (Million Maloti)	**2006**		
	QII	**QIII**	**QIV**
5.1 Current Account Balance	-6.85	121.38	54.43
5.2 Capital and Financial Account Balance	353.19	311.38	211.86
5.3 Reserves Assets	-442.82	-641.50	-32.81

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

5. Selected Economic Indicators

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

* Preliminary estimates