December 2004
IMF Country Report No. 04/387

Lesotho: Sixth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Nonobservance of Performance Criteria—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Lesotho

In the context of the sixth review under the Poverty Reduction and Growth Facility and request for waiver of nonobservance of performance criteria with Lesotho, the following documents have been released and are included in this package:

- the staff report for the sixth review under the Poverty Reduction and Growth Facility and request for waiver of nonobservance of performance criteria, prepared by a staff team of the IMF, following discussions that ended on May 18, 2004, with the officials of Lesotho on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 19, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of September 10, 2004, updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its September 10, 2004, discussion of the staff report that concluded the review and request.

- a statement by the Executive Director for Lesotho.

The documents listed below have been or will be separately release.

Ex Post Assessment of Longer-Term Engagement
Joint Staff Assessment of the Poverty Reduction Strategy Paper Progress Report
Poverty Reduction Strategy Paper Progress Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

LESOTHO

Sixth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Nonobservance of Performance Criteria

Prepared by the African Department

(In consultation with the Legal, Policy Development and Review, Statistics, and Finance Departments)

Approved by Michael Nowak and Juha Kähkönen

July 19, 2004

- The discussions for the sixth and final review under the PRGF arrangement and the ex post assessment (EPA) of Fund longer-term program engagement in Lesotho took place in Maseru during May 5-18, 2004, and continued at headquarters through June 30, 2004.
- The staff team comprised Mr. Kpodar (head), Mr. Arora (resident representative), Mr. Engström, Ms. Masha, Ms. Nyankiye, Mr. Erickson (all AFR), and Mr. Martijn (PDR). The team met with the Minister of Finance and Planning, the Governor of the Central Bank of Lesotho, other senior officials, representatives of the private sector, and development partners in Lesotho.
- The authorities have requested waivers for the nonobservance of one quantitative and three structural performance criteria. They have also expressed their interest in continued Fund support through a successor PRGF arrangement. To help maintain the momentum of economic reform until a possible successor arrangement is in place, understandings were reached on a macroeconomic framework for 2004-05 and on supporting structural reforms.
- Lesotho has accepted the obligations of Article VIII, Sections 2-4 of the Fund's Articles of Agreement and maintains an exchange system that is free of restrictions on payments and transfers for current international transactions.
- The Executive Board approved a three-year arrangement under the PRGF for Lesotho on **March 9, 2001**, in an amount equivalent to SDR 24.5 million. The fifth review under the arrangement was concluded on January 21, 2004 (IMF Country Report No. 04/21) and on June 29, 2004 the arrangement was extended through October 31, 2004 to provide more time for completing the final review. Upon completion of the sixth review, Lesotho would be eligible to draw an additional SDR 3.5 million (about US$5.1 million).

Contents Page

Figures

Tables

Contents Page

Appendices

Executive Summary

Overview and recent developments

- Real GDP growth slowed to 3¼ percent in 2003/04 (fiscal year starts April 1) owing to the adverse impact of drought on agricultural output and slower-than-envisaged growth in the construction sector. The manufacturing sector remained the key source of growth. In line with trends in South Africa, the inflation rate has continued to decline and was 5¼ percent (12-month basis) in March 2004. The fiscal performance was substantially stronger than projected in 2003/04, and the overall fiscal balance (including grants) moved into a surplus equivalent to ¾ percent of GDP in 2003/04, compared with an overall deficit of 4 percent in 2002/03. Interest rates have declined, and the spread between interest rates on treasury bills in Lesotho and South Africa has narrowed since the second half of 2003.

- The food situation is serious and Lesotho will need food support in 2004/05. The World Food Program (WFP) estimates that about 600,000 people (more than a quarter of the population) may need emergency assistance in 2004; the total cost is likely to exceed US$60 million. Donors have responded favorably to the government's appeal for food aid of February 2004. The budget for 2004/05 (April-March) also includes a famine relief contingency equivalent to US$10 million (¾ percent of GDP).

- Performance under the PRGF-supported program was mixed during January-May 2004. Lesotho met all quantitative performance criteria for December 2003 and indicative targets for March 2004. However, the continuous performance criterion on the stock of external payment arrears was breached in May 2004, when a debt service payment was delayed by ten days. Implementation of structural reforms was slower than expected. Out of four structural performance criteria, only one was met on time. Two of the measures were completed with delays in May, and the authorities have committed to implement the outstanding one (appointment of a vehicle lease contract representative) prior to the completion of this review.

Macroeconomic and structural policies

- The medium-term macroeconomic framework for 2005-09 envisages real GDP growth in the range of 3½-4 percent a year and inflation of about 5½ percent. The fiscal scenario aims at containing the annual fiscal deficit (including grants) to below 2½ percent of GDP, owing to an expected decline in Southern African Customs Union (SACU) revenues and a rise in social spending in line with the Poverty Reduction Strategy Paper (PRSP) priorities. Major risks remain over the medium term: (i) The phasing out of quotas under the World Trade Organization (WTO) Agreement on Textiles and Clothing (in 2005) is likely to erode Lesotho's attractiveness for foreign investment; (ii) a rapid depreciation of the loti/rand against the dollar and the euro could raise debt and debt service costs; (iii) HIV/AIDS could further dampen GDP growth, and (iv) agricultural production remains vulnerable to drought.

- The level of total fiscal expenditure in the budget for 2004/05 is consistent with the medium-term fiscal framework. The fiscal surplus (including grants) is projected to increase to 2½ percent of GDP in 2004/05 from a surplus of ¾ percent of GDP in 2003/04, owing mainly to a large, but temporary, rise in receipts from SACU, by nearly 5 percentage points of GDP.

- The mission raised concerns about the composition of fiscal spending and emphasized the need to contain the cost and risks of three new initiatives – a new pension system, public-private partnerships (PPPs), and a postbank – that were announced in the budget, without prior consultation with the staff. Their cost is estimated at about 1 percent of GDP in 2004/05, but would rise to 1¾ percent of GDP starting in 2005/06.

- The staff encouraged the authorities to continue with structural reforms. A possible successor Poverty Reduction and Growth Facility (PRGF) arrangement should be focused on reforms that further improve the foundation for economic growth and poverty reduction. In this context, financial development was seen as important for strengthening the private sector financing and growth prospects. Another focus of structural reform is Lesotho's weak public financial management system. The staff and the authorities also discussed the need for civil service reform and agreed to continue these discussions later.

Program issues

- The authorities expressed their interest in continued Fund support, subject to the outcome of a Board consideration of the ex post assessment (EPA). The staff and the authorities agreed on informal quarterly indicative targets through March 2005, to monitor economic performance until a successor PRGF arrangement could be put in place.

I. INTRODUCTION

1. This report reviews developments during 2003 and the first five months of 2004 in the context of the sixth and final review of the program under the Poverty Reduction and Growth Facility (PRGF) arrangement, and sets forth policies and measures that the government of Lesotho intends to implement during 2004/05 (April to March). The report also presents the discussions of the ex post assessment (EPA) of Fund involvement in Lesotho prepared by an interdepartmental task force.

2. **The authorities have implemented an economic reform program supported by a PRGF arrangement since 2001.** In the attached letter of intent (LOI), the authorities summarize performance in the context of the sixth review, briefly outline their objectives and policies through March 2005, and request waivers for the nonobservance of one quantitative and three structural performance criteria. They also express their interest in continued Fund support through a successor PRGF arrangement. Lesotho's relations with the Fund and the World Bank are described in Appendices II and III, respectively.

II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PRGF ARRANGEMENT

3. **Real GDP growth slowed to 3¼ percent in 2003/04 (April-March) owing to the adverse impact of drought on agricultural output and slower-than-envisaged growth in the construction sector**. Consumer price inflation has continued to decline in line with trends in South Africa; inflation has fallen steadily from a peak of 13 percent (12-month average) in 2002 to 5.2 percent in March 2004 (Table 1 and Figure 1).

4. **The food shortage situation is serious, and the World Food Program (WFP) estimates that about 600,000 people (more than a quarter of the population) need food support.** The drought in late 2003 has negatively affected the summer harvest in May 2004. The authorities are seeking to cover food needs through imports, likely amounting to more than US$60 million (equivalent to 4½ percent of GDP) in 2004. Donors have responded favorably to the government's appeal for food aid of February 2004. The budget for 2004/05 (April to March) also includes a famine relief contingency equivalent to 0.8 percent of GDP.

5. **Fiscal performance in 2003/04 was stronger than envisaged in the program, partly reflecting temporary factors** (Tables 2 and 3). The overall fiscal balance (including grants) shifted into a surplus equivalent to 0.7 percent of GDP in 2003/04, from a deficit of 4 percent in 2002/03 and a program target of 2.9 percent for 2003/04. This reflected both higher revenue and lower expenditures. Value-added tax (VAT) receipts were slightly higher than envisaged, partly reflecting the effectiveness of the newly established Lesotho Revenue Authority (LRA), and nontax revenue exceeded program projections by ¾ percent

of GDP as a result of larger seigniorage transfers from South Africa.[1] Total expenditure turned out 3½ percent of GDP lower than programmed; current expenditure was lower than expected because of the postponement of the local government elections to 2004/05, and savings on transfers and subsidies. The favorable impact of the appreciation of the loti (by an average of almost 40 percent in dollar terms in 2003/04) and, to a lesser extent, repayment of domestic debt helped reduce total government debt from 88 percent of GDP at end-March 2003 to 60 percent at end-March 2004.

6. **Interest rates have declined by about 400 basis points since last summer.** The Central Bank of Lesotho (CBL) has lowered policy interest rates in step with monetary easing by the South African Reserve Bank, and the fall in the government's domestic borrowing requirement has contributed to a narrowing of the treasury bill yield spread between Lesotho and South Africa from a peak of 2½ percentage points in the second half of 2003 to 1¼ percentage points in March 2004 (see Figure 1). Bank credit to the economy increased by 15¼ percent, slightly above program target, while the expansion of broad money was contained at 5½ percent in 2003/04 (Tables 4 and 5).

7. **The appreciation of the loti vis-à-vis the U.S. dollar, reflected the strengthening of the external value of the rand, to which it is pegged.** In the twelve months through March 2004, the loti appreciated by 20 percent in nominal effective terms (NEER) and 23 percent in real effective terms (REER), as inflation in Lesotho was higher than the average rate among its trading partners (Figure 2).

8. **Notwithstanding the exchange rate appreciation, external sector performance strengthened in 2003/04.** The external current account deficit (including official transfers) narrowed to 11 percent of GDP in 2003/04, from 17 percent in 2002/03, largely as a result of continued strong exports of clothing. Gross official reserves increased by US$29 million to US$437 million, US$17 million more than programmed, in the year through March 2004, remaining equivalent to 4.3 months of imports (Table 6).

9. **Performance under the program was mixed during January-May 2004.** All *quantitative performance criteria* for December 2003 and indicative targets for March 2004 were met (Table 7). However, the *continuous performance criterion* on the stock of external payment arrears was not observed in May 2004, when a debt service payment was ten days late for administrative reasons. Implementation of structural reform measures was slower than expected. Out of four *structural performance criteria*, only one was met on time (Table 8). Two of the measures were completed with delays in May, and the remaining one (appointment of a vehicle lease contract representative), remains to be done. Moreover, two of the four *structural benchmarks* were implemented with delay, and the other two (reorganization of the treasury and entering transactions in bank accounts into the treasury

[1] Lesotho receives compensation from South Africa for the seigniorage loss it incurs due to the circulation of the rand as legal tender in Lesotho.

ledger system) were partially met. The authorities explained that they had adopted a range of alternative actions to limit the high vehicle lease costs, resulting in savings of about one third in April and May 2004. In addition, they indicated their intention to complete the *outstanding structural performance criterion* before the completion of the review. Implementing this long overdue measure should significantly improve the government's ability to contain future spending on vehicle leases. To allow more time for this, the commitment period of the PRGF arrangement has been extended from June 30 to October 31, 2004.

III. Policy Discussions

10. The discussions with the authorities centered on medium-term policies to maintain a sustainable fiscal position and generate higher growth as well as macroeconomic policies and the budget for 2004/05, including the implications of the initiatives announced in the context of the budget, actions to accelerate the completion of the remaining structural reform and conclude the sixth review, and the ex post assessment of Lesotho's performance under Fund-supported programs.

A. Medium-Term Framework and Fiscal Sustainability

11. The Lesotho economy's response to the macroeconomic adjustment and reforms launched in the early 1990s has been positive: major domestic and external imbalances have been corrected and real GDP growth averaged 3½ percent over 1991-2003.[2] Nevertheless, faster growth is needed to alleviate Lesotho's high poverty and unemployment rates, and improve social conditions. The authorities concurred with the staff that this would require maintaining macroeconomic stability through further fiscal consolidation and the implementation of wide-ranging structural reforms to (i) strengthen public financial management and accountability; (ii) deepen financial intermediation; and (iii) improve governance as well as the legal and judiciary systems to provide an enabling environment for private sector development. In addition, efforts would be needed to expand human capital and physical infrastructure. The socioeconomic outlook also depends crucially on success in addressing the HIV/AIDS pandemic.

12. **The revised medium-term framework for 2005-09 envisages real GDP growth in the range of 3½-4 percent a year and inflation of about 5½ percent**, in line with the moderate trend in South Africa. Economic activity should be supported by manufacturing and a modest rebound in agricultural production. The completion of the Poverty Reduction Strategy Paper (PRSP; see paragraph 32) should strengthen the execution of growth-enhancing policies and support the mobilization and effective use of donor support. In this context, Lesotho has become eligible to apply for assistance under the U.S. Millennium Challenge Account in 2004.

---

[2] Key achievements under the PRGF arrangement are described in Appendix IV.

13. **The medium-term fiscal scenario aims at containing the annual fiscal deficit (including grants) below 2½ percent of GDP and total gross government debt (domestic and external) below 55 percent**, to help ensure debt sustainability.[3] Receipts from the Southern African Customs Union (SACU) constitute Lesotho's main source of fiscal revenue. These receipts are, however, expected to decline by 7 percentage points of GDP during 2004/05-2008/09 owing to the introduction of a new revenue-sharing formula and trade liberalization, including vis-à-vis the United States.[4] A small part of the revenue loss is projected to be accommodated through somewhat higher borrowing than previously foreseen, while still leaving the public sector debt ratio on a gradual downward path. But, the loss mainly calls for a further improvement in domestic revenue mobilization and a better prioritization of public expenditure.

14. **The external outlook is mixed and subject to uncertainties**. The current account deficit is projected to be kept below 7 percent of GDP over the medium term, in large part reflecting the phasing out of investment for LHWP. The outlook for 2004/05 benefits from large official transfers related to SACU (see paragraph 17). With the loss, however, of the LHWP-related foreign financing, and even with a gradual reduction in reserve cover to four months of imports after 2004/05, a financing gap of over 1 percent of GDP is projected.

15. **However, the medium-term outlook is subject to major risks.**

- The economy is not well diversified and remains vulnerable to external shocks, as clothing destined for the US market accounts for most of manufacturing and 70 percent of exports. Investment in clothing is vulnerable to the phasing out of the quota regime under the WTO Agreement on Textiles and Clothing (in 2005) and a possible appreciation of the loti/rand versus the U.S. dollar.

- A sizeable depreciation of the loti/rand would raise the external debt level and debt service costs.

---

[3] The deficit would be financed from both domestic and foreign sources, although a financing gap of ½-1 percent of GDP remains in the medium term. In part, this reflects some donors' intention to move away from general budget support toward financing specific projects (see paragraph 24).

[4] The new revenue-sharing formula links Lesotho's receipts to the total collection of SACU customs and excise duties and also contains a development component that reallocates revenues in favor of members with a lower per capita GDP. At current tariff rates, most of Lesotho's SACU revenues will be generated by customs duties. Lesotho is, therefore, vulnerable to tariff-reducing trade agreements.

- Economic growth could be further dampened by HIV/AIDS.[5]
- Agricultural production is highly vulnerable to drought, reflecting the lack of irrigation infrastructure.
- The structural reforms necessary to support economic growth could be hampered by capacity constraints and also require strong political commitment.

B. Macroeconomic Policies for 2004/05

16. **Real GDP growth has been revised downward to around 3 percent for 2004/05**, reflecting a more conservative forecast for agricultural output because of the drought, further moderation in construction activity, and uncertainties among investors in the clothing sector. Average consumer price inflation is expected to fall to 6 percent, in line with price developments in South Africa.

Fiscal policy

17. **The primary fiscal objective for 2004/05 is to save most of the SACU revenue windfall to repay domestic debt.** The budget envisaged an increase in the fiscal surplus (including grants) to 2¾ percent of GDP, owing mainly to a temporary rise in SACU revenue of nearly 5 percent of GDP.[6] Based on new information, the fiscal surplus is now projected at 2½ percent of GDP. Despite the budgetary impact of new initiatives (see paragraph 19), the staff' believes that the budget for 2004/05 is consistent with a sustainable medium-term fiscal framework. Total revenue and grants are projected to exceed their medium-term path by about 5 percent of GDP, while total expenditure of 44 percent of GDP (excluding one-off spending on local elections by about 1 percent of GDP) would be in line with the medium-term path.

18. **Government revenue is projected to increase to 45 percent of GDP in 2004/05**, owing to the increase in SACU revenue. Domestic tax collections are projected to rise, reflecting the introduction of a 14 percent VAT on July 1, 2003 and improvement in tax collection. This is expected to be more than offset by the reduction in nontax revenue

---

[5] A World Bank study estimates that annual GDP growth will be reduced by ½-1 percent over the next decade because of HIV/AIDS. For further discussions, see the Ex Post Assessment of Longer-Term Program Engagement in Lesotho, the Staff Report for the 2003 Article IV Consultation (IMF Country Report No. 04/21), and chapter 2 in Lesotho: Selected Issues and Statistical Appendix, IMF Country Report No. 04/23.

[6] Revenue allocations to SACU member countries are based on imports into SACU with a two-year lag. Actual imports in 2002/03 turned out to be substantially higher than projected, resulting in a one-off increase in the 2004/05 allocation.

(1¼ percent of GDP) because of lower seigniorage transfers from South Africa and lower receipts of water royalties and other property income.

19. **The mission raised concerns about the composition of spending**. *Current expenditure* is expected to increase by almost 3 percent of GDP in 2004/05, partly because of the cost of new initiatives—a new pension system, public-private partnerships (PPPs), and a postbank—that will boost outlays on goods and services and transfers. These initiatives were announced in the 2004/05 budget, without prior consultation with the staff. Their cost is estimated at about 1 percent of GDP in 2004/05, and would rise to1¾ percent of GDP starting in 2005/06 (see Appendix V). The increase in transfers also reflects the lack of concrete control mechanisms for scholarships; the authorities agreed to speed up the work of a task force introduced under the program to identify effective measures to contain these outlays.

20. **The staff emphasized the need to contain the high cost and risks of the new initiatives.** The authorities concurred that to accommodate these plans, while preserving fiscal sustainability, nonpriority outlays had to be contained.

- They argued that the new **pension system** was motivated by the HIV/AIDS problem, which had rendered the elderly highly vulnerable to the loss of support and income. They indicated that the scheme will be monitored to keep the cost within budgetary appropriations. The staff advised the authorities to move towards more targeted income support for the poor, and to establish a pension system with a clear link between pension entitlements and contributions.

- The staff underscored that **PPPs** need a comprehensive institutional framework and a transparent supporting legislation to reduce the related financial risks, and they should not serve to circumvent fiscal targets.

- The authorities indicated that the **postbank** will fill the void left by the closing of the Lesotho Bank's rural network and would provide basic financial services to the rural population (see paragraph 26). The staff stressed the risk of contingent liabilities and supported the rigorous supervision of the bank and the limitation of its investment to government securities.

Monetary policy and capital account liberalization

21. **The prime objective of monetary policy remains to preserve the exchange rate peg and maintain an adequate level of international reserves.** In light of the peg of the loti to the South African rand and Lesotho's membership in the Common Monetary Area (CMA), the scope for an independent monetary policy is highly limited.[7] In this context, the

[7] Capital can move virtually freely among CMA members (Lesotho, Namibia, South Africa, and Swaziland). In addition, the rand is legal tender in Lesotho and Namibia.

staff and the authorities agreed on a monetary framework consistent with the fiscal policies discussed above. Assuming an increase in money demand in line with nominal GNP, the envisaged net repayment of government debt to the banking system would allow more room for credit to the private sector, which is projected to grow by 11¼ percent in 2004/05. The international reserve cover would rise somewhat to almost 4½ month of imports at end-March 2005.

22. **The staff supported the authorities' gradual approach to capital account liberalization.** In June 2003, the government lifted all restrictions on long-term capital inflows and partially liberalized outflows by allowing companies and private individuals to open foreign currency accounts outside the CMA (subject to central bank limits and approval). It was agreed that Lesotho's objective over time should be to achieve the same level of liberalization as other CMA members, and that a gradual pace of liberalization was preferable in view of the risk of external volatility and the prevalence of structural rigidities. Private sector representatives welcomed the measures and the overall approach, which they felt would stimulate foreign investment.

C. Structural Policies

Governance and structural reforms

23. **The government expressed its intention to continue improving governance.** Its key objectives, beyond enhancing transparency and accountability in public financial management, include further decentralization, deregulation, and privatization of state entities. Decentralization is expected to be advanced under a proposed Local Government Act. Privatization has progressed substantially since the mid-1990s, notably privatization of the Lesotho Bank and the state telecommunication company; the cabinet is considering deregulation of the electricity company next, including a privatization scheme and a tariff adjustment that ensures financial viability. A regulatory agency for power and tele-communication is expected to be established by end-2004.

24. **Improving public financial management remains a key focus of structural reforms.** In fact, donor representatives noted that difficulties in tracking the use of budget support, was leading them to move to project support. There has been progress during the last few years in this area. For example, (i) the establishment of the LRA in 2002 has improved tax administration; (ii) an Anti-Corruption Unit established in late 2002 was an important step toward reducing graft in the public service; and (iii) the public accounts have improved. The Auditor General has identified many weaknesses in expenditure management and compliance with accounting rules. These audits are, however, a sign of improvement, as the public accounts for 2001/02 and 2002/03 are the first to be audited since the mid-1990s. The authorities recognized that considerable scope remained for improving overall accountability and transparency in public financial management, and they plan to review the legislative framework, close the remaining gap of unaudited accounts from the mid-1990s, introduce a medium-term expenditure framework (MTEF), and reexamine procurement procedures.

25. **The staff and the authorities discussed the need for civil service reform.** The authorities noted that the civil service was relatively lean in Lesotho, and wages were not high in comparison with neighboring countries.[8] Moreover, since the social priority areas emphasized in the PRSP were labor-intensive, a rise in the civil service employment may be appropriate over the medium term. The staff recognized these points but noted that the civil service wage bill was already equivalent to more than one-third of public current expenditure. The staff encouraged the authorities to give priority to the public sector reform program that they are developing in collaboration with the World Bank and key donors. It was agreed to discuss civil service reform further in the context of a possible future PRGF arrangement.

26. **The banking system in Lesotho is healthy, but structural impediments limit its scope.**[9] Nonperforming loans were equivalent to 5 percent of total loans at end-December 2003, and banks are profitable. However, the volume of lending is low and a significant proportion of the population has no access to banking. Banking sector representatives pointed out that women were prevented from effectively participating in banking transactions due to their subordinate legal status, and that aspects of the land tenure system, particularly land fragmentation and the high administrative costs associated with verifying land titles, inhibited real estate development and the use of land as collateral. Lending was also hampered by high credit risk, but the credit information bureau expected to be established in July 2004 would help in this regard. The postbank could help reduce the share of the unbanked population, although it needs to be carefully regulated and supervised by the central bank. Overall, financial development was seen as important for strengthening the private sector financing and growth prospects.

27. **The authorities emphasized that Lesotho's trade policy is largely governed by its membership in SACU.**[10] In this context, free trade agreements are being discussed, including with the United States and the European Union. The staff advised the authorities to address the several nontariff barriers that Lesotho has maintained at the national level.

Social issues

---

[8] The civil service comprises 4 percent of total formal employment (35,000 people), compared with 12 percent in South Africa. The civil service wage bill is 13 percent of GDP, compared with an average 12 percent in other SACU countries.

[9] The banking sector comprises Nedbank and Standard Bank, which are subsidiaries of South African banks.

[10] The Fund's trade restrictiveness index for Lesotho is 5 (on a scale of 0 to 10, with 10 being the most restrictive).

28. **The staff commended the authorities' efforts to address the food shortage, but urged that the underlying weakness in agricultural productivity be addressed in order to make the sector more resilient and reduce poverty.** Agricultural productivity is low, due to overgrazing and obsolete farming techniques. The authorities have prepared a national agricultural strategy that emphasizes measures to diversify production and develop commercial agriculture. Investment in irrigation is important to achieve this objective. HIV/AIDS, which is prevalent in rural areas, is a significant impediment in the effort to raise agricultural productivity and reduce poverty.

29. **The staff welcomed the authorities' efforts to address the HIV/AIDS pandemic, and encouraged them to move forcefully with the initiatives under way.** About one third of the population is infected. With World Bank support, the authorities are strengthening the institutional framework, and a National AIDS Commission should become effective in the first half of 2005. The Global Fund for HIV/AIDS, Tuberculosis, and Malaria awarded Lesotho a US$29 million grant in 2003, to be disbursed over five years, and other donors are expected to raise their support.

D. Program Monitoring and Indicative Targets

30. **The government has requested waivers for the nonobservance of the continuous quantitative performance criterion on the stock of external payment arrears and for the three structural performance criteria that were missed in April 2004.** All actions under the structural performance criteria are expected to be observed before the conclusion of the sixth review (see paragraph 9). Moreover, the authorities are committed to maintaining the reform momentum after the program has expired, with emphasis on enhancing public financial management.

31. **To monitor economic performance until it is decided whether to proceed with a successor PRGF arrangement, the staff and the authorities agreed on informal quarterly indicative targets through March 2005,** consistent with the fiscal framework and the monetary program (Table 9). The authorities were encouraged to continue with growth-enhancing structural reforms and development of the public financial management system to improve the allocation of public spending.

32. **Because of the delays in submitting the PRSP, the authorities have produced a preparation status report.** The PRSP, which has been prepared in a fully participatory manner and appears to have gained broad support from both domestic groups and the donor community, is being reviewed by the cabinet. The PRSP and the joint staff assessment (JSA) are expected to be submitted to the Executive Board by end-December 2004.

IV. EX POST ASSESSMENT OF FUND INVOLVEMENT

33. **The mission discussed with the authorities the ex post assessment (EPA) of Fund involvement in Lesotho, prepared by an interdepartmental task force.** The EPA presents a record of significant but uneven progress under consecutive Fund arrangements

since 1988. While initial programs focused on achieving macroeconomic stability through prudent fiscal and monetary policies, the 2001 PRGF arrangement also emphasized institutional reform, particularly in the area of fiscal management. The EPA shows that macroeconomic developments have been broadly in line with program projections, and quantitative conditions have generally been met, although fiscal limits have been exceeded repeatedly since 2001. Progress in structural reform has generally been slow.

34. **The authorities argued that several conclusions were not well supported and that greater attention should have been given to the role of Lesotho's development partners other than the World Bank**. They also indicated that, while the report highlights the lack of control over the wage bill, this had not been a target under Fund-supported programs, and wages were broadly in line with other SACU countries. The authorities mentioned that minimum wages and job protection positively contributed to social harmony and disagreed with the call for a liberalization of the labor market. Furthermore, they stressed that several practices criticized in the evaluation had already been addressed, such as directed bank lending and the role of civil servants in supervising public corporations. The authorities also noted that some privatizations—instigated by donors—had not yielded the intended results.

35. **The authorities disagreed with the staff's view that program ownership and commitment had been insufficient and reiterated that the structural reform agenda under the PRGF program had been overly ambitious and detailed**. They felt that this had contributed to the recent delays in achieving structural conditions and thought that structural conditionality in future programs should be more streamlined. Moreover, they argued that some program conditions had been missed due to design flaws—in particular, the targeting of means rather than outcomes—and that, in some instances, problems had arisen from weak cooperation between the staffs of the Fund and the World Bank, and contradictory advice provided. They concurred with the EPA on the role of capacity constraints, and pointed to the adverse effects on program performance of external shocks. The mission encouraged the authorities to be proactive and to raise such concerns immediately if they were to arise again.

36. **The authorities welcomed the recommendation of the EPA that the Fund should remain involved, in order to support reform and help provide concessional financing**. The EPA emphasizes the importance of further economic reforms to promote economic growth and diversification, and to reduce poverty, while safeguarding financial sustainability, in the face of exogenous shocks including the erosion of trade preferences, declining workers remittances, recurrent droughts, and the HIV/AIDS pandemic. Within core Fund areas, efforts to improve expenditure management and tax administration would be crucial. The authorities agreed on most of the conclusions, but noted that the EPA provided little practical guidance for achieving them. Moreover, they saw tensions between the recommendations on fiscal restraint and raising social spending, especially as tax rates are already high and tax administration is fairly efficient. The mission explained that identifying key reforms would be at the core of the discussions on a possible successor

program, in line with the PRSP, and in close cooperation with the World Bank and other development partners.

V. STAFF APPRAISAL

37. **Lesotho's macroeconomic performance in 2003, and thus far in 2004, has been generally strong, notwithstanding the drought and an unfavorable external environment.** Growth has remained relatively resilient, while inflation has declined and is expected to remain in line with the moderate inflation outlook in South Africa. The authorities' efforts in recent years toward achieving macroeconomic stability have contributed to strengthen the economy's resilience to shocks.

38. **However, Lesotho is facing daunting challenges over the medium and long term.** The key challenges are to raise the rate of economic growth in a sustainable manner, to reduce poverty, and to improve overall social conditions. In order to meet these challenges, it will be essential for the authorities to maintain macroeconomic policy discipline. Structural reforms are needed to improve public financial management, improve productivity, and strengthen the investment climate. Such reforms will support the development of human capital and physical infrastructure that is essential for private sector development and job creation. These efforts need to be complemented by actions to address the country's key social priorities of overcoming the HIV/AIDS pandemic and food insecurity.

39. **The staff supports the key macroeconomic objectives of the authorities' budget for 2004/05.** The envisaged underlying paths for revenue and expenditure are broadly consistent with a sustainable medium-term fiscal position. The authorities' intention to save most of the SACU windfall receipts in 2004/05 to repay domestic debt is welcome, and will help strengthen the resilience of the budget to exogenous shocks.

40. **While the targeted level of expenditure in 2004/05 is appropriate, its composition should be improved.** The staff strongly supports the increased attention to social priorities such as famine relief and HIV/AIDS. However, the increase in spending on transfers and subsidies in the 2004/05 budget must be controlled, both because of the need to free resources for other social purposes and because some of the underlying expenditures (such as scholarships) are not yet subject to effective control mechanisms. The staff stressed the need to speed up the work of a task force identified under the program to initiate measures to strengthen such mechanisms.

41. **The new initiatives announced in the 2004/05 budget create public sector financial obligations or contingent liabilities that need to be monitored.** The national pension system will help increase the welfare of the elderly, who are especially vulnerable to poverty. However, more targeted support aimed specifically at the poor would be less costly and more effective in addressing poverty. The public-private partnerships (PPPs) should help attract private capital to fund public sector needs. Private capital is relatively costly however, and the government must monitor the fiscal implications on an ongoing

basis. In addition, an institutional framework is needed with clear supporting legislation to manage the financial risks associated with PPPs. The postbank should help enhance the access of the rural poor to banking services, but for prudential reasons its investment should be limited to government securities and it should remain subject to close financial supervision and regulation of the central bank.

42. **The staff urges the authorities to remain alert to the key risks that remain in the fiscal outlook.** In particular, SACU revenue could turn out to be lower than expected in future years, owing to the new formula that will be the basis for determining the country's allocations or the impact of free trade agreements that are currently being negotiated. Also, uncertainties remain regarding the cost of the new initiatives. Should such fiscal risks materialize, the authorities are urged to respond promptly, mainly through expenditure reduction in nonpriority areas. There is scope to improve tax efficiency, but as tax rates are already high, further increases should be avoided owing to their negative impact on incentives to save and invest.

43. **The authorities are urged to continue with public financial management reforms.** The staff welcomes the submission of the public sector accounts to the Auditor General in 2003 that brought government accounting and reporting practices closer in line with constitutional requirements, and was a step toward greater transparency and accountability in public administration. Corrective actions should be taken to address the key weaknesses noted by the Auditor General. In this context, it will be critical that the authorities promptly implement the public sector reform program that they are developing. In particular, public employment should be rationalized and the civil service wage bill kept under control.

44. **The staff supports the ongoing reforms of Lesotho's financial institutions and regulations.** The reforms should help increase access to financial services by the private sector, including small- and medium-sized enterprises, and contribute to financial development and growth. Future measures should address the legal and judiciary impediments to lending by strengthening property rights and improving the functioning of the judicial system.

45. **The staff commends the authorities' efforts to deal with the HIV/AIDS pandemic. Continued actions in this direction are needed in view of its scale.** The increased attention given to the fight against HIV/AIDS in the 2004/05 budget is fully appropriate. In addition, the authorities' collaboration with the World Bank to improve the capacity to use donor funds, as well as prompt implementation of the proposed measures to reform the institutional framework for fighting HIV/AIDS, should help to make the anti-HIV/AIDS effort more effective, as well as attract additional donor support.

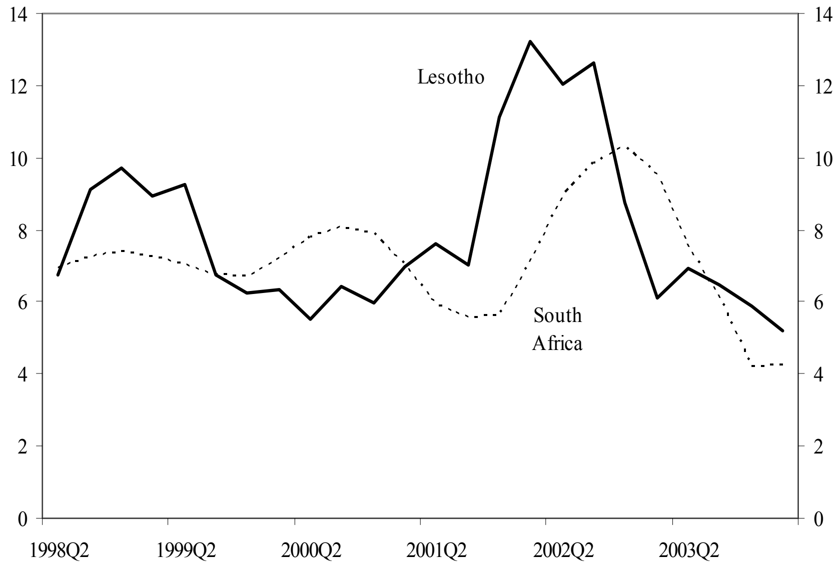
46. **The staff considers that a follow-up PRGF arrangement would be appropriate given Lesotho's remaining reform challenges and balance of payments needs** and assuming an ambitious but realistic program of measures. The relatively weak progress under consecutive Fund arrangements in structural reform underscores the importance of

both careful program design, supported by appropriate technical assistance, and strong commitment to implementation. As completing the Poverty Reduction Strategy Paper is a requirement for a possible new PRGF arrangement, staff encourages the authorities to complete this document without further delay.

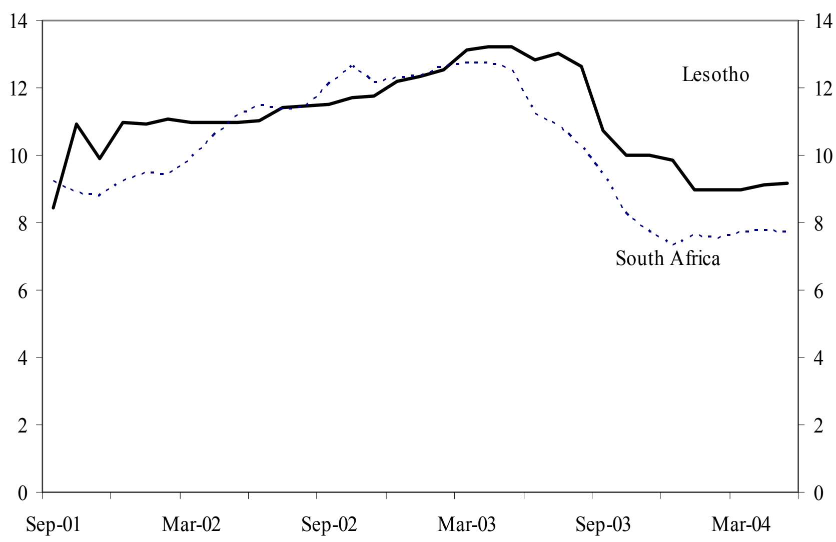
47. The staff supports the authorities' request for waivers of the nonobservance of three structural performance criteria, for a waiver of the nonobservance of the performance criterion on external payment arrears in May, and for completion of the sixth review. The December 2003 quantitative performance criteria and March 2004 benchmarks were met, and the measures required under two of the structural performance criteria for the review have been implemented with delay. The authorities have committed to implementing the final one (appointing a vehicle lease contract representative) prior to the completion of this review to help sustain savings on vehicle costs. The arrears in May were small in magnitude and were paid within a short period of time. The authorities remain committed to policies that are consistent with the objectives of the PRGF arrangement.

Figure 1. Lesotho: Prices and Interest Rates

Consumer Price Inflation, 1998:Q2 - 2004:Q1 1/
(Annual percent change)



Interest Rate on Three-Month Treasury Bills, September 2001 - May 2004
(In percent)

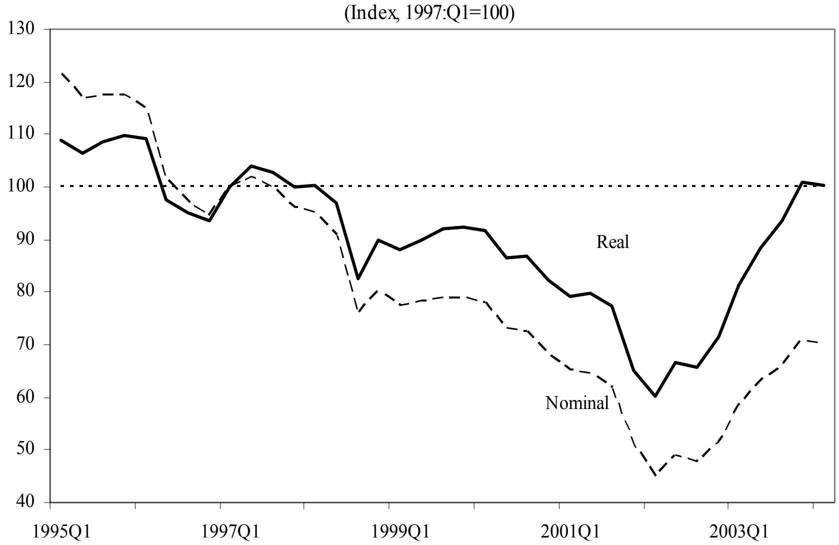


Source: Central Bank of Lesotho; Fund staff estimates; and IMF *International Financial Statistics*.

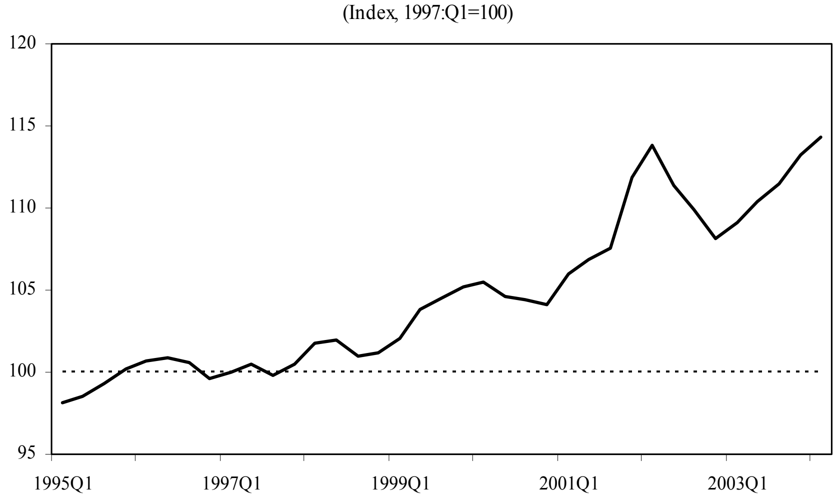
1/ Data for South Africa is CPIX, which excludes interest rates on mortgage bonds.

Figure 2. Lesotho: Nominal and Real Exchange Rates

Nominal and Real Effective Exchange Rates, 1995:Q1-2004:Q1 1/
(Index, 1997:Q1=100)



Real Exchange Rate: Lesotho Versus South Africa, 1995:Q1-2004:Q1
(Index, 1997:Q1=100)



Source: Fund staff estimates; and IMF *International Financial Statistics* .

1/ Lesotho's trading partners excluding South Africa.

Table 1. Lesotho: Selected Economic and Financial Indicators, 2002/03-2008/09 1/

	2002/03	2003/04		2004/05	2005/06	2006/07	2007/08	2008/09
	Act.	Rev. prog.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Annual percentage change, unless otherwise specified)							
National income and prices								
Real GDP	3.7	3.9	3.2	3.0	3.4	4.0	4.0	4.0
Real GNP	3.8	3.3	2.3	4.0	3.7	3.4	3.1	2.9
Consumer price index (period average)	9.3	6.4	6.4	6.0	5.5	5.5	5.5	5.5
Consumer price index (end of period)	7.2	6.9	5.2	5.5	5.5	5.5	5.5	5.5
Nominal GDP (in millions of maloti)	7,735	8,548	8,533	9,296	10,140	11,125	12,207	13,386
Nominal GNP (in millions of maloti)	9,477	10,399	10,361	11,400	12,468	13,595	14,791	16,048
External sector 2/								
Exports, f.o.b.	29.8	29.0	36.1	4.2	3.4	5.4	5.4	5.4
Imports, f.o.b.	21.9	22.6	31.1	6.7	0.6	4.7	4.8	4.6
Net labor income	8.2	26.6	44.8	10.5	4.1	3.0	3.2	2.7
Nominal effective exchange rate 3/	-7.2	...	30.8	...	...	...	...	...
Real effective exchange rate 3/	1.0	...	34.3	...	...	...	...	...
Government budget								
Revenue (excluding grants)	8.9	11.0	13.3	21.6	2.0	3.1	6.0	8.9
Total expenditure and net lending	24.5	6.4	-2.9	17.4	11.3	4.3	7.4	9.6
Current expenditure	23.6	10.8	2.5	17.7	10.5	2.4	7.3	9.0
Capital expenditure and net lending	28.2	-9.3	-22.0	16.2	14.9	13.1	7.6	12.1
Money and credit								
Net foreign assets 4/	-70.6	-6.0	-11.1	23.0	2.9	6.0	6.2	6.9
Net domestic assets 4/	73.4	16.6	16.5	-13.8	5.7	3.1	2.5	1.6
Credit to the government 4/	15.0	8.3	-5.9	-10.4	1.4	0.4	-1.3	-2.0
Credit to the rest of the economy 5/	-45.8	13.3	15.2	11.3	10.4	11.2	11.0	10.6
Broad money	2.7	10.6	5.3	9.1	8.6	9.0	8.8	8.5
Velocity (GDP/average broad money)	3.6	3.7	3.8	3.9	3.9	3.9	3.9	4.0
Interest rate 6/	12.1	...	12.0	...	...	...	...	...
	(In percent of GDP, unless otherwise specified)							
Investment and saving								
Investment	37.6	34.4	34.1	31.4	28.6	29.2	29.5	30.1
Public	9.7	8.8	7.6	7.7	8.0	8.5	8.3	8.5
Private	20.7	21.8	21.2	20.6	20.6	20.7	21.1	21.6
Lesotho Highlands Water Project	7.2	3.8	5.4	3.1	0.1	0.1	0.0	0.0
Gross national savings (including remittances)	20.6	22.6	23.0	25.1	22.1	23.0	22.5	23.1
Public	6.1	5.6	8.1	10.3	6.7	6.7	6.1	6.0
Private	14.4	17.0	15.0	14.8	15.4	16.3	16.4	17.1
Government budget								
Revenue	39.2	39.4	40.3	45.0	42.1	39.5	38.2	37.9
Total grants	3.8	3.2	2.1	2.4	2.2	2.2	2.2	2.2
Total expenditure and net lending	47.3	45.5	41.7	44.9	45.8	43.6	42.6	42.6
Overall balance (excluding grants)	-8.1	-6.1	-1.4	0.1	-3.7	-4.0	-4.4	-4.7
Overall balance (including grants)	-4.2	-2.9	0.7	2.4	-1.5	-1.8	-2.2	-2.5
Domestic balance	0.0	0.0	3.6	4.9	2.2	2.1	2.2	2.7
Domestic Primary balance	-2.8	-1.4	2.2	3.4	-0.8	-1.1	-1.6	-1.8
Gross government debt 7/	87.5	68.2	59.8	54.0	52.9	51.1	50.9	51.0
Domestic debt	16.6	14.8	12.9	10.8	10.1	9.4	9.6	9.7
External debt 7/	71.0	53.4	47.0	43.2	42.8	41.6	41.2	41.3
Domestic debt, net of deposits	0.8	2.0	-2.1	-2.9	-2.3	-1.9	-1.8	-1.9
External debt-service ratio 8/	12.0	9.4	8.2	9.4	7.8	7.1	6.5	7.2
External sector								
Current account balance (excluding official transfers)	-33.2	-27.0	-25.5	-24.2	-20.9	-20.3	-20.0	-19.8
Current account balance (including official transfers)	-17.0	-11.8	-11.1	-6.4	-6.5	-6.2	-6.9	-7.0
Gross official reserves (end of period)								
(In millions of U.S. dollars)	408.4	419.8	436.8	445.0	447.1	457.3	478.3	501.6
(In months of imports of goods and services)	4.3	3.9	4.3	4.4	4.2	4.1	4.1	4.1

Sources: Lesotho authorities; and Fund staff estimates and projections.

1/ Fiscal year beginning in April.

2/ In U.S. dollars.

3/ Based on partner-country data excluding South Africa. A minus sign indicates a depreciation.

4/ Change in percent of broad money at the beginning of the period.

5/ Credit to the rest of the economy affected by a write-off of bad loans in 2002/03.

6/ The average effective rate on three-month treasury bills.

7/ The appreciation of the loti had a significant effect on the debt-to-GDP ratio in 2003/04.

8/ In percent of exports of goods and nonfactor services.

Table 2. Lesotho: Central Government Operations, Annual, 2003/04-2008/09 1/

	2003/04		2004/05		2005/06	2006/07	2007/08	2008/09
	Rev. prog.	Prel.	Budget	Proj.	Proj.	Proj.	Proj.	Proj.
	(In millions of maloti)							
Revenue	3,368.9	3,438.3	4,232.0	4,182.0	4,266.4	4,399.6	4,664.0	5,078.6
Tax revenue	2,873.7	2,886.5	3,692.8	3,688.4	3,728.0	3,808.9	4,015.9	4,367.8
Customs revenue (SACU) 2/	1,421.6	1,421.6	2,012.4	2,012.4	1,956.1	1,860.9	1,875.2	2,020.3
Noncustoms tax revenue	1,452.1	1,464.9	1,680.4	1,676.0	1,771.9	1,948.0	2,140.7	2,347.5
Income taxes	850.9	851.5	902.0	902.0	956.4	1,058.2	1,169.3	1,287.6
Sales tax / value-added tax (VAT)	501.9	519.3	678.2	678.2	715.7	785.2	861.6	944.8
Petrol levy	86.3	80.6	82.1	82.1	84.9	88.3	91.9	95.5
Other tax revenues	13.0	13.5	18.1	13.7	14.9	16.3	17.9	19.7
Nontax revenue	495.2	551.8	539.2	493.6	538.4	590.7	648.2	710.8
Grants	276.8	177.8	336.8	218.5	222.1	243.7	267.4	293.2
Total expenditure and net lending	3,891.6	3,554.5	4,318.9	4,173.2	4,644.2	4,845.6	5,202.2	5,703.0
Current expenditure	3,164.4	2,929.1	3,494.0	3,446.4	3,809.0	3,901.3	4,185.8	4,563.8
Wages and salaries	1,123.2	1,123.2	1,222.9	1,222.9	1,316.0	1,416.1	1,523.9	1,639.8
Interest payments	215.2	216.4	216.1	168.5	176.7	174.7	201.6	268.6
External	90.3	90.5	94.7	78.1	99.2	94.3	122.8	181.6
Domestic	124.9	125.9	121.4	90.4	77.5	80.4	78.7	87.0
Other expenditure	1,826.0	1,589.5	2,055.0	2,055.0	2,316.3	2,310.5	2,460.3	2,655.4
Goods and services 3/	1,193.0	1,029.9	1,210.2	1,227.6	1,339.4	1,265.6	1,344.8	1,461.9
Famine relief	0.0	0.0	75.0	75.0	0.0	...	...	...
Agricultural support	41.0	64.8	0.0	0.0	...	...	...	...
Vehicle leases	149.0	150.1	135.0	120.0	...	...	...	...
Election costs	141.2	15.0	109.0	93.0	0.0	...	...	...
District assemblies	0.0	0.0	0.0	0.0	50.0	52.8	55.7	58.7
Other spending on goods and services	861.8	800.0	891.2	939.6	...	...	...	...
Transfers and subsidies	633.0	559.6	844.8	827.4	976.9	1,044.8	1,115.5	1,193.5
Pensions and gratuities	112.4	118.9	207.0	207.0	309.3	332.9	358.2	385.5
Of which: old age pensions	0.0	0.0	45.0	45.0	135.0	142.4	150.3	158.5
Subventions and transfers	520.6	440.7	637.8	620.4	667.6	711.9	757.3	808.0
Of which: scholarships	215.0	215.1	270.0	270.0	...	...	...	...
Capital expenditure	740.9	634.9	842.7	744.6	835.2	944.3	1,016.5	1,139.2
Domestically funded	320.8	314.3	360.0	360.0	338.1	362.8	333.8	336.0
Externally funded	420.1	320.6	482.7	384.6	497.1	581.6	682.6	803.2
Grant funded	240.0	140.2	272.6	174.5	222.1	243.7	267.4	293.2
Loan funded	180.1	180.4	210.1	210.1	275.0	337.9	415.3	510.0
Net lending	-13.7	-9.5	-17.8	-17.8	0.0	0.0	0.0	0.0
Overall balance, before grants	-522.7	-116.2	-86.9	8.8	-377.7	-445.9	-538.2	-624.4
Overall balance, after grants	-245.9	61.6	249.9	227.3	-155.6	-202.3	-270.8	-331.2
Domestic balance 4/	1.7	308.9	472.7	453.7	218.6	229.9	267.3	360.4
Total financing	245.9	-61.6	-249.9	-227.3	155.6	202.3	270.8	331.2
External financing	-25.9	-25.7	-41.9	-43.9	26.5	89.4	202.8	284.4
Loan drawings	180.1	180.4	210.1	210.1	275.0	337.9	415.3	510.0
Amortization	-206.0	-206.1	-252.0	-254.0	-248.5	-248.5	-212.5	-225.6
Financing gap	0.0	0.0	0.0	56.7	94.6	100.6	107.3	110.2
Domestic financing	271.8	-37.3	-208.0	-240.0	34.6	12.3	-39.3	-63.5
Bank	182.3	-129.6	…	…	…	…	…	…
Nonbank	89.5	92.3	…	…	…	…	…	…
Residual	0.0	1.4	0.0	0.0	0.0	0.0	0.0	0.0

Table 2. Lesotho: Central Government Operations, Annual, 2003/04-2008/09 1/ (concluded)

	2003/04		2004/05		2005/06	2006/07	2007/08	2008/09
	Rev. prog.	Prel.	Budget	Proj.	Proj.	Proj.	Proj.	Proj.
	(In percent of GDP, unless otherwise indicated)							
Revenue	39.4	40.3	45.2	45.0	42.1	39.5	38.2	37.9
Customs revenue (SACU) 2/	16.6	16.7	21.5	21.6	19.3	16.7	15.4	15.1
Noncustoms tax revenue	17.0	17.2	17.9	18.0	17.5	17.5	17.5	17.5
Nontax revenue	5.8	6.5	5.8	5.3	5.3	5.3	5.3	5.3
Grants	3.2	2.1	3.6	2.4	2.2	2.2	2.2	2.2
Total expenditure and net lending	45.5	41.7	46.1	44.9	45.8	43.6	42.6	42.6
Current expenditure	37.0	34.3	37.3	37.1	37.6	35.1	34.3	34.1
Wages and salaries	13.1	13.2	13.0	13.2	13.0	12.7	12.5	12.3
Interest payments	2.5	2.5	2.3	1.8	1.7	1.6	1.7	2.0
External	1.1	1.1	1.0	0.8	1.0	0.8	1.0	1.4
Domestic	1.5	1.5	1.3	1.0	0.8	0.7	0.6	0.7
Other expenditure	21.4	18.6	21.9	22.1	22.8	20.8	20.2	19.8
Goods and services 3/	14.0	12.1	12.9	13.2	13.2	11.4	11.0	10.9
Transfers and subsidies	7.4	6.6	9.0	8.9	9.6	9.4	9.1	8.9
Pensions and gratuities	1.3	1.4	2.2	2.2	3.1	3.0	2.9	2.9
Subventions and transfers	6.1	5.2	6.8	6.7	6.6	6.4	6.2	6.0
Capital expenditure	8.7	7.4	9.0	8.0	8.2	8.5	8.3	8.5
Of which: domestically funded	3.8	3.7	3.8	3.9	3.3	3.3	2.7	2.5
Net lending	-0.2	-0.1	-0.2	-0.2	0.0	0.0	0.0	0.0
Overall balance, before grants	-6.1	-1.4	-0.9	0.1	-3.7	-4.0	-4.4	-4.7
Overall balance, after grants	-2.9	0.7	2.7	2.4	-1.5	-1.8	-2.2	-2.5
Domestic balance 4/	0.0	3.6	5.0	4.9	2.2	2.1	2.2	2.7
Total financing	2.9	-0.7	-2.7	-2.4	1.5	1.8	2.2	2.5
Financing abroad	-0.3	-0.3	-0.4	-0.5	0.3	0.8	1.7	2.1
Financing gap	0.0	0.0	0.0	0.6	0.9	0.9	0.9	0.8
Domestic financing	3.2	-0.4	-2.2	-2.6	0.3	0.1	-0.3	-0.5
	(In millions of maloti, unless otherwise indicated)							
Memorandum items:								
GNP at current prices	10,399	10,361	11,376	11,400	12,468	13,595	14,791	16,048
GDP at current prices	8,548	8,533	9,373	9,296	10,140	11,125	12,207	13,386

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Fiscal year from April to March.

2/ Adjustment receipts of M 343 million in 2005/06 and M 133 million in 2006/07 included.

3/ Capitalization of the new SACU secretariat of M 172 million included in spending for 2005/06.

4/ Domestic balance excludes grants, foreign-financed capital spending, foreign interest payments, and exceptional factors.

Table 3. Lesotho: Central Government Operations, Quarterly, 2003/04 and 2004/05 1/

	Cumulative 2003/04						Cumulative 2004/05				
	Q1	Q2	Q3		Q4		Q1	Q2	Q3	Q4	
	Act.	Act.	Rev. prog.	Prel.	Rev. prog.	Prel.	Proj.	Proj.	Proj.	Budget	Proj.
	(In millions of maloti)										
Revenue	725.9	1,647.2	2,483.8	2,481.6	3,368.9	3,438.3	975.8	2,000.7	3,095.0	4,232.0	4,182.0
Tax revenue	591.0	1,358.9	2,092.5	2,102.3	2,873.7	2,886.5	874.9	1,794.3	2,748.3	3,692.8	3,688.4
Customs revenue (SACU)	355.4	710.8	1,066.2	1,066.2	1,421.6	1,421.6	503.1	1,006.2	1,509.3	2,012.4	2,012.4
Noncustoms tax revenue	235.6	648.1	1,026.3	1,036.1	1,452.1	1,464.9	371.8	788.1	1,239.0	1,680.4	1,676.0
Income taxes	134.0	391.5	595.7	595.5	850.9	851.5	191.4	422.7	664.5	902.0	902.0
Sales tax / value-added tax (VAT)	78.0	209.9	357.5	367.8	501.9	519.3	156.5	317.5	502.7	678.2	678.2
Petrol levy	21.8	43.2	64.8	65.4	86.3	80.6	20.5	41.1	61.6	82.1	82.1
Other tax revenues	1.8	3.5	8.3	7.4	13.0	13.5	3.4	6.8	10.2	18.1	13.7
Nontax revenue	134.9	288.3	391.3	379.3	495.2	551.8	100.9	206.4	346.7	539.2	493.6
Grants	46.1	85.6	187.4	138.3	276.8	177.8	43.6	131.2	174.8	336.8	218.5
Total expenditure and net lending	918.6	1,789.6	2,901.3	2,703.5	3,891.6	3,554.5	1,213.4	2,218.8	3,055.7	4,318.9	4,173.2
Current expenditure	714.3	1,461.9	2,373.1	2,244.2	3,164.4	2,929.1	1,006.2	1,832.8	2,496.8	3,494.0	3,446.4
Wages and salaries	278.5	557.7	840.5	839.5	1,123.2	1,123.2	304.2	609.0	912.9	1,222.9	1,222.9
Interest payments	39.4	92.8	155.1	160.6	215.2	216.4	38.8	88.0	128.5	216.1	168.5
External	14.1	32.2	62.2	65.4	90.3	90.5	12.2	41.4	59.3	94.7	78.1
Domestic	25.3	60.6	92.9	95.2	124.9	125.9	26.6	46.6	69.2	121.4	90.4
Other expenditure	396.4	811.4	1,377.5	1,244.1	1,826.0	1,589.5	663.2	1,135.8	1,455.4	2,055.0	2,055.0
Goods and services	264.5	560.5	894.6	827.0	1,193.0	1,029.9	390.0	667.0	868.6	1,210.2	1,227.6
Famine relief	0.0	0.0	0.0	0.0	0.0	0.0	…	…	…	75.0	75.0
Agricultural support	16.3	26.6	…	36.7	41.0	64.8	0.0	0.0	0.0	0.0	0.0
Vehicle leases	31.6	71.4	…	…	149.0	150.1	…	…	…	135.0	120.0
Election costs	...	...	...	10.0	141.2	15.0	…	…	…	109.0	93.0
Other spending on goods and services	...	...	...	...	861.8	800.0	…	…	…	891.2	939.6
Transfers and subsidies	131.9	250.9	482.9	417.1	633.0	559.6	273.2	468.8	586.8	844.8	827.4
Of which: scholarships	70.0	…	…	…	215.0	215.1	77.2	136.9	208.9	270.0	270.0
Capital expenditure	208.0	331.4	535.3	468.1	740.9	634.9	211.7	394.9	572.3	842.7	744.6
Domestically funded	132.6	196.0	254.0	245.2	320.8	314.3	115.6	202.6	283.9	360.0	360.0
Externally funded	75.4	135.4	281.3	222.9	420.1	320.6	96.1	192.3	288.4	482.7	384.6
Grant funded	46.1	71.6	150.6	100.9	240.0	140.2	43.6	87.2	130.8	272.6	174.5
Loan funded	29.3	63.8	130.7	122.0	180.1	180.4	52.5	105.1	157.6	210.1	210.1
Net lending	-3.7	-3.7	-7.1	-8.8	-13.7	-9.5	-4.5	-8.9	-13.4	-17.8	-17.8
Overall balance, before grants	-192.7	-142.4	-417.5	-221.9	-522.7	-116.2	-237.5	-218.1	39.3	-86.9	8.8
Overall balance, after grants	-146.6	-56.8	-230.1	-83.6	-245.9	61.6	-193.9	-86.9	214.1	249.9	227.3
Domestic balance 2/	-86.9	51.8	-105.4	103.1	1.7	308.9	108.3	233.7	347.7	472.7	453.7
Total financing	146.6	56.8	230.1	83.6	245.9	-61.6	193.9	86.9	-214.1	-249.9	-227.3
External financing	-16.4	-25.8	-39.0	-62.7	-25.9	-25.7	-11.0	-21.9	-32.9	-41.9	-43.9
Loan drawings	29.3	63.8	130.7	122.0	180.1	180.4	52.5	105.1	157.6	210.1	210.1
Amortization	-45.7	-89.6	-169.7	-184.7	-206.0	-206.1	-63.5	-127.0	-190.5	-252.0	-254.0
Financing gap							0.0	0.0	0.0	0.0	56.7
Domestic financing	163.6	82.7	269.1	145.4	271.8	-37.3	204.9	108.8	-181.2	-208.0	-240.0
Bank	104.5	-6.8	179.6	23.2	182.3	-129.6	204.9	108.8	-181.2	-208.0	-240.0
Nonbank	59.1	89.5	89.5	122.1	89.5	92.3	0.0	0.0	0.0	0.0	0.0
Residual	-0.6	-0.1	0.0	0.9	0.0	1.4	0.0	0.0	0.0	0.0	0.0

Table 3. Lesotho: Central Government Operations, Quarterly, 2003/04 and 2004/05 1/ (concluded)

	Cumulative 2003/04						Cumulative 2004/05				
	Q1	Q2	Q3		Q4		Q1	Q2	Q3	Q4	
	Act.	Act.	Rev. prog.	Prel.	Rev. prog.	Prel.	Proj.	Proj.	Proj.	Budget	Proj.
	(In percent of GDP, unless otherwise indicated)										
Revenue	8.5	19.3	29.1	29.1	39.4	40.3	10.5	21.5	33.3	45.5	45.0
Customs revenue (SACU)	4.2	8.3	12.5	12.5	16.6	16.7	5.4	10.8	16.2	21.6	21.6
Noncustoms tax revenue	2.8	7.6	12.0	12.1	17.0	17.2	4.0	8.5	13.3	18.1	18.0
Nontax revenue	1.6	3.4	4.6	4.4	5.8	6.5	1.1	2.2	3.7	5.8	5.3
Grants	0.5	1.0	2.2	1.6	3.2	2.1	0.5	1.4	1.9	3.6	2.4
Total expenditure and net lending	10.8	21.0	33.9	31.7	45.5	41.7	13.1	23.9	32.9	46.5	44.9
Current expenditure	8.4	17.1	27.8	26.3	37.0	34.3	10.8	19.7	26.9	37.6	37.1
Wages and salaries	3.3	6.5	9.8	9.8	13.1	13.2	3.3	6.6	9.8	13.2	13.2
Interest payments	0.5	1.1	1.8	1.9	2.5	2.5	0.4	0.9	1.4	2.3	1.8
Other expenditure	4.6	9.5	16.1	14.6	21.4	18.6	7.1	12.2	15.7	22.1	22.1
Goods and services	3.1	6.6	10.5	9.7	14.0	12.1	4.2	7.2	9.3	13.0	13.2
Transfers and subsidies	1.5	2.9	5.6	4.9	7.4	6.6	2.9	5.0	6.3	9.1	8.9
Capital expenditure	2.4	3.9	6.3	5.5	8.7	7.4	2.3	4.2	6.2	9.1	8.0
Net lending	0.0	0.0	-0.1	-0.1	-0.2	-0.1	0.0	-0.1	-0.1	-0.2	-0.2
Overall balance, before grants	-2.3	-1.7	-4.9	-2.6	-6.1	-1.4	-2.6	-2.3	0.4	-0.9	0.1
Overall balance, after grants	-1.7	-0.7	-2.7	-1.0	-2.9	0.7	-2.1	-0.9	2.3	2.7	2.4
Domestic balance 2/	-1.0	0.6	-1.2	1.2	0.0	3.6	1.2	2.5	3.7	5.1	4.9
External financing	-0.2	-0.3	-0.5	-0.7	-0.3	-0.3	-0.1	-0.2	-0.4	-0.5	-0.5
Financing gap							0.0	0.0	0.0	0.0	0.6
Domestic financing	1.9	1.0	3.1	1.7	3.2	-0.4	2.2	1.2	-1.9	-2.2	-2.6
Memorandum items:											
GNP at current prices (in millions of maloti)	10,361	10,361	10,399	10,361	10,399	10,361	11,400	11,400	11,400	11,400	11,400
GDP at current prices (in millions of maloti)	8,533	8,533	8,548	8,533	8,548	8,533	9,296	9,296	9,296	9,296	9,296

Sources: Ministry of Finance; and Fund staff estimates and projections.

1/ Fiscal year from April to March.

2/ Domestic balance excludes grants, foreign-financed capital spending, foreign interest payments, and exceptional factors.

Table 4. Lesotho: Central Bank Balance Sheet, March 2003-March 2005

	2003					2004					2005
	Mar.	June	Sep.	Dec.	Dec.	Mar.	Mar.	June	Sep.	Dec.	Mar.
	Act.	Act.	Act.	Rev. prog.	Act.	Rev. prog.	Act.	Proj.	Proj.	Proj.	Proj.
	(In millions of maloti)										
Net foreign assets	2,949.7	3,060.2	2,687.6	2,672.4	2,837.7	2,672.4	2,567.9	2,699.7	2,796.6	2,930.5	3,066.9
Foreign assets	3,569.1	3,570.2	3,177.3	3,371.0	3,325.7	3,403.6	3,074.5	3,205.8	3,338.2	3,471.6	3,607.8
Foreign liabilities	619.5	510.0	489.7	698.6	488.0	731.2	506.6	506.1	541.6	541.1	540.9
Net domestic assets	-2,635.0	-2,673.9	-2,429.9	-2,411.2	-2,488.2	-2,407.5	-2,266.6	-2,391.8	-2,481.8	-2,608.8	-2,738.1
Net claims on government	-792.2	-966.1	-978.6	-803.0	-1,090.1	-770.6	-1,021.4	-994.0	-968.7	-1,092.6	-1,081.2
Claims on government	184.0	196.1	175.8	182.6	173.8	215.2	196.1	195.6	231.1	230.6	230.4
Government deposits	-976.2	-1,162.1	-1,154.3	-985.7	-1,263.9	-985.8	-1,217.4	-1,189.6	-1,199.8	-1,323.2	-1,311.6
Official entities' deposits	-151.1	-150.0	-160.8	-163.0	-158.4	-165.3	-157.4	-160.9	-164.4	-168.1	-171.8
Claims on commercial banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net claims on private sector	2.4	3.5	3.4	3.5	4.3	3.5	4.4	4.5	4.6	4.7	4.9
Other items (net)	-1,694.1	-1,561.4	-1,293.9	-1,448.6	-1,244.0	-1,475.0	-1,092.3	-1,241.4	-1,353.3	-1,352.8	-1,490.0
Other assets	150.2	147.4	148.5	150.6	177.4	152.7	227.6	232.6	237.8	243.0	248.4
Other liabilities	-263.3	-25.9	-33.9	-33.9	-28.5	-33.9	-28.9	-28.9	-28.9	-28.9	-50.0
Capital account	-1,580.9	-1,682.8	-1,408.6	-1,565.3	-1,392.9	-1,593.9	-1,291.0	-1,445.1	-1,562.2	-1,566.9	-1,688.3
Reserve money	314.7	386.3	257.7	261.2	349.5	264.9	301.3	308.0	314.8	321.7	328.8
	(In millions of U.S. dollars, unless otherwise specified)										
Memorandum items:											
Net foreign assets (in millions of U.S. dollars)	377	405	389	365	427	365	403	408	408	412	417
Gross international reserves											
(in percent of currency in circulation)	1,807.0	1,842.9	1,524.6	1,555.4	1,646.2	1,590.6	1,340.1	1,367.7	1,394.1	1,419.1	1,443.6
(in percent of M1)	223.6	232.2	201.6	190.6	196.5	190.8	180.8	184.5	188.1	191.4	194.8
(in percent of M2)	147.3	143.7	129.7	127.0	131.5	127.0	120.5	123.0	125.4	127.6	129.8
(in months of imports)	4.3	4.2	4.1	3.8	4.5	3.9	4.3	4.3	4.3	4.4	4.4

Sources: Central Bank of Lesotho; and Fund staff estimates and projections.

Table 5. Lesotho: Monetary Survey, March 2003-March 2005

	2003					2004					2005
	Mar. Act.	June Act.	Sep. Act.	Dec. Rev. prog.	Dec. Act.	Mar Rev. prog.	Mar. Act.	June Proj.	Sep Proj.	Dec Proj.	Mar. Proj.
	(In millions of maloti)										
Net foreign assets	3,722.3	3,635.6	3,438.0	3,555.9	3,460.8	3,591.3	3,478.4	3,617.8	3,722.4	3,864.0	4,008.2
Central bank	2,949.7	3,060.2	2,687.6	2,672.4	2,837.7	2,672.4	2,567.9	2,699.7	2,796.6	2,930.5	3,066.9
Commercial banks	772.6	575.3	750.4	883.4	623.2	918.9	910.5	918.1	925.8	933.5	941.3
Net domestic assets	-1,530.9	-1,381.2	-1,226.3	-1,158.6	-1,163.0	-1,167.3	-1,170.0	-1,258.5	-1,311.0	-1,399.5	-1,489.4
Domestic credit 1/	321.4	454.5	359.1	560.7	380.6	571.5	269.3	487.2	404.3	127.9	95.8
Claims on central government (net)	-190.3	-85.8	-204.5	-10.7	-167.0	-8.0	-319.9	-115.0	-211.1	-501.1	-559.9
Central bank	-792.2	-966.1	-978.6	-803.0	-1,090.1	-770.6	-1,021.4	-994.0	-968.7	-1,092.6	-1,081.2
Commercial banks	602.0	880.3	774.1	792.4	923.1	762.7	701.5	879.0	757.6	591.5	521.2
Claims on the rest of the economy 1/	511.6	540.3	563.6	571.4	547.7	579.5	589.2	602.2	615.5	629.0	655.8
Other items (net) 1/	-1,852.3	-1,835.7	-1,585.4	-1,719.3	-1,543.6	-1,738.8	-1,439.3	-1,745.7	-1,715.4	-1,527.4	-1,585.2
Money and quasi money (M2)	2,191.3	2,254.4	2,211.6	2,397.2	2,297.8	2,424.0	2,308.4	2,359.3	2,411.3	2,464.5	2,518.9
Money	1,443.9	1,395.8	1,422.9	1,597.7	1,537.7	1,613.1	1,539.1	1,573.0	1,607.7	1,643.2	1,679.4
Of which: currency outside dep. mon. banks	178.6	175.8	188.2	195.8	183.5	193.5	207.6	212.2	216.9	221.7	226.6
demand deposits	1,103.4	1,059.6	1,063.6	1,078.1	1,185.2	1,093.5	1,163.2	1,188.9	1,215.1	1,241.9	1,269.3
Quasi money	747.5	858.6	788.7	799.5	760.1	810.9	769.3	786.3	803.6	821.3	839.5
Of which: time and savings deposits	747.5	858.6	788.7	799.5	760.1	810.9	769.3	786.3	803.6	821.3	839.5
	(Annual change in percent of beginning-of-year M2, unless otherwise specified)										
Net foreign assets	-70.6	-50.4	-53.4	-15.1	-19.5	-6.0	-11.1	-0.8	12.9	17.5	23.0
Central bank	-71.5	-39.6	-53.5	-24.4	-16.8	-12.7	-17.4	-16.0	4.9	4.0	21.6
Commercial banks	0.9	-10.8	0.1	9.2	-2.8	6.7	6.3	15.2	7.9	13.5	1.3
Net domestic assets	73.4	51.9	54.5	25.7	25.5	16.6	16.5	5.4	-3.8	-10.3	-13.8
Claims on central government (net)	15.0	17.8	6.3	14.3	7.1	8.3	-5.9	-1.3	-0.3	-14.5	-10.4
Claims on the rest of the economy 1/	-20.2	-18.7	-20.3	-20.4	-21.5	3.1	3.5	2.7	2.3	3.5	2.9
Claims on the rest of the econ. (yearly change) 1/	-45.8	-43.5	-44.0	-43.6	-46.0	13.3	15.2	11.5	9.2	14.9	11.3
Other items (net) 1/	78.6	52.7	68.5	31.8	39.9	5.2	18.8	4.0	-5.9	0.7	-6.3
Money and quasi money (M2)	2.7	1.5	1.1	10.6	6.0	10.6	5.3	4.7	9.0	7.3	9.1
Quasi money (yearly change)	3.8	14.3	7.0	9.9	4.5	8.5	2.9	-8.4	1.9	8.1	9.1
Memorandum item:											
Money multiplier (M2/reserve money)	7.0	5.8	8.6	9.2	6.6	9.2	7.7	7.7	7.7	7.7	7.7

Sources: Central Bank of Lesotho; and Fund staff estimates and projections.

1/ Claims on the rest of the economy and other items (net) affected by a write-off of bad loans in February 2003.

Table 6. Lesotho: Balance of Payments, 2003/04 - 2008/09 1/
(In millions of U.S. dollars)

	2003/04		2004/05	2005/06	2006/07	2007/08	2008/09
	Rev. prog.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
Trade balance	-515.9	-537.7	-586.3	-574.8	-597.5	-622.0	-646.1
Exports, f.o.b.	514.7	518.8	540.8	559.1	589.4	621.5	654.8
Imports, f.o.b.	-1,030.6	-1,056.5	-1,127.0	-1,133.9	-1,186.9	-1,243.5	-1,300.8
Services (net)	-36.4	-39.2	-38.5	-32.9	-34.1	-35.1	-35.8
Receipts	48.5	52.5	54.3	53.7	56.5	59.7	63.2
Of which : water royalties (and power sales)	14.6	15.7	17.8	18.5	19.8	21.3	22.9
Payments	-84.9	-91.7	-92.8	-86.6	-90.6	-94.8	-99.0
Income (net)	243.4	258.7	296.9	312.6	324.1	332.3	335.6
Labor income (net)	235.3	258.9	286.1	297.8	306.6	316.3	324.7
Receipts	267.0	291.1	308.3	313.0	324.1	336.7	348.5
Of which : miners' wages	218.4	236.1	250.1	253.9	262.9	273.1	282.7
Payments	-31.7	-32.2	-22.3	-15.2	-17.5	-20.4	-23.8
Investment income (net)	8.0	-0.2	10.8	14.8	17.5	16.0	10.9
Receipts	37.0	27.4	31.2	32.0	33.8	35.8	37.8
Payments	-28.9	-27.5	-20.4	-17.2	-16.3	-19.7	-26.9
Of which : interest on debt	-14.1	-12.7	-15.6	-13.5	-12.6	-16.0	-23.1
Unrequited transfers	176.8	183.6	244.6	206.7	216.4	215.7	227.8
Official	171.3	173.0	233.7	195.7	205.2	204.3	216.2
Southern African Customs Union nonduty receipts	146.2	153.6	216.7	177.4	186.3	184.0	194.4
Rand compensation	8.7	9.3	7.0	7.3	7.8	8.4	9.0
Other	16.4	10.0	10.0	11.1	11.1	11.9	12.8
Private	5.4	10.6	10.9	11.0	11.2	11.4	11.6
Current account (including official transfers)	-132.2	-134.6	-83.3	-88.4	-91.1	-109.1	-118.4
Current account (excluding official transfers)	-303.5	-307.6	-317.0	-284.1	-296.3	-313.4	-334.6
Of which: LHWP 2/	-37.1	-59.0	-20.0	17.9	19.3	20.9	22.6
Capital and financial account	132.2	62.1	90.9	78.4	79.9	97.3	106.7
Capital account (transfers received)	20.1	19.1	20.6	19.9	21.3	22.9	24.6
Financial account	112.1	43.0	70.3	58.6	58.6	74.4	82.0
Direct investment (excl. LHDA) 3/	70.0	45.9	45.1	50.1	57.1	60.9	62.6
Financing LHWP (net)	115.9	78.4	33.1	0.0	0.0	0.0	0.0
Other investment	-62.4	-52.8	0.3	10.6	11.6	34.5	42.8
Assets 4/	-37.0	-62.5	18.3	9.4	3.2	13.7	12.6
Liabilities	-25.4	9.7	-18.0	1.1	8.5	20.8	30.2
Loans	5.3	-8.8	-8.6	3.8	12.1	26.4	36.2
Public and publicly guaranteed	-1.0	-8.7	-8.9	3.6	11.7	26.1	35.9
Disbursements	30.4	23.1	29.6	36.9	44.3	53.4	64.3
Repayments	-31.5	-31.8	-38.6	-33.4	-32.6	-27.3	-28.4
Private (net)	6.3	-0.1	0.3	0.3	0.3	0.3	0.3
Other liabilities	-30.7	18.5	-9.4	-2.7	-3.6	-5.6	-6.0
CBL liabilities	-21.4	1.2	-5.9	-2.1	-3.2	-5.2	-5.6
Commercial banks' liabilities	-9.3	17.3	-3.5	-0.6	-0.4	-0.4	-0.4
Change in reserve assets 4/	-11.4	-28.4	-8.2	-2.1	-10.2	-21.0	-23.3
Valuation adjustment	0.0	44.8	-15.5	-2.7	-2.0	-2.0	-2.1
Errors and omissions	0	27.7	0	0	0	0	0
Financing gap	0	0	8.0	12.7	13.2	13.8	13.9
Memorandum items:							
Gross official reserves (end of period)							
(In millions of U.S. dollars)	412.4	436.8	445.0	447.1	457.3	478.3	501.6
(In months of imports of goods and services)	3.9	4.3	4.4	4.2	4.1	4.1	4.1

Sources: Central Bank of Lesotho (CBL); and Fund staff estimates and projections.

1/ Financial year is April-March.
2/ Lesotho Highlands Water Project.
3/ Lesotho Highlands Development Authority.
4/ Transaction-based data, a minus sign indicates an increase in reserves.

Table 7. Lesotho: Quantitative Performance Criteria, Benchmarks, and Indicative Targets, December 2003 - June 2004

	December 2003 Perf. Criteria				March 2004 Benchmarks					June 2004 Indicative Targets	
	Prog. 1/	Rev. Prog. 2/	Act.	Met (M) or Not met (NM)	Prog. 1/	Rev. Prog. 1/	Rev. Prog. 3/	Act.	Met (M) or Not met (NM)	Proj.	Rev. Proj.
					(In millions of maloti)						
Ceiling on the domestic financing requirement of the central government 4/	269	263	145	M	341	272	218	-37	M	-48	205
Ceiling on the stock of net domestic assets of the Central Bank of Lesotho 5/	-2,411	-2,411	-2,741	M	-2,495	-2,495	-2,495	-2,653	M	-2,490	-2,774
					(In millions of U.S. dollars)						
Floor on the stock of net international reserves of the Central Bank of Lesotho 5/	357	357	390	M	357	357	357	373	M	357	389
Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector (cumulative from end-November 2000) 6/ 7/ 8/											
Maturity of less than one year 9/	0	0	0	M	0	0	0	0	M	0	0
Maturity of one year or more	0	0	0	M	0	0	0	0	M	0	0
Ceiling on the stock of external payments arrears 8/ 10/	0	0	0	M	0	0	0	0	M	0	0

Sources: Ministry of Finance; Central Bank of Lesotho; and Fund staff estimates.

1/ Before application of adjusters.
2/ After application of adjusters, as indicated in the technical memorandum of understanding (TMU) in EBS/03/66.
3/ After application of adjusters, as indicated in the technical memorandum of understanding (TMU) in EBS/04/1.
4/ Data for December 2003 and March 2004 are cumulative from end-March 2003. Data for June 2004 are cumulative from end-March 2004.
5/ The exchange rates used for the calculations are indicated in the TMU in EBS/03/66 for December 2003, and the TMU in EBS/04/1 for March and June 2004.
6/ This performance criterion applies not only to debt as defined in point no. 9 of the Guidelines on Performance Criteria with Resptect to Foreign Debt, adopted on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received. A loan is concessional if its grant element is at least 35 percent, calculated using a discount rate based on the ten-year average of OECD commercial interest reference rates (CIRRs) for loans of maturity of greater than 15 years; for loans of maturity of 15 years or less, the discount rate is based on the six-month average of OECD CIRRs. To both the ten-year and six-month averages, the same margin for differing repayment periods would be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more.)
7/ Excludes borrowing for water transfer operations of the Lesotho Highlands Development Authority.
8/ Continuous performance criterion.
9/ Except for normal short-term import credits and nonresident holdings of treasury bills.
10/ Breached in May 2004, when a payment of debt service was delayed by ten days.

Table 8. Lesotho: Structural Performance Criteria and Benchmarks, January-April 2004

	Status
Structural performance criteria	
• Complete action plan for near-term improvements to GOLFIS and identify resources to implement the plan (January 31, 2004).	Not met. Finalized with a delay in May.
• Advertise positions for Deputy Accountant General (February 28, 2004).	Met.
• Integrate into the treasury accounting system loans to parastatals and ministry accounts that are not being captured by the system and report such integration to the Fund (March 31, 2004).	Not met. Report submitted with a delay in May.
• Appoint vehicle lease Contract Representative (April 1, 2004).	Not met. Authorities have committed to make appointment before the completion of the sixth review.
Structural benchmarks	
• Establish a task force to recommend a comprehensive policy for the National Manpower Development Secretariat and the program it administers. The policies would cover both administrative and educational matters. The task force would report to the Minister of Finance and Development Planning (January 31, 2004).	Met with a delay. The task force was established on February 9, 2004.
• Present final supplementary budget for 2003/04 to parliament (March 31, 2004).	Met with a delay. Bill submitted in end-April.
• Transactions in bank accounts, including diplomatic missions, will be entered into the treasury ledger system. Initiate practice of reconciling all cash balances with bank balances monthly (April 30, 2004).	Partly observed. Transactions of one diplomatic mission still pending.
• Implement reorganization of treasury top management and appoint two new Deputy Accountants General (April 30, 2004).	Partly observed. Two deputies appointed on May 5, but reorganization still pending.

Table 9. Indicative Targets, September 2004 - March 2005

	2004 September	2004 December	2005 March
	(In millions of maloti)		
Ceiling on the domestic financing requirement of the central government 1/	109	-181	-240
Ceiling on the stock of net domestic assets of the Central Bank of Lesotho 2/	-2,297	-2,354	-2,410
	(In millions of U.S. dollars)		
Floor on the stock of net international reserves of the Central Bank of Lesotho 2/	410	420	430
Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector (cumulative from end-November 2000) 3/ 4/ 5/			
Maturity of less than one year 6/	0	0	0
Maturity of one year or more	0	0	0
Ceiling on the stock of external payments arrears 5/	0	0	0

Sources: Ministry of Finance; Central Bank of Lesotho; and Fund staff estimates.

1/ Numbers are cumulative from end-March 2004.
2/ At end-March 2004 exchange rates.
3/ This indicative target applies not only to debt as defined in point no. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt, adopted on August 24, 2000, but also to commitments contracted or guaranteed for which value has not been received. A loan is concessional if its grant element is at least 35 percent, calculated using a discount rate based on the ten-year average of OECD commercial interest reference rates (CIRRs) for loans of maturity of greater than 15 years; for loans of maturity of 15 years or less, the discount rate is based on the six-month average of OECD CIRRs. To both the ten-year and six-month averages, the same margin for differing repayment periods would be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).
4/ Excludes borrowing for water transfer operations of the Lesotho Highlands Development Authority.
5/ Continuous indicative target.
6/ Except for normal short-term import credits and nonresident holdings of treasury bills.

Table 10. Lesotho: Savings-Investment Balances, 2002/03-2008/09 1/
(In percent of GDP at market prices, unless otherwise indicated)

	2002/03 Act.	2003/04 Prel.	2004/05 Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.
Total economy (current account balance 2/)	-17.0	-11.1	-6.4	-6.5	-6.2	-6.9	-7.0
Gross national savings 3/	20.6	23.0	25.1	22.1	23.0	22.5	23.1
Gross domestic investment	37.6	34.1	31.4	28.6	29.2	29.5	30.1
Private sector	-13.5	-11.6	-9.0	-5.2	-4.4	-4.7	-4.5
Gross national savings	14.4	15.0	14.8	15.4	16.3	16.4	17.1
Gross domestic investment	27.9	26.6	23.8	20.7	20.8	21.1	21.6
Of which: Lesotho Highlands Water Project (LHWP)	7.2	5.4	3.1	0.1	0.1	0.0	0.0
Public sector	-3.5	0.5	2.6	-1.3	-1.8	-2.2	-2.5
Gross national savings 4/	6.1	8.1	10.3	6.7	6.7	6.1	6.0
Gross domestic investment	9.7	7.6	7.7	8.0	8.5	8.3	8.5
Memorandum items:							
Gross national product	122.5	121.4	122.6	123.0	122.2	121.2	119.9
Total consumption	118.7	113.6	116.2	116.0	114.0	112.4	110.3
Private	84.6	81.8	80.9	80.2	80.5	79.8	78.2
Public	34.1	31.8	35.3	35.8	33.5	32.6	32.1

Sources: Lesotho authorities; and Fund staff estimates and projections.

1/ Fiscal year begins in April.
2/ Including unrequited transfers.
3/ Gross national product plus unrequited transfers minus total consumption.
4/ Government revenue plus grants minus current expenditure.

Table 11. Lesotho: External Financing Requirements and Sources, 2003/04-2008/09
(In millions of U.S. dollars)

	2003/04		2004/05	2005/06	2006/07	2007/08	2008/09
	Rev. prog.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
Gross financing requirements	-346.4	-367.8	-363.8	-319.6	-339.1	-361.8	-386.5
External current account deficit (excl. off. transfers)	-303.5	-307.6	-317.0	-284.1	-296.3	-313.4	-334.6
Debt amortization	-29.7	-30.0	-38.4	-33.2	-30.9	-23.5	-23.6
Medium- and long-term debt 1/	-29.7	-30.0	-38.4	-33.2	-30.9	-23.5	-23.6
Public sector	-29.7	-30.0	-38.3	-33.1	-30.8	-23.5	-23.6
Corporate private sector	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Short-term debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves accumulation (-)	-11.4	-28.4	-8.2	-2.1	-10.2	-21.0	-23.3
IMF repurchases and repayments	-1.7	-1.8	-0.2	-0.2	-1.8	-3.9	-4.9
Available financing	346.4	367.8	355.8	306.9	325.9	348.0	372.6
Foreign direct investment (net)	115.5	45.9	45.1	50.1	57.1	60.9	62.6
Debt financing by corporate private sector	6.3	0.0	0.4	0.3	0.4	0.4	0.4
Of which: short-term financing (net)	0.0	0.0	0.0	0.0	1.0	2.0	3.0
Official grants and loans 3/	208.3	205.1	278.9	252.5	270.8	280.7	305.1
External grants (net)	191.4	192.1	254.2	215.6	226.5	227.3	240.8
South African Customs Union nonduty receipts	146.2	153.6	216.7	177.4	186.3	184.0	194.4
Other	45.1	38.5	37.6	38.2	40.2	43.2	46.4
Loans	16.9	13.0	24.6	36.9	44.3	53.4	64.3
Multilateral creditors	16.9	25.6	21.4	32.8	40.5	51.8	63.2
Bilateral creditors	0.0	0.0	1.8	3.4	3.4	1.6	1.1
Commercial creditors	0.0	0.0	1.4	0.6	0.4	0.0	0.0
Financing LHWP (net)	70.5	78.4	33.1	0.0	0.0	0.0	0.0
Other net financial flows 3/	-63.8	-44.0	8.9	6.7	-0.4	8.1	6.6
IMF disbursements	9.6	10.0	5.0	0.0	0.0	0.0	0.0
Valuation adjustments	0.0	44.8	-15.5	-2.7	-2.0	-2.0	-2.1
Errors and omissions	0.0	27.7	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	8.0	12.7	13.2	13.8	13.9

Sources: Central Bank of Lesotho; and Fund staff estimates and projections.

1/ Excluding the IMF.
2/ Excluding Lesotho Highland Development Authority.
3/ In particular, changes in commercial bank NFA and central bank foreign liabilities.

Table 12. Lesotho: Indicators of Financial Obligations to the Fund, 2003/04-2008/09

	2003/04 Act.	2004/05 Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.	2008/09 Proj.
Debt service to the Fund						
In millions of U.S. dollars	1.9	0.2	0.2	1.8	3.9	4.9
In millions of SDRs	1.3	0.2	0.2	1.2	2.6	3.3
In percent of exports of goods and nonfactor services	0.3	0.0	0.0	0.3	0.6	0.7
In percent of debt service of nonfinancial public sector	4.5	0.5	0.5	4.0	9.0	9.5
In percent of gross international reserves	0.4	0.1	0.1	0.4	0.8	1.0
Gross Fund financing						
In millions of U.S. dollars	10.4	5.2	0.0	0.0	0.0	0.0
In millions of SDRs	7.0	3.5	0.0	0.0	0.0	0.0
In percent of Lesotho's financing needs 1/	2.8	1.4	0.0	0.0	0.0	0.0
Fund credit outstanding						
In millions of U.S. dollars	31.2	36.1	36.2	34.8	31.2	26.5
In millions of SDRs	21.0	24.5	24.5	23.5	21.0	17.9
In percent of quota	60.2	70.2	70.2	67.2	60.2	51.1
In percent of exports of goods and nonfactor services	5.5	6.1	5.9	5.4	4.6	3.7
In percent of total debt outstanding	5.5	6.4	6.2	5.7	4.8	3.8
Memorandum item:						
U.S. dollar/SDR exchange rate	1.49	1.47	1.48	1.48	1.48	1.48

Sources: Central Bank of Lesotho; and Fund staff estimates and projections.

1/ Gross financing needs are defined as the sum of the current account deficit before grants, amortization of medium-and long-term debt, repayment to the Fund, reduction in payments arrears, and targeted accumulation of gross assets of the banking system.

Table 13. Lesotho: Phasing of Disbursements Under the PRGF Arrangement, 2001-04

Date	Disbursement [1]		Activity
	Millions of SDRs	Percent of quota	
March 9, 2001	3.5	10	Board approved new three-year PRGF arrangement.
March 31, 2001	...	...	Test date for performance criteria.
July 20, 2001	3.5	10	Board completed first review.
September 30, 2001	...	...	Test date for performance criteria.
March 18, 2002	3.5	10	Board completed second review.
March 31, 2002	...	...	Test date for performance criteria.
September 20, 2002	3.5	10	Board completed third review.
September 30, 2002	...	...	Test date for performance criteria.
June 16, 2003	3.5	10	Board completed fourth review.
June 30, 2003	...	...	Test date for performance criteria. [2]
December 31, 2003	...	...	Test date for performance criteria. [3]
January 21, 2004	3.5	10	Board completed fifth review.
September 10, 2004	3.5	10	Board scheduled to complete sixth review.
Total	24.5	70	

[1] Disbursements are expected to take place approximately two weeks after the date of the Board meeting.
[2] Test date for fifth review.
[3] Test date for sixth review.

Table 14. Lesotho: Millennium Development Goals

	1990	1995	2001	2002	2003	2004
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 1 U.S. dollar a day poverty and malnutrition rates					
Population below 1 U.S. dollar a day (percent)	..	36	..	..	..	..
Poverty gap at 1 U.S. dollar a day (percent)	..	19	..	..	..	..
Percentage share of income or consumption held by poorest percent	..	2	..	..	..	..
Prevalence of child malnutrition (percent of children under 5)	16	21	18	..	..	..
Population below minimum level of dietary energy consumption (percent)	27	26	25	..	..	..
2. Achieve universal primary education	2015 target = net enrollment to 100					
Net primary enrollment ratio (percent of relevant age group)	73	71	84	..	..	..
Percentage of cohort reaching grade 5 (percent)	71	63	67	..	..	..
Youth literacy rate (percent of ages 15-24)	87	89	91	..	..	..
3. Promote gender equality	2005 target = education ratio to 100					
Ratio of girls to boys in primary and secondary education (percent)	126	118	105	..	..	..
Ratio of young literate females to males (percent of ages 15-24)	126	122	119	..	..	..
Share of women employed in the nonagricultural sector (percent)	40	..	..	..	..	..
Proportion of seats held by women in national parliament (percent)	..	5	..	..	..	..
4. Reduce child mortality	2015 target = reduce 1990 under 5 mortality by two-thirds					
Under 5 mortality rate (per 1,000)	148	140	133	132	..	..
Infant mortality rate (per 1,000 live births)	102	97	92	91	..	..
Immunization, measles (percent of children under 12 months)	80	83	70	70	..	..
5. Improve maternal health	2015 target = reduce 1990 maternal mortality by three-fourths					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	550	..	..	..
Births attended by skilled health staff (percent of total)	..	50	60	..	..	..
6. Combat HIV/AIDS, malaria, and other diseases	2015 target = halt, and begin to reverse, AIDS.					
Prevalence of HIV, female (percent of ages 15-24)	..	..	38	..	..	..
Contraceptive prevalence rate (percent of women ages 15-49)	23	..	..	..	..	..
Number of children orphaned by HIV/AIDS	..	..	73,000	..	..	..
Incidence of tuberculosis (per 100,000 people)	..	..	655	726	..	..
Tuberculosis cases detected under DOTS (percent)	..	47	64	61	..	..
7. Ensure environmental sustainability	2015 target = various (see notes at bottom of this page)					
Forest area (percent of total land area)	0.5	..	0.5	..	..	..
Nationally protected areas (percent of total land area)	..	0.3	0.2	0.2	..	..
GDP per unit of energy use (PPP U.S. dollar per kg oil equivalent)	..	..	..	..	..	..
CO2 emissions (metric tons per capita)	..	..	..	..	..	..
Access to an improved water source (percent of population)	..	..	78	..	..	..
Access to improved sanitation (percent of population)	..	..	49	..	..	..
Access to secure tenure (percent of population)	..	..	..	..	..	..
8. Develop a global partnership for development	2015 target = various (see notes at bottom of this page)					
Youth unemployment rate (percent of total labor force ages 15-24)	..	47	..	..	..	..
Fixed line and mobile telephones (per 1,000 people)	7	9	36	56	..	..
Personal computers (per 1,000 people)	..	..	..	..	..	..

Source: World Development Indicators database, April 2004.

Note: In some cases the data are for earlier or later years than those stated.
Goal 1 targets: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.
Goal 2 target: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.
Goal 3 target: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.
Goal 4 target: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.
Goal 5 target: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.
Goal 6 targets: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.
Goal 7 targets: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.
Goal 8 targets: Develop further an open, rule-based, predictable, nondiscriminatory trading and financial system. Address the special needs of the least developed countries. Address the special needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

July 16, 2004

Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C.

Dear Mr. de Rato,

In March 2001, the Executive Board approved a three-year arrangement for Lesotho under the Poverty Reduction and Growth Facility (PRGF). At the time of the fifth review, on January 21, 2004, the arrangement was extended through June 30, 2004 to allow more time to implement the planned structural reforms. On June 29, 2004, the Executive Board extended the period of the PRGF arrangement further through October 31, 2004 to allow sufficient time to conclude the final sixth review.

The Government's policies aim to promote economic growth and to improve delivery of services to the people in accordance with the priorities identified by Basotho during the preparation of the poverty reduction strategy. These priorities are to be achieved through sustainable fiscal policy, rebuilding of international reserves and reduction of domestic debt.

During the period of the sixth review, the Government experienced a 10-day technical delay in effecting a payment to South Africa in relation to shared costs arising from joint financing of the Lesotho Highlands Water Project, for which a waiver is requested. The Government is also requesting waivers for three structural performance criteria.

The action plan for improvements to the government financial system (GOLFIS) was completed in February, however the needed financial resources were not identified until May. The integration of loans to parastatals and ministry accounts into the treasury accounting system was also completed with a delay. The appointment of the contract representative is proceeding and will be completed prior to the Executive Board meeting. Meanwhile, Government has implemented cost-saving measures that have proven more effective in controlling costs such as rationalisation of the fleet and curtailment of the use of short-term vehicle hire.

The Government of Lesotho requests the completion of the sixth review under the PRGF arrangement and the release of the final disbursement, in the amount of SDR 3.5 million. The Government is resolute to maintain the current cooperation with the IMF and to initiate discussions for a new PRGF-supported program after the completion of the sixth review.
We note that IMF support for low-income countries such as Lesotho falls into four categories, namely surveillance and policy advice, technical assistance, signalling to the international community, and loans to support economic development. The Government is looking forward to strong cooperation in these areas.

Our comprehensive Poverty Reduction Strategy Paper (PRSP) has almost been finalised, and we envisage submitting it to the Boards of the World Bank and the IMF by end-December, 2004. We have produced a brief PRSP preparation status report.

Sincerely yours,

//sgd//

Timothy Thahane
Minister of Finance and Development Planning Lesotho

LESOTHO: FUND RELATIONS
(As of May 31, 2004)

I. **Membership Status**: Joined 07/25/1968; Article VIII

II. **General Resources Account**:

	SDR million	Percent Quota
Quota	34.90	100.0
Fund holdings of currency	31.36	89.9
Reserve position in Fund	3.54	10.1

III. **SDR Department**:

	SDR million	Percent Allocation
Net cumulative allocation	3.74	100.0
Holdings	0.41	11.0

IV. **Outstanding Purchases and Loans**:

	SDR million	Percent Quota
PRGF arrangements	21.00	60.2

V. **Financial Arrangements**:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
PRGF	03/09/2001	6/30/2004	24.50	21.0
Stand-By	09/23/1996	9/22/1997	7.17	0.0
Stand-by	07/31/1995	7/30/1996	7.17	0.0

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	0.0	0.0	0.4	1.8	3.2
Charges/Interest	0.1	0.2	0.1	0.1	0.1
Total	0.1	0.2	0.5	1.9	3.3

VII. **Safeguards Assessments**:

An updated Safeguards Assessment of the Central Bank of Lesotho (CBL) in July 2003 concluded that the CBL had made commendable progress in strengthening its safeguards, as recommended in the previous Safeguards Assessment of July 2001. The assessment noted that there were still some unresolved issues at various levels of the bank's operations, including the need for strengthened program data compilation procedures, timely payment of PRGF obligations to the Fund, and rapid implementation of measures to enhance the internal audit function. The authorities are addressing the outstanding areas for improvement.

VIII. **Exchange Arrangements**:

Lesotho's currency, the loti (plural maloti), is pegged at par to the South African rand. The Central Bank of Lesotho (CBL) deals with commercial banks mainly in South African rand. As of May 31, 2004, the rand (maloti) rate per U.S. dollar was M 6.52.

IX. **Article IV Consultation**:

The Executive Board concluded the last Article IV consultation (IMF Country Report No. 04/21) on January 21, 2004. Executive Directors noted that economic performance had remained favorable, with moderate growth and declining inflation, despite a regional food shortage. They endorsed the authorities' medium-term strategy to achieve higher and sustainable economic growth and reduce poverty by creating appropriate conditions for private sector development and, in particular, labor-intensive industries.

Directors welcomed the authorities' efforts to bring the fiscal deficit under control, with a view to reducing reliance on domestic financing. They commended the reprioritization of government spending to create room for investment in basic health care, education, and other social services, as well as physical infrastructure. They stressed that reforms to the public financial management system would be essential to bring spending in line with government priorities. Directors supported the ongoing reforms to Lesotho's financial institutions and regulations, noting that these reforms were crucial to increase access to credit for the private sector, particularly for small- and medium-sized businesses.

X. **Technical Assistance**:

Advisor: national accounts	STA	long-term	1998-99
Advisor: banking supervision	MAE	long term	1998-2001
Advisor: governor of the CBL	MAE	song-term	1998-2001
Mission: money and banking statistics	STA	short-term	1999
Mission: money and banking statistics	STA	short-term	2000
Mission: taxation (VAT/tax administration)	FAD	short-term	2000
Advisor: taxation (VAT/tax administration)	FAD	long-term	2000-2001
Mission: monetary policy implementation	MAE	short-term	2001
Mission: public accounts	FAD	short-term	2002
Mission: GDDS project for Anglophone Africa	STA	short-term	2002
Mission: balance of payments	STA	short-term	2002
Mission: safeguards assessment	FIN	short-term	2003
Mission: monetary policy and AML/CFT	MFD	short-term	2003
Mission: government finance statistics	STA	short-term	2003
Mission: national accounts	STA	short-term	2003
Mission: legislation and supervision (AML/CFT)	MFD/LEG	short-term	2004

XI. **Resident Representatives**:

The resident representative posted in South Africa has been covering Lesotho since January 2004.

LESOTHO: RELATIONS WITH THE WORLD BANK GROUP

A. PARTNERSHIP IN LESOTHO'S POVERTY REDUCTION STRATEGY

Lesotho's strategy for poverty reduction is laid out in the government's interim poverty reduction strategy paper (I-PRSP) discussed by the Executive Board of the Bank on March 6 2001 and by the Fund Board on March 9, 2001. The I-PRSP outlines the government's medium-term economic strategy that will serve as the basis for developing a poverty reduction strategy. It emphasizes economic growth and poverty reduction in the context of macroeconomic stability and contains the following elements: export-led economic growth driven by private sector development, prudent fiscal management, cautious monetary policy, strengthened capacity for national economic management, and increased efficiency and accessibility to quality social services. The I-PRSP, however, was weak with respect to sectoral policies and programs for the medium and longer term. It lists ongoing sectoral programs in trade, state enterprise reform, telecommunications, power, water, agriculture, and the social sectors without defining follow-up medium-term measures and policies in these areas. These weaknesses are being addressed in the development of the full poverty reduction strategy paper (PRSP), which is expected to be finalized by end-December 2004 after substantial delays to the original timetable[11]. Employment creation has been identified as a top priority. Other priorities include food security, governance, infrastructure, human resource development (health and education), HIV/AIDS, and children and gender issues.

The World Bank and the IMF continue to cooperate closely in assisting the Government of Lesotho to implement its poverty reduction and development strategy, with each institution taking the lead in the policy dialogue in its areas of expertise. The IMF leads the dialogue on macroeconomic policy (fiscal, monetary and exchange rate policies) under the Poverty Reduction Growth Facility (PRGF) program and on the following areas of structural reforms: fiscal management, and tax administration reform. The Bank will continue to lead the policy dialogue on sectoral structural reforms, including employment generation through private sector development, infrastructure development, education sector, health sector, HIV/AIDS, and poverty monitoring and evaluation. Areas of close collaboration include the PRSP, public sector reform, financial sector reform, and the Integrated Framework for Trade. The Bank and Fund also routinely exchange views on macroeconomic policies, tax reform, and private sector development.

B. BANK-FUND COLLABORATION IN SPECIFIC AREAS

Poverty Reduction Strategy Paper

The World Bank is supporting the government with the PRSP process by providing technical assistance to the PRSP Secretariat and its Technical Working Group (TWG). The leading cause of

---

[11] Part of the delay was due to the national elections of May 2002, and further delays were encountered on account of the desire of the new cabinet to merge the National Vision document with the PRSP, which the PRSP secretariat has been instructed to coordinate. Delays were compounded because of capacity limitations in key government offices.

poverty in Lesotho is rising unemployment and underemployment caused by a series of structural changes which began in the early 1990s with the decline of mining in South Africa. The latter employed a third of the male Basotho labor force in the 1980s. Traditionally, a significant proportion of the Basotho labor force was absorbed on neighboring South African farms. However, with rising unemployment among unskilled South Africans, job prospects for Basotho workers have depleted. With the return of retrenched Basotho miners, the pressure on agriculture has increased and unemployment has risen in the rural areas. In the late 1990s, the unemployment problem was exacerbated by slow economic growth and the winding down of construction activity on the Lesotho Highlands Water Project. The one bright spot was the creation of some 15,000 jobs in the garment industry (which now employs 6% of the labor force) under AGOA. Given the absence of a productive natural resource base and a vibrant local private sector, there are few employment opportunities for Basotho workers.

The Bank undertook a Growth and Employment Options study[12] which examined in a comprehensive modeling framework the trade-off between growth, employment, and poverty reduction of alternative policy options to inform the development of the government's medium and longer-term poverty reduction agenda. To reduce poverty sufficiently in the medium term, high GNP per capita growth rates of at least 4 percent per annum are required. The study finds that to achieve this target, the government will have to follow a broad-based strategy comprising increases in public investment (about 25 percent in key public infrastructure) as well as private investment (5-10 percent in manufacturing and agriculture). These can only be achieved with supportive policy reforms in the core areas of property rights, education and technical training, governance and capacity building. Actions will need to be taken to improve the efficiency and quality of government spending, as well as to create social safety nets for those who are unlikely to benefit from job creation (HIV/AIDS victims, the old and the disabled, etc.).

Public Sector Reform and Public Expenditure Management

The Government of Lesotho recognizes that strengthening public expenditure management is critical to reduce the high level of government spending and to maintain fiscal discipline, as well as achieve macroeconomic stability. Recent increases in public spending, especially for lease of vehicles for government use and college scholarships (in addition to the agricultural support program to farmers) have threatened fiscal sustainability. With the support of the Fund, the government has prepared some corrective actions for the remainder of the fiscal year to enable it to offset some of the increases in expenditures in the first quarter of the fiscal year 2003/04. The Fund program also includes several structural measures aimed at improving financial management.

The Bank is undertaking a Public Expenditure Review (PER), in close collaboration with the government and interested donor partners, to inform and guide the reforms needed to improve the efficiency and quality of public expenditures. The PER will help the government focus on core functions, remove discretionary public interventions in the private sector, and identify "high

---

[12] The report was discussed with the government in June 2003.

yielding" uses of public funds that will help to attain its development objectives. The PER will strengthen the analytical base for making decisions about the size and composition of public expenditure in order to have maximum impact on growth and poverty reduction. It will also identify the issues in public expenditure and financial management that need to be addressed subsequently to effectively implementing public policies and achieving development objectives. In collaboration with the government and key donors, preparation of a program of public sector reform that will focus on public expenditure management including financial management and decentralization for improved service delivery is well advanced.

Financial Sector Development

The Bank has conducted a review of the Lesotho's Financial System with three major objectives: to assess the safety and soundness of selected sectors in the financial system; to evaluate major constraints facing the financial system and its ability to support private sector development; and to formulate actions and policies to address these constraints. Areas covered include (i) macrofinancial environment; (ii) safety and soundness of the banking system; (iii) non bank financial institutions; and (iv) microfinance and finance for small and medium-sized enterprises. The assessment was shared with the IMF and other donors before being discussed with the government.

Private Sector Development (PSD)

The Bank is currently engaged in the formulation of a comprehensive action-oriented PSD Strategy for Lesotho, which aims to provide concrete recommendations for increased private sector's contribution to economic growth and poverty alleviation. The strategy is based on ongoing analytical work that will follow an integrated approach organized around the concept of the Minimum Infrastructure Platform for Growth (MIP). The MIP consists of a combination of priority physical infrastructure investments with a specific set of investments in supporting facilities, including business environment, trade and investment facilitation regulations and institutions, and human capital and financial services. The analytical work is designed as a follow-up to the recently completed Integrated Framework Report (see below), UNCTAD Investment Policy Review, the Country Economic Memorandum and the PSD Mission that took place in Feb/March 2003. This is reflected in the proposed blend of implementation support/TA to the GOL. TA was provided in two areas: (i) red tape/administrative constraints (in collaboration with FIAS); and (ii) immigration and customs services. The two reports prepared as a result of this TA were submitted directly to the Government of Lesotho. Two areas were subjected to a detailed analytical examination with the output of two policy notes: (i) value chain analysis - infrastructure and support services requirements for the development of key economic sectors in Lesotho (in collaboration with the Investment Climate Unit), and (ii) skills development and industrial linkages framework for Lesotho. Based on the results of the analytical and TA work (compiled in four individual reports), a draft PSD strategy was prepared. In the spirit of cooperation and consultation that the Government of Lesotho has followed during the formulation of the PRSP and the preparation of the Integrated Framework report, it is proposed that these documents be disseminated and discussed with a broad spectrum of stakeholders, including the public sector, the private sector and the donor community. This could be facilitated by a PSD workshop, which could be organized by the government with the assistance of the World Bank. Such a workshop would also serve as a first step in defining the content of the proposed World Bank PSD project to be prepared during the course of the coming fiscal year.

Integrated Framework (IF)

The Integrated Framework for Trade Related Technical Assistance to Least Developed Countries, established in 1997, was redefined in 2000 to ensure better integration of trade with national development strategies, and was complemented by a trust fund for IF activities. The Government of Lesotho requested to become part of the redefined IF process. Its initial component, the Lesotho Diagnostic Trade Integration Study (DTIS), has been carried out in close consultation with the government and core agencies and donors, and has benefited from several ongoing projects, including the Bank's growth and employment options study, UNCTAD's Investment Policy Review, and the government's PRSP and National Vision documents. Background papers for the IF study were prepared by the IMF, ITC, UNCTAD, and WTO. The study recommends that Lesotho take advantage of its sovereign status to pursue ***two parallel strategies***: one designed to lower the "costs of trading" with South Africa, other SACU partners and the rest of the world, and another aimed at establishing a competitive business environment relative to other countries in the region. The former calls for the removal of various remaining barriers to trade (customs, technical regulations and standards, etc.) and movement of capital and labor within SACU, thereby transforming it into a full-fledged single market, as well as lowering the common external tariffs (CETs). The latter calls not only for the removal of various administrative barriers impeding the conduct of business activity but also the effective provision of public services including public order and good governance. A comprehensive action matrix has been prepared and agreed with the government. The various donors have expressed interest in supporting key elements of this actions matrix through technical assistance.

HIV/AIDS

In response to the high adult HIV prevalence rate in Lesotho, the government adopted a National HIV/AIDS Strategic Plan and the National AIDS Policy Framework in 2000. These are based on multi-sector approach to the fight against HIV and AIDS. The Lesotho AIDS Program Coordinating Authority (LAPCA) was established in 2001 with a mandate to coordinate, monitor and evaluate implementation of the national response. Under the health sector reform project, the World Bank allocated US$2 million to support multi-sector activities for HIV/AIDS. This component has been managed by LAPCA and is mainly disbursed against project proposals submitted by NGOs and government agencies. In 2002, The Global Fund to Fight AIDS, Tuberculosis and Malaria (GFATM) awarded US$29 million to Lesotho to fight HIV/AIDS (over a five year period). Due to weak institutional capacity of the recipients and implementing agencies, implementation of activities financed under the GFATM has been very slow. To support the government's efforts, the Bank is providing a technical assistance grant to increase the capacity of government and non-governmental institutions responsible for the national response to HIV and AIDS to utilize and assess the impact of funds received for HIV/AIDS.

Human Development

The Bank is supporting a health sector reform program with the objective of achieving a sustainable increase in access to quality preventive, curative and rehabilitative health care services. The objectives of the project (phase I of an adaptable program loan), are to (i) strengthen the institutional capacity of the MOHSW to refine, implement and evaluate the comprehensive sector reform program, and (ii) expand the capacity of the government to respond to HIV/AIDS. The education sector is supported through an adaptable program loan (APL) spanning the 12 years from 1999 to 2011. Its objectives are to assist the Government of Lesotho in its efforts to increase the equity of access to quality education and the efficiency of the education system. The development objectives are: (a) to increase enrollment and completion in primary education; (b) improve learning achievement in primary education; (c) increase enrollment in secondary education; (d) build capacity in the education sector, including for ECCD, TVET, higher education, nonformal education, and MOET core functions.

Infrastructure

Bank support to the infrastructure sector is directed to institutional strengthening as well as physical works. The Bank contributed to the financing of the Lesotho Highlands Water Project. The objective is to put in place the physical and managerial capacity for Lesotho to transform its principal natural resource of abundance – water – into export revenues and to produce hydro power to reduce Lesotho's dependence on imported energy. It helps to store and transfer water through a series of dams and tunnels from Lesotho to South Africa. Phase 1A was completed 1998 and phase 1B is under construction. Entire project could include five phases with a total capacity to transfer about 70m3/ sec of water but reduced demand in RSA may delay future phases. Support is also being provided to improve reliability and access for urban and peri-urban water supply, including through community based approaches. In the transport sector, the World Bank is supporting strategic policy and regulatory reforms; plus capacity building and performance based contracting. Support is also being provided for restructuring road management, and road and bridge rehabilitation and upgrading. Support for the setting up of utilities regulatory body and preparing of LEC for privatization is being provided.

Poverty and Social Impact Analysis (PSIA)

As part of the preparation of the proposed World Bank financed Water Sector Improvement Project, a study was conducted using participatory processes, to examine issues related to affordability and willingness to pay for urban water supply at different levels of service. Key objectives included establishing factors affecting water consumption levels and behaviors; assessing changes in the extent and nature of water supply; considering the impacts of tariffs on the very poor; establishing the informal price of water; and determining how access can be maintained for the poor without other income groups drawing free water. The findings[13] suggest that based purely on people's ability to pay (for the currently connected customers), there is room for an increase in tariffs in all bands. Further, the study finds that about two-thirds of the nonconnected households could afford to pay three times the average amounts currently paid by the public utility's lowest band. However, the full cost of private connections can only be borne by a very small proportion of the peri-urban residents. In the context of the Utilities Sector Reform project, a PSIA is being carried out to assess the impact of the proposed privatization of the Lesotho Electricity Corporation. The specific objective of the proposed PSIA is to provide guidance on the expected impact of changes in tariff policy on (i) different residential consumer and income groups in different locations which currently have access; (ii) industrial and business consumers (especially SMEs) in terms of likely impact on economic performance (competitiveness, profitability) leading to income effects through their job/employment creation abilities; and (iii) different income groups which currently do not have access. A draft report is currently being discussed with the Government. The Bank and Fund are also considering to review closely the poverty and social impact of possible changes resulting from revisions in the SACU revenue-sharing formula in the context of their respective macroeconomic programs.

C. Bank Group Assistance Strategy

The Bank Group's assistance strategy for Lesotho for FY 04-07 is currently under preparation. It is guided by the Government's I-PRSP, past development plans, its poverty reduction strategy (that is at an advanced stage of preparation) and the Millennium Development Goals. It is enriched by extensive consultations with all segments of civil society over the past year and molded by lessons learned in the implementation of our previous country assistance strategies (CAS). The last CAS was discussed by the Bank's Board in May 1998, with the overarching objectives of achieving sustainable poverty reduction and improving the country's competitiveness in order to support employment creation. Our policy dialogue and assistance contributed to the maintenance of a stable macro- environment and improved competitiveness. The Bank has been most successful in the *education sector*, where comprehensive reforms included a renewed emphasis on affordable access and equity, nonformal education, and early childhood development, in order to achieve universal primary education by 2011. The two overarching objectives of achieving sustainable growth and improving the country's competitiveness in order to support employment creation will remain in force in the CAS for the period FY2004-FY2007.

As of May 31, 2004, IDA had approved 30 credits amounting to US$353.6 million, of which US$260.3 million was disbursed; US$58.8 million was canceled; and US$43.3 million remains undisbursed. An IBRD loan of US$110 million was approved for Phase IA of the Lesotho Highlands Water Project (LHWP) in July 1991; of which US$68.9 million was disbursed and US$41.1 million canceled. A second IBRD loan of $45 million was approved in June 1998 for Phase IB of the

[13] The full results can be found in "Ability & Willingness to Pay for Urban Water Supply: An Assessment of Connected and Unconnected Households in Maseru, Lesotho" by David Hall and David Cownie (available upon request from the World Bank).

Lesotho Highlands Water Project, of which US$20.4 million has been disbursed and US$15.6 million is un-disbursed and the remainder US$9.0 million was cancelled. The Bank Group's first operation in Lesotho was approved in February 1966. To date, the World Bank has financed six projects in education; five in roads and roads rehabilitation and maintenance; four in agriculture, three in industry, two in water supply (including highland water engineering), three in urban development, three in health, two in privatization, and one in community development.

Currently, the IFC has no outstanding investments in Lesotho. However, the IFC African Project Development Facility (APDF) has completed two projects by providing project appraisal and assistance in the mobilization of loan financing to (a) Maseru Private Hospital, a US$3.4 million project to build and operate a 31-bed private general and maternity hospital; and (b) Pioneer Plastics Limited, a US$0.5 million project to install facilities to manufacture polyethylene film bags, the first of its kind to be established in Lesotho. In addition, the IFC contributed to industrial reform in Lesotho through its Foreign Investment Advisory Service (FIAS). Studies and technical advice by FIAS contributed to the design of the ongoing IDA-assisted Industry and Agro-industry development project and to the Privatization and Private Sector Development project.

Contact Persons

Questions may be addressed to Ms. Pamela Cox, Acting Country Director, at 202 458-1344; or Ms. Preeti Arora, Sr. Country Economist, at 202 473-8275.

Lesotho: Key Achievements Under the PRGF-Supported Program

This appendix summarizes Lesotho's achievements against program objectives since the start in March 2001.

Policy Areas	Program and Implementation Status
Macroeconomic objectives	Macroeconomic objectives have been largely achieved. In line with program projections, real GDP growth has averaged 3½ percent a year. Inflationary expectations and monetary policy have been anchored by Lesotho's membership in the Common Monetary Area, but drought and the rapid depreciation of the loti in 2001 raised inflation temporarily. After a gradual appreciation during the last two years, the real exchange rate is now back at approximately the level in the mid-1990s. In line with program objectives, gross official reserves have risen by about $45 million and are equal to about 4¼ months of imports at present.
Poverty reduction	Poverty has probably remained unchanged on average, while it has deteriorated in rural areas where repeated droughts have obstructed agricultural production. Stagnating wage remittances from South Africa have limited real GNP growth to about 2¼ percent a year, comparable to population growth.
Fiscal policy	Fiscal policy has been weaker than programmed, mainly because of unbudgeted spending on vehicle leases, agricultural support, and scholarships. The overall budget balance (including grants) declined from a surplus of ½ percent of GDP in 2001/02 to a deficit of 4¼ percent of GDP in 2002/03, and domestic financing exceeded the programmed ceiling on three occasions. Fiscal performance improved in 2003/04, when the overall balance recorded a surplus of ¾ percent of GDP.
Tax policy and administration	Tax administration has been modernized successfully, including the launch of a new national revenue authority in 2002 and introduction of the value added tax (VAT) in 2003.
Fiscal management including expenditure policy	The whole process of forecasting, budgeting, accounting, and auditing is in need of improvement, but progress has been slower than expected. As part of the reform agenda, (i) all payments are now backed by payment vouchers; (ii) for the first time since 1995/96, the Auditor General was requested to audit the public sector accounts for 2001/02 and 2002/03; and (iii) all loans to parastatals and ministry accounts have been integrated into the treasury accounting system.
Civil service reform	A comprehensive reform program (monitored by the World Bank) has been delayed for a few years, raising questions about commitment and ownership.
Financial system	The modernization of the financial system has continued in line with program objectives. Regular auctions for treasury bills started in 2001 and the authorities have developed a strategy to address impediments to a well-functioning financial market. As part of this strategy, the first stage of the capital account liberalization was completed in 2003.
Statistics	Lesotho's statistical data has improved, but there are still deficiencies in quality and timeliness. Monetary surveys compiled within 30 days of each month's end have been published since 2001, while monthly budget execution reports are more irregular. Lesotho participates in the General Data Dissemination System (GDDS) and its metadata has been published on the IMF website since 2003. Lesotho received technical assistance from the Statistics Department of the IMF in 2002 and 2003.

New Initiatives Presented in the Budget for 2004/05

Public-Private Partnerships (PPPs)	The cabinet decided in 2002 that the Ministry of Finance and Development Planning would appoint a Transactions Advisory Consulting Group with legal, financial, and technical expertise to assist the government in establishing a policy, legal and procedural framework for the use of PPPs. The government is negotiating two projects: (i) a contract to construct and refurbish prison buildings, and (ii) the construction of a headquarter for the Ministry of Health. The private contractors would pay the construction costs and own the buildings, while the government is committing itself to long-term leases of the buildings. The government intends to seek technical assistance from South Africa for future implementation of PPPs.
Old Age Pensions	All citizens of age 70 or older will start receiving a monthly pension of M 150 (about US$20) later this year. The first payment is expected in December and as a result, four months of payments will be made in fiscal year 2004/05. The cost of the payments is estimated to M 45 million (½ percent of GDP) in 2004/05 and M 135 million (1¼ percent of GDP) in 2005/06, the first fiscal year with full payments. Staff responsible for current pension payments to war veterans would also manage the new pensions to limit additional administrative costs.
The Postbank	To improve access to basic financial services for the rural population, a postbank using the facilities of the postal offices will be launched on a limited trial basis in 2004. The postbank will be established as a regular company, according to the Public Company's Act of 1967, and it will be regulated as any other financial institution by the Central Bank of Lesotho. The postbank is expected to obtain a limited license only, allowing it to collect deposits and make withdrawals but not to grant any loans. The postbank will seek cooperation with existing private banks, and postbank savings could then be used as collateral for borrowing in the private banks. The budget for 2004/05 includes an allocation of M 40 million (½ percent of GDP) for the postbank. The government will carefully assess the benefits of the first postbank offices before expanding the initiative on a country-wide basis.

Statement by the IMF Staff Representative
September 10, 2004

The following information has become available after the staff report was issued on July 21, 2004. This information shows that the Poverty Reduction and Growth Facility (PRGF) arrangement remains on track and does not alter the thrust of the staff appraisal.

1. As of Monday, August 30, 2004, the authorities appointed a vehicle lease contract representative, thereby completing the outstanding performance criterion.

2. Preliminary data indicate that the authorities met all indicative quantitative targets for end June 2004. The target on net domestic financing was met by a wide margin, as spending on goods and services as well as transfers and subsidies were less than programmed. Reflecting the favorable fiscal position, net international reserves exceeded the program floor and net domestic assets of the central bank were contained within the ceiling.

3. Consumer price inflation has continued to decline and was reported at 4½ percent (12-month basis) in July. This is consistent with the current forecast and the inflation outlook remains unchanged.

4. However, the food shortage situation looks worse than earlier estimates indicated. A recent assessment by the World Food Program (WFP) (July 22, 2004) estimates that about 950,000 people (nearly half of the population) might need emergency assistance in 2004/05. The WFP has available less than half of the food tonnage that is needed. Donors have indicated that they would respond favorably to a new appeal from the government, to cover the remainder.

Press Release No. 04/191
FOR IMMEDIATE RELEASE
September 10, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Sixth and Final Review Under Lesotho's PRGF Arrangement and Approves US$5 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the sixth and final review of Lesotho's economic performance under an SDR 24.5 million (about US$36 million) Poverty Reduction and Growth Facility (PRGF) arrangement (see Press Release No. 01/8). This decision enables Lesotho to receive the final loan disbursement of SDR 3.5 million (about US$5 million), and results in the arrangement being fully drawn.

In completing the review, the Executive Board approved Lesotho's request for a waiver of nonobservance of the performance criterion on the stock of external payment arrears and of three structural performance criteria. The Board also concluded that progress on the development of Lesotho's full Poverty Reduction Strategy Paper (PRSP), as evidenced by the PRSP Preparation Status Report, is satisfactory and provided a sound basis for continued access to IMF concessional assistance.

In commenting on the Board's discussion of Lesotho, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, issued the following statement:

"Lesotho has made commendable progress under the current PRGF-supported program. Economic growth has been above the average for sub-Saharan Africa, macroeconomic stability has been largely achieved, and the public debt has declined. Macroeconomic performance has remained strong despite the continuing drought and an unfavorable external environment. The textile and clothing industry continues to be the key source for economic growth. The drought has worsened the humanitarian situation and a substantial part of the population might need food assistance in 2004/05.

"The authorities remain committed to pursue sound macroeconomic policies and to accelerate the implementation of reforms. This will be important to meet the substantial challenges Lesotho faces over the medium and long term in its quest to raise economic growth, reduce poverty, and improve social conditions. These challenges include increasing competition following the phasing out of export quotas on textiles and clothing, a decline in miners' remittances from South Africa, the fragile food situation, and the HIV/AIDS pandemic. Particular emphasis will need to be placed on maintaining fiscal discipline, which will require continued domestic revenue mobilization, expenditure re-prioritization, and effective public expenditure management. Tax administration has been modernized successfully, but further work is needed to improve the fiscal management system, and the process to develop a comprehensive agenda for civil service restructuring has been more protracted than expected.

"Lesotho's Poverty Reduction Strategy Paper (PRSP), which has been prepared through a broad-based participatory process, is expected to be finalized before the end of this year. The authorities intend to implement an agenda of structural reform based on recommendations in the PRSP. The objectives are to reinforce the investment climate to support economic growth and job creation, to empower the poor and vulnerable, and to raise the quality and efficiency of public sector service delivery," Mr. Kato said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in the Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period on principal payments.

Statement by Ismaila Usman, Executive Director for Lesotho
September 10, 2004

Key points

- *Lesotho is experiencing renewed economic growth and development supported by a vibrant and growing textile export sector although many challenges remain;*
- *The country still faces an acute food deficit that has spanned three cropping seasons and further undermines the achievement of the Millennium Development Goals (MDGs);*
- *The fiscal performance has improved with the PRGF Program broadly on track save for a few benchmarks which were achieved slightly after the set deadlines;*
- *Great strides have been made to strengthen public financial management, transparency and accountability;*
- *A new PRGF program would consolidate the performance already achieved through strengthening of the wide-ranging structural reform agenda, reducing poverty and sustaining economic growth.*

1. Introduction

My authorities express their appreciation to Fund staff for their invaluable policy advice and support throughout the Fund engagement with the country.

The situation in Lesotho remains difficult, characterized by: decline in agricultural output as a result of the erratic weather patterns; an appreciating currency undermining competitiveness of the export sector, deepening poverty and rapid spread of the HIV/AIDS pandemic, among other things. This difficult situation has resulted in serious realignment of the PRGF program to meet with the emerging challenges and in particular the worsening humanitarian crisis coming with the food shortfall. Lesotho remains a poor country with this scourge manifesting predominantly in the rural subsistence farming population which harbors a great proportion of the total population. The recent economic gains do not seem to have made any significant effect on this problem which has in effect worsened with an increase in the numbers of the people living below the poverty line and worsening income inequality.

The Kingdom of Lesotho is going through difficult and challenging times starting in the 1980s, due largely to exogenous shocks exacerbated by institutional deficiencies and capacity weaknesses. Policy implementation during the period under review improved, government has made commendable strides to reduce the budget deficit and to improve the external sector performance. These efforts are however, yet to translate into sustained higher growth rates to improve social conditions and make a meaningful impression on the pervading poverty. The country is also inextricably linked to the South African economy.

2. Recent Economic Developments and Prospects

Notwithstanding the specter of protracted poor harvests, real GDP growth was positive supported by a vibrant textile export sector benefiting from an extended American Growth and Opportunities Act (AGOA). Textile exports grew to account for three quarters of total exports and the textile industry surpassed the government as the largest employer in Lesotho. However, the recent firming of the Rand/Loti's exchange rate against the US dollar, somewhat undermined the profitability of the textile sector during the review period.

Gross Domestic Product (GDP) grew by an average 3.6 percent during 1991-2003, well above the Sub-Saharan average. Inflation remained subdued at single digit figure of 5.2 percent in March 2004 compared to an average 13 percent in 2002, closely following positive developments in South Africa.

3. Fiscal Issues

Fiscal performance has largely been in line with the PRGF targets and the authorities are committed to curtailing expenditure and improving revenue collection and keeping domestic borrowing within manageable levels. Revenue collections also improved and exceeded program targets largely due to the efforts of the newly established Lesotho Revenue Authority (LRA) and the introduction of Value Added Tax (VAT). Southern African Customs Union (SACU) receipts continue to be the major source of the fiscal revenue, but are expected to decline as a result of the on-going trade liberalization talks aimed at forming the SACU-USA Free Trade Area (FTA) and the new revenue sharing formula coming with the new SACU arrangement. Future revenue shortfalls are expected to put pressure on government to raise additional resources from domestic and external markets to meet pressing activities including the food shortfall. This development will also require the government to reprioritize its expenditure program while maintaining a low public sector debt position. The authorities are committed to reducing the domestic debt beginning 2004/2005 financial year while implementing a broad public sector structural reform agenda aimed at improving public sector management, transparency and accountability.

4. Monetary and Exchange Rate Issues

The authorities allowed interest rates to decline for a greater part of the year resulting in a 400 basis points easing beginning the last year. Monetary policy remains in tandem with developments in South Africa given the country's membership to the Common Monetary Area (CMA), which limits the authorities' scope to influence aggregate demand through monetary policy, although pegging of the country's currency to the South African rand has assisted in providing macroeconomic stability.

5. Structural Reforms

The authorities acknowledge the slow progress being made in some areas due to limited institutional and administrative capacity. They are however, making considerable progress in others. They have established the Lesotho Revenue authority which has facilitated exceeding program targets in performance, established the Ant-Corruption Unit and have audited government accounts. The Anti-Corruption Unit has prosecuted a number of international companies including those involved in the Lesotho Highlands Water Project (LHWP) scandal. They remain committed to implementing further reforms, reexamining the procurement process and introducing a medium-term expenditure framework.

The authorities are also committed to strengthening the investigative and prosecution capabilities of responsible agencies and improving the legal environment that will enhance good governance. In this connection, massive international support is crucial if they are to succeed against the war on corruption.

The HIV and AIDS pandemic remains a significant challenge both, and government has recently opened a specialized hospital for administering anti-retroviral drugs. Also following the resurgence of polio in some parts of Africa, Lesotho has joined its neighbors in a regional vaccination programme targeted at eliminating polio in their region.

6. Reforms Proposed

The country's Poverty Reduction and Strategy Paper (PRSP), which will bolster their efforts in mobilizing donor support and set the basis for implementation of effective and broad-based strategies and intervention has recently been completed and will be sent to the IMF and World Bank board by mid-November 2004.

In recent years food security has evolved into a structural problem, initially triggered by persistent droughts in the region, but cemented by farmer expectations that it is a long term spell as well the disabling effects of the HIV/AIDS pandemic. Government is buttressing its intervention to ensure that there is enough food from Lesotho's farmland. Farmers are being encouraged to resort to small irrigation activities and in the long term bulk water will be supplied to all irrigable lands in the country. Under NEPAD's Common Africa Agricultural Development Programme, government will be increasing resources allocated to the agricultural sector to address the structural constraints in this sector. The authorities are indeed appreciative of donors' concern with the food shortage situation and their willingness to respond favourably to new appeals of assistance.

7. Conclusion

My authorities are committed to sound macro economic management of the country through improving the legislative and institutional environment. They are gradually putting the appropriate mechanisms and institutions in place to facilitate this process. They appreciate immensely the technical support received from the Fund, the World Bank and other donors to deal with the wide range of structural issues faced by the country. Further support is required in the area of data quality and improvement of the statistical systems. The authorities hope they can continue to count on the understanding and support of the Fund and the rest of the international community and hope today's discussion will approve the completion of the sixth review under the PRGF arrangement.