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THE MONETARY SYSTEM OF LESOTHO:  
AN ANALYSIS OF COSTS AND BENEFITS.

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Lesotho has been using a foreign currency as its own medium of exchange and store of value since general purpose money was introduced in the country by Europeans at the beginning of the 19th Century. This situation prevailed in all other colonial and ex-colonial countries the world over at the early stages of colonial regimes. However, many of these peripheral states later on established what became known as the Currency Board Monetary system.<sup>1</sup> At the time of political independence, or just before, most of the ex-colonial states introduced relatively more independent Monetary systems than the currency board one. Thus, it could be said that political independence was the most important event which caused the creation of central banks in most of the relevant states. Indeed, such actions were regarded by many monetary experts from the metropolitan centres as mere expression of sovereignty which had no economic significance.<sup>2</sup> Other writers view the creation of central banks in these countries before significant development of the indigenous financial structure as an "active" behaviour which should be conducive to the promotion of economic development.<sup>3</sup>

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The material in this article is based on an earlier unpublished paper and on the writer's M.Phil. thesis at the University of Leeds.

1. Newlyn, W.T. and Rowan, D.C., Money and Banking in British Colonial Africa (London, Oxford University Press 1954)
2. Johnson, H.G., Further Essays in Monetary Economics (London, George Allen & Unwin Ltd., 1972), pp. 223 - 228.
3. Sayers, R.S., Central Banking After Bagehot (Oxford at the Clarendon Press 1957). chapter 9.

Lesotho is one of the very few countries which continues to use the most rigid foreign currency monetary system long after political independence.

The South African currency was made legal tender in Lesotho in 1932, without any formal monetary agreement. It was not until December, 1974 that a formal Monetary Agreement was signed.<sup>1</sup> However, as will be shown below, the agreement still leaves the basic features of the foreign currency system intact.

The aim of this study is to examine the costs and benefits of such a dependent monetary system from Lesotho's point of view. For an application of the theory of optimum currency areas to the Rand Monetary area, see the writer's earlier paper.<sup>2</sup> The approach here is to assess the costs and benefits of the present currency arrangements within the framework of the theoretical functions of the central banking monetary system in underdeveloped economies.<sup>3</sup>

## I. EVOLUTION AND FUNCTIONS OF CENTRAL BANKS

According to Hayek<sup>4</sup> the first use of the term "Central Bank" was that made by the Saint-Simonists in 1829 and 1830 when they were planning the reorganization of the banking system. However, the concept of central banking envisaged then bears very little relationship to the current concept which has evolved through experience.

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1. Monetary Agreement Between the Governments of Lesotho, South Africa and Swaziland, (December, 1974).
  2. "The Theory of Optimum Currency Areas and the Rand," Rhodesian Journal of Economic vol. 6, no. 2 (June 1972), pp. 49-53.
  3. This approach was employed by the writer in the unpublished M.Phil. Thesis: "The Development of the Monetary Economy and an Analysis of the Monetary and Financial System in the Republic of Botswana." The University of Leeds, 1976 ch. VI. Substantial parts of this paper are drawn from this work.
  4. Hayek, F.A., v. "The Counter-Revolution of Science" Economica Vol. 8 (May 1941), p. 145.

As Professor Sayers puts it,

"Before 1900, the development of central banking was almost entirely empirical. Ideas on the subject sprang largely from the efforts of the Bank of England to deal with practical problems."<sup>1</sup>

What then are the functions of a modern central bank? A list and discussion of these functions can be found in Fleetwood<sup>2</sup> and Newlyn.<sup>3</sup> For our purposes here we shall examine the costs and benefits of the absence of a central bank in Lesotho within the framework of the following functions of such an institution in a developing economy:

1. Sole issuer of elastic currency.
2. Creation and control of money and credit.
3. Lender-of-last-Resort.
4. Engine of growth of other financial institutions.
5. Banker to Government and other institutions.
6. Manager of exchange - rates and - controls.
7. Stimulation of National Savings for productive investment.
8. Economic research and financial planning.

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1. Sayers, R.S., "Central Banking" in International Encyclopedia of Social Sciences. Vol.2, p. 1.
  2. Fleetwood, E.E., Money and Finance in Africa (N.Y. Frederick A. Praeger 1964) pp. 67-68
  3. Newlyn, W.T., Money in an African Context (Nairobi, Oxford University Press 1967) pp. 71-79

## II. THE COSTS OF THE FOREIGN CURRENCY SYSTEM

The first cost to Lesotho for the use of a foreign issued currency as her domestic currency is connected with the factors behind changes in money supply. Currency is imported into Lesotho in exchange for exports of goods and services (EX) and as a result of inflow of capital funds from abroad (KI). The same currency leaves the country as a result of importation of goods and services (IM) and outflows of capital funds (KO). Therefore, the annual increments in EX and KI increase the stock of the Rand currency in the country while increments in IM and KO reduce the currency stock.

Given the fractional reserve banking principle, the changes in money supply (demand deposit component) are caused by changes in bank lending to the Government and the private sector. This is generally called domestic credit expansion (DC). The complete money stock (MO) marginal relation in Lesotho can be written as in any economy with an independent monetary system as:

$$\Delta MO = \Delta EX + \Delta NKI + \Delta DC - \Delta IM$$

Where MO = Currency plus deposits  
 NKI = net capital inflow  
 the rest as defined above.

The social cost here results from the fact that a large part of the export element in the currency imported is obtained by giving up real goods and services when in practice that part of the currency could be issued without giving up these real resources. This type of currency has been called fiduciary issue. This means that there is currency circulating in Lesotho which will never be converted into foreign currencies. The real goods and services backing this possible fiduciary issue are clearly being hoarded. The opportunity cost of hoarding these resources is the number of productive projects (and number of jobs and output) not financed.

The second source of costs to Lesotho is connected with the inability of the system to provide sufficient elasticity in the supply of currency to meet wide seasonal fluctuations in the demand for currency or the medium of exchange in general. Inelasticity in the supply of currency is increased by absence of swift and cheap means of transport and communications and by the absence of bank offices in the larger part of the country.

Evidence available shows that many Lesotho producers in the hinterland have to wait for two or so months for their receipts from sale of mohair. In the meantime, any improvements in their production for the next market must be suspended. Very often the producers are forced to sell their products to local traders for immediate cash but at usurious discounts.

The benefits derived from the use of money are bound to be reduced in an economy characterised by shortages of cash. Further, there will be a redistribution of these benefits from those poorer communities to the urban areas where not only currency is readily available but where cheque book money is used widely. With reference to the period when America used European currencies as medium of exchange,

"The burden of the inelasticity of note issues, resulting under the given circumstances in a partial inelasticity of loanable funds, fall on those sections of the country which were not sufficiently developed to find a way out by using deposit money instead of banknotes."<sup>1</sup>

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1. Redlich, F. The Holding of American Bankings: Men and Ideas.

(New York and London, John Wiley & Sons, 1911) Vol. II, p. 120.

The social cost involved should not be underestimated because the majority of people in rural Lesotho have no access to deposit money.

The third form of cost to Lesotho is the foregone net income which arises from the manufacture of currency. Since currency is now issued the world-over under monopoly conditions, nearly all central banks are making profits (although they are supposed to be non-profit motivated) on various accounts.

One form of income foregone by Lesotho is seigniorage which any issuer of currency must earn. It is defined as the difference between the monetary value of currency and the value of raw materials used in the manufacture of the currency. The amount of seigniorage foregone by Lesotho (up to 1972) can be represented by the following expression:

$$S = \sum_{t=0}^T [C_t - C_{t-1}] - K_t$$

Where S = net seigniorage

C = currency outstanding at the end of each period,

K = Cost of manufacturing the incremental currency.

The significance of this source of revenue can be discerned from the following legal provision by the South African Government:

"The Minister of Finance may ... pay to any other state such portion of the profit derived from the manufacture, in the Pretoria Branch of the Royal Mint, of silver and copper coins issued therefore for use in such state, as may be agreed upon between the said minister and the government of such state."1

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1. The Union Financial Adjustments Act, No. 34 of 1930,

Section I(1).

However, no such payment was made to Lesotho although Southern Rhodesia received half of the profits on South African coinage imported into that country.<sup>1</sup> It is important to note that over the period 1870 to 1937 the rate of seigniorage at the Royal Mint ranged from 9,09% to 529,87%<sup>2</sup>.

A more important source of revenue which Lesotho lost for several decades is the backing of currency in circulation. Instead of holding the Rand, Lesotho could have issued her own local currency and used the Rand withdrawn from circulation to purchase South African interest-earning debt instruments. The net income from this investment account can be represented by the following expression:

$$Y = \sum_{t=0}^T (i_t C_t - K_t)$$

Where Y = sum of net income foregone up to (1972)

C = currency outstanding at the end of period t,

i = current rate of return on earning assets

Even if Lesotho decided to convert all the Rand withdrawn from circulation into Gold, she would have earned the large capital gains from the recent increases in the price of Gold. In fact, South Africa has held a very high proportion of its foreign assets in form of gold partly because the interest income from foreign exchange investment was believed to be much less than the capital gains from the probable rise in the price of gold.<sup>3</sup>

1. Ibid. Section I(2).

2. Annual Reports of the Deputy Master and Comptroller of the Royal Mint, 1935-1938

3. Fransen Commission Report, 1970, p. 261. The other reason is the fear of having her foreign assets frozen for political reasons.



By virtue of its role as a pool of cash reserves of the economy and a creator of money a central bank is placed in a strong position to earn interest income on advances and discounts to the private sector (via financial institutions or directly) and the public sector. The 1974 Rand Monetary Agreement actually has made it easier for the above sectors to borrow from abroad, which implies larger payments of interest to South African residents.<sup>1</sup> Since nearly half of local deposits end up in South Africa through the financial system, Lesotho is actually paying interest on its own resources to foreigners.

•• The fourth form of revenue lost by Lesotho due to the use of a foreign currency as her circulating medium is the inflation tax<sup>2</sup> which the economy is paying to the issuer of the Rand currency - the South African Government. The amount of inflation tax revenue can be represented by the following expression:

$$R = \frac{dP}{P} \cdot \frac{C}{P}$$

Where R = inflation tax revenue

$\frac{dP}{P}$  = rate of inflation which is the tax rate.

$\frac{C}{P}$  = real stock of currency in circulation which is the base of the tax.

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1. Monetary Agreement, 1974, Article 4.
  2. Friedman, M., "Government Revenue from Inflation", Journal of Political Economy vol. 79, (July/August 1971), pp. 846 - 856.

If and when Lesotho issues her own currency, this revenue will be received by the Lesotho Government. Should the inflation rate be very high, then from this revenue must be subtracted the loss to society resulting from reduction in the demand for currency and therefore reduction in the benefits derived from the use of currency.<sup>1</sup> This form of tax revenue can be significant if the rate of inflation is moderate (that is up to 10%).<sup>2</sup> Newlyn puts the limit at 30%.<sup>3</sup> However, since the tax base (ratio of money to income) is smaller in economies with large non-monetary sectors, this form of tax revenue be very small.

Since the rate of inflation in the Rand monetary area rose up to a maximum of 14% and has never reached the Newlyn limit, it can be inferred that Lesotho has indeed not only lost substantial inflation tax revenue but, as holder of Rand Currency, has also paid inflation tax to the more developed neighbour. Given an estimated real stock of currency in circulation in Lesotho as at 31st December, 1973 of about R11,0 million<sup>4</sup>, the gross inflation tax revenue involved here is about R1,54 million at a rate of inflation of 14,0%.<sup>5</sup>

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1. Bailey, M. J. "The Welfare Cost of Inflationary Finance," The Journal of Political Economy, vol. LXIV, 1956, pp. 93-110.
  2. Johnson, H. G. Essays in Monetary Economics, (London, George Allen & Unwin Ltd., 1967) p. 201.
  3. Newlyn, W. T. Financing Economic Development, (Forthcoming)
  4. 1974 Monetary Agreement, Article 6(1d) gives a nominal stock of currency of R12,5 million.
  5. This cost is not taken into account by the formula for compensatory payments to Lesotho and Swaziland as provided by Article 6.

The sum of the above revenues foregone has been reduced as of 1st January, 1972. From this date, Lesotho has been receiving annual revenues equal to two thirds of the product of the prevailing yield on South African Government bonds and the agreed estimated currency in circulation in Lesotho. This amounts to about R1 million per year, and is said to represent a return on the Rand currency circulating in Lesotho.<sup>1</sup> According to our analysis here, this compensation may not even cover the net seigniorage plus income from the currency fund investment. For one thing, the stock of currency in circulation could be much higher than is used in the formula. Secondly, the costs of management of the currency suggested by the formula may not be as high as one third.

The third point is that (as indicated by table 1), if Lesotho had an independent currency and therefore freedom of choice, there is no doubt that she would most probably invest at least higher yield part of the currency backing in/United Kingdom Government bonds.

Table 1

	Long-Term Government Bond Yield Differentials				
	South Africa (%)	Japan (%)	United Kingdom (%)	United States of America (%)	Differential S.A. - U.K. (%)
1972	8,13	8,70	8,91	5,63	-0,78
1973	8,00	7,26	10,72	6,30	-2,72
1974	9,50	9,26	14,77	6,99	-5,27
1975	10,00	n.a.	14,39	6,98	-4,39

Sources: SARB, Quarterly Bulletin, Dec. 1974 and March, 1976. IMF., International Financial Statistics, March, 1976.

The sum of the inflation tax, capital gains from the recent 16% to 20% rise in the price of Gold for monetary use, and interest income from discounts, advances and loans is still being lost by Lesotho as a result of her membership of the Rand Currency Union.

1. 1974 Monetary Agreement, Article 6(1a).

The Fourth Cost to Lesotho arises from the inability of the authorities to create money and credit in order to facilitate growth of national income. The need to create money and credit is generated by the failure of the economy to produce sufficient savings to finance domestic investment.<sup>1</sup> The inelastic supply of goods in a country like Lesotho may obviate the need to create money. Nevertheless, when the need to create money arises, the authorities should be in a position to do so in the national interest.

The absence of a lender-of-last resort in Lesotho has deprived the economy of an important instrument for the promotion of the sound development of indigenous producers of goods financial institutions and financial assets. Without an institution equipped with unlimited powers to supply liquidity for the whole economy in the event of economic and financial crises, the economy is exposed to damaging deflationary pressures.

Empirical evidence exists showing that the Lesotho farmers, traders and consumers co-operative movement since 1931, has been seriously constrained by shortage of liquidity and lack of sound financial management guidance.<sup>2</sup> With respect to marketing societies there was,

"Considerable delay between the time the members delivered the wool/mohair to the society and the day on which they received payment. In order to avoid this constraint societies needed finance to give advances to members while awaiting the sale of wool/mohair at the coast."<sup>3</sup>

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1. Newlyn, W.T. Financial For Development (1963) p. 61.
  2. Co-op Division, Annual Report 1975 pp 1 - 3.
  3. Ibid., p.1.

This legitimate need for credit was partially met by the establishment of the Basutland CO-operative Banking Union (B.C.B.U.) in 1957. The main objective was to finance primary societies for agricultural credit, marketing of agricultural produce and bulk purchasing of goods in order to take advantage of cash discounts.<sup>1</sup> The relative importance sources of funds required to meet this objective can be seen from Table 2. The heavy reliance on expensive loan finance was clearly one of the most serious weaknesses of the BCBU. Secondly, some of those funds were employed in long-term projects which reduced the liquidity of the institution. In 1963, the BCBU was dissolved,

" ... because of serious financial problems which had been caused by misappropriation of funds." <sup>2</sup>

According a credit expert to Lesotho, if all depositors with the B.C.B.U. were to demand immediate withdrawal the position would have been very serious.

What is not mentioned as one of the causes of failure of the B.C.B.U. is that in the absence of sharp competition from foreign commercial banks (backed by powerful lenders-of-last resort), this indigenous banking concern would have had more profitable business and the liquidity problem would have been substantially reduced.

In short, this indigenous banking concern lacked both liquidity and sound financial management. A lender of last resort would have guaranteed adequate liquidity and would have necessarily laid down sounder financial management rules. The failure of the BCBU had two effects. Firstly it reduced economic activity in Lesotho to some extent since this institution had become the basic source of liquidity for the entire

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1. Ibid. p.3.

2. Co-op Division, Annual Report, 1975 p.3

Table 2

Basutoland Co-operative Banking Union Ltd. Sources of  
Funds as at End of year 1961/62

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	<u>Amount</u> (R)	<u>Percent of</u> <u>Total</u> (%)
1. <u>Overdraft at Barclays Bank</u>	300 000	45,8
(a) Guaranteed by British Government( 2000000)		
(b) Guaranteed by Lesotho Government(100 000)		
2. <u>American Revolving Loan</u>	173 500	26,5
3. <u>Loans From Internal Sources</u>	69 000	10,5
(a) Basutoland National Treasury(15 000)		
(b) Basutoland Co-operative Savings Society(47 000)		
4. <u>Deposits, Investments and Share     <u>Capital</u></u>	72 700	11,1
5. <u>Gifts from Oxfam</u>	40 000	6,1
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TOTAL	655 200	100,0
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Source: Annual Report on Lesotho, 1962. p.45.

Cooperative movement. Secondly, the development of an indigenous banking and financial system was seriously retarded, thus increasing the public's confidence in foreign banks which have consistently acted negatively to the development of the Lesotho's infant monetary economy.

Recently, (October 1972) the indigenous Lesotho Bank; National Development Bank started operations in the absence of a lender-of-last resort. The bank was equipped legally with powers to act in an active or supply-leading manner in agriculture, local industry, commerce and tourism.<sup>1</sup> A study of the operations of this bank shows that the institution has been transformed into a commercial bank doing very little development banking. Its liquid assets deposit ratio was as high as 103,7% in 1975 and 94,5% in 1976. If migrant workers deferred pay fund is included in the denominator the corresponding ratios are 54,9% and 50,6%.<sup>2</sup> These developments, the change from development banking to commercial banking and the maintenance of high liquid asset ratios are quite consistent with the circumstances within which the institution is operating. Without the backing of an indigenous lender of last resort, it would be bad banking business for the bank to act otherwise.

Another reason advanced for the above behaviour is that the bank is having severe staffing problems. The central bank or lender of last resort we have in mind here is expected to provide not only finance but also financial management services to the institutions it lends funds.

It should be noted, however, that according to the 1974 Rand Monetary Agreement, the Lesotho and Swaziland authorities can make an arrangement with the Government of South Africa whereby the latter,

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1. First Five-Year National Development Plan 1970-75 pp 211-212.
  2. Deferred Pay Fund increased from R6, 6 million in 1975 to R10,3 million in 1976.

" .... shall in special circumstances cause the South African Reserve Bank in its capacity as lender of last resort to make available to either such Government temporary central banking credit facilities in such forms and amounts and on such terms as may be agreed upon at the time." 1

Whether the South African Reserve Bank (SARB) can be taken as a true lender of last resort for Lesotho's economy or not will depend on what is meant by special circumstances. It is very unlikely that the inducement and encouragement of the rapid develop<sup>ment</sup> of indigenous and financial institutions, domestic enterprises in Lesotho could be accepted as a special case deserving central banking credit support. In an underdeveloped economy, the central bank has to be much closer to productive units than in an advanced economy. That the SARB is not really regarded as a reliable lender of last resort for the entire economy is confirmed by the following quotation:

"The present ratio (of local loans to deposits of commercial banks) may be considered low in comparison with many other countries. However, in view of the absence of a central bank as a lender of last resort the lower ratio in Lesotho provides an additional safety margin which is needed." 2

The point here is that the sort of lender of last resort envisaged in the 1974 Monetary Agreement cannot be the one designed for the promotion of economic development in the poorer member countries.

The next important loss from the absence of a full-central banking concern in Lesotho is the higher costs of borrowing funds (by the Government itself) than if such an institution existed. Governments with central banks practically pay zero rate of interest when they borrow from the latter. The Lesotho Government must pay a rate greater than zero since it has to borrow from commercial banks which charge a rate of 1,5% above the South African Reserve Bank rate.

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1. 1974 Rand Monetary Agreement. op.cit. Article 4(4). Underlining is my own.
  2. Registrar of Financial Institutions, Annual Report, 1976. p.6.



The magnitude of the cost involved here can be discerned from table 3. For an underdeveloped economy, this cost should not be underestimated.

Table 3.

The SARB Rate and Rate of Interest By the Lesotho Government

End of	Bank Rate	Rate Paid By Lesotho Government	Government advances from Commercial banks.
	(%)	(%)	(ROOC)
	(1)	(2)	(3)
1968	5,5	7,0	336,0
1969	5,5	7,0	444,0
1970	5,5	7,0	
1971	6,5	8,0	
1972	6,0	7,5	
1973	5,5	7,0	
1974	8,0	9,5	
1975			

Source: SARB, Quarterly Bulletin 1974 & 1976 for Column (1). Lesotho Authorities for columns (2) and (3), March, 1978.

On this account, the costs to the Government of Lesotho and the economy clearly exceed the benefits (if any). The amounts of borrowing constituted about 1,1% of the average overall deficit<sup>1</sup> for period 1966/67 - 1968/69 and 7,0% over the period 1969/70 - 1971/72. Thus, such borrowing from the central bank could not have been inflationary. As we indicated above, a moderate rate inflation in any case would have transferred real resources from money holders to the Government for development purposes.

1. Current and capital expenditure minus current receipts.

From the point of view of the economy as a whole, it has been observed that for many underdeveloped economies, a central bank was regarded,

"As an agency for bringing about an era of low interest rates and the rapid development of the resources of the country."<sup>1</sup>

The low interest rate policy suggested here is only appropriate to the "small man" who constitute the majority of people in Lesotho. It would be inefficient to apply it to more prosperous borrowers.

The outflow of surplus funds from Lesotho due mainly to the absence of an indigenous banker to the Government and other financial institutions is another source of losses to the Lesotho economy. The funds so exported earn income which accrues to foreign shareholders of the private foreign financial institutions. To <sup>the</sup> extent that some nationals also invest their surplus funds outside the economy, the higher interest income earned abroad may be an important addition to the national income. However, the development of a growing stock of liquid financial assets is clearly more important than private interest income.

Another important point here is that the banker to the Government also advises the latter in all financial matters. In the absence of such an institution, a foreign private bank has been playing this role, in its own private interest, of course.

We now turn to an extremely important function of a central bank in underdeveloped economies.

It is now generally accepted that the inducement of the development of sound local financial institutions is one of the most important supply-leading development functions of a central reserve bank in financially

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1. Sen, S.N. Central Banking in Underdeveloped Money Market (Calcutta, 1967)

developing economies.<sup>1</sup> First, we should examine the case for active indigenous financial systems in developing countries.

The theory of finance tells us that the greater the financial intermediation, the larger will be the volume of national savings for economic development and the more convenient and cheaper the finance to borrowers.<sup>2</sup>

Although foreign financial institutions have existed in most developing countries of Africa, these have not been successful in achieving the objectives assigned to financial intermediation. The basic reason is that the foreign private financial institutions operating in Africa have a structure, specialism, orientation and philosophy which are not tailored to the mobilization and productive utilization of domestic financial resources within a developing economy.<sup>3</sup> Indigenous financial institutions help to broaden the financial structure in order to provide avenues for effective utilization of domestically-generated investible funds. Public and private indigenous financial institutions are likely to be more responsive to the call for national economic development than foreign owned and managed ones. For one thing indigenous managers are subject to domestic laws and for another they have naturally closer ties with the masses of users of financial services.

For these basic reasons, the deliberate development of active local financial institutions is essential for economic development. However,

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1. Patrick, 1966, *Op. Cit.*,; R. Goldsmith, "Central Banks and Financial Institutions" in: D. Krivine (Ed). Fiscal and Monetary Problems in Developing States: The Proceedings of the Third Eschvath Conference. (New York, Praeger Publishers, 1967) chapter 22.; A. F. Brimmer, "Central Banking and Economic Development" Journal of Money, Credit and Banking (November 1971), pp. 780-792.
  2. Furness, E. L., An Introduction to Financial Economics (London, Heinemann, 1972); U. Tan Wei Financial Intermediaries and National Savings in Developing Countries (London, Praeger Publishers, 1972) p. 111.
  3. UN, ECA, Savings Mobilization in Developing African Countries (Addis Ababa, 12 November 1973) E/CN.11/HOU/107, p. 29

"Without an effective lender of last resort it is unrealistic to hope for the development of indigenous banks in small economies in the face of stiff competition from the entrenched branches of international banks."<sup>1</sup>

development of local credit institutions.

The situation in Lesotho is very critical in that the bulk of total domestic deposits is collected by the two foreign commercial banks, building society agencies and insurance companies. Thus, banking power is completely in the hands of foreign financial institutions. For this reason, they pose an effective threat to any private indigenous commercial bank which may be established.

If a central bank existed in Lesotho with an objective of inducing rapid development of indigenous institutions, it would have to protect the local banks against competition from the foreign ones.<sup>2</sup> The "infant bank" protection can take different forms, including subsidization, granting them monopoly in certain areas of business, tax concessions, and turning them into bankers of public institutions.

It may be argued that there is no need for a central bank for the particular purpose of promoting the development of local financial development institutions because the Government of Lesotho has actually created the Post Office Savings Bank, the Lesotho National Development Corporation and the National Development Bank without a central bank. However, it is generally recognised that the efficient inducement and control of financial institutions requires an institution whose staff has a common background with that of staff of other institutions whose day to day operations are similar.<sup>3</sup> In this case a central bank is the most suitable enterprise to develop and control indigenous financial institutions.

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1. McLeod, A., "The British Currency - board system - Successes and short-comings" The Banker, Vol. 125, 1975, pp. 247-252.
  2. Griffiths, B., Invisible Barriers to Invisible Trade (London, 1975)
  3. Newlyn, W. T., Report on Economic Policy in Uganda Unpublished (May 1959)

For example, the situation where indigenous financial institutions find themselves depositing huge reserves with foreign banks, whose investment behaviour is negatively responsive and was the very reason for establishing local banks of a different type, is clear evidence for the failure by the Government of Lesotho to correct the exploitative and inefficient financial system. Only a central banking system is likely to promote a sound and efficient indigenous financial system.

The basic point here is that the absence of a central bank in Lesotho has deprived the present indigenous credit institutions of a reliable and effective lender of last resort. As a result, their impact has been limited. That none of the Government financial institutions has yet collapsed is because they have been extremely cautious in the absence of ultimate re-discounting facilities. As a monetary commission to Cuba also observed,

"This lack of re-discounting facilities has doubtless been one of the factors retarding the development of Cuban-owned banks"<sup>1</sup>

Actually most of the Cuban banks did collapse in 1920 in the face of severe insufficiency of liquidity.<sup>2</sup> Most of the Nigerian indigenous banks had collapsed by 1954 due basically to shortage of funds.<sup>3</sup>

In summary, the economy of Lesotho has incurred social costs in form of a higher volume of national savings foregone and higher cost of finance to borrowers, as a result of the absence of relatively more important and efficient indigenous financial institutions. However,

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1. "Report to the Cuban Government of the American Technical Mission to "Cuba" Federal Reserve Bulletin Vol. 28, no.8 (August 1942) p.775.
  2. Wallich, H.C., Monetary Problems of an Export Economy (Cambridge, Harvard University Press 1960) p.43
  3. Ewankwo, G.O., "Indigenisation of Nigerian Banking" The Bankers' Magazine Vol. 214 ( July 1972) pp. 15 - 21.

this social cost must ultimately be traced to the lack of a central reserve bank equipped to act as an effective lender of last resort.

Once an indigenous financial system has emerged the allocation and control of credit has to be socially optimum. For one of the key purposes of a central bank equipped to regulate the movement of money and capital funds is to capture all investible surpluses and direct them towards national development according to the national development plan.

Many developing countries have employed differential discount rates, portfolio ceilings, differential reserve requirements linked to the composition of bank portfolios and import deposit requirements in an attempt to reallocate credit optimally from a development point of view.<sup>1</sup> There is no doubt that credit has been misallocated in Lesotho from a social point of view. This must be so because the foreign private banks which are responsible for over 90% of domestic credit expansion are guided by the profit motive rather than social gain.

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1. Brimmer, A.F. "Central Banking and Economic Development"  
"Journal of Money, Credit and Banking" (November 1971) pp. 780-792,  
particularly pp. 786-789.

Lesotho does not possess one of the most powerful tools of monetary policy - the foreign exchange rate. The Government of Lesotho cannot devalue or revalue the currency or resist such changes in the interest of the Lesotho economy.

It has been argued that there is no balance of payments "problem" in a dependent economy such as that of Lesotho.<sup>1</sup> This argument correctly refers to the problem of finding means of financing a deficit. The Ministry of Finance in Lesotho need not worry about where to get foreign exchange to finance the deficit. However, the process of adjustment in the balance of payments deficit results in the reduction in economic activity, employment and money incomes since the exchange rate is fixed immutably.<sup>2</sup> The social costs of this deflationary adjustment process should not be underestimated in an underdeveloped economy with a large unemployed population.

According to the theory of optimum currency areas,<sup>3</sup> if labour can move freely from the depressed (Lesotho) to the prosperous member of the currency union, the social cost involved here would be reduced. In that case, the currency area can be regarded as optimum or ideal. The situation is that because of job reservations for whites and general apartheid laws and practices, the free mobility labour, especially from Lesotho to South Africa is extremely restricted.

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1. Greaves, I. Colonial Monetary Conditions, (H.M.S.O., 1953), and A Hazelwood, "Economics of Colonial Monetary Arrangements" Social and Economic Studies Vol. 3, Nos 3 and 4, 1954.
  2. Thomas, C.Y. "The Balance of Payments and Money Supplies of a Colonial Monetary Economy," Social and Economic Studies Vol. 12, 1963.
  3. Mundell, R.A. "A Theory of Optimum Currency Areas," American Economic Review Vol. 5, no. 4. (September, 1961) pp. 657-665.

Advance deposits on imports is another monetary instrument connected with the exchange rate which has been employed by several underdeveloped economies to correct balance of payments deficits, to promote economic development or to maintain domestic monetary stability.<sup>1</sup> Dual exchange rate system has also been used by several underdeveloped countries as an instrument of industrial development.<sup>2</sup> Before introduction of a local currency in Botswana foreign commercial banks and other financial institutions could not be prevented from employing huge surplus funds outside the economy. After introduction of exchange controls, foreign balances of the institutions dwindled.

All these instruments have had some favourable effects on the economy of countries possessing currency issuing central banks. Therefore there is no reason why Lesotho should not benefit from possession of the same instruments.

Planning for economic development is now widely regarded as an instrument of economic policy. However intelligible planning requires adequate statistical data and economic and financial analysis of relevant variables. The free flow of goods and services on one hand and payments and receipts on the other between Lesotho and South Africa makes collection of statistical data extremely costly and impossible in some cases.

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1. Brimmer, 1971, op.cit. pp - 788-789. Birnbaum, E.A. and M.A. Qureshi, "Advance Deposit Requirements for Imports," IMF Staff Papers Vol. - 8, 1960/61, pp. 115 - 125.
  2. Kahnert, F. et al. Economic Interrelation Among Developing Countries (Paris, O-E-C-D. 1969) p.107



The introduction of a local currency in Lesotho will not only make it possible to collect more adequate data but will also enable the authorities to undertake more significant economic and financial research. Every central bank the world over has a research department, and, of course, a unit.

" The relevance of central banks to economic planning derives from the fact that nowadays they are almost everywhere regarded as being, in some sense, part of the governmental structure and are expected to contribute to the formulation of national economic policy."<sup>1</sup>

Being unable to create money and credit, the Government of Lesotho cannot be expected to control money and credit. This is why it has been said that indigenous monetary policy is not possible in a country without its own currency. This does not mean that monetary and credit conditions in Lesotho do not change. Changes in the monetary policy of South Africa designed to deal with economic conditions in that country influence the cost of borrowing, availability of credit and the price level in Lesotho.

The writer believes that a greater scope for monetary control existed than the authorities recognised or were willing to exercise. For example, Lesotho could have had a banking legislation of its own immediately after political independence directed at the control of two foreign commercial banks.<sup>2</sup> Such a law could have modified the investment

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1. Moynihan, M. "The Role of a Central Bank," In Economic Planning and The Banking System: Proceedings of a Seminar of the 21st International Banking Summer School (Dublin, Institute of Bankers in Ireland, 1965) pp. 13-27, especially p.14.

2. The relevant Financial Institutions Act No.23 of 1973 was finally introduced in 1974, nearly ten years after political independence.

policy of these foreign banks, even-though it is more difficult for the Government to do so than a central banking authority. A few examples of the potential monetary policy instruments in the absence of a central banking authority can be cited.

Moral suasion by the Minister of Finance or the Prime Minister has been used in Lesotho. The foreign banks have been asked through speeches, the National Development Plans and articles in the press. This weapon has not had much effect(if any) basically because the Financial institutions involved are foreign and bound by their country's laws and head offices to follow an investment policy which suits the interests of their shareholders, even if such a policy goes against Lesotho national development objectives.

For example, after the Government of Lesotho had written to the Foreign financial institutions to change their investment behaviour in the interest of Lesotho from which they collect savings, two of the foreign financial institutions replied.<sup>1</sup>

"In response to your recent request that we should investigate the feasibility of investing in Lesotho we have to advise that our investment policy, which is formulated by our parent company in the United Kingdom, does not permit us to invest in territories outside the Republic of South Africa. (Security Life Assurance Corporation Ltd- 12th October, 1976)."

" Our investment policy, which is laid down by our chief office in London, does not permit us to invest funds outside the Republic. (The Prudential Assurance Company Ltd-14th October 1976)."

There is no doubt, however, that if these institutions were <sup>indigenous,</sup> moral suasion would have been much more effective than has been the case.

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1. Gurr, R. (Ed.) Transnational Corporations and Developing Countries: Proceedings of a Conference held at Maseru, ( March 23-25, 1977),  
p.3.

Another possible instrument of monetary policy in the absence of a central bank is liquid Assets ratio accompanied by ceilings on liquid assets ratio and credit floors on a discriminatory basis. The Financial Institutions Act 1973 provides for minimum liquid assets ratio, the maximum maturity of these assets being set at 370 days.<sup>1</sup> The Act, however, does not provide for liquid assets ratio ceilings and credit floors in particular sectors of the economy such as agriculture.

The net result is that the banks affected by the Act hold most of their deposit liabilities in foreign assets which are legally included in the liquid assets ratio. Since the introduction of the liquid assets ratio, the commercial banks in Lesotho have generally maintained excess liquid assets of over 100% of the required ratio.<sup>2</sup> This provision has therefore the effect of ensuring liquidity in order to meet sudden wide withdrawals of deposits but this monetary policy instrument has little effect (in any) on the amount of commercial bank credit channelled into agriculture or indigenous industrial enterprises.

The main point here is that some monetary policy is possible in Lesotho. However, from an economic development point of view a more meaningful and effective monetary policy is impossible without the appropriate monetary authority - a central bank.

The openness of the economy of Lesotho will impose limitations on effective monetary policy even if a local currency is introduced. However, limited independent monetary policy is better than none at all. Once

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1. Financial Institutions Act, 1973, Section 22.

2. Registrar of Financial Institutions, Annual Report, 1976, p.8.

the country possesses the instruments of independent monetary management, innovations can always be made to make monetary policy more effective. In any case, monetary independence should be regarded as an important attribute and symbol of national identity and sovereignty.

There is an important cost connected with lack of monetary management. It is often said that use of the Rand enables Lesotho to save on manpower which is one of the most crucial factors constraining development. What is not recognised is the fact that by not running an independent monetary system, the country is foregoing the opportunity of <sup>acquiring</sup> / expertise in monetary matters. The result is that ten years after political independence the country still has to rely heavily on foreign monetary experts, most of whom are unfamiliar with local conditions.

III SOME BENEFITS OF THE FOREIGN CURRENCY SYSTEM

The next task is to examine the gains Lesotho receives from the use of a foreign currency as a domestic medium of exchange.

One of the benefits which is associated with a common currency is that the larger the area within which a monetary unit circulates freely, the greater the benefits from the use of money (and specialization) accruing to the area as a whole.<sup>1</sup> Within the larger currency area, transactions costs and costs are lower than in a smaller one. Factors of production move more freely seeking higher returns. This results in greater allocative efficiency and higher degree of integration of the member countries. However, it must be pointed out that these gains from formation of currency areas do not always accrue to all members of the currency area equitably.

Lesotho has been a heavy exporter of capital to the South African money and capital market. The benefit from reduction in costs of transfer of these funds and interest income is much less than the opportunity cost of capital so transferred. On the goods and services account, costs of transactions between Lesotho residents and South African residents are indeed lower than they would have been if exchange control existed between the two countries. However, the free inflow of goods and services into Lesotho - the less industrially developed country

has subjected infant industries in this country. This is the case even though the 1969 Customs Union Agreement between Botswana, Lesotho, South Africa and Swaziland and the 1974 Monetary Agreement between Lesotho, South Africa and Swaziland Governments do include clauses which give the less developed members of the area powers to restrict the outflow of capital funds to and the inflow of certain goods and services from the more developed member.<sup>2</sup>

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1. Bos, P.C. Money in Development (Rotterdam, Rotterdam University Press, 1969), pp. 60-61.  
2. The 1969 Customs Union Agreement, Article 6. The 1974 Rand Monetary Agreement, Article 3.

In summary, exchange costs, exchange risks, and the inconvenience thereof are smaller in a larger monetary area than in a smaller one. However, the opportunity costs of free capital outflow and free commodity and services inflow with respect to Lesotho are much greater than the gains mentioned here. That is why partial monetary and customs unions have been formed in most integration schemes involving countries at different stages of economic development, such as those in Southern Africa.

Another benefit to Lesotho of the use of the Rand currency is said to come from the strength of this currency and its international acceptability. It is said that because Lesotho is a small developing economy it does not have the resources with which to issue and manage a stable currency of its own. Therefore, Lesotho is said to be fortunate in that her medium of exchange is, from her point of view, a "ready-made" strong one. The strength of the Rand derives from two sources: competent and experienced management of the currency and a high gold content of official reserves.

What benefits flow from a "hard" currency? Such a currency is expected to induce an inward flow of private foreign investment and attract foreign tourists.<sup>1</sup> Since currency is a medium of savings, in the sense that current consumption of goods and services is foregone in order to acquire it, a very strong currency must make the public confident to save by holding it. However, the beneficiary of these hard savings is not the economy of Lesotho but the South African economy which is ultimately responsible for issuing the currency. As for the inflow of private foreign investment, this did not happen to any significant degree until quite recently. Even then, the bulk of the inflow of private foreign investment is not necessarily

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1. Johnson, H.G., Further Essays in Monetary Economics (London, George Allen & Unwin 1972) p.23

sensitive to currency stability or lack of it because whether the Lesotho currency is weak or not, as long as rich diamond pipes are available in commercially exploitable quantities, foreign private investment will come in. Rhomberg has also argued that currency depreciation has very little role to play in the deflection of direct and equity foreign investment from developing economies.<sup>1</sup>

The strength of the Rand must not be over-estimated. In fact, there have been two devaluations in five years. The policy of apartheid and its effects have in the past caused a massive outflow of funds during the Sharpeville massacre, for example. In several quarters pressures have been mounting against South Africa's racial policies and this could well result in the weakening of the currency. In summary, the strength of the Rand has gains but most of the gains accrue to South Africa in absolute and relative terms. Since the strength of a currency also depends on the domestic policies of respective countries, there is no reason why an independent currency in Lesotho should not be sound and well managed.

The most important real benefit which Lesotho has derived from the membership of the Rand monetary area is the economy realized from the pooling of foreign exchange reserves.<sup>2</sup> The larger the currency area, the wider the domain of risk-sharing according to the insurance principle.<sup>3</sup> Lesotho's saving from this must be substantial since the country's export receipts from wool/mohair and grain sales are subject to wide fluctuations. For this reason the country would have had to keep a larger stock of foreign exchange reserves if she had her own national currency.

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1. Rhomberg, R.R., "Private Capital Movements and Exchange Rates in Developing Countries." IMF Staff Papers, Vol. 13, 1966, pp 1-23.
  2. Newlyn, W.T. "Monetary Systems and Integration," The East African Economic Review Vol. 11, no.1, (June 1964), pp.41-58, especially p.51.
  3. Mundell, R., "Uncommon Argument for Common Currencies" In Johnson, H.C.A. and A. Swoboda (Eds.), The Economics of Common Currencies (London, George Allen & Unwin Ltd, 1973) chapter 7.

#### IV SUMMARY AND CONCLUSIONS

This study has been concerned with an analysis of the current monetary system of Lesotho using the cost-benefit approach. It was shown that even from the single / criterion point of view, the currency area to which Lesotho belongs is not optimum. This country has had to bear the cost or burden of adjustment alone in the absence of common incomes, employment and pricing policies in the area. Labour mobility has been severely restricted basically by the racist practices of South Africa. Capital mobility has been quite high but has tended to move from the depressed Lesotho to the more prosperous - South Africa.

We also examined the costs of the absence of an institution with powers to create money and credit. The cost of acquiring foreign currency was found to be heavy. The use of the Rand foreign currency as a domestic medium of exchange and store of value means that every money using person in Lesotho holds a certain amount of foreign exchange reserves. As a result, the benefits of importation of capital goods have been foregone. The economy involved in pooling the Rand foreign currency reserve at the central bank has been lost. Yet, a certain quantity of currency in circulation does not have to be obtained by giving up real resources to foreigners. Mainly due to institutional factors, the currency supply was seen to be less elastic than required for an economy subject to wide fluctuations in sales of domestic produce. Virtually all central banks, being monopolists in their business, are making some profits. Therefore, Lesotho has foregone this almost guaranteed net income.

Lesotho has been lending capital funds to South Africa at almost zero rate of return until 1972. A social cost is also involved in the absence of a lender-of-last-resort, a function which was first performed by what is now called a central bank. The cost of borrowing by the Government



of Lesotho is higher than is possible under central banking.

Lesotho is deprived of the foreign exchange rate instrument which has been used successfully by other developing economies to promote economic development. The underdevelopment of the indigenous financial institutions has been explained partly by the absence of a central reserve bank. As a result a higher level of national savings and a more optimum allocation of financial resources have been foregone.

Although some monetary action was possible but not fully utilized, generally the monetary system does not permit a relatively more independent monetary policy. As a result, there is no deliberate monetary policy directed at domestic employment, the price level, monetization and economic development in general. Instead, the economy is influenced by foreign monetary policy actions unrelated to the domestic economic and financial conditions.

Against the above social costs has to be weighed the benefits of Lesotho's foreign domesticated monetary system. Although the benefits of use of money grow with the size of the common currency area, it has been shown that these benefits are very likely to polarize onto the richer member of the currency area away from Lesotho. A partial currency union would have benefited Lesotho much more than has been the case. Even the benefits of the use of a "hard" currency have not been distributed proportionately. In any case, there is no doubt that Lesotho could take appropriate measures to maintain a reasonably stable currency, like many other developing small countries have done.

The <sup>most</sup> important single benefit Lesotho derives from the currency union is the economy involved in the pooling of foreign exchange reserves other than the Rand reserve which is held by every money-using resident of Lesotho.

The assessment of the net social benefits or costs is made extremely difficult by the unmeasurability of certain items. The problem of quantification of the variables involved is compounded if we look at the issues from a dynamic point of view. Yet, decisions to remain within a common currency area or to break off have been taken on the basis of even less rigorous assessment of the social costs and benefits than we have been able to do here. Our general conclusions are that the social costs of Lesotho's dependent monetary system exceed the social benefits. There is therefore a good economic case for a more independent monetary system.

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January, 1978.



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