Lesotho and the IMF

Press Release:
IMF Executive Board Completes First Review Under ECF Arrangement for the Kingdom of Lesotho and Approves Disbursement of US$9 Million
April 4, 2011

Lesotho: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

February 24, 2011

The following item is a Letter of Intent of the government of Lesotho, which describes the policies that Lesotho intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Lesotho, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.
February 24, 2011

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431
United States of America

Dear Mr. Strauss-Kahn:

This letter and the attached Memorandum of Economic and Financial Policies (MEFP), updates and supplements my communication of May 17, 2010; describes performance under the government’s economic program and outline our economic policies and program for 2011/12.

The implementation of our economic program, supported by a three-year Extended Credit Facility (ECF) arrangement, is on track. All performance criteria through end-September 2010 have been met, except for the Net International Reserves (NIR) floor which was missed by a small margin. With respect to the structural benchmarks, (a) the Financial Institutions Act was not finalized due to Parliament schedule; (b) the Capital Projects Review was not completed due to administrative constraints and the crowded Cabinet calendar. The Financial Institutions Act (FIA) has been submitted to Parliament and Cabinet is looking at the Government’s project portfolio, based on contribution to economic growth, employment, revenue mobilization. In view of the foregoing, the Government of Lesotho wishes to seek a waiver for inability to meet the performance criterion on NIR and requests completion of the first review, modification of the end-March 2011 performance criteria and disbursement of the second tranche under the program, equivalent to SDR 5.68 million (16.3 percent of quota). Performance criteria and structural benchmarks for 2010-11 are included in Tables 1 and 3, MEFP.

We continue to believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, and we stand ready to take any further measures that may become necessary to achieve our policy objectives. Lesotho will consult with the International Monetary Fund (IMF)—at its own initiative or whenever the Managing Director of the IMF requests such a consultation—on the adoption of these measures and in advance of any revisions to the policies contained in the MEFP, in accordance with the IMF’s policies on such consultations.

The Government will provide the IMF with such information as the IMF may request in connection with the progress made in implementing the economic and financial policies, and
achieving the objectives of the program. The Government authorizes the IMF to publish this letter, the attached MEFP and TMU, and the related Staff Report, including placement of these documents on the IMF website.

Yours sincerely,

/s/
Hon. Timothy T. Thahane,
Minister of Finance and Development Planning
I. INTRODUCTION AND BACKGROUND

1. The Government of Lesotho remains firmly committed to its medium-term program, supported by the ECF. The program was adopted in the context of large fiscal and external imbalances over the medium term as a result of a sharp drop in Southern African Customs Union (SACU) revenues, particularly in 2010/11 and 2011/12. Our policies are aimed at restoring fiscal sustainability, while limiting the adverse impact of fiscal consolidation on the poor and vulnerable groups; achieving external sustainability and broad-based growth for sustained poverty reduction; and strengthening the financial sector and the business climate.

2. This memorandum summarizes the government’s assessment of progress under our program in 2010/11 and sets out our policy intentions for 2011/12. These policies are consistent with the program objectives.

II. RECENT ECONOMIC DEVELOPMENTS

3. Economic growth has continued to recover, but at a slower pace than projected under the program. Real GDP for 2010 is estimated at 2.4 percent, considerably lower than the 5.6 percent projected under the program. This slower pace of recovery reflects delays in implementing the Metolong Dam Project and ongoing weaknesses in the textile sector. The sector, which is our main foreign exchange earner and the largest employer outside of government, has already suffered from declining demand in the United States. The situation has been compounded by a significant appreciation of the loti, resulting in job losses and a few factory closures. At the same time, inflation fell to an average rate of about 3.8 percent in 2010, reflecting both the strong loti and lower global food prices since mid-2009—a trend which has recently been reversed.

4. The external current account position is projected to deteriorate from a broadly balanced position in 2009 to a deficit of 16.1 percent in 2010. This is mainly due to the sharp decline in SACU revenues, combined with a further widening of the trade deficit. However, thanks to our past surpluses, international reserves still cover close to five months of imports and 140 percent of M1 in 2010.
III. PERFORMANCE UNDER THE PROGRAM

5. **Overall performance under the program has been strong.** All quantitative performance criteria for end-September 2010 were met, except for the floor on the stock of NIR which was missed by a small margin (Table 1). Implementation of structural reforms is also progressing steadily (Table 2):

- We have been closely monitoring the impact of modifications to our Integrated Financial Management Information System (IFMIS) to prevent over-commitments. A report summarizing both the problems and the measures undertaken to solve them, was completed in August, and monitoring continues.

- A new Companies Bill, which will significantly simplify the burden of starting a business, was submitted to Parliament in August.

- In October, we successfully placed M125 million of 3-year and 5-year treasury bonds in the domestic market, which was followed by a placement of M62 million in December, and a placement of M63 million in February 2011. All issues were oversubscribed.

- However, we were challenged in meeting some of the structural benchmarks by the agreed dates, such as:
  - The audit of user access rights in IFMIS, which was piloted in four ministries, revealed a number of systemic problems. On the basis of these findings, we prepared a report, finalized in August, with recommendations that we are implementing across all ministries.
  - The submission to Cabinet of a comprehensive review of on-going capital projects was also delayed to allow for broad consultations with line ministries. The report will be submitted by end-March 2011.
  - The submission to Parliament of the Financial Institutions Act (FIA) was also delayed due to changes in consultants and the heavy legislative agenda of the Parliamentary Drafting Council Office. The Financial Institutions Bill\(^1\) will now be submitted to Parliament by end-March 2011 (structural benchmark).

6. **Fiscal performance during the first half of 2010/11 was well within program targets.** Preliminary data for April-September\(^2\) indicate a deficit of 0.2 percent of GDP, much better than the projected 6.4 percent of GDP under the program. This largely reflects a boost in revenues by an unexpected SACU payment and a large dividend receipt from the Central

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\(^1\) The new legislation is now referred to as a Bill because it replaces, rather than amends, the existing Act.

\(^2\) The fiscal year runs from April to March.
Bank of Lesotho (CBL), amounting together to some 6 percent of GDP. We built the reserves with part of these unexpected revenues, and made a once-off payment to the pension fund, which we had initially planned for 2011/12.

7. **For the remainder of FY2010/11, we have continued our ambitious consolidation effort.** On this basis, we expect a deficit of 8.2 percent of GDP, compared with 19 percent of GDP projected under the program. The sharp improvement relative to the program mainly reflects the savings from the first half of the fiscal year, and broad adherence to our budgetary ceilings—though with some increase in domestic capital spending, which partially offsets the reduction in externally-funded spending from the delayed implementation of the Metolong Dam Project. The deficit is being financed through a combination of drawdown of government deposits at the CBL, budget support grants and loans from development partners, and issuance of domestic treasury bonds.

IV. **MACROECONOMIC POLICIES FOR 2011/12**

**Medium-Term Program Objectives**

8. **Our medium-term program centers on adjustment to a reduction in SACU revenues, with a particularly sharp drop of some 18 percent of GDP from 2009/10 to 2010/11 and 2011/12.** The shock, which has resulted in large fiscal and external imbalances, calls for significant fiscal consolidation to restore macroeconomic stability and preserve an adequate level of international reserves in support of our exchange rate peg. The bulk of the adjustment will rely on curtailing nonproductive and nonpriority expenditure, while preserving adequate room for crucial infrastructure projects and for support to vulnerable groups. We expect that the implementation of our medium-term policy framework will restore our fiscal and external current account positions to sustainable levels that remain broadly in line with initial program projections.

**Macroeconomic Framework for 2011/12**

9. **Lesotho’s macroeconomic environment remains challenging.** Real GDP is expected to grow by around 3.1 percent in 2011, driven by the MCC and Metolong Dam Projects, coupled with other public investment in infrastructure development. The associated boost in imports will further raise the external current account deficit in 2011 to 23.4 percent

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3 Lesotho received M466.6 million in SACU revenue following a tribunal settlement between South Africa and the BLNS over disputed shares for 2006/07-2007/08. In addition, the CBL paid dividends of M500 million from retained earnings for 2008 and 2009.

4 The decision to pay during the current fiscal year came after more detailed analysis of the impact on the fiscal profile of the interest costs on this liability.
of GDP. Over the medium-term, however, we expect the deficit to narrow in line with the recovery in SACU revenues and fiscal consolidation. Inflation in 2011 is projected to be 5.4 percent, broadly in line with the rate in South Africa.

Fiscal Policy

10. **The main challenge for FY2011/12**, is to meet a number of spending demands, while maintaining the momentum for medium-term fiscal consolidation:

- While we remain committed to containing the wage bill, including by freezing new positions in FY11/12, there will be a significant increase in wages and salaries, partly as a result of inclusion of new positions for the Army and the Police. A large part of the increase reflects adjustments in teachers’ salaries following the introduction of a new salary scale consistent with the provisions of the new Education Act. The new scale will bring teachers’ salaries more in line with those of public servants and is intended to address our difficulties in retaining qualified teachers. In addition, provisions will be made for an across-the-board salary adjustment of 5 percent, below the expected rate of inflation.

- The budget will also need to accommodate priority spending on infrastructure to support sustained economic development for poverty reduction. In this context, capital expenditure will be slightly higher in FY2011/12, relative to FY2010/11. The focus will be on high-priority developmental projects and the construction of the Metolong Dam to secure our medium- and long-term water supply. To ensure effective use of public resources, we will seek to better prioritize our investment spending through improved monitoring and evaluation, drawing on the recommendations of our Project Appraisal Committee.

- Support to the poor and most vulnerable members of society remains a matter of priority for the Government. We will maintain the floor on social spending under the program at M680 million, to ensure that efforts to strengthen fiscal consolidation do not compromise support to priority areas such as the school feeding program, old age pensions, and HIV/AIDS.

- Additional expenses will arise from conducting the local and national government elections during the coming fiscal year. We will firmly resist spending pressures that are not directly related to the cost of organizing and conducting the elections.

Notwithstanding these demands on our fiscal resources, some of which are temporary, we recognize that fiscal consolidation must be sustained to preserve our program objectives.

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5 The FY2011/12 budget was tabled in Parliament on February 14, 2011.
11. **In support of these objectives, we intend to keep tight control on other spending.** This means that higher wages and salaries, and the once-off expenditure for elections (estimated at 1.5 percent of GDP), will be partially offset by savings in other recurrent expenditure. To this effect, the Government will place tight limits on appropriations for goods and services and will freeze new positions, with the exception of the Army and the Police, while eliminating non-priority posts vacated for more than a year—a practice that we are already following.

12. **As part of the fiscal consolidation effort, we will also continue to strengthen non-SACU revenues by further improving tax administration and compliance.** We will be building on the significant progress that has been made, with technical assistance from the U.S. Treasury Department, to strengthen tax collection, provide improved services to taxpayers and improve the operational efficiency of the Lesotho Revenue Authority. The automation of our cashier system at the border posts will also help to improve revenue collection. We are also taking steps to increase domestic non-tax revenue through a review of existing fees and charges to bring them to levels commensurate with the cost of providing the services. Nevertheless, the overall revenue ratio is expected to fall this year as a result of lower SACU revenues and CBL dividends, implying an increase in the projected fiscal deficit to about 15 percent of GDP.

13. **To ensure debt sustainability, the government will continue to seek external financing through grants and concessional loans and save any unplanned inflows.** As agreed with the IMF, non-concessional financing will be limited to the European Investment Bank loan for the Metolong Dam Project, in the short term. In addition, we are assessing options for the medium-term financing of the second phase of the Lesotho Highlands Water Project, which is unlikely to be available on concessional terms only. Consistent with the current practice, the part of the deficit in 2011/12 that is not covered by external flows, will be financed by drawing down our deposits at the CBL and issuing additional domestic government bonds of M500 million. In the event that fiscal performance is better than expected, including as a result of higher-than-programmed SACU receipts, the available resources will be used to build up our deposits at the CBL, while a further drawdown would be required in the event of shortfalls in SACU receipts or budget support.

**Public Financial Management**

14. **Further fiscal consolidation over the medium term will need to be based on an explicit understanding of priorities.** We will undertake a comprehensive review of recurrent expenditure, with a view of identifying those that are of low priority and can be eliminated. In addition, we will develop a time-bound plan for capacity building in ministries to strengthen their preparation of medium-term expenditure frameworks, by end-June 2011 (structural benchmark).
15. **Public Financial Management (PFM) reforms, supported by development partners, will continue to improve the efficiency of our budget process.** Steady progress has been made but challenges remain, including problems with the functionality of IFMIS. In 2011/12, we will implement measures to strengthen expenditure controls, improve revenue tracking and enhance accountability. Activities will focus on further improvements in the functionality of IFMIS, resolving interface and other IFMIS problems, and increasing staff training in the use of the system. To help improve revenue tracking, by end-September 2011, we will implement a front office revenue receipting system and ensure that all revenues are captured in the IFMIS (structural benchmark).

16. **The accumulation of domestic arrears remains a concern.** We intend to complete a full audit, by end-June 2011, to determine the size and develop a time-bound plan to eliminate these arrears (structural benchmark). We are also committed to prevent the emergence of new domestic arrears in the future, by developing and implementing processes that ensure timely payment.

V. **Mitigating Financial Sector Risks and Supporting Development**

17. **The government is moving ahead with financial sector reforms.** While our banks remain well capitalized, profitable and liquid, vulnerabilities in our financial system stem from weakly supervised nonbank financial institutions (NBFIs). Reforms are underway to strengthen the institutional and regulatory framework for all financial institutions, while enhancing access to financial services, particularly for rural areas. Measures include:

- Submitting to Parliament the new Financial Institutions Bill, which incorporates amendments to deal with supervision of NBFIs by the CBL, and unlawful business practices, including Ponzi schemes, by end-March 2011 (structural benchmark).

- Submitting to Cabinet a review of the Cooperatives Societies Act, by end-March 2011, with a view to ensuring that cooperatives who accept deposits from the public comply with and are registered under the FIA, and are therefore subjected to CBL supervision and the same prudential and anti-money laundering requirements as banks (structural benchmark).

- Completing the draft regulations for the scope and mandate of the Financial Intelligence Unit and the AML regime.

- Advancing the modernization of Postbank, to better enable it to expand its services and products to individuals and small and medium-size enterprises, including those in rural areas. To this end, we will prepare a time-bound plan for expansion of microlending products and services by Postbank, including introduction of smartcards.
• Launching a Partial Credit Guarantee Scheme by end-March 2011, and submitting to Cabinet a National Leasing Finance proposal by end-June 2011 (both structural benchmarks) to enhance access to financial services.

VI. IMPROVING PRODUCTIVITY AND THE INVESTMENT CLIMATE

18. We will also continue improving our business climate to support private sector-led growth and diversify our economy. The uncertainties arising from the serious difficulties in the textile sector reinforce the need to fast-track the reforms. A number of reforms aimed at improving the business environment have been implemented, and several are underway. The recently amended Land Reform Act provides security of tenure to use land as an economic assets that can be used as collateral to access financing for investment. The new Companies Bill, once it is passed by Parliament, will significantly reduce the time and cost of setting up a business. In addition, the automation of the Companies Registry and the implementation of a new business plan for the One Stop Business Facilitation Centre will help the ease of doing business in Lesotho. The Government is fully aware that despite these achievements, more needs to be done to improve Lesotho’s business climate and competitiveness. Among the next steps, we intend to submit the Industrial Licensing Bill to Parliament by end-March 2011 (structural benchmark), and we will continue to work closely with our development partners to implement reforms that strengthen private sector development and economic diversification.

VII. POVERTY REDUCTION STRATEGY

19. Lesotho’s Interim National Development Framework (INDF) (2008/09–2010/11) is based on the priorities and objectives contained in the original Poverty Reduction Strategy Paper (PRSP) (2004/05–2007/08) and Vision 2020. The INDF is a precursor to a comprehensive five-year National Strategic Development Plan (NSDP), which is planned to be implemented starting 2012/13, and focuses on diversifying the economy to achieve sustained economic growth and generate alternative employment opportunities for Basotho.

VIII. SAFEGUARD ASSESSMENT

20. We remain committed to implementing the recommendations of the recently completed safeguards assessment of the CBL, which updates the previous assessment completed in 2003. The current assessment concluded that key elements of the CBL’s safeguards framework have been strengthened since the 2003 assessment, but also that risks exist in the external audit mechanism. We commit to taking the necessary steps to appoint an international audit firm as the CBL’s sole auditor, including by waiving the residency and registration requirements contained in the Accountants Act of 1977.
IX. PROGRAM MONITORING

21. Completion of the second and third reviews of the arrangement, by August 24, 2011 and February 24, 2012, respectively, will be based on the observance of quantitative performance criteria through end-March 2011 and end-September 2011, respectively (Table 1). The targets for end-June 2011 will be indicative. The definitions of the variables monitored as quantitative performance criteria are provided in the Technical Memorandum of Understanding (TMU).

The Government is committed to ensuring that the program remains on track, and will continue to monitor implementation.
Table 1. Lesotho: Quantitative Performance Criteria, Benchmarks, and Indicative Targets  
September 2010 - September 2011

<table>
<thead>
<tr>
<th>FY2010/11</th>
<th>FY2011/12</th>
</tr>
</thead>
<tbody>
<tr>
<td>September</td>
<td>December</td>
</tr>
<tr>
<td>Ceiling on the domestic financing requirement of the central government 1, 2, 3</td>
<td>311.5</td>
</tr>
<tr>
<td>Adjusted benchmark 4</td>
<td>765.6</td>
</tr>
<tr>
<td>Ceiling on the net domestic assets of the Central Bank of Lesotho 1, 2, 3</td>
<td>1,884.0</td>
</tr>
<tr>
<td>Adjusted benchmark 4</td>
<td>1,539.4</td>
</tr>
<tr>
<td>Ceiling on the stock of net international reserves of the Central Bank of Lesotho 2, 3</td>
<td>956</td>
</tr>
<tr>
<td>Adjusted benchmark</td>
<td>938</td>
</tr>
<tr>
<td>Floor on the stock of external payments arrears 5</td>
<td>0</td>
</tr>
<tr>
<td>Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector (cumulative from end-March 2010 2, 5)</td>
<td>Maturity of less than one year</td>
</tr>
<tr>
<td>Maturity of one year or more 6</td>
<td>182</td>
</tr>
<tr>
<td>Ceiling on the stock of external payments arrears 5</td>
<td>0</td>
</tr>
</tbody>
</table>

Indicative targets:

Floor on the central government social expenditures 7 | 170 | 253 | Met | 170 | 174 | 170 | 170 | 170 |

Ceiling on gross cumulative payments of domestic arrears 1 | 200 | 199 | Met | 200 | 199 | 200 | ... | ... |

Memo items:

Net disbursements 1, 2 | 196.9 | 69.5 | 208.0 | 206.1 | 396.3 | 303.5 | -2.3 | -8.0 |
| General budget support | 358.0 | 204.1 | 448.0 | 389.6 | 718.0 | 552.4 | 55.6 | 154.4 |
| Debt service payments | 159.1 | 134.8 | 240.0 | 183.5 | 321.7 | 248.8 | 57.9 | 172.4 |
| Unused outstanding Metolong balances 1 | 1,123.4 | 0.0 | 984.2 | 0.0 | 1,144.4 | 0.0 | 0.0 | 0.0 |
| Metolong loan disbursement | 1,370.9 | 2.4 | 1,370.9 | 2.4 | 1,716.6 | 151.3 | 140.3 | 140.3 |
| Use of Metolong loan | 247.5 | 2.4 | 386.8 | 2.4 | 572.2 | 151.3 | 140.3 | 140.3 |
| Payment of domestic arrears 1 | 200.0 | 198.8 | 200.0 | 198.8 | 200.0 | 198.8 | 200.0 | 200.0 |

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

1 Values are cumulative from end of previous fiscal year
2 Definitions and program adjusters are specified in the TMU
3 Excludes unused outstanding balances from the EIB loan for the Metolong dam.
4 Adjustments for September and December 2010 include corrections to program assumptions on the treatment of Metolong balances
5 Continuous performance criteria
6 New nonconcessional borrowing is limited to financing the Metolong dam.
7 Covers quarterly spending on school feeding program, old age pension and HIV/AIDS
Table 2. Lesotho Structural Benchmarks for FY2010/11

<table>
<thead>
<tr>
<th>Structural Benchmarks</th>
<th>Test Date</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Public Financial Management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prepare monthly monitoring reports assessing the impact of modification to the IFMIS to prevent over-commitment.</td>
<td>End-Sept. 2010</td>
<td>Met. A Quality Assurance Report was also completed in August</td>
</tr>
<tr>
<td>Complete an audit of user access rights to the IFMIS and assign user access rights on a “need-to-use” basis</td>
<td>End-June 2010</td>
<td>Not met but implemented with delay. A preliminary report was completed July 9th and the final report Aug 6th</td>
</tr>
<tr>
<td>Submit to Cabinet a comprehensive review of all on-going capital projects, assessing their desirability and make recommendations on projects to be retained or eliminated</td>
<td>End-Sept. 2010</td>
<td>Not met. Delayed to allow broad consultation with line ministries. Draft report completed and to be submitted to Cabinet by end-March 2011</td>
</tr>
<tr>
<td>II. Structural Reforms</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Submit the Companies Bill to Parliament</td>
<td>End-Sept. 2010</td>
<td>Met</td>
</tr>
<tr>
<td>III. Financial Sector Regulation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issue domestic bonds</td>
<td>End-Dec 2010</td>
<td>Met. Institutional infrastructure was in place by August and bond issuance began in October</td>
</tr>
</tbody>
</table>
## Table 3. Structural Benchmarks through September 2011

<table>
<thead>
<tr>
<th>Benchmarks</th>
<th>Test date</th>
<th>Macroeconomic rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Public Financial Management</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Complete an audit of domestic arrears and prepare a time bound plan for elimination</td>
<td>End-March 2011</td>
<td>Support expenditure control and medium-term fiscal consolidation</td>
</tr>
<tr>
<td>Prepare a time bound plan for capacity building in line ministries to strengthen preparation of MTEF by all ministries</td>
<td>End-June 2011</td>
<td>Support expenditure control and medium-term fiscal consolidation</td>
</tr>
<tr>
<td>Implement the front office revenue receiving system and ensure that all revenues are captured in the IFMIS</td>
<td>End-September 2011</td>
<td>Strengthen revenue tracking and support medium-term fiscal consolidation</td>
</tr>
<tr>
<td><strong>II. Financial Sector Regulation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Submit to Cabinet a review of the Cooperatives Societies Act with a view to ensuring that all financial institutions that accept deposits from the public comply with and are registered under the FIA</td>
<td>End-March 2011</td>
<td>Strengthen prudential regulations and reduce systemic risks to the domestic financial sector</td>
</tr>
<tr>
<td>Submit to Parliament the new Financial Institutions Bill, which incorporates amendments to deal with supervision of NBFIs by the CBL, and unlawful business practices, including Ponzi schemes</td>
<td>End-March 2011</td>
<td>Strengthen prudential regulations and reduce systemic risks to the domestic financial sector</td>
</tr>
<tr>
<td>Launch a Partial Credit Guarantee Scheme, aimed at reducing the risks for banks to lend to small and medium-sized enterprises</td>
<td>End-March 2011</td>
<td>Improve access to financing for small and medium-sized enterprises</td>
</tr>
<tr>
<td>Submit to Cabinet the National Leasing Finance proposal, aimed at creating a legal environment conducive to leasing, by supplementing the 1974 Hire Purchase Act.</td>
<td>End-June 2011</td>
<td>Improve access to financing for small and medium-sized enterprises</td>
</tr>
<tr>
<td><strong>III. Other Structural Reforms</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Submit to Parliament the Industrial Licensing Bill, which will improve the process of licensing industrial enterprises</td>
<td>End-March 2011</td>
<td>Improve the business climate to facilitate private sector-led growth, and increase productivity and competitiveness</td>
</tr>
</tbody>
</table>
Attachment III: Kingdom of Lesotho—Technical Memorandum of Understanding

February 24, 2011

1. This memorandum sets forth the understandings between the government of Lesotho and the IMF staff regarding the definitions of the quantitative performance criteria and benchmarks for the second review of its arrangement supported under the ECF-supported program, as well as the respective reporting requirements. These performance criteria and benchmarks are reported in Table 1 of the government’s Memorandum of Economic and Financial Policies (MEFP).

   A. Ceiling on the Domestic Financing Requirement (DFR) of the Central Government

2. Definition. The central government includes the central administration and all district administrations. The domestic financing requirement of the central government is defined as net credit to the government from the banking system (that is, the Central Bank of Lesotho and the commercial banks) plus holdings of treasury bills and other government securities by the nonbank sector. For program monitoring purposes, the domestic financing requirement will be calculated as the change from the end of the previous fiscal year (which runs from April 1 to March 31) of net credit to the government by the banking system and of holdings of treasury bills and other government securities by the nonbank sector. In particular, the calculation of the domestic financing requirement shall include changes in (i) balances held in the privatization account or balances of other accounts into which proceeds from the sale of public enterprises are deposited; (ii) the amount of outstanding treasury bills issued by the Central Bank of Lesotho for monetary policy purposes and held in the balance of the blocked government deposit account used by the Central Bank of Lesotho to sterilize reserve money absorbed by monetary policy operations. The calculation of the domestic financing requirement shall exclude changes in balances held in any account into which revenues collected by the customs department are held pending their transfer to the SACU revenue pool. External debt service, amortization, disbursements and external grants will be calculated at an exchange rate of M 7.33 per U.S. dollar.

3. Supporting material. The Central Bank of Lesotho will provide the monetary survey and other monthly monetary statistics, as well as a table showing the details of all government financing operations from the nonbank public, on a monthly basis and within 30 days of the end of the month. The following information will be presented as memorandum items in the monetary survey: (i) the outstanding balances in the privatization account or accounts; and (ii) details of any monetary operations with treasury bills, including changes in government deposits as a result of such operations. The Central Bank of Lesotho will also provide a table showing the details of government debt by type and holder. The
Ministry of Finance and Development Planning will provide detailed monthly budget operation reports and tax arrears reports.

### B. Ceiling on the Stock of Net Domestic Assets of the Central Bank of Lesotho

4. **Definition.** The net domestic assets (NDA) of the Central Bank of Lesotho are defined as the difference between reserve money (currency in circulation plus total bank deposits at the central bank) and NFA (as defined in paragraph 5). For program monitoring purposes, the NDA will be calculated as the change from the end of the previous fiscal year (which runs from April 1 to March 31). The NDA thus includes net claims by the Central Bank of Lesotho on the government (loans and treasury bills purchased less government deposits), claims on banks, and “other items net” (other assets, other liabilities, and the capital account).

5. **Definition.** The net foreign assets (NFA) of the Central Bank of Lesotho are defined as foreign assets minus foreign liabilities, and include all foreign claims and liabilities of the central bank. The values of all foreign assets and liabilities will be calculated in U.S. dollars at the end of each quarter using the program exchange rates.

6. **Supporting material.** The Central Bank of Lesotho will provide detailed data on its balance sheet on a monthly basis within 21 days of the end of the month. The central bank will also provide a table of selected monetary indicators covering the major elements of its balance sheet on a weekly basis.

### C. Floor on the Stock of Net International Reserves of the Central Bank of Lesotho

7. **Definition.** The net international reserves (NIR) are defined as the Central Bank of Lesotho’s liquid, convertible foreign assets minus its convertible foreign liabilities. Pledged or otherwise encumbered assets, including, but not limited to, assets used as collateral or as guarantee for third-party external liabilities are excluded from reserve assets. Reserve assets include cash and balances held with banks, bankers’ acceptances, investments, foreign notes and coins held by the Central Bank of Lesotho, Lesotho’s reserve position in the Fund, and SDR holdings. Reserve liabilities include nonresident deposits at the Central Bank of Lesotho, use of IMF credit, and any other short term liabilities of the central bank to nonresidents. The stock of NIR at the end of each quarter is defined in U.S. dollars and will be calculated using the program exchange rates.\(^6\)

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\(^6\) Program cross exchange rates are: South African rand per U.S. dollar: 7.3; U.S. dollars per pound sterling: 1.5; U.S. dollars per euro: 1.3; Swiss francs per U.S. dollar: 1.1; Swedish kronor per U.S. dollar: 7.3; and Botswana pula per U.S. dollar: 6.8. SDR per U.S.dollar: 0.648; Program maloti per U.S. dollar exchange rate: 7.3.
8. **Supporting material.** The Central Bank of Lesotho will provide data on its NIR on a monthly basis within three weeks of the end of the month. The NIR data will be provided in a table showing the currency breakdown of the reserve assets and reserve liabilities of the Central Bank of Lesotho converted into U.S. dollars and maloti at the program exchange rates.

D. **Ceiling on the Amount of New Nonconcessional External Debt Contracted or Guaranteed by the Public Sector, with Original Maturity of One Year or More**

9. **Definition.** For purposes of the ECF, concessionality requirements will be applied to foreign-currency denominated debt regardless of the residency of the creditor. The public sector comprises the central government, the Central Bank of Lesotho, and all public enterprises and other official sector entities with majority state ownership. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, adopted by Decision No. 6230-(79/140), as revised on August 24, 2000, as amended effective December 1, 2009, but also to commitments contracted or guaranteed for which value has not been received. Included in this performance criterion are all current liabilities that are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and that require the public sector (obligor) to make one or more payments in the form of assets (including currency) at some future point(s) in time to discharge principal and/or interest liabilities incurred under the contract. In effect, all instruments that share the characteristics of debt as described above (including loans, suppliers’ credits, and leases) will be subject to the ceiling. New nonconcessional borrowing is limited to the Metolong Dam Project, a high-return public investment project. The performance criterion will be evaluated on a continuous basis as the cumulative change in the amount of new nonconcessional debt contracted or guaranteed from end-March 2010 onward.

10. **Definition.** A loan is concessional if its grant element is at least 35 percent of the value of the loan, calculated using a discount rate based on commercial interest reference rates (CIRRs) reported by the OECD. For loans of maturity of greater than 15 years, the grant element will be based on the ten-year average of OECD CIRRs. For loans of maturity of 15 years or less, the grant element will be based on the six-month average of OECD CIRRs. Margins for differing repayment periods would be added to the CIRRs: 0.75 percent for repayment periods of less than 15 years, 1 percent for repayment periods of 15 to 19 years, 1.15 percent for repayment periods of 20 to 29 years, and 1.25 percent for repayment periods of 30 years or more.

11. **Supporting material.** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the Ministry of
Finance and Development Planning on a monthly basis within 30 days of the end of the month.

E. Ceiling on the Amount of New External Debt Contracted or Guaranteed by the Public Sector, with Original Maturity of Less than One Year

12. **Definition.** The public sector comprises the central government, the Central Bank of Lesotho, and all enterprises with majority state ownership. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, adopted by Decision No. 6230-(79/140), as revised on August 24, 2000, as amended effective December 1, 2009, but also to commitments contracted or guaranteed for which value has not been received. Included in this performance criterion are all current liabilities that are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and that require the public sector (obligor) to make one or more payments in the form of assets (including currency) at some future point(s) in time to discharge principal and/or interest liabilities incurred under the contract. In effect, all instruments that share the characteristics of debt as described above (including loans, suppliers’ credits, and leases) will be subject to the ceiling. Excluded from this performance criterion are normal short-term import credits. The performance criterion will be evaluated on a continuous basis as the cumulative change in the amount of new nonconcessional debt contracted or guaranteed from the end of the previous fiscal year (March 31).

13. **Supporting material.** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the Ministry of Finance and Development Planning on a monthly basis within 30 days of the end of the month.

F. Ceiling on the Stock of External Payments Arrears

14. **Definition.** During the period of the arrangement, the stock of external payments arrears of the public sector (central government, Central Bank of Lesotho, and all enterprises with majority state ownership) will continually remain zero. Arrears on external debt-service obligations include any nonpayment of interest and/or principal *in full and on time* falling due to all creditors, including the IMF and the World Bank.

15. **Supporting material.** Details of arrears accumulated on interest and principal payments to creditors will be reported within one week from the date of the missed payment.
G. Floor on the Central Government Social Expenditures

16. **Definition:** There will be a floor on the central government social expenditures. The observance of this floor is an indicative target. Social expenditures comprise spending on the following programs: school feeding program, old age pension, and HIV/AIDS.

17. **Supporting material:** Data on social spending will be compiled by the Ministry of Finance and Development Planning and will be provided on a quarterly basis, to be submitted no later than six weeks after the end of each reporting period.

H. Adjusters

18. The quantitative performance criteria specified under the program are subject to the following adjusters:

A. Southern African Customs Union Revenues

- The program targets for the NDA in any quarter will be adjusted downward (upward) by the full amount of any excess (shortfall) in receipts from the Southern Africa Customs Union (SACU) relative to the programmed levels specified in Table 1 of the MEFP as well as any SACU advance receipts in that quarter, where such advance receipts constitute amounts that would otherwise have been received in a subsequent quarter.

- The program targets for the DFR in any quarter will be adjusted downward (upward) by the full amount of any excess (shortfall) in receipts from the Southern Africa Customs Union (SACU) relative to the programmed levels specified in Table 1 of the MEFP as well as any SACU advance receipts in that quarter, where such advance receipts constitute amounts that would otherwise have been received in a subsequent quarter.

- The program targets for the NIR in any quarter will be adjusted upward (downward) by the full amount of any excess (shortfall) in receipts from the Southern Africa Customs Union (SACU) relative to the programmed levels specified in Table 1 of the MEFP as well as any SACU advance receipts in that quarter, where such advance receipts constitute amounts that would otherwise have been received in a subsequent quarter.

19. **Supporting material:** The Central Bank of Lesotho will provide data on SACU receipts on a quarterly basis within the first month of the quarter.
B. Budgetary Support net of Debt Service

- The ceiling on the NDA will be adjusted downward (upward) by the full amount of the excess (shortfall) in budgetary support net of debt service relative to the programmed levels specified in Table 1 of the MEFP.

- The ceiling on the DFR will be adjusted downward (upward) by the full amount of the excess (shortfall) in budgetary support net of debt service relative to the programmed levels specified in Table 1 of the MEFP.

- The floor on the NIR of the Central Bank of Lesotho will be adjusted upward (downward) by the full amount of the excess (shortfall) in budgetary support net of debt service relative to the programmed levels specified in Table 1 of the MEFP.

20. **Supporting material**: Data on budget support and debt service will be compiled by the Ministry of Finance and Development Planning and will be provided on a quarterly basis, to be submitted no later than six weeks after the end of each reporting period.

C. Payment of Domestic Arrears

- The ceilings on the NDA will be adjusted upward (downward) by the full amount of the excess (shortfall) in payments of arrears relative to the programmed levels specified in Table 1 of the MEFP.

- The ceilings on the DFR will be adjusted upward (downward) by the full amount of the excess (shortfall) in payments of arrears relative to the programmed levels specified in Table 1 of the MEFP.

- The floor on the NIR of the Central Bank of Lesotho will be adjusted downward (upward) by the full amount of the excess (shortfall) in payment of arrears relative to the programmed levels specified in Table 1 of the MEFP.

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7 General budget support consists of grants and loans received by the Central Government for financing its overall policy and budget priorities.

8 Domestic arrears are overdue payment obligations of the central government other than external payment arrears, including on wages and salaries, pensions, transfers, domestic interest, goods and services, obligations arising from court cases, legally established compensation claims, and tax refunds. Payments on wages and salaries, pensions, transfers, court-established obligations, and compensations are in arrears when they remain unpaid for more than 45 days beyond their due date. Domestic interest payments are in arrears when the payment is not made on the due date. Payments for goods and services are deemed to be in arrears if they have not been made within 45 days of the date of invoice, or—if a grace period has been agreed—within the contractually agreed grace period.
21. **Supporting material**: Data on domestic arrears will be compiled by the Ministry of Finance and Development Planning and will be provided on a quarterly basis, to be submitted no later than six weeks after the end of each reporting period.