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FINANCIAL INTERMEDIARIES AND PRACTICES IN LESOTHO: IMPLICATIONS FOR THE AGRICULTURAL SECTOR

FINAL REPORT

JUNE 7, 1990

Office of Government Services
1801 K Street, N.W.
Washington, DC 20006
Telephone 202 296 0800

Price Waterhouse

June 7, 1990

Mr. Curt Reintsma, ADO
USAID/Lesotho
American Embassy
Kingsway
Maseru, Lesotho

Dear Mr. Reintsma:

Re: Financial Sector Development Project (FSDP)
Contract No. PDC-2206-Z-00-8191-00
USAID/Lesotho - Financial Sector Survey
PIO/T No. 632-0510-2-90025

Attached please find five copies of the Final Report, Financial Intermediaries and Practices in Lesotho: Implications for the Agricultural Sector, as prepared by Dr. Martin Barrett and reviewed by Price Waterhouse, Prime Contractor under FSDP.

It has been a pleasure to work with USAID/Lesotho on this important assignment. We look forward to working with you again in the future as your plans for new projects in the financial sector develop.

Very Truly Yours,

Price Waterhouse

attachments

FINAL

FINANCIAL INTERMEDIARES AND PRACTICES IN LESOTHO: IMPLICATIONS FOR THE AGRICULTURAL SECTOR

Table of Contents

EXECUTIVE SUMMARY

The purpose of this study is to provide a better understanding of Lesotho's local financial market and to identify potential intervention strategies that would mobilize local resources for investment in agriculture and private enterprise.

A. Objective and Scope

As part of a four person team, a Price Waterhouse consultant, Dr. Martin Barret, was assigned the following tasks:

- To describe monetary and fiscal policy trends in the financial markets of the Republic of South Africa as they affect the Lesotho economy.

- To describe Lesotho's formal financial markets and institutions, as well as their management of liquidity (including an analysis of transaction costs in Lesotho to identify the main economic rationale for the behaviour of the formal sector).

- To analyze Lesotho's government policy and market distortions.

- To make recommendations regarding the strengthening and deepening of financial markets in Lesotho and potential strategies for appropriate intervention.

With these objectives in mind this study will provide an overview of the intermediaries, financial practices and policy developments in Lesotho that condition the cost and availability of credit.

B. Principal Findings

1. Economic and Policy Linkages with South Africa

The degree of economic integration of Lesotho and of South Africa is, not surprisingly, high. The volume of bilateral trade between these two nations accounts for 50 percent of Lesotho's exports and 95 percent of its imports. In addition, as a member of the South African Customs Union (SACU), Lesotho is entitled to customs revenue collected by the South African authorities. These collections are the source of more than half of Lesotho's overall government revenues. Perhaps more evident is Lesotho's dependence on South Africa as a source of employment and income. South African mines absorb almost half of Lesotho's adult male labor force, and more importantly, their remittances contribute to 45 percent of gross national product. Inevitably, patterns in consumption and employment opportunities in South Africa have a significant effect on the economy of Lesotho.

Unfortunately, this level of dependence makes Lesotho overwhelmingly vulnerable to policy developments in South Africa. Lesotho has virtually no policy autonomy with regard to managing its revenue base, implementing effective investment incentives or determining interest rate policy. Changes in South Africa's tariff structure, moreover, can have a major impact on the incoming tariff revenues of Lesotho.

Likewise, investment incentives in Lesotho, concentrating mostly on export-oriented industries, are linked to the political situation in South Africa. Although many companies have turned to Lesotho to avoid the sanctions and boycotts on certain South African-made products, Lesotho is only regarded as a second choice. Once these restrictions are lifted the implications for Lesotho's economy will be serious because companies may easily choose to relocate to South Africa. Moreover, South Africa offers incentives to invest in the so called "homelands" which detracts potential investors from Lesotho.

The lack of effective restrictions on convertibility of the maloti into rand at par brings about yet another dependence on South African policy. As long as companies in Lesotho can borrow in either currency, and as long as Lesotho residents can move funds into rand-denominated accounts, its interest rates will be virtually tied to comparable rates in South Africa.

2. Recent Policy Developments

Lesotho's economy has experienced considerable deterioration in the last decade. Inflation has gathered momentum, while GNP has slowed in real terms, the budget deficit and domestic credit have both increased and the current account has moved from a surplus into massive deficit. Facing these conditions the government has adopted a structural adjustment program which seeks to reduce the budget deficit and restricts the growth of domestic credit. Increased availability of credit in the future will depend on the ability to narrow the budget deficit.

3. Financial Institutions, Practices and Performance

Commercial Banks - Viewed within the context of a small economy the financial sector in Lesotho appears to be well-managed and well-capitalized. However there is a limited number of financial institutions and the markets are highly segmented. Both foreign owned banks and the Bank of Lesotho are guided by fairly conservative standards in their credit risk appraisals and adhere to short term maturities in their loan portfolios. This limits the range of eligible borrowers to established, well capitalized companies or individuals with high net worth.

In Lesotho, interest on government debt is fully exempt from taxes, therefore excess liquidity brings no financial penalty. This subsidy also restricts the availability of credit to other borrowers and in the least of cases, increases the cost. Given this situation of limited competition and subsidized government loans, the returns on assets and equity generated by banks are remarkably high. Not surprisingly the incidence of loan losses is very low in Lesotho. Even if banks were willing to extend their maturities and ease credit standards there would be no incentive to do so as long as the government maintains its current demand for credit and the subsidy exists.

Development banks - Lesotho's two development banks have experienced significant losses in recent years. As specialized lending institutions, these banks were established to fill the credit availability gap from other sources. Originally capitalized by the government, these banks have shifted their funding structure to grants and concessional loans from international agencies, and more recently, to deposited sources of funds. Mismanagement and high operating costs had kept them from being profitable. By 1986 they both faced problems of non-performing loans and had to make substantial loan loss provisions. Increased deposits have funded most of their growth in recent years, however.

4. Interest Rate Patterns

Financial authorities in Lesotho manage to exert control only over the savings deposit and the prime lending rate in their country. For all practical purposes all other interest rates are market determined, i.e. they move roughly in line with market developments in South Africa. As long as residents in Lesotho can move funds freely to and from South Africa, the general level of interest rates in Lesotho is almost bound to follow movements in South Africa.

The imposed minimum savings deposit rate in Lesotho counteracts the risk brought about by the absence of competition by commercial banks which would enable the latter to drive down the rate. The prime lending rate in Lesotho is also set by the government, however, commercial banks are free to adjust any lending rate above prime, and this study suggests that the average lending rate in Lesotho reacts very quickly to borrowing costs in South Africa. Only those who have access to the development banks can escape higher lending rates. With regard to term deposits, unregulated in Lesotho, they are higher than in South Africa. Banks may be unwilling to raise the rates due to the current credit ceilings, and thus have experienced an outflow of deposits.

C. Conclusions and Recommendations

It is important to recognize that the high degree of economic integration between Lesotho and South Africa restricts the former's ability to control its financial markets. Should inflationary pressures in South Africa recede and nominal interest rates return to lower levels, borrowers in Lesotho would face fewer obstacles to borrowing money. However Lesotho cannot count on that happening and must act decisively to facilitate credit to its borrowers, especially those in the agricultural sector.

With regard to the general financial climate in Lesotho there are three main areas which Lesotho's monetary authorities must address. First, is imperative that the government concentrate on reducing the budget deficit, second, elimine or phase out the tax exemption of interest on government obligations, and third, it should dismantle the current credit ceilings. These three recommendations are geared toward making more credit available to all borrowers and to avoid the crowding out of non-governmental borrowers.

With regard to credit for agricultural activities, a first recommendation that monetary authorities must consider, is the use of graduated payment obligations, which would tailor repayments to the borrower's capabilities. A second recommendation concerns redefining the terms and conditions for lending. Since lending is collaterally-based, yet property ownership is often communal (and not considered to be eligible collateral) this recommendation involves transferring the rights to land to the form of "operating leases" which could be used directly to reinvest or indirectly to secure bank credit. Such a move would open doors to many would-be borrowers. A third recommendation is to opt for the use of tax incentives which would invite lenders to obligate funds for longer terms to certain types of agricultural activities.

I. INTRODUCTION

In Lesotho, as elsewhere in southern Africa, the rate and nonrate terms on which credit is available to the agricultural sector has long been a matter of major policy concern -- for the government, for the donor community, and, of course, for agricultural producers as well. This concern is easily understood, for despite very substantial public investment in agricultural activities over the past two decades, production has been slow to respond, the country has become a net importer of a wide range of foodstuffs, and much of the rural population has moved in large numbers to urban areas, only to discover that employment and income opportunities in urban centers are often few and far between.

Some of the constraints on agricultural output are non-financial in character, and there are limits to which additional investment or non-subsidized credit can contribute to higher levels of farm production. The amount of arable land is very limited to begin with and, much cultivable area has been subject to soil degradation and erosion, perhaps exacerbated by the communal system of land tenure which encourages overgrazing by livestock. The existence of more remunerative employment opportunities in South Africa, moreover, has left many rural households without the skilled labor needed to make more effective use of the limited acreage they do farm.

Yet, even within the confines of these "resource constraints" there appears to be considerable potential for improved agricultural performance. The incipient development of an informal land leasing market certainly suggests that this potential is recognized by individuals who could be more productive than current allottees. To the casual observer, there appears to be no significant difference in soil quality between the lowlands along the western edge of the country and the larger and more productive farms in South Africa, just a stones throw away. And the explosive growth in production of asparagus for export suggests that there is considerable room for further production of this crop or opportunities for the development of other types of similarly high value crops.

All this will require financing of one kind or another. The purpose of this report is to provide a brief, and necessarily selective, overview of the intermediaries, financial practices, and policy developments in Lesotho that condition the cost and availability of credit. Some of these influences are purely domestic in origin, peculiar to Lesotho. But Lesotho is fully integrated with the larger economy of South Africa, and given the high mobility of funds between the two countries, interest rates in Lesotho, both real and nominal, are shaped largely by market developments in South Africa. To put the same matter in a slightly different way, there is little if any scope for the conduct of an independent interest rate policy in Lesotho. For better or worse, interest rates in Lesotho are conditioned by monetary policy or other policy developments in the larger South African economy. Before turning to a discussion of the financial market in Lesotho, therefore, it is important to review financial and other linkages with the Republic of South Africa.

II. ECONOMIC AND POLICY LINKAGES WITH SOUTH AFRICA

A. Macroeconomic Connections.

Most of the major linkages between Lesotho and the larger South African economy are well known and need only be quickly summarized. Virtually all of Lesotho's international trade is essentially bilateral in character, dominated by flows to and from the RSA, which absorbs roughly half of Lesotho's exports and originates all but 5 percent of the country's imports. Still another dimension of the economy's structural dependence is reflected in the mix of government revenues. As a member of the South African Customs Union (SACU), Lesotho shares customs revenue collected by the South African authorities, and in recent years receipts from that source have amounted to 50-70 percent of the government's overall revenues, inclusive of grants from donors. And Lesotho's access to the South African labor market, although restricted in scope, is even more important in terms of its income effects. Close to half of the adult male labor force (twenty years and above) works in South African mines, and their remittances account for about 45 percent of gross national product and nearly 70 percent of external current account receipts.

The implications of these linkages need to be clearly recognized. Given the sheer size of the South African economy, even marginal changes in economic conditions there are often magnified when their effects are transmitted to Lesotho. Since the import content of personal consumption is close to 80 percent, and the local currency (maloti) is convertible into rand at par, inflationary pressures in South Africa -- whether internally generated or external in origin -- are quickly transmitted to Lesotho. Not surprisingly, the year-to-year price changes in both countries tend to move in tandem, if not in lock step.

Nor is it surprising that rates of income growth (and unemployment rates) in Lesotho are very sensitive to employment opportunities in the South African mines, even though there appear to be very substantial leakages between income earned by mine workers and the amounts remitted back to Lesotho. Under the Miners Deferred Payment Fund (MDPF) arrangements, 60 percent of the basic pay of Basotho at participating mines in South Africa is withheld automatically and deposited, along with designated voluntary remittances, into special accounts at Lesotho Bank, which the miners can normally access only when they return home at the end of their contracts. Any overtime pay is not subject to withholding, and non-contract employees (or workers between contracts) are exempt from withholding of any pay, basic or overtime. Moreover, even workers under contract are allowed to make "emergency" withdrawals from the MDPF, on short notice and at no significant penalty for premature withdrawal, whenever they return home, perhaps as often as every other week. At least part of these withdrawals, if not spent fully, may be reinvested with bank or quasi-bank organizations in South Africa, which offer somewhat higher returns than the effective rate paid by the Lesotho Bank on funds placed with the MDPF.

But despite all these leakages, there is no doubt that changes in employment opportunities in South Africa are reflected, sooner or later, in roughly comparable changes in rates of growth in real income in Lesotho. Clearly, Lesotho's rate of growth throughout the eighties (whether measured inclusive of migrant workers' remittances or exclusive of those receipts) has slowed considerably since the seventies, when mine employment was increasing much more rapidly, in part because many Basotho migrants replaced migrant labor from other countries. In the period since then, the coal mines have undergone considerable mechanization and over the years ahead, Basotho migrants may face increased competition from South African labor. This need not be accompanied by a sudden or massive repatriation of miners, but it does suggest that employment opportunities in the mines may shrink significantly over the remainder of this decade, which would have a profound effect on national income, and, with it, Lesotho's capacity to sustain the current level of imports.

B. Policy Vulnerability in Lesotho.

Quite apart from changes in economic conditions in the larger South African economy, the sheer size and weight of the RSA leaves Lesotho dangerously vulnerable to policy developments in that country. Indeed, South Africa looms so large that even modest adjustments in policy, so unobtrusive as to go almost unnoticed within the Republic, may create unmanageably large policy problems for the authorities in Lesotho. Viewed from a somewhat different perspective, the Lesotho government enjoys little or no scope for independence in the management of its revenue base, in the implementation of effective investment incentives, or in the conduct of interest rate policy.

While membership in the South African Customs Union provides most of the government's revenue, it also limits the government's control over its primary source of revenue. In effect, Lesotho's revenues depend on South Africa's import requirements from sources outside the customs union. Over the near term no major growth can be expected in Lesotho's SACU receipts, at least not until 1992, when South Africa makes "advance" royalty payments to Lesotho in the form of rebates of duties on imports related to the development of the Highland Water Project. Before then, however, there is always a possibility that South Africa may restructure the SACU arrangements in order to reduce the burden on its own budget, effectively reducing Lesotho's revenues. To make matters worse, South Africa has already announced plans to replace the general sales tax with a value added tax. As proposed, the VAT would not be rebated on trade within SACU, but only on exports between South Africa and third countries. If introduced in this way, the VAT would clearly have an adverse effect on Lesotho's own revenue base, since Lesotho would need to reduce its own rates of sales taxation to keep final prices in line with those in South Africa. Of course, Lesotho could extend sales taxation (or user fees) to non-tradeable services -- electricity, telecommunications, and water -- but the revenue potential from these services is relatively small. Alternatively, it may be possible to negotiate revenue sharing for VAT along the lines of the SACU arrangements, and/or subject migrant workers to effective income taxation. However, either of these approaches would require the full cooperation of the South African government. The plain fact is that there are clear limits to Lesotho's ability to mobilize additional revenue on its own.

Likewise, the government's efforts to encourage investment in export-oriented activities are to some extent undermined by the fact that non-resident investors (many of them companies based in South Africa) are offered similarly attractive, or better, incentives by the South African Government to locate in the so called "homelands". Moreover, the driving force behind much of the foreign investment in Lesotho that has been made over the past decade has been an effort to escape the official sanctions and consumer boycotts imposed by third countries on a wide range of South African exports. Still other companies have moved from South Africa to Lesotho because third countries are unwilling to export components for assembly in South Africa. The implications of all this are quite clear. If sanctions and other restrictions are relaxed as South Africa moves to end apartheid, many of the "footloose" companies that have moved to Lesotho may choose to change their base of operations once again.

Finally, and perhaps most importantly, the absence of virtually any restrictions on convertibility of the maloti into rand at par means that interest rates in Lesotho are governed basically by financial market developments in South Africa. To be sure, commercial banks in Lesotho are subject to a minimum local asset requirement, which calls for the banks to commit at least 85 percent of their domestic liabilities in loans to resident borrowers. Since the banks' foreign liabilities are negligible, this in effect limits the overall level of foreign assets. But apart from this requirement, Lesotho places no formal restrictions on the ability of non-financial businesses, individuals, or households to borrow and/or invest in South Africa. Many lenders, or bank depositors, are well positioned to take advantage of the full range of financial services and higher interest rates available in South Africa, and, as noted earlier, migrant workers may find it much more convenient to maintain accounts with South African banks. Moreover, most of the larger business borrowers in Lesotho (many of which are subsidiaries of South African companies) have dependable relationships with South African banks and can just as readily borrow in South Africa as in Lesotho. For smaller, locally-owned companies, however, the South African market is impossible to access.

As long as residents in Lesotho are free to move funds out of domestic banks into rand-denominated assets, and larger companies can borrow in either currency, then in the absence of any perceived exchange rate risk, interest rates in Lesotho must move in line with rates on comparable financial instruments in South Africa. Under the best of circumstances, when inflation in South Africa is well contained and the rand is stable in terms of third currencies, both real and nominal rates of interest would be much lower, as they were earlier in the eighties. But in recent years, with inflation increasing at double digit rates and the rand under relentless pressure in the foreign exchange markets, both real and nominal interest rates have risen to unusually high levels.

Under the best of circumstances, there is very little that the monetary authorities in Lesotho can do to insulate domestic interest rates from developments in South Africa. In a sense, Lesotho is the prototype of a small open economy, in which interest rates and international reserves are both residual variables, determined largely by developments in South Africa. Thus, if the monetary authorities attempt to increase the supply of domestic credit, by monetizing either public or private debt, over and above the demand for money (both currency and maloti-denominated deposits) then the non-bank public would dispose of any excess balances, either by spending on additional imports or by converting maloti into rand for deposit with banks in South

Africa or placement in other financial assets. Either way, any attempt to force or facilitate an expansion of domestic credit is likely to produce an offsetting deterioration in the country's balance of payments and a corresponding loss in international reserves. In effect, any deliberate attempt by the central bank to force the expansion of domestic credit is likely to result in little more than a change in the composition of its balance sheet as between domestic credit and net international reserves.

In a sense, each of these dimensions of policy vulnerability is nothing more than a symptomatic reflection of the extent to which the economy is almost fully integrated with the larger South African market. Despite the loss in policy autonomy, however, integration carries with it certain very real advantages. Certainly, the unemployment problem in Lesotho would be much more severe, and average income levels significantly lower, were it not for the fact that South Africa generates a much wider range of employment opportunities for which many Basotho workers are well qualified. As a member of the Common Monetary Area, moreover, Lesotho enjoys much easier access to South African sources of capital, both official and private, than would be possible if Lesotho opted out of the arrangement. And as a member of SACU, the Lesotho Government can mobilize much higher levels of revenue than would be feasible if it had to rely exclusively on taxation of income from domestic sources. Thus, for Lesotho, integration with the South African economy, as it has evolved thus far, has effectively disposed of many of the disadvantages inherent in the small size of its own economy.

Just how the relationship between the two countries may unfold over the years ahead is very difficult to assess, especially in view of changes now underway in South Africa. As already noted, much of the recent surge in foreign investment in Lesotho has been prompted primarily by an effort to avoid the effects of sanctions on exports from South Africa. The rather grim irony is that the relaxation or removal of those sanctions could quickly lead to "disinvestment" in Lesotho. Moreover, if much of the apparatus of apartheid is dismantled, Basotho migrant workers are likely to encounter increasing competition with South African labor, not only for employment in the mines, but in other activities as well. At the same time, the immense backlog of accumulated needs for public services in South Africa, both in and outside the "homelands" may well limit the readiness of the South African government to share revenues with Lesotho.

Of course, there is nothing that is inexorably ordained about any of these possibilities. However, they do suggest that it is all the more urgent for the authorities in Lesotho to create as much productive employment as possible through growth in the domestic economy. This calls for policy changes over a very broad front, directed at a wide range of activities, but clearly the development of the agricultural sector must remain an integral part of the entire process. The plain fact is that employment opportunities elsewhere -- in industrial, smaller-scale business, and service activities -- are still quite limited, despite their rapid growth over the past decade. In short, it seems almost inevitable that most new additions to the labor force over the years ahead will have to be absorbed by agriculture and rural Lesotho.

III. RECENT POLICY DEVELOPMENTS

All of these problems have contributed to the emergence of massive macro-economic imbalances, which have left the economy even more vulnerable to events in South Africa. Following a period of moderate inflation and rapid growth in output -- averaging 7-8 percent annually -- in the seventies, the performance of Lesotho's economy has fallen far short of its potential. In real terms, growth in GNP slowed to an average annual rate of about 4 percent over the three year period ending in March 1989. Workers' remittances dropped in real terms, and on a per capita basis, the outcome was much more serious. Over the same period, prices rose at an average annual rate of about 13 percent, in line with price developments in South Africa, and the inflation appears to have gathered considerable momentum, as import prices rose at an annual rate of close to 18 percent through the second half of the year. At the same time, the budget deficit, which amounted to less than 2 percent of GNP in fiscal 1985, has widened considerably, largely as a result of the government's inability to contain current expenditures in the face of relatively slow growth in SACU receipts. Indeed, in fiscal 1988 and then again in fiscal 1989, the overall budgetary deficit had swollen to around 10 percent of GNP.

Most of the resultant increase in the government's borrowing requirements over these past two years has been financed domestically by bank lenders or on non-concessional terms from foreign banks. And of these two sources, domestic financing was roughly four times as large as the amount of credit mobilized from foreign lenders. Not surprisingly, total domestic credit, after increasing by very modest amounts during the early eighties, has exploded upward since 1984, at an average annual rate of close to 36 percent. Predictably enough, the current account balance has shifted from a surplus into massive deficit, equivalent to about 6.8 percent of GNP. By late last year, the country's international reserves, already under pressure for other reasons, had fallen to roughly one month's imports.

Against this background, the government has adopted a medium-term macroeconomic and structural adjustment program, supported by a three-year arrangement under the structural adjustment facility with the IMF. Now in its second year, the program calls for a significant reduction in the overall budget deficit, from 10.9 percent of GNP in the fiscal year ended March 1989 to 4.4 percent during fiscal 1990. Moreover, given the large overhang of liquidity within the banking system (most of it invested in short-term government obligations), and the need to rebuild the country's reserve position, the program also places limits on the expansion of total domestic credit -- targeted to increase by less than 16 percent during the current fiscal year.

The short-term implications of these policy commitments for the availability of credit to the private sector depend in large part on how the budget balance changes over time. In the event that the budget deficit for fiscal 1991 turns out to be no larger than targeted amount, but external financing of the budget deficit exceeds the program estimate, then both government borrowing through the banking system and the ceiling on total domestic credit would be reduced by the amount of the excess. In this case there would still be no additional room for increased lending to the private sector. But if the budget deficit narrows and falls below the programmed amount, then the implied ceiling on credit to the private sector would increase by the amount of the shortfall.

If events materialize as projected, the budget deficit will continue to narrow in fiscal 1991 and may swing into surplus in 1992, when the government receives the first of the "advance" royalty payments for imports used in connection with the Highlands Water Project. With any repayment of domestically held government debt, resources would be released for additional loans to the private sector. But whether would-be borrowers in the agricultural sector are in a position to take advantage of easier credit conditions is another, very different, matter.

IV. FINANCIAL INSTITUTIONS, PRACTICES, AND PERFORMANCE.

A. Commercial Banks in Profile.

When viewed in the context of a very small economy, the organized, or formal, financial sector in Lesotho appears to be reasonably well developed. Most of the essential range of financial services are available in urban centers, and some intermediaries have begun to establish agencies or branches in rural areas as well. Moreover, unlike the situation encountered in many other developing countries in Africa and elsewhere, all of the commercial banks in Lesotho are well capitalized, if not overcapitalized. The incidence of loan losses, or burden of non-performing loans, is relatively small, and without exception, all of the major institutions appear to be well-managed, for reasons that are not hard to find. Like it or not, commercial banks in Lesotho are exposed, directly or indirectly, to crossborder competition, from South African banks and from non-bank lenders as well. Some of the larger farmers in nearby areas in South Africa provide trade credit to importers in Lesotho on what appear to be very easy terms. And consumer installment loans are available through many of the South African retail chains with operations in Lesotho.

Nonetheless, the number of financial intermediaries is very small, and markets remain highly segmented. Each of the major institutions -- three commercial banks and two specialized development finance companies -- focus on a particular market niche. At best, inter-institutional competition appears to be very subdued. Among commercial banks, Barclays operates as a full service branch in Lesotho, but its business is geared primarily to the needs of larger commercial borrowers, and where possible it lends only against guarantees from the borrower's home country bank and/or parent company. The Standard Chartered Bank, also a branch of a well-known British institution, has traditionally functione as banker to the Government of Lesotho, long before the central bank was established. This function still forms the core of its business, although the bank has begun to compete for commercial business through its branches outside the Maseru area. The Lesotho Bank, although established less than two decades ago as a government-owned institution, has since developed an extensive network of branches and agencies and generated more credits than the other commercial banks combined. Originally envisaged as a commercial and development bank, the Lesotho bank has in fact operated as commercial bank, oriented primarily to the needs of locally-owned business borrowers and the second tier of foreign-owned companies.

Despite these differences -- in target markets, in ownership, and dissimilarities in tax treatment -- the commercial banks have much in common. Management at each institution is guided by essentially the same institutional objective; the need to maintain spreads between average interest earned on assets, and the interest cost of liabilities in amounts large enough to cover the full costs of financial intermediation. These costs include operating expenses, provisions for possible loan losses, and the cost of bank capital. For the foreign-owned commercial banks the need to generate some minimally adequate return on assigned capital is self-evident, since they are, after all, privately-owned institutions. Much the same need must be recognized by the Lesotho Bank. Even though the latter is fully-owned by the government, unless it builds capital (through retained earnings) in line with the projected expansion of its deposit base, the bank would quickly become undercapitalized.

Both of the British banks operate in accordance with credit standards established by their head offices in London. For the most part, their loans are fully collateralized, usually by the borrowers' inventories, and/or guaranteed by a third party. Typically, their clients have an established financial record, and most of their credits take the form of overdrafts. Such term loans as are made available carry fairly short maturities. Given these standards, the population of "eligible" borrowers is confined largely to businesses in urban trade and industry. Somewhat surprisingly, the Lesotho Bank appears to follow similarly conservative standards in its appraisal of credit risks, and although the bank is more deeply involved in project finance, the average maturity of its loan portfolio is reportedly not much longer than at Barclays or Standard Chartered.

Without exception, all of the commercial banks are highly liquid, with most of their excess liquidity invested in three-month Treasury bills or similarly short-dated loans and advances to the government. Unlike the situation in other countries, however, excess liquidity imposes no financial penalty in Lesotho, since interest on government debt is fully exempt from tax. Apparently, this exemption was originally intended to facilitate government borrowing through the commercial banks shortly after Lesotho became independent, and long before the Central Bank was created. But whatever the original rationale for the exemption, it no longer has any validity, if indeed it ever did. In Lesotho, as elsewhere, the government is a pre-emptive borrower, and needs no extra advantage of any kind. Yet with Treasury bills offered at a "bond equivalent" yield of about 20 percent per annum, and with banks subject to a 45 percent tax on income, the taxable equivalent return on other loans is well over 36 percent. In a paradoxical way, the exemption subsidizes bank financing of the one sector that requires no assistance of any kind, and in effect increases the cost, or limits the availability, of credit to all other borrowers.

Given this subsidy, and the absence of any meaningful competition within the local market, it is no wonder that banks generate extraordinarily high returns. Even the Lesotho Bank, which might not be expected to perform very well in view of its exposure to political pressures, appears to have done very well in recent years. Thus, the return on assets, as measured by the ratio of net income to average assets, amounted to about 2.1 percent over the period 1987-88, compared to 2.5 percent at the two commercial banks. More importantly, the return on equity, before dividend payments to the government, was more than 19 percent, which is exceptionally high by standards common in more competitive financial markets. Just how this compares with the performance of the foreign-owned banks is not clear, since neither bank publicly discloses the results of its Lesotho operations. But such information as is available suggests that the two foreign-owned banks do even better, since their return on average assets is higher, and capital/asset ratios lower, than at the Lesotho Bank. Even on an inflation-adjusted basis, the foreign-owned banks have managed to generate very high real rates of return on equity. Indeed, last year the three commercial banks, taken together, generated a combined return on capital of slightly more than 35 percent.

Even after allowance is made for the credit and other risks to which banks are normally exposed, the rate of return on bank capital in Lesotho is extraordinarily high by any standard, certainly much higher than in other developing countries elsewhere in Africa. To a large degree, this simply reflects the tax exemption of interest on government obligations held by foreign-owned banks and the fact that the Lesotho Bank is fully exempt from taxes. But it also suggests that the allowance for credit risk implicit in bank lending rates is much higher than required by their actual loan loss experience. Both of the foreign-owned banks are bound by credit standards established by their head offices, and those standards typically call for substantial collateral requirements and/or assurance that the borrower is virtually invulnerable to cash flow problems. As a practical matter, these standards provide layer upon layer of protection against credit risks. Viewed from a somewhat different angle, the population of eligible borrowers is confined largely to established, well capitalized companies or to individuals whose net worth is relatively high to begin with. It is no wonder, therefore, that the incidence of loan losses is very low at both of the foreign-owned banks. But even if the banks were prepared to assume additional credit risks, either by relaxing credit standards or by extending loan terms, there is very little incentive to do so as long as the government continues to borrow heavily and interest on government securities remains tax exempt.

B. <u>Development Banks</u>

By contrast, the two development banks - the Lesotho Agricultural Development Bank (LADB) and the Lesotho Building Finance Corporation (LBFC) -- have each experienced sizable losses in recent years. Both institutions were established as specialized lenders, designed to fill some of the more obvious gaps in the availability of credit from other sources. Both were fully capitalized by the government at inception and have since funded their operations largely with grants or concessional loans from international agencies. Increasingly over the past three years, both banks have begun to rely on deposited sources of funds as well. Indeed, by the end of 1988 deposits with the LADB amounted to roughly one-third of its total liabilities. At the LBFC, the shift in funding structure has been even more pronounced, with deposits now well over half of its total liabilities.

By the very nature of their functions as development banks, these institutions should not be subject to the same standards of performance as commercial bank lenders. Clearly, commercial banks enjoy much more portfolio flexibility, and management is guided by a different set of corporate objectives. For development banks institutional objectives are more difficult to define, and there simply are no unambiguously clear criteria for performance. But it would be illusory to pretend that they are, in some sense, exempt from the need to perform altogether. To the extent that they rely on depositors funds they assume the same fiduciary responsibilities that any commercial bank lender carries. Capital committed by the government, or grants provided by donor organizations, both have implicit social costs, even if they are not recognized explicitly in the way the development banks conduct their operations. For whatever else they may be, development banks are not quasi-philanthropic organizations, and if they are to perform their essential functions utilizing revolving funds then, at the very least, they must manage to avoid any substantial or sustained losses.

In fact, both the LADB and LBFC experienced very serious losses a few years ago, but with new management the worst of their problems appears to be behind them. At the LADB, many of those problems were masked, at least for a while, by the failure of management to make realistic provisions for possible loan losses and the bank reported an average return on equity of 6.7 percent in three years ending in 1985. When the problem of non-performing loans was finally recognized in 1986, however, the bank had to write off as bad debts almost half of its loan portfolio and these losses, coupled with substantial increases in operating expenses, resulted in a massive reduction in the bank's reported capital. No new loan loss provisions were taken in 1987, or in 1988, but the bank continued to experience operating losses, bringing its cumulative net losses since 1979 to more than M 2.5 million, or about 43 percent of the government's paid-in and accumulated equity in the bank.

Until now the LADB has managed to ride out these losses on the basis of the substantial equity provided by the government. But clearly its future as an ongoing concern will depend on its ability to bring expenditures into line with available revenues, and to limit its vulnerability to loan losses through major improvements in credit management. There are some signs within the bank that this process has already begun. Moreover, at least part of the growth in operating expenses may reflect what are essentially non-recurrent expenditures incurred in connection with the recent expansion of the bank's branch network. And the average return on assets should continue to improve, as older loans originated earlier at relatively low rates are replaced by new loans at market-related rates of interest. But whether the bank is finally out of difficulty is by no means clear. Operating ratios are much higher than at the commercial banks, and until those expenses are under better control the bank will be hard pressed to maintain its competitive presence in deposit markets.

The LBFC suffered similarly heavy losses in 1986-87, when it had to make substantial provisions for possible loan losses. With the worst of those problems now out of the way, the bank is now profitable, at least marginally so. As already noted, LBFC has funded much of its recent growth through increased deposits, and all of its new mortgage loans now contain provisions for adjustment in rates in line with changes in deposit costs. Nonetheless, the average effective maturity of the mortgage portfolio is still longer than the average maturity of its deposit and other liabilities. Thus, the bank is exposed to interest rate risks, and if interest rates rise substantially it may discover that it has taken on credit risks as well. For owner-occupied housing, the bank typically finances at least 85 percent of the property value, and may go up to 95 percent. In the kind of sellers' market that has developed in Maseru, these loan to value ratios might seem to present no special problems. But if the market becomes overbuilt, as it could after the demands associated with the Highlands Water Project have died down, property values could turn out to be very fragile, especially for the kind of up-scale housing in which LBFC is heavily involved.

As a mortgage-specialized institution, LBFC appears to be sufficiently well-capitalized to absorb the kinds of routine credit risks to which mortgage lenders are exposed. However, its operating expenses, at about 5.5 percent of assets, appear to be higher than the operating ratios at commercial banks. And it is still burdened by the legacy of older mortgage loans originated years ago at relatively low interest rates. At this juncture, LBFC is still quite small, and hardly a competitive force in the Lesotho market. But even if the situation were otherwise, that would have little effect on the availability of agricultural credit, until ways are found to mobilize some of the accumulated equity in real estate for reinvestment in the agricultural sector.

V. INTEREST RATE PATTERNS

As long as residents in Lesotho are free to move funds to or from South Africa, the general level of interest rates in Lesotho is almost bound to follow movements in South African markets. As a practical matter, there is very little scope for any kind of independent interest rate policy in Lesotho. But there is at least some room for maneuver, and within the confines of the constraints imposed by monetary integration, the authorities do manage to influence both lending and deposit rates. The central bank establishes both the minimum rate payable on savings deposits and the prime lending rate. All other deposit rates are market-determined. And apart from an informal (and largely ineffective) ceiling on loans to smaller borrower, all lending rates to non-prime borrowers are also market-determined.

This pattern of interest rate regulation ensures that the level of domestic interest rates moves roughly in line with market developments in South Africa. Of course, in a fully competitive environment rates would respond very quickly. But in a country as small as Lesotho, with only a very limited number of rival banks, explicit or implicit collusion to drive down deposit rates is a very real risk. In a sense, an imposed minimum deposit rate compensates for the absence of any meaningful competition among banks. At present, the minimum rate on savings account, at 15.25 percent, is fractionally higher than the rate on similar accounts in South Africa. By contrast, the unregulated rates on time deposits in Lesotho are significantly lower than rates on deposits of comparable maturity in South Africa. Not surprisingly, the banks have been subject to large deposit withdrawals. Of course, the presence of credit ceilings may explain the banks' reluctance to bid more aggressively for term deposits. But whatever the reason, the fact remains that rates on term accounts are positive in real terms in South Africa and negative in Lesotho.

With respect to lending rates, the prime rate in Lesotho has usually been somewhat lower than in South Africa. However, even if the prime is not in perfect alignment, commercial banks in Lesotho are free to adjust any lending rates above prime, and there is every indication that average lending rates in Lesotho, currently about 20 percent, react very quickly to borrowing costs in South Africa. Whatever influence the authorities may exert in restraining any increase in lending rates is, at best, only transitory. The only borrowers that remain insulated from market developments are those that enjoy access to credit through the development banks, and even those institutions have begun to move lending rates closer to market levels. But they still have some way to go.

At the LADB lending rates are differentiated both by term to maturity and between certain loans funded on concessionary terms from external sources and those funded through deposits. In the latter case, rates currently range from 21 percent on short-term loans to 24 percent on loans with an original maturity of more than five years. However, the average return on the loan portfolio, including loans made at subsidized rates is clearly much lower. And until the LADB manages to raise its return on assets, it will be difficult to maintain, let alone increase its competitive presence in deposit markets. The plain fact is that the LADB cannot become a more self-sustaining institution, by paying fully competitive rates on an increasing deposit base, until it also manages to generate much higher, market-related rates of return on the loan portfolio as well. Much the same problem arises at the LBFC, where the initial rates on residential mortgage loans now range between 13 and 16 percent. Although these rates are subject to "ad hoc" adjustments as the cost of deposits changes, the present level of rates is still too low to enable the institution to pay more than the minimum rate on savings deposits.

This pattern of interest rate regulation presents a variety of policy dilemmas. It seems clear that the minimum rate on savings accounts is probably higher than it would be in the absence of any regulation. Moreover, the spread between that rate and the prime, or base, lending rate is certainly large enough to cover costs of intermediation at the commercial banks. But the development banks must offer the same minimal rate, even though they are not well equipped to do so, since their return on assets is much lower, and operating ratios much higher, than at the commercial banks. And in the absence of meaningful competition for term accounts, the banking public has every reason to maintain the bulk of their deposits in savings accounts. For the commercial banks, this need not present any special problems, since most of the assets they hold are similarly short-term in character. However, at the development banks, especially the LBFC, which still holds a large portfolio of fixed-rate loans, there is a substantial gap between the average loan maturity and the average term of the deposits used to fund those assets. In principle, the LBFC could reduce this maturity mismatch by offering higher rates on time deposits. But that would entail a further increase in interest expenses at an institution that is just marginally profitable.

All this suggests that the pattern of rate regulation is much more effective in raising returns to savers on very short-dated accounts than in insulating borrowers from the effects of rising interest rates in South Africa, where the prime rate is now 21 percent. For any borrower that requires medium- or long-term credit, interest rates at these levels can be very difficult to live with, unless a project generates large cash flows at a very early stage. Although the borrower's repayment obligation is fixed in nominal terms over the life of the loan, the real, inflation-adjusted burden, of repayments is higher in the earlier years of the loan than it is as the loan approaches maturity. To put the matter in a slightly different way, higher nominal rates of interest shorten the effective maturity of a loan, since the burden of repayments, in real terms, shifts increasingly toward the earlier years.

VI. CONCLUSIONS AND RECOMMENDATIONS

Many of the problems encountered by agricultural and other borrowers in Lesotho could quickly fade away, if inflationary pressures in South Africa subside and nominal rates of interest return to lower levels. However, in view of all the uncertainties about unfolding developments in that country, interest rates, both real and nominal, are more likely to stay at relatively high levels in the years ahead. Either way, the level of interest rates in Lesotho will remain dominated by events in South Africa as long as the linkages between the two countries remain intact.

This does not mean that the monetary authorities in Lesotho should leave borrowers at the mercy of market developments. Within limits, much more could be done than has been done to facilitate access to credit, and on terms that both borrowers and lenders would find possible to live with. This calls for policy changes in a wide range of areas, some of them far removed from the immediate needs of the agricultural sector. But unless some of the larger problems are resolved it will be all the more difficult to deal with problems that may seem confined to agriculture alone.

Perhaps most importantly, every effort should be made to reduce the budgetary deficit as quickly as possible in order to limit the government's recourse to monetary financing. For as long as the government continues to pre-empt financial resources, many would-be borrowers will simply be crowded out, and in the process otherwise viable, credit eligible, projects may have to be shelved. At the same time, and for much the same reason, the tax exemption of interest on government obligations should be eliminated, or phased out as rapidly as possible. As matters now stand, the exemption provides every incentive for lenders that are subject to income taxation to commit more of their assets to investments in short-term government bills than they would if interest on all loans and investments were treated the same way for tax purposes. Thus, rather than extend additional credit to non-government borrowers or bid more aggressively for new business through lower lending rates, banks have little or no incentive to develop new lending opportunities. As intended, the exemption facilitates financing of the government deficit, by subsidizing bank lenders, but the cost of this form of subsidization is carried by other borrowers for whom credit is available only at much higher taxable equivalent interest rates. Finally, the credit ceilings, however necessary they may be for other reasons, are counterproductive in terms of their effects on the willingness of banks to compete for deposits by offering higher interest rates. This problem could be alleviated by announcing that the bank-by-bank credit ceilings would favor those banks with the largest increase in deposits in the current year. In other words, banks would have to grow their way out of their present allocation by responding more fully to the needs of the banking public.

In targeting the specific problems of agricultural borrowers, changes are called for in three separate but related areas. First, in order to ease some of the repayment problems that may arise in the early years of a conventional term loan, consideration should be given to the use of graduated payment obligations under which repayments are tailored more closely to the borrowers repayment capabilities. These arrangements typically carry market rates of interest, but have lower initial payments than term loans of comparable maturity. In the many variants of these arrangements, all or part of the principal repayment is deferred, or interest actually paid is less than the computed interest charge, with the unpaid amounts capitalized and added to the outstanding balance due. If properly structured, the use of graduated payments arrangements would breathe life into projects that might otherwise never see the light of day.

Credit in any form, however, is no substitute for equity, and given the credit criteria followed by bank lenders in Lesotho, access to credit is virtually impossible, unless the applicant is willing and able to commit capital of his own to the project, or use assets owned outright to collateralize the loan. Many would-be borrowers are perhaps better capitalized than is readily apparent, because much of their capital is embodied in assets, that for many purposes are non-negotiable -- land, cattle, and shelter. In many countries, it is a simple matter to monetize any accumulated equity in residential property by refinancing a first mortgage loan or by taking on a second mortgage loan. Much the same kind of financing arrangement could be employed in Lesotho, since the LBFC now makes second mortgage loans. To be sure, it only does so on properties on which it holds the first mortgage, but there appears to be no reason why refinancing could not be extended to other properties as well.

More often than not, land is unsaleable, and hence ineligible as loan collateral, since most land is communally owned. But the rights to land use can be transferred in the form of "operating leases", and, in principle, the lease, or the stream of rental income it generates, can be used either for direct reinvestment in other activities or as a means to secure bank credit. At the very least, the authorities should examine the kinds of legal or regulatory changes that would facilitate the development of a more active market for land leases.

Finally, consideration should be given to the use of tax incentives to encourage lenders to commit funds for longer terms to certain types of agricultural activities. If there conspicuous gaps in the availability of agricultural credit, they lie in the provision of medium-term or project finance for agri-business. Whether this gap reflects a misperception of the risks involved or simply an inability on the part of lenders to recognize a viable proposal when they see it, is difficult for an outsider to assess. Whatever the reason, lenders are not indifferent to the after-tax return on loans. Thus, if the availability of project financing is limited by lenders' misperceptions of the risks involved, it may be appropriate to allow a lending institution to deduct part of its taxable income as an addition to its bad debt reserves, provided a specified percentage of its loans are held in project loans or other qualifying assets. In effect, this "bad debt" deduction would amount to a reduction in the tax rate for qualifying institutions, since it would exceed any reasonable expectation of loss.

Obviously, this kind of approach is designed to address the risk-adverse practices of the foreign-owned banks, since they are the only lending institutions that are currently subject to taxation. Moreover, an approach of this kind would be all the more effective if government securities were no longer tax exempt. For the LADB, however, tax incentives are irrelevant, since it is not subject to taxation of any kind. Indeed, the LADB stands ready to provide medium- and long-term financing, and has recently organized a project finance unit to identify viable projects or work with would-be borrowers in the preparation of project proposals. This is an area in which management at the bank is not very experienced, and could perhaps well use technical assistance.

Local Financial Markets Development

Study Outline and Scope of Work

Introduction

USAID is interested in conducting a study of the Local Financial Market (LFM) in Lesotho. The reason for this study is to better understand the functions of the LFM and to identify potential intervention strategies to strengthen the financial intermediation system, particularly as this relates to mobilizing local resources for investment in agriculture and private enterprise.

It is important that the donor community and Government understand the impact of interventions on the formal financial sector to ensure that programming contributes to a deepening of the LFM and increased availability of financial services. Past responses to the lack of readily available sources of credit have been to introduce specialized credit programs or a credit component to development projects.

Credit programs in the past have been predicated on the assumption that there is a strong demand for credit and that a real constraint to development has been a lack of supply. This study would challenge this premise by examining both the supply and demand constraints to credit delivery by the formal financial market. There needs to be a strategic approach to LFM development that considers both the reasons for restrictive credit policy and unexpressed demand.

Flooding the market with cheap credit is not a solution to this problem. Cheap and easily accessible credit can undermine the financial viability of local financial institutions. Instead we need to better understand why financial institutions behave the way they do and what the restrictions are on demand. In short, successful development programs will be demand led, especially with regard to credit.

The location of Lesotho's economy situates it under a much larger regional economy, that of the Republic of South Africa (RSA). There is a common monetary union that by definition integrates Lesotho's financial market into the RSA market. Lesotho can at best hope to build a regulatory and policy environment that resists the larger forces of the RSA market and extracts the greatest benefit locally. Monetary policy cannot be viewed in isolation of this reality. Therefore, in order to understand the LFM in Lesotho is important to understand the larger system which determines the conditions of development for Lesotho.

The banking system in Lesotho has for some years had excess liquidity. This liquidity has been drawn off and invested in RSA markets. There are four major players in the local market, two foreign commercial banks and two locally owned development banks.

The Government of Lesotho (GOL) has in recent years introduced regulations that have significantly increased the proportion of assets held in Lesotho. Banks have reduced foreign holdings and recently increased their local lending. This has resulted in increased lending to traders, households for consumption and GOL but has done little to channel investment into more productive sectors of the economy as was intended.

Effort now needs to be made to find ways of developing the potential for investment in local enterprise, mainly agriculture, agribusiness and manufacturing. This may be achieved with interventions that will increase the capacity of the formal sector to penetrate deeper into local markets while at the same time increasing the capacity of entrepreneurs to gain access to these institutions. The product of this study will be recommendations for intervention strategies to do this.

Proposed Study

A team consisting of four individuals; one resident Technical Advisor to the Lesotho Cooperative Credit Union League, one resident economist, one local individual familiar with commonly used in-formal financial arrangements, and one International Financial Market Expert hired from abroad, are expected to carry out the study over a period of six to eight weeks. The details of the study are outlined below.

I. Macro description of the RSA financial market system that shows trends in monetary and fiscal policy as it effects the Lesotho economy.

II. Description of formal financial markets and institutions and their management of liquidity.

A. An analysis of transactions costs in Lesotho to identify the main economic rational for the behavior of the formal sector. This would include an assessment of the perceptions of risk.

B. A description of the set of incentives under which the formal sector operates with an analysis of the underlaying logic of these institutions.

III. Description of household liquidity management.

A. An overview of transaction costs to households in dealing with the formal sector to provide insights to barriers to access these services.

B. Analysis of the real rate of return of traditional financial holdings used as alternatives to participation in the formal sector ie. livestock, buildings, inter-family lending and other common financial arrangements.

IV. Demand for Financial services.

A. What needs to be done to make it economically attractive for financial institutions to get more involved in expanding services to some of those presently left out.

B. What can be done at the household level to increase their usage of formal financial services.

V. Analysis of government policy and market distortions.

A. What are the major market distortions in the financial system (i.e.,donors, Govt, Others..)

B. How is government policy affecting the financial market.

VI. Conclusions.

A. What measures should be taken to strengthen and deepen financial markets in Lesotho.

B. Strategy for intervention.

21

Scope of Work for the Financial Markets Expert

The financial markets expert is expected to carry out the following tasks which were outlined above:

1. Macro description of the RSA financial market system that shows trends in monetary and fiscal policy as it effects the Lesotho economy.

2. Description of formal financial markets and institutions and their management of liquidity.

   a. An analysis of transactions costs in Lesotho to identify the main economic rational for the behavior of the formal sector. This would include an assessment of the perceptions of risk.

   b. A description of the set of incentives under which the formal sector operates with an analysis of the underlaying logic of these institutions.

3. Analysis of government policy and market distortions.

In addition, the financial markets consultant will be expected to advise on all other areas of the study and make appropriate recommendations regarding strengthening and deepening of financial markets in Lesotho and strategies for appropriate interventions. The consultant will also provide recommendations regarding the need for further studies. The consultant will spend 5 working weeks (30 working days) in Lesotho to complete his/her portion of the study.

Qualifications of the Financial Markets Expert

In order to complete this study USAID/Lesotho is interested in recruiting a senior level expert in financial market development to direct the policy and the institutional analysis portions of the study. A qualified candidate is expected to have employment experience with a formal financial insitution (either public or private). The financial markets expert shall have several years of experience in international financial market development with relevance to developing countries, formal financial institutions, and analysing government policy as it effects financial markets and financial institutions. Experience in developing countries is essential, experience in Africa is preferable. The consultant must be capable of communicating effectively with local senior level bank officials in both the public and private sectors, as well as with senior level government officials of the Central Bank of Lesotho and the Ministry of Finance.

The consultant must be able to write well in English, produce a written report within the time deadline, and work in a team setting.

Product

A written report is to be submitted to USAID/Lesotho by the financial markets consultant upon completion of his consultancy and before leaving Lesotho. This will be incorporated into a broader report to be completed by the resident team members.