Regional currency areas and the use of foreign currencies: Lesotho's experience

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1. Background

Lesotho is situated in southern Africa and is completely surrounded by the Republic of South Africa (RSA). The country obtained its independence from Britain in October 1966. With a per capita income of USD 1,854, adult literacy rate of 83%, life expectancy of 48 years and infant mortality rate of 125 per 1,000 live births in 1999, the United Nations Development Programme classified Lesotho as a country with a medium human-development level.

Strong trade and labour market links between Lesotho and the RSA existed long before Lesotho gained independence. As a result, the South African rand became widely accepted as a medium of exchange in Lesotho. After Lesotho's independence, this situation continued so that the two countries could be said to have been a de facto currency union until at least 1980. In 1974, however, the governments of the two countries, together with the government of the Kingdom of Swaziland, formalised this arrangement through the signing of the Trilateral Monetary Area Agreement.[2] Under the terms of the Agreement, the South African rand would continue to be legal tender in Lesotho and Swaziland although Lesotho and Swaziland would each have the right to issue their own national currencies. There would be a free flow of capital between the countries and member countries would adopt a common exchange control regime with third countries. In January 1980, Lesotho established its own Monetary Authority, and on the same date issued its own currency - maloti (singular: loti). The exchange rate between the loti and the rand was fixed at one-to-one. It could be said that on that day Lesotho and South Africa essentially moved from having a de facto currency union to having a de jure common monetary area. This arrangement remains in force.

Although the common monetary area arrangement between Lesotho and the RSA has been in existence for about 22 years, recent experience shows that similar arrangements are not always sustainable or successful.[3] In the late 1990s a number of emerging market countries that had adopted currency area arrangements of one form or another, but primarily using the US dollar as a reference currency, found that these arrangements could not be sustained. The breakdown of these arrangements sparked off financial crises in various parts of the world. More recently, Argentina de-linked its currency from the US dollar when it became clear that the peg could not be sustained. On the other hand, experience shows that even if these arrangements may be sustainable, they may not always be beneficial. The decision by the government of Botswana to move away from linking its currency to the South African rand, to an arrangement where that country's currency is linked to a basket of currencies, is perhaps illustrative in this regard.

Given these rather varying experiences, two issues of immense policy importance for Lesotho arise. The first is whether from Lesotho's point of view the benefits of staying within the arrangement outweigh the costs. The second issue could be whether the arrangement would be sustainable even if the authorities were to decide that the arrangement is more beneficial. The purpose of this paper is to

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1 The views expressed in this paper are solely those of the author and do not necessarily represent the official policy stance of the Central Bank of Lesotho.

2 As with Lesotho, the rand had started circulating in Swaziland long before the formal signing of the agreement.

3 Experience shows that, around the world, there is a wide array of currency arrangements. At one extreme, a country unilaterally decides to peg the exchange rate of its currency to that of a reference currency. Such an arrangement need not be formalised through a treaty. The other extreme is a formalised arrangement where a group of countries adopt a common currency through a treaty. In between these extremes there are numerous permutations that include: a country pegging its value to a basket of currencies, or a country allowing its currency to trade within a narrow band of a reference currency. There is, however, a commonality in all these arrangements. This is that exchange rates of various currencies are allowed to follow predetermined patterns.

examine these issues in some detail. The issue of the current benefits versus costs of the arrangement is examined first (Section 2 of the paper). This is followed by an examination of whether the arrangement would be sustainable going forward (Section 3). The final section of the paper outlines some possible future policy directions for Lesotho.

2. Lesotho's experience

The first issue at hand is whether the 22-year old arrangement has, in the main, generated more benefits than costs for Lesotho.

Macroeconomic stability

The policy of linking one's currency to another currency can contribute to the attainment of macroeconomic stability. Under a flexible exchange rate regime, prices of tradable goods are rendered unstable. Each time the exchange rate changes, prices of traded goods change. Such changes may ultimately create a destabilising effect, particularly if the currency is depreciating. This may ultimately lead to instability in the general price level. However, once the exchange rate is fixed, any macroeconomic imbalances that arise from time to time will have to be accommodated through changes in the level of foreign reserves rather than through changes in the exchange rate. Of course, pegging one's currency to some reference currency is only a part of the stabilisation story. The ability of the authorities to stabilise the economy will also depend on whether they are able to sustain and defend the peg.

The fixed exchange rate between Lesotho and the RSA has contributed to stabilising prices of tradables between the two countries. Lesotho has probably been the bigger beneficiary in this regard given that about 80% of goods imported into Lesotho come from the RSA. *Had the exchange rate been flexible, prices of Lesotho goods imported from the RSA would change every time there is a change in the exchange rate even if the price of the same goods in the RSA remained unchanged.* Even cases of frequent but small depreciations of the loti against the rand would ultimately destabilise the general price level in Lesotho. Under such circumstances, a policy of fixing the Lesotho/RSA exchange rate has arguably contributed to price stability in Lesotho.

The fixed exchange rate arrangement has enabled Lesotho to anchor its inflation rate to that of South Africa. The benefits of such an arrangement would be further enhanced if the RSA inflation rate itself were to be low and stable. Happily, the RSA's inflation rate history has been relatively favourable, especially when compared to that of other emerging market countries or other sub-Saharan African countries.

Of course, fixing the exchange rate between the loti and the rand does not solve the problem entirely. There is still the question of the other 20% of the goods imported into Lesotho from countries other than the RSA. In this regard, Lesotho would derive maximum benefit from this arrangement if it also turned out that the rand was stable with respect to third currencies.

This tends to suggest that the benefits to be derived from a fixed exchange rate arrangement are likely to be heavily dependent on two factors. The first is the level of trade between the two countries and the second is the stability of the value of the anchor currency (internal as well as external value). This latter requirement raises another important policy issue. This is that the prerogative to defend the value of the anchor currency rests with the central bank of the anchor currency. It may therefore be necessary that the two countries should share broadly similar views as to the appropriate/tolerable rate of inflation in the region.

Convenience in obtaining rand

Under the arrangement between Lesotho and the RSA, the rand is legal tender in Lesotho. For historical reasons as well as for reasons of strong trade and labour market links between the two countries, the rand is available widely in Lesotho. Every public trading place, be it a supermarket, a petrol station, etc, has a mix of rand and loti in its cash till. This situation is of great convenience to cash shoppers wishing to do shopping in the RSA. They do not have to visit authorised foreign exchange dealers to convert maloti into rand. Each one of these public trading places provides this service free of charge to shoppers. Had the rand not been circulating widely in Lesotho, shoppers would have to make trips to dealers, mostly commercial banks, every time they want to go to the RSA for shopping. This would severely restrict the amount of cross-border trade between the two countries. Thus, in addition to the convenience, the arrangement has contributed to increased cross-border trade between the two countries.

Although the loti is formally not legal tender in the RSA, it is also widely accepted as a medium of exchange in towns on the border with Lesotho. Lately, the growth in the amount of maloti collected from the RSA by the Central Bank of Lesotho has been far in excess of the growth in currency issued by the South African Reserve Bank. This indicates increasing acceptance of loti in these towns. The fact that loti is widely accepted as a medium of exchange in these towns is a further indication of the benefits associated with using foreign currencies.

Elimination of exchange rate uncertainty

The fixing of the exchange rate between the loti and the rand also eliminates exchange rate uncertainty between the two countries. However, this should not be construed as meaning that it guarantees that the peg will remain in force forever. Rather, it means that as long as Lesotho's balance of payments situation is healthy, there will be no unexpected changes in the value of the loti against the rand. The Central Bank will be in a position to defend the peg. Should large payments imbalances arise, the peg will be difficult to sustain and may ultimately break down. But as long as such imbalances are not present, the fixed exchange rate arrangement eliminates exchange rate uncertainty.

If Lesotho had adopted a flexible exchange rate system with the RSA, there would be hourly, daily, weekly, etc movements in the value of the loti against the rand. The magnitude of these variations would depend on several factors, including the liquidity in the foreign exchange market, the magnitude and direction of speculative capital flows, and the policy stance of the Central Bank of Lesotho. A highly illiquid Lesotho foreign exchange market would lead to a highly volatile currency as trading in the currency would be thin. Similarly, large inflows of capital into Lesotho would lead to temporary appreciation of the loti against the rand. However, the Central Bank of Lesotho might decide to intervene in the foreign exchange market from time to time in order to smooth out the disturbances in the value of the currency but not necessarily to seek to change the direction of the currency movement. Such interventions would introduce a measure of stability in the exchange rate.

It is difficult on an a priori basis to determine how volatile the loti would be against the rand if it was allowed to fluctuate. However, Table 1 sheds some light on this issue. It shows that the weekly percentage volatility of some selected African currencies against the rand ranges from nearly 7% for the Uganda shilling during 1996-98, to 37% in the case of the Zimbabwe dollar during the same period.

Table 1

Volatility of selected African currencies against the rand

Weekly percentage volatility

Period	Zambia kwacha	Uganda shilling	Zimbabwe dollar
1993-1995	18.3	16.5	9.0
1996-1998	8.6	6.9	36.9
1999-2000	11.4	10.8	9.3

Source: Bloomberg.

Exchange rate volatility makes business decisions somewhat difficult. Cross-border trade and investment decisions between Lesotho and the RSA would be carried out in an environment of increased uncertainty. However, this volatility has now been avoided by adopting the policy of a fixed exchange rate between the loti and the rand. Under this arrangement, comparison of prices across the two countries is made easier. For example, an RSA investor contemplating investing in Lesotho can make direct comparisons between wage levels in the RSA and Lesotho without having to worry about where the exchange rate would be over his planning horizon. Obviously, the more volatile the currency, the more difficult it is to predict where it will be in the future. The long planning horizon inherent in investment decisions exacerbates the situation. However, a fixed exchange rate environment eliminates the former source of risk and thereby greatly facilitates long-term decision-making by businesses. This certainty greatly contributes to cross-border investment activity.

The currency as a national symbol

Until 1980, some 14 years after Lesotho's independence, the RSA rand was the sole medium of exchange in the country. The people of Lesotho did not have a currency of their own or a central bank. During this period, Lesotho and the RSA could be said to have been in a de facto currency union since the two shared a single common currency and the South African Reserve Bank essentially implemented monetary policy for the region. However, there was no formal treaty specifying this arrangement until 1974. The Lesotho Monetary Authority, which later assumed the status of a central bank, was established in January 1980 and at this time the country issued its own national currency.

It is interesting to note that, although a national currency was issued, a conscious policy decision was taken to preserve the essential elements of a currency area: the loti would change hands on a one-to-one basis with the rand, which would continue to be legal tender in Lesotho. In addition, in order to preserve the exchange rate parity, any maloti circulating in Lesotho would be backed 100% by the rand (later, this was amended to include any other major convertible currency). The Lesotho Monetary Authority was essentially to operate as a currency board.

The fact that the essential elements of a currency area were preserved, even as the country decided to issue its own national currency, leads one to speculate that perhaps the primary motive for issuing the national currency was more for political considerations than for economic reasons. Under normal circumstances, a national currency would be issued as a first step to de-linking the currency from a reference currency, allowing the exchange rate to fluctuate, and thereby reclaiming monetary policy autonomy. In the case of Lesotho these features were not introduced. Rather, a conscious policy decision was taken to preserve the old order. The only new variable in the new scheme of things was the national currency.

An important point to note here is that at the time when Lesotho took a decision to issue its own national currency, it was common for countries that had just attained independence to assert their new found freedom by, among other things, issuing their own national currencies. The debate for or against formalised currency unions belonged largely to academia. Therefore at the time it seemed logical for Lesotho to issue its own currency *as a national symbol*. Also, it has to be remembered that, at the time, the RSA government was going through a period of political and economic isolation for its policy of apartheid. It was therefore important for Lesotho to maintain as much "political distance" from the RSA as possible. The issuance of a national currency may have been seen as a step for Lesotho to distinguish itself from RSA. For those who are politically inclined, it could be said that an important benefit of the present arrangement is that it has allowed Lesotho to issue its own national currency and yet still reap the benefits of having a unified exchange rate with the RSA.

Loss of monetary policy independence

The downside of the present arrangement is that the Central Bank of Lesotho has lost the ability to implement its monetary policy independently of the policy adopted by the South African Reserve Bank. If, for example, the South African Reserve Bank wished to increase interest rates at a time when economic conditions in Lesotho suggested that Lesotho rates should be lowered, the Central Bank of Lesotho would find it difficult to lower interest rates. Any such lowering of rates would be futile as there would be a massive outflow of capital from Lesotho to the RSA which would eventually lead to Lesotho rates moving back up to restore equilibrium.

At present, monetary policymaking in Lesotho essentially involves reacting to monetary changes by the South African Reserve Bank. What typically happens is that if the South African Reserve Bank decides to increase rates in its country, the Central Bank of Lesotho will intervene in its domestic money market in order to steer interest rates in the same direction as that taken by the RSA. In short, the Central Bank of Lesotho is an implementing agency of the South African Reserve Bank monetary policy stance.

It is, however, important to note that the need for monetary policy independence arises only when the two countries are affected differently by various shocks. This may be the case for example when economic growth in the RSA gains momentum that brings in inflationary risks at a time when the Lesotho economy may be experiencing a recession. If the two countries' booms and recessions are naturally synchronised, the issue of monetary policy independence would not arise.

3. Is the arrangement sustainable?

A vexing issue is whether the arrangement is sustainable. In particular, can Lesotho sustain the peg between the loti and the rand? This issue has become much more current in recent years following the breakdown of similar arrangements in Southeast Asia, which sparked off what is now commonly referred to as the 1997 financial crisis. More recently the breakdown of the fixed exchange rate arrangement between the Argentine peso and the US dollar during the latter part of 2001, or early 2002, has forced academics and central bankers to rethink the issues surrounding currency areas.

The Lesotho-RSA currency arrangement has been in place for 22 years. During this period the peg has never broken down. There is no evidence of parallel markets for rand in Lesotho, and maloti continue to be converted into rand at the official exchange rate of one-to-one in shops, department stores, petrol stations and other public trading places. There is no evidence that individuals are hoarding rand. More interestingly, even though maloti are not formally legal tender in the RSA, traders in RSA border towns are increasingly accepting them. Cross-border trade and investment between the two countries has grown from strength to strength.

So, why has this arrangement held its own in the face of similar arrangements elsewhere experiencing problems? Or are we to see another currency crisis waiting to happen? The reason for the apparent success, it would seem, lies in two important but unrelated developments. The first is that the external or internal shocks hitting the Lesotho economy have so far been cancelling each other out in terms of their impact on the country's balance of payments position. The first real shock to hit the Lesotho economy occurred in the 1990s when the country's major source of foreign exchange - cash remittance by mineworkers from Lesotho working in the RSA - fell considerably. These cash remittances fell from 53% of Lesotho's imports in 1989 to 30% by 1998. This was mainly due to the fall in the number of mineworkers from Lesotho employed in the RSA from a peak of 127,000 to only 80,000 during the same period. One would have expected that such a huge decline in the country's prime foreign exchange earner would lead to huge payments imbalances. Luckily, during the same period, there was a major boom in capital inflows related to the construction of a series of dams and water transfer tunnels that was financed by the RSA. These capital inflows rose from a small 12% of imports to nearly 30% of imports by 1998. These capital inflows served to almost cancel out any fall in cash remittances by mineworkers. Had this not happened, a huge payments imbalance would have arisen and the exchange rate parity would probably have broken down.

The second contributory factor has been the fact that the rand itself has been depreciating in recent years, particularly against the US dollar. Between early 1998 and end-2001 the rand depreciated by around 60% against the US dollar. During the same period Lesotho's exports to the United States rose from 19% of total exports to 47%, evidently benefiting from, among other things, the depreciation of the rand (and hence the loti) against the dollar. It is doubtful whether Lesotho's exports would have made such major inroads into US markets if the currencies had not been depreciating rapidly. The export boom during this period has contributed to the maintenance of the parity between the loti and the rand. Had the rand been appreciating against the dollar, payment imbalances between Lesotho and the RSA would have emerged by now and the peg would have been difficult to sustain.

To be sure, sound macroeconomic (including fiscal) management has also contributed to the maintenance of the parity between the loti and the rand. Had macroeconomic management been imprudent during much of the 1990s, a large payment imbalance would have emerged. The rapid increase in long-term investment from abroad would have been barely sufficient to maintain the peg. The maintenance of budgetary surpluses by the government of Lesotho during much of the same period served to reinforce the positive effect of capital inflows.

4. Suggestions for the future

The foregoing analysis tends to suggest that although the macroeconomic management in Lesotho has been relatively sound, favourable global developments have been perhaps the biggest contributor to the success of the fixed exchange rate arrangement between the loti and the rand. The question that then arises is whether prudent fiscal management on its own, without the help of favourable global developments, can be enough to undo the damage caused by unfavourable shocks. Recent experience from Argentina tends to suggest that this may be an uphill battle. If this conclusion is valid, then it would seem that the future success of the arrangement cannot be guaranteed. To avoid the possibility of the parity breaking down, the authorities in Lesotho may wish to expedite the move to a currency union with the RSA. However, this would have to be accompanied by a liberalisation of labour markets between the two countries. The latter reform measure would ensure that restrictive monetary policy by the South African Reserve Bank, at a time when the Lesotho economy is in recession, does not lead to undue hardship for residents of Lesotho.