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Kingdom of Lesotho: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Lesotho

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with the Kingdom of Lesotho, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 8, 2005, with the officials of the Kingdom of Lesotho on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 18, 2005. 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 19, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 19, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Kingdom of Lesotho.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

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

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INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representative for the
2005 Consultation with Lesotho

Approved by Sharmini Coorey and Mark Plant

August 18, 2005

- The 2005 Article IV discussions were held in Maseru during June 27–July 8, and in Washington D.C. on July 11, 2005. The staff team met with Finance Minister Thahane, Central Bank Governor Matekane, other senior officials, and representatives of the private sector and donor community.

- The staff team comprised Messrs. Basu (Head), Wang, Gons, and Lledo (EP), Ms. Masha (all AFR), and Mr. Martijn (PDR). Mr. Arora, the Senior Resident Representative for South Africa and Lesotho, assisted the mission. Mr. Kanu (OED) participated in the discussions.

- The last Article IV consultation was concluded in January 2004. At that time, Directors commended Lesotho's favorable economic performance, with moderate growth and declining inflation, despite adverse weather conditions and a regional food shortage. They emphasized, however, that Lesotho must address daunting medium-term challenges, such as falling agricultural productivity, HIV/AIDS-related and other health problems, potential erosion in trade preferences, inadequate infrastructure, weak enforcement of property rights, and insufficient access to credit.

- Lesotho has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund's Articles of Agreement and maintains an exchange system free of restrictions on payments and transfers for current international transactions.

- The Executive Board approved a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) for Lesotho on March 9, 2001, in an amount equivalent to SDR 24.5 million. The sixth and final review under the PRGF, together with an ex-post assessment of longer-term program engagement, was completed on September 10, 2004.

- The final version of Lesotho's poverty reduction strategy paper (PRSP) became available on July 18, 2005, and the joint staff advisory note (JSAN) is expected to be considered by the Executive Boards of the World Bank and the IMF on September 8, 2005 and September 19, 2005, respectively.

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EXECUTIVE SUMMARY

Lesotho has made considerable gains in macroeconomic stability in the past two years. The government's fiscal position and the external current account have improved markedly, the inflation rate has slowed, and net international reserves have increased. However, poverty, aggravated by a high incidence of HIV/AIDS, remains widespread.

Growth has been weakened by the cumulative impact of several shocks: a substantial real appreciation of the exchange rate of the rand, to which the loti is pegged; the removal of textile quotas by industrial countries; a continuing decline in the terms of trade; and persistent drought. Lesotho's economic prospects could be affected by further trade preference erosion, a declining trend in revenue receipts from the Southern African Customs Union (SACU), and falling remittances from Lesotho workers in South Africa.

Lesotho is facing the challenge of restoring external competitiveness and promoting rapid and broad-based growth to reduce poverty and achieve the Millennium Development Goals (MDGs). Discussions focused on the policies required to address the immediate shocks, consolidate macroeconomic stability, and promote private sector–led growth over the medium term.

The authorities acknowledged that, under the exchange rate parity arrangement, the burden of safeguarding macroeconomic stability would necessarily fall on fiscal policy. The staff cautioned against any fiscal deficits in excess of available grants and concessional loans because of the risks of widening the external current account deficit and depleting international reserves.

Implementing the recently finalized PRSP will entail scaling up development and poverty reduction expenditures. Informed by a debt sustainability analysis (DSA), the staff advised that new expenditures be phased in based on a clear set of debt sustainability and absorptive capacity criteria. The authorities will continue their efforts to increase domestic revenues and improve public expenditure management and accountability, to attract donor funding for outlays related to Lesotho's poverty reduction strategy.

Given the authorities' commitment to maintaining the exchange rate parity, the staff emphasized the urgency of accelerating structural reforms to restore competitiveness. The authorities are preparing an action plan, in collaboration with development partners, to improve the business climate. Critical measures aim to increase labor productivity through training, reduce domestic costs for the private sector by addressing infrastructure bottlenecks, remove regulatory and administrative impediments, improve access to financial services, and promote product and export market diversification.

The authorities expressed their strong interest in continued Fund involvement through policy dialogue and technical assistance.

I. Introduction

1. **Lesotho is a small, open, low-income economy with very close financial and commercial ties to South Africa.** It is a member of the Southern African Customs Union (SACU) and the Common Monetary Area (CMA), and its currency—the loti—is pegged at par to the rand.[1] There are no exchange controls between CMA countries. Trade among SACU countries is free of tariffs and duties. Trade with South Africa accounts for about two-thirds of Lesotho's external trade, and foreign direct investment (stock) from South Africa is about one-fifth of Lesotho's GDP. Lesotho's banking system comprises four banks, three of them South African. Workers' remittances from South Africa and receipts of Lesotho's share of SACU revenue constitute a significant part of national income.

2. **Lesotho enjoys a relatively stable political situation.** Local government elections were held for the first time in April 2005, in which the ruling party won over three-fourths of the seats. It led to the establishment of 129 new councils to replace the Village Development Councils. The new councils function in accordance with the Local Government Act.

3. **Lesotho has achieved moderate growth since the early 1990s.** Growth was strongest during 1991-95**,** mainly reflecting the impact of substantial public investment in the Lesotho Highlands Water Project. During 1996-2000, growth weakened because of a political crisis and the adverse effects of exogenous shocks. Since 2000, garment exports to the United States, benefiting from preferences under the U.S. African Growth and Opportunity Act (AGOA), have become the main engine of growth. Nonetheless, overall real GDP growth has been driven primarily by factor accumulation (mainly of capital), with a minimal contribution from total factor productivity (TFP) growth. Per capita GDP in Lesotho was US$520 in 2004, and the HIV/AIDS prevalence rate was about 29 percent of the adult working population.

4. **At the time of the recent ex-post assessment of Fund involvement in Lesotho and the previous Article IV consultation, Directors noted that Lesotho had made progress in achieving macroeconomic stability and implementing structural reforms during the last PRGF-supported program.** The authorities reformed public expenditure management and the financial sector and privatized public enterprises. The introduction of the value-added tax (VAT) and the creation of the Lesotho Revenue Authority (LRA) helped to raise non-SACU revenue. In addition, Lesotho has participated in the Fund's General Data Dissemination System (GDDS) since August 2003, and made progress in providing a broad range of statistics for program monitoring under the PRGF arrangement.

5. **The authorities welcomed the Fund's role in providing policy advice—through surveillance, program design, and technical assistance**. However, they also stated that the policy advice would be more effective if the Fund were to focus more on identifying the

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[1] The SACU was established in 1910, with membership comprising Botswana, Lesotho, Namibia, South Africa, and Swaziland. The CMA includes the same countries, except Botswana. The rand is legal tender in all CMA countries.

beneficial linkages between macroeconomic policies and complementary microeconomic and structural reforms. The authorities requested that the Fund assist them in developing such an integrated policy package, through the timely provision of technical assistance and capacity building support.

II. Recent Economic Developments

6. **Real GDP growth weakened to about 2 percent in 2004/05 from over 3 percent in the preceding two years, reflecting the adverse impact of external shocks on manufacturing and the ongoing drought on agricultural output (Text Table and Table 1).** The slowdown in manufacturing reflected the appreciation of the real exchange rate since February 2002, uncertainty about Lesotho's duty–free access to the U.S. market,[2] and the elimination of textile quotas in January 2005. The effects of these shocks in the garment sector were particularly pronounced in the second half of 2004/05, resulting in factory closures and the loss of about 10,000 jobs (20 percent of jobs in the sector). Agricultural output has declined, as a result of a three-year drought and such long–standing structural weaknesses as poor farming techniques, soil erosion, lack of water in the lowlands, and a shortage of agro-financing. According to a 2005 government estimate, 500,000-741,000 people (about 23–34 percent of the population) need emergency food assistance.[3]

Text Table: Sectoral breakdown of real GDP growth

	2002/03	2003/04	2004/05	2005/06
	(In percent)			
Primary sector	**-4.3**	**-1.9**	**0.3**	**3.2**
Crops	-11.3	-6.5	-3.3	1.7
Livestock	11.5	6.2	6.1	5.6
Agric. services	-2.4	0.2	0.2	0.2
Secondary sector	**6.2**	**4.9**	**1.1**	**-6.7**
Secondary sector (excl. LHWP)	5.8	4.6	4.0	-1.9
Mining	3.6	43.3	127.3	63.7
Manuf.&handicraft	6.1	5.1	0.9	-8.2
Construction	5.6	3.6	6.6	3.0
Tertiary sector	**2.8**	**4.3**	**3.6**	**2.7**
GDP at constant market prices	**3.2**	**3.3**	**2.0**	**-0.7**

Source : Bureau of Statistics, Central Bank and Fund Staff estimates

7. **The loti has appreciated substantially since early 2002, contributing to a decline in consumer price inflation (CPI)**. Relative to the U.S. dollar, the loti's nominal appreciation reached 40 percent over the three years to end-March 2005 (Appendix Figure 1). In the second quarter of 2005, however, the loti depreciated by about 7 percent, owing in part to the lowering of interest rates by the South African Reserve Bank. In real effective terms, the appreciation during the three-year period ending June 2005 amounted to 30 percent. In line with trends in South Africa, the CPI-based annual inflation rate declined from 7.7 percent at end-March 2003 to 3.7 percent ending March 2005, notwithstanding increases in oil import prices.

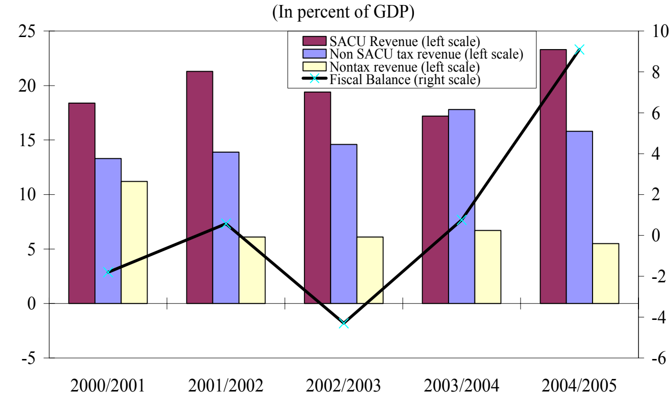
[2] Under AGOA, garment exporters in Lesotho can import fabric from the cheapest available suppliers while enjoying duty-free access to the US market. This provision, which was due to expire in December 2004, was extended until 2007.

[3] In the first four months of 2005, the World Food Programme distributed about 19,000 metric tons of cereal.

8. **Lesotho has a high unemployment rate (about 30 percent)[4] partly because of downward wage rigidity and upward wage pressure.** There is a minimum wage, and wage increases are determined through tripartite negotiations between the government (represented by the Ministry of Labor), the unions, and representatives of the private sector. In an environment of tense labor relations, productivity has remained low and wage costs have drifted up since the mid-1990s.

9. **In the past two fiscal years, the overall fiscal balance (including grants) has turned from a deficit into a surplus** (Table 2). The large fiscal surplus of 9.1 percent of GDP in 2004/05 reflected mainly temporary factors, particularly a 6.1 percentage points of GDP[5] windfall increase in SACU receipts due to the revision of the 2002 import data[6]. Domestic (non-SACU) revenue collection has improved since the launch of the LRA, although outturns in the last fiscal year were affected by the slowdown in economic activity. Current expenditures, particularly salaries and wages, were lower than projected because the new local government administration did not take off during the fiscal year as envisaged.

Figure 1. Lesotho: Fiscal Balance and Revenues, 2000/01-2004/05
(In percent of GDP)



Sources: Lesotho authorities and Fund staff estimates

10. **Monetary developments in Lesotho have mirrored those in South Africa**. The discount rate has held steady since August 2004; market yields on treasury bills have moved downward, influenced by the fall in the government borrowing equirement; and by end-March 2005 the interest rate spread relative South Africa had narrowed to less than 40 basis points. Banks' financial soundness indicators remain strong (Table 4). Recently, two new banks started operations, one of

Figure 2. Lesotho: Interest Rate Spread with South Africa, 2000/01 - 2004/05
(In percent)

Sources: Lesotho authorities and Fund staff estimates

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[4] Based on data provided by the Lesotho Bureau of Statistics.

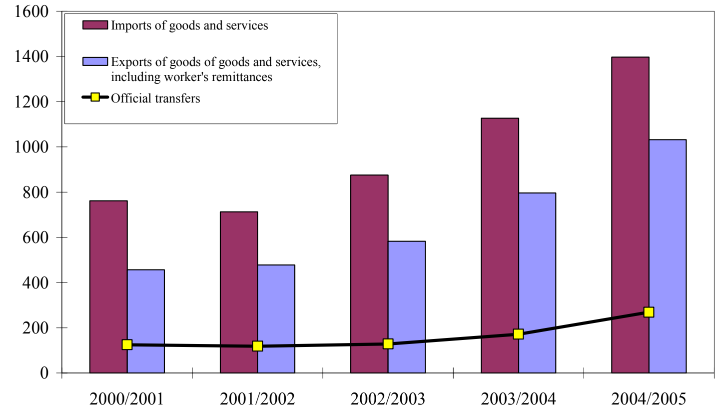
[5] The data are from the Government of Lesotho Financial Information System (GOLFIS), and differ from data reported by such agencies as the Lesotho Revenue Authority (LRA).

[6] See footnote 12 for additional explanation.

which is the Post Bank set up by the government with a focus at this stage on mobilizing savings in rural areas. Draft anti-money-laundering legislation is expected to be presented to parliament by end-2005. The authorities have also begun implementing the recommendations of the stage-one safeguards assessment of 2001[7].

11. **Lesotho's external current account deficit has narrowed significantly and net international reserves increased during 2003/04 and 2004/05** (Table 5). Exports were boosted by strong volume growth in the garment sector, especially during the first half of the year, as a foreign-funded denim mill started operations, and by the mid-2004 reopening of a diamond mine. SACU receipts rose sharply in 2004/05, while remittances from South Africa also grew strongly despite ongoing layoffs[8], owing to increases in the wages of miners working there. These positive effects more than offset the adverse impact of a worsening of the terms of trade, which, since 2001, has been exacerbated by the real appreciation of the rand vis-à-vis the U.S. dollar.[9]

Figure 3. Lesotho: Foreign Trade and Grants (in millions of US dollars), 2000/01 - 2004/05



Sources: Lesotho authorities and Fund staff estimates

12. **Lesotho's debt indicators have improved markedly** over the past two years (Table 1). With the strengthening of the country's fiscal position, the government reduced its domestic debt and the stock of treasury bills fell from 17 percent of GDP in 2002/03 to 8 percent in 2004/05. Lesotho's external public debt as a share of GDP declined from 83 percent of GDP at end-March 2003 to 53 percent in 2005, largely because of the exchange rate appreciation. In net present value terms, the stock has fallen below 40 percent of GDP.

13. **The authorities have strengthened their efforts to tackle poverty and HIV/AIDS**. They have prepared a poverty reduction strategy, which identifies reforms that are important if Lesotho is to make progress toward the MDGs. The government has begun aligning its budget with the strategy, paying particular attention to strengthening institutional and implementation

[7] See Appendix I for details.
[8] The number of Basotho mine workers in South African mines fell from an average of 96,000 in 1997 to 62,000 in 2002 due to the scaling down of mining operations.
[9] The terms of trade deterioration largely reflects the fact that Lesotho exports primarily to the U.S. market and imports mainly from South Africa.

capacity, so that it can avail itself more quickly of funding, including from donors, in the fight against poverty and the HIV/AIDS pandemic[10].

14. **To promote private sector development, the authorities, with support from the World Bank, organized a private sector development forum in April 2005.** In line with plans under preparation, several laws and business procedures will be reviewed and simplified, products and markets will be diversified, physical infrastructure will be developed, and workers' skills will be strengthened.

III. Policy Discussions

A. Outlook, Future Challenges, and Strategy

15. **Lesotho is vulnerable to a range of potentially permanent adverse developments over the medium term:** the eventual elimination of the new restraints on textile imports in the United States and other industrialized countries, the expected removal of the AGOA provision allowing the use of third-country fabrics in 2007, the forecast decline in SACU tariff revenues as a result of trade liberalization, and the likelihood of further decreases in inward remittances as Basotho workers continue to be retrenched from South Africa's mining sector. Even more worrisome is the likely impact of HIV/AIDS. The high infection rate could, over time, contribute to higher mortality rates, a loss of productivity and real income, mounting fiscal pressures, and deeper social and humanitarian distress.

16. **The near-term economic outlook has also been affected by the cumulative impact of several shocks, including the erosion of trade preferences and the real effective appreciation of the exchange rate.** Despite the recent weakening of the loti vis-à-vis the U.S. dollar, garment exporters expected their export earnings to stagnate or decline as export prices came under downward pressure from low-cost producers in Asia. In the agricultural sector, although drought conditions have recently eased somewhat in the highlands, the authorities expected farm output to remain depressed because of the structural weaknesses noted earlier. On the upside, diamond exports are projected to rise further with the opening of two more mines, supported by foreign investment. On balance, GDP is forecast to decline in 2005/06 by about ¾ of 1 percent, the average annual inflation is expected to be somewhat higher, and the external current account deficit is projected to widen.

17. **The authorities agreed that the principal challenge facing Lesotho is to generate more rapid and broad-based economic growth**. To this end, policies need to (i) address the immediate trade shocks, (ii) consolidate the gains in macroeconomic stability achieved so far, and (iii) promote private sector development and foreign investment. Given Lesotho's narrow export base, characterized by heavy dependence on a few textile products, the authorities shared the staff's view that a strong export diversification strategy could be helpful in both generating higher growth and reducing the country's vulnerability to exogenous shocks.

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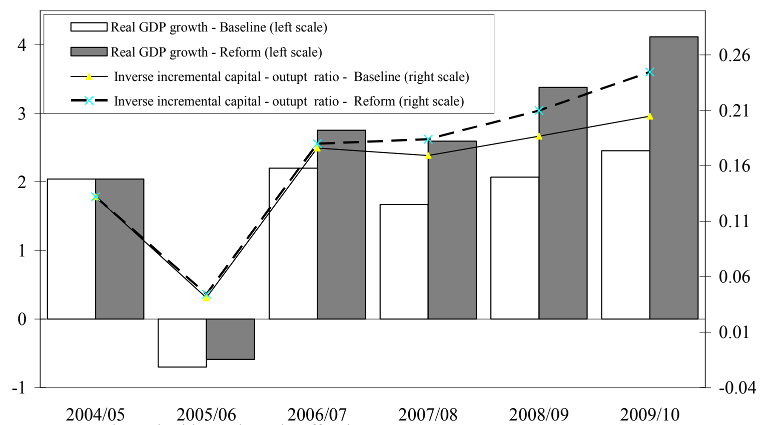
[10] See the Selected Issues Paper *The Management of HIV/AIDS in Lesotho.*

18. **While recognizing the urgent need to restore external competitiveness, the authorities plan to maintain the exchange rate parity, given the benefits of the CMA and Lesotho's close trade and financial ties to South Africa.**[11] They noted that the currency peg and the circulation of the rand as legal tender facilitated commercial ties with neighboring countries. For these reasons, they plan to rely on structural reforms to strengthen competitiveness. In view of this, and as a backdrop to the policy discussions, the staff explored two alternative medium-term scenarios with the authorities. The first one illustrated the shortcomings of a policy package with no acceleration of structural reforms and a weakening of the fiscal balance (baseline scenario); the second one showed the benefits of policies that aimed to improve competitiveness and the business climate through accelerated structural reforms and consolidation of macroeconomic stability.

19. **Under the *baseline* scenario for 2005/06-2007/8, real GDP growth remains weak because the dampening effect of the trade shock on growth is only partially offset by increases in nongarment manufacturing and diamond mining** (Table 6). With the implementation of the PRSP, this scenario assumes that public investment and implementation capacity improve beginning in 2005/06 and that private investment remains at about 24 percent of GDP. Taking into account the impact of HIV/AIDS, and assuming some improvement in the marginal output–capital ratio, annual real GDP growth is projected to pick up to about 2 percent a year over the medium term. The fiscal surplus (including grants) is projected to decline in 2005/06 and switch to a deficit in subsequent years. The fiscal weakening reflects both a downward trend in revenues (after 2005/06) and a sharp rise in total expenditures in 2005/06 followed by gradual reductions (relative to GDP) in subsequent years. The revenue decline is due to the anticipated drop in SACU receipts precipitated by trade liberalization, which lowers import duties. The expenditure pressures stem mainly from increases in current outlays on goods and services and transfers and subsidies, and in domestically funded capital outlays in 2005/06. Reflecting these developments and the adverse impact of the shocks mentioned above, the external current account deficit (excluding official transfers) is expected to widen sharply in 2005/06 and deteriorate further in subsequent years. Reserve coverage is projected to fall from 4.5 months of imports in 2004/05 to 3.1 months by 2010.

Figure 4. Medium-Term Scenarios, 2004/05 - 2009/10

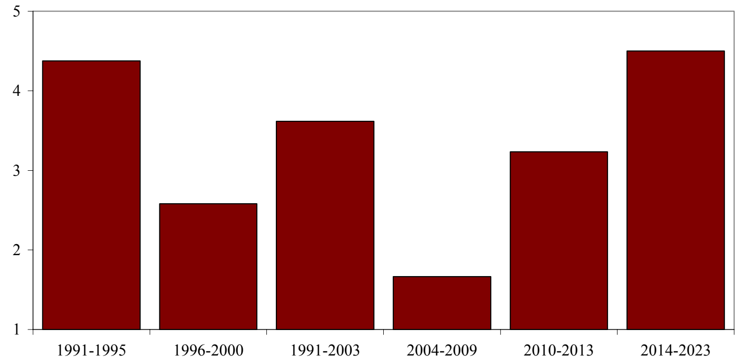


Sources: Lesotho authorities and Fund staff estimates

[11] See the Selected Issues Paper *The Institutional Arrangements of the Common Monetary Area*.

20. **Given the importance of continuing prudent debt management, the staff prepared, jointly with the World Bank staff, a Debt Sustainability Analysis (DSA) and discussed its implications with the authorities**. The baseline assumptions include an annual net external borrowing equivalent to about 2 percent of GDP, and a gradual pick-up in the real growth rate (reaching 4.5 percent after 2012/13).[12] Under this scenario, Lesotho's external debt drops well below the debt-burden thresholds applicable to low-income countries with a policy and institutional environment of median quality, as measured by the World Bank's CPIA rating (Appendix IV). It thus appears to be sustainable, although severe adverse shocks to the garment sector could alter this assessment. A reversal of the large exchange rate appreciation of the past few years could also substantially raise the debt-to-GDP ratio.

Figure 5. Average Real GDP Growth Rates in percent
Historical: 1991-2004
DSA Baseline: 2004 - 2023



Sources: Lesotho authorities and Fund staff estimates

21. **Under the alternative accelerated *reform* scenario, comprehensive reforms to improve the business climate and government operations would set in motion a virtuous circle of increasing economic activity and fiscal resources**—both domestic and donor-provided. The rate of economic growth (3-4 percent) would be somewhat higher over the medium term, with a larger improvement in the marginal output-capital ratio and broad-based increases in production that are supported by a higher volume of international trade (including higher exports). Macroeconomic stability would be consolidated because the projected weakening in the fiscal and external current account positions would be somewhat moderated and higher inflows of foreign direct investment and concessional official financing would limit the loss of international reserves.

B. Fiscal Policy

22. **The authorities recognized that under the exchange rate parity arrangement the burden of safeguarding macroeconomic stability would necessarily fall on fiscal policy and that, as a consequence, they would need to address the envisaged weakening of the fiscal position in 2005/06 and later years.** They explained that, for 2005/06, the government had

[12] This delayed recovery of the growth rate allows for sufficient progress to be made in implementing the necessary structural reforms and for an adequate time lag to yield the benefits of improved productivity and higher output growth. The long-term growth projection also compares favorably with the average growth rate achieved in the first half of the 1990s (4.4 percent), when the country was in a much earlier stage of macroeconomic stabilization and structural reform.

budgeted a deficit of 3 percent of GDP before taking into account an expected one-time revenue windfall from SACU. [13] Including this windfall, the overall fiscal balance after grants could turn into a surplus of about 2 percent of GDP. The authorities noted that Lesotho's underlying revenue performance would be hurt by weaker economic growth and a 5 percent increase in the threshold for the individual income tax, and that expenditure would rise mainly because of a 5 percent increase in civil service wages. The staff noted that taking into account the updated estimates for 2004/05, the revenue and expenditure growth envisaged in the 2005/06 budget were much stronger than past trends.[14] Nonetheless, the authorities expected to maintain an overall fiscal balance that would be consistent with macroeconomic stability and planned to prepay two high-interest loans (equivalent to 3 percent of GDP) to reduce future debt service. In view of these loan repayments, and given the expected declining trend in SACU tariff revenue and the mounting expenditure pressures, the authorities indicated that they may have to resort to domestic financing over the medium term.

23. **The staff pointed out that any domestic financing of fiscal deficits in excess of available grants and concessional loans could weaken the external current account and worsen Lesotho's international reserve position**. This is because domestic money demand may not be adequate to accommodate increased domestic government borrowing, and also because the country's import propensity is high. At a time when the economy is facing adverse shocks with permanent effects, the staff suggested that it would be prudent to minimize the loss of foreign reserves. In the same vein, the staff explained that if expenditures and the related deficit (excluding grants) were scaled up in the context of the implementation of the PRSP, it would be important to ensure that the increases were phased in, as foreign grants and concessional financing became available on terms consistent with maintaining a sustainable debt burden. It was noted that, given Lesotho's relatively manageable debt situation, if somewhat larger concessional financing than currently foreseen were to be offered, it could be accepted so long as it did not seriously raise the risk of debt distress. Prudence would still require lowering the NPV of external debt below the threshold level of 40 percent of GDP, which is the appropriate indicative threshold for the debt/GDP ratio based on an assessment of the quality of Lesotho's policies and institutions.[15] In light of this, the authorities indicated that they were prepared to limit fiscal deficits (including grants) over the medium term to no more than 2-3 percent of GDP and to periodically review their stance based on realistic assessments of the country's prospects

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[13] Under current rules, SACU member countries receive an additional allocation if, after two years, SACU's actual revenue collection turns out to have been higher than the benchmarks used for the early distributions.

[14] On this basis, staff prepared revised projections for 2005/06 to correct for an over estimation of corporate tax revenue collections, as well as for expenditure overestimation in the wage bill and transfers and subsidies.

[15] This assessment reflects the latest Country Policy and Institutional Assessment rating of the World Bank.

of mobilizing foreign grants and concessional loans and of the potential domestic financing that they could raise, if money demand strengthened.

24. **The authorities indicated their intention to strengthen revenue mobilization**. The LRA plans to improve tax administration by following up on donor commitments, which will be used to finance the computerization at the tax offices and the planned ASYCUDA project. Revenues should increase, if progress is made in reducing government entities' noncompliance with VAT payment and refund procedures. The authorities shared the staff's view that increases in tax rates were inadvisable because of their adverse impact on the poor, on overall incentives to save and invest, and on Lesotho's regional competitiveness. On SACU revenue, they stated that, in cooperation with their SACU partner countries, they hoped to reform the allocation mechanism of the development component of the SACU, taking into account the needs of the poorest members.[16]

25. **The authorities stressed that they were strengthening the institutional framework for the development, execution, monitoring, and evaluation of new programs for scaling up poverty reduction expenditures** (Box 1). While encouraging the authorities to continue their ongoing efforts to restructure and realign expenditure priorities in line with their poverty reduction strategy, the staff stressed the need to set expenditure priorities with reference to a sustainable medium-term expenditure framework, taking into account fiscal sustainability and absorptive capacity criteria. The recurrent cost of the planned scaling up of outlays related to the poverty reduction strategy would have to be clearly identified, as well as the measures envisaged to cover these outlays on a sustainable basis. The staff strongly recommended that the authorities assess the impact of the new expenditures on the wage bill, materials and maintenance, other current and capital outlays, and estimate the "headroom" created by the planned phasing out of outlays not related to poverty reduction. Such an assessment would provide a basis for ensuring an appropriate mix of recurrent and capital outlays, which is important for efficient and sustainable public service delivery, and for the mobilization of donor funding. In this context, the staff emphasized the importance of containing the government wage bill under the government's Public Sector Reform and Improvement Program, to provide the needed savings for social spending.

26. **The authorities informed the staff that they were pursuing public-private partnerships, with a focus on improving infrastructure and the delivery of public services in the health and education sectors**. They have started improving primary health services by training health workers, building a network of clinics and medicine distribution centers, and upgrading a major hospital with support from the International Finance Corporation. The authorities noted that, using primarily their own resources, they were on target to provide free primary education throughout Lesotho next year and that they would rely on public-private partnerships to further improve education facilities. The staff expressed strong support for improving services in the key social sectors but cautioned against incurring future liabilities that

[16] Article 34 of the 2002 SACU Agreement states that distribution of the development component "shall be weighted in favor of the less developed member states."

would be inconsistent with the poverty reduction strategy and repayment capacity of the budget. It noted that long-term financial leases were comparable to nonconconcessional debt.

Box 1. Reforms of Public Resource Management

The reform of public financial management aims to improve budget planning, execution, and reporting, as well as transparency and financial accountability. As part of the reforms, a medium-term expenditure framework was introduced, cash accounts were consolidated, and audited accounts submitted in 2003. In addition, the authorities began to reorganize the treasury's top management and are at an advanced stage of improving GOLFIS, the *Government of Lesotho Financial Information System*. The government is working to:

- expand the coverage of the central government fiscal operations;
- ensure that all revenues and grants, expenditures, donor-funded projects, and debt data are fully captured in GOLFIS;
- establish a single treasury account, and integrate all government accounts into it with regular reconciliation;
- strengthen the Accountant General's office and train its staff in financial management; and
- review the classification of government expenditure, so as to better track poverty-related spending.

The Public Sector Improvement and Reform Program is a multidonor-supported program coordinated by the World Bank, which aims to increase the efficiency and effectiveness of the public sector. A major component of the program is the public financial management subprogram. The program will:

- implement an integrated planning and budgeting process;
- integrate the accounting, revenue, and expenditure management systems;
- strengthen macroeconomic analysis and forecasting linked to fiscal policy formulation and budget performance monitoring;
- secure the effective participation of the Cabinet in the budget process;
- strengthen the role of independent oversight; and
- modernize the procurement system.

27. **The staff indicated that Lesotho's public resource management was being hampered by a lack of reliable, comprehensive, and timely data for fiscal analysis and budget management, as evidenced in the significant differences between the fiscal and monetary outturn data for 2004/05.** The staff explained that the authorities could have avoided most of the inconsistencies between the fiscal accounts, which show a surplus of 3.7 percent of GDP, and the monetary accounts, which imply an additional 5.4 percentage points of GDP surplus in the last fiscal year, as well as between these data and national accounts and balance of payments statistics, by implementing the measures already formulated with Fund technical assistance. The staff worked with the Lesotho representatives to address these data inconsistencies, and ensure an adequate database through 2004/05 for surveillance purposes. In light of this, the authorities expected to make further progress in improving the database, including those relating to fiscal and monetary accounts, recognizing that it would help them strengthen the management of treasury operations and better control their expenditure commitments.

C. External Policies and the Monetary Framework

28. **The authorities explained that under the current exchange rate parity, regional trade was facilitated and progress was made in achieving fiscal and monetary discipline and reducing inflationary pressures.** However, they were concerned that the country's external competitiveness had been weakened by adverse exogenous exchange rate movements that were large and could not be offset by wage adjustments. As this had a contractionary impact on output and employment, they indicated that they were exploring with their CMA partners ways in which the common exchange rate arrangement could be modified to promote long-term growth in the smaller member countries. In the meantime, the authorities planned to rely on sound macroeconomic policies, including prudent fiscal restraints and structural reforms to enhance competitiveness. In the context of the latter, the staff noted that in view of the recent output and job losses, consideration should be given, if feasible, to greater wage flexibility and avoiding a rigid adherence to minimum wages. Nevertheless, the staff recognizes that the scope for exercising wage flexibility was constrained because in the context of collaboration with the International Labour Organization and major US garment importers, the authorities are abiding by agreed minimum labor standards.[17]

29. **The authorities stated that they would continue to maintain an open trade and exchange system**. Lesotho's trade policies are largely dictated by its SACU membership—essentially implying free trade with its regional partners and common external trade policies. In the context of the SACU and the SADC, Lesotho is actively pursuing free trade arrangements and trade partnerships, including with the European Union and the United States, which would compress customs revenues.

30. **With regard to a monetary framework, the authorities recognized that, with the exchange rate fixed at par to the rand and the virtual absence of exchange controls--**

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[17] These implicitly include a wage floor, or a so-called "living wage." Currently, this wage floor is 650 maloti (about US$100) per month in the garment sector.

including on capital movements to and from South Africa--Lesotho had no autonomy in determining its monetary policy. Nevertheless, they explained that they considered it useful to have an indicative monetary framework for 2005/06 that targeted net international reserves of about four months of imports and included a realistic projection of money demand, taking into account the projected slight decline in real GDP and the inflation rate projection. Such a framework would indicate the limits to be observed with regard to two crucially important policy variables, namely net domestic assets and the government's net creditor position in the banking system. On this basis, the staff estimates that after the government allows for a reasonable increase in credit to the private sector, net domestic assets should decline by about 4 percent in terms of the beginning-of-period money stock. This decrease is possible if the government builds up deposits in the banking system of about 2 percent of GDP, consistent with the projected overall fiscal surplus.

D. Structural Reforms

31. **The government's structural reform agenda includes measures designed to increase labor productivity and contain domestic cost pressures** (Box 2). The staff strongly supports the authorities' efforts to expand training and skill enhancing programs in the manufacturing sector. Given the high unemployment rate in that sector, the staff advised the authorities to encourage the various parties participating in wage negotiations to take into account productivity and terms of trade movements. In this context, it also emphasized the importance of exercising adequate restraints on public sector wage increases to avoid triggering comparable wage demands in the rest of the economy. The authorities stated that they would consider subsidies to the textile sector to help avoid further declines in employment. The staff cautioned the authorities against the risk of creating pressures for granting subsidies to other sectors, incurring large fiscal costs, distorting incentives, and possibly weakening fiscal transparency and accountability. The authorities indicated that any subsidy scheme would be designed carefully to protect against these risks and launched only if it was likely to yield net benefits in terms of investment inflows, output and employment.

32. **To attract foreign investment, the authorities are seeking to improve the investment climate.** They expressed their intention to accelerate the reforms designed to remove the legal and regulatory impediments to private sector development. They also plan to improve infrastructure facilities and expect to complete the privatization of the Lesotho Electricity Company by the end of next year, which should make the electricity supply more regular. With these measures, they hope to attract more foreign investment, including setting up a knitting mill so that garment exporters will have a domestic source of fabric, thereby maintaining duty-free access to the U.S. market after 2007.

Box 2. Enhancing External Competitiveness Through Structural Reforms

The government's structural reform program includes the following key elements:

Raising labor productivity to strengthen competitiveness. Having identified lack of skills as a key factor contributing to low labor productivity, the government is developing an industry-led, demand-driven skills-development program, with the private sector and donors sharing the cost. A donor-supported pilot training project has already yielded productivity gains of about 20 percent. Aside from the two priority sectors, garments and sandstone mining, training will also be launched to promote growth in agriculture, agro processing, and tourism.

Reducing the costs of investing and doing business in Lesotho. Key measures aim to (i) remove the obstacles to market entry by simplifying company registration and industrial licensing procedures and requirements, and replacing trade licensing with a registration process; (ii) improve immigration services by streamlining and simplifying the procedures to issue basic documents such as visas and, work, residency, and import permits; (iii) establish a one-stop window for customs clearance of imports and exports; (iv) strengthen the public institutions supporting private sector development, including an investment promotion center, the commercial and labor courts, and the anticorruption commission; and (v) amend trade and investment laws (e.g., the 1969 Industrial Licensing Act, the Pioneer Industries Encouragement Act, and the Aliens Control Act) in line with best international practices. In addition, the bottlenecks in infrastructure are to be addressed, including in the provision of water, electricity, and transport services, by increasing the efficiency and reliability of service delivery.

Improving access to credit and financial services. This would include developing leasing facilties, collateralized lending, microfinancing and community-based financial institutions, as well as implementing land tenure and mortgage legislation reforms. The Post Bank started operations in February 2005 and has attracted about 5,000 depositors, mainly from rural areas, as of end-June. In addition, the central bank has launched a rural credit guarantee scheme to support bank lending to the agricultural sector. The banks are collaborating to set up a credit registry that would contain relevant data on borrowers' credit history. In addition the authorities are finalizing an implementation plan focusing on the financial sector and legislative reforms under a project supported by the U.S. Millennium Challenge Corporation.

Supporting economic diversification. The government is developing a program to (i) attract new foreign investors; (ii) retain and expand the existing foreign direct investment base in the garment industry, with a view to developing input sourcing and market linkages within Africa; and (iii) support the local private sector in developing high value-added products and activities, such as horticulture, mining, and tourism. Agricultural development is expected to be supported by improved extension services and projects to supply water to the lowlands.

33. **On financial sector reform, the authorities focused on measures to increase competition and improve the private sector's access to bank credit**. The measures include developing a three-tier banking system consisting of (a) large foreign-owned banks, (b) locally based cooperatives and mid-sized banks, and (c) microfinance institutions; strengthening banking regulation through the introduction of risk-based supervision; amending the relevant laws to

remove obstacles to bank lending, notably the Matrimonial Act,[18] and the Lands Act; and putting in place a functioning payment system. The latter involves modernizing the payment system by revising the outdated legislation that currently applies, and by moving from manual data entry and clearing procedures (which are error prone) to electronic transfer payments.

34. **Product and market diversification is an essential part of the authorities' strategy to reduce Lesotho's vulnerability to shocks.** Key to the authorities' diversification effort is the development of agriculture and the agroprocessing sector. The authorities noted that the construction of the Metolong Dam would provide much-needed water to the lowlands to help Lesotho realize its agricultural potential. Discussions continue with the U.S. Millennium Challenge Corporation to obtain grant financing for this project. As indicated in their poverty reduction strategy, the authorities are also pursuing reforms to lower the cost of trading with their SACU partner countries and the rest of the world, including through a duty-credit certificate scheme that provides substantial incentives to exporters. These efforts are expected to foster the development of new growth sectors, such as horticulture, sandstone products, mining, and tourism.

E. Capacity Building and Technical Assistance Issues

35. **The authorities expressed strong interest in continued Fund involvement through capacity building and technical assistance**. They requested the staff's assistance in fiscal and public resource management, financial sector reform and prudential supervision, and design of macroeconomic framework. Specifically, the authorities expressed strong interest in receiving Fund staff assistance in drafting an appropriate law for electronic banking; reviewing their study conducted to determine an adequate level of foreign reserves once it is completed and providing field training to Lesotho officials in financial programming.

IV. Staff Appraisal

36. **Over the past two fiscal years, Lesotho's economic performance has been mixed: its overall financial situation has improved, but real economic activity has remained sluggish**. The government's fiscal position and the external current account improved markedly, the inflation rate fell, and official net international reserves increased. The government succeeded in containing its domestic and foreign debt at manageable levels. However, growth performance has weakened, reflecting a substantial real appreciation of the exchange rate that has weakened external competitiveness, the phasing out of textile quotas by industrial countries, a continuing decline in Lesotho's terms of trade, and persistent drought conditions. As a result of these developments and the high incidence of HIV/AIDS, poverty remains widespread.

37. **The key challenge facing the Lesotho authorities is to generate more rapid and broad-based economic growth, so that significant progress can be made toward achieving**

[18] Under current legislation, married women need their husbands' agreement to engage in financial transactions, including obtaining credit.

the MDGs and reducing poverty. These objectives will have to be achieved in the context of a medium-term outlook that is clouded by the prospects of a further loss of trade preferences, a declining trend in SACU revenue, and a contraction of inward remittances from migrant workers in South Africa. There is therefore an urgent need for the country to broaden its production and export base to reduce its vulnerability to future shocks.

38. **To address these challenges, the authorities will need to implement a growth-oriented development strategy that focuses both on consolidating the recent gains in macroeconomic stability and on accelerating structural reforms to strengthen competitiveness and promote private sector development.** With the exchange rate of the loti pegged at par to the rand and the virtual absence of exchange controls on external current and capital transactions under the CMA, the authorities will have to sustain their recent record of fiscal prudence to cope with the anticipated adverse shocks. Moreover, structural reforms will need to be implemented to enhance labor productivity and ensure wage restraint, address bottlenecks in infrastructure and public service delivery, eliminate the legal and administrative impediments to investment, increase domestic financial intermediation (including efforts to broaden access to domestic credit facilities), and expand trade and investment links with the regional markets.

39. **It will be important to limit future fiscal deficits to levels that can be financed largely through available inflows of foreign grants and concessional loans**. This would support the continuation of a prudent public debt management policy and reduce the risk of weakening the government's net creditor position vis-à-vis the banking system and the country's official net international reserve position. It would also provide room to expand private sector credit without pushing domestic interest rates much higher than those prevailing in South Africa. Such a cautious stance of fiscal policy would be appropriate, given that the anticipated shocks are expected to have permanent effects.

40. **To achieve the necessary fiscal restraint, the authorities need to take steps to strengthen both revenue collection and public expenditure management**. The expected declining trend in SACU revenues as a result of trade liberalization makes it necessary to strengthen efforts to broaden the tax base and improve tax administration. To contain revenue losses, the authorities will need to press forward with their plans to upgrade the hardware and provide appropriate training to the staff of the LRA. Moreover, they will also need to strengthen revenue mobilization efforts by implementing the planned ASYCUDA project and addressing government entities' noncompliance with VAT payment and refund procedures.

41. **With regard to improving public expenditure management, the staff welcomes the authorities' efforts to accelerate the ongoing restructuring and realignment of expenditures to reflect the priorities of the poverty reduction strategy and overall budgetary financing constraints, and to strengthen the institutional framework for the execution, monitoring, and evaluation of public expenditure programs.** In preparing to scale up outlays for poverty reduction measures, the authorities will need to ensure that any such scaling up is consistent with a sustainable medium-term expenditure and fiscal framework and with the country's absorptive capacity. In view of the existing and anticipated constraints on budgetary resources, it will be important to assess the recurrent cost implications of new outlays, implement measures to cover

these costs on a sustainable basis, create fiscal space by phasing out outlays in other categories, and expedite the implementation of the Public Sector Reform and Improvement Program so as to contain the wage bill and improve public service delivery.

42. **The staff welcomes Lesotho's recent progress in strengthening efforts to address the incidence of HIV/AIDS, especially the steps taken to strengthen the institutions involved in managing related programs, coordinate and facilitate the extension of such programs across the country, and set up appropriate monitoring and evaluation systems**. It encourages the authorities to accelerate similar efforts that are under way in the other priority areas related to poverty reduction.

43. **The authorities recognize that under the current exchange rate regime of the CMA countries, Lesotho's official foreign reserve position will need to be protected through appropriately tight fiscal and domestic credit policies**. Accordingly, the staff welcomes the authorities' intention to maintain prudent limits on the expansion of net domestic assets and on any weakening of the government's net creditor position in the banking system.

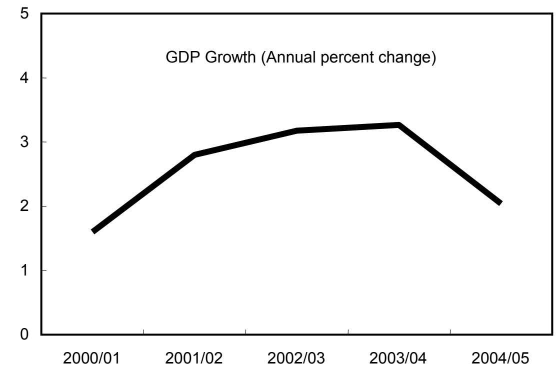
44. **The staff encourages the authorities to intensify their ongoing efforts to promote financial sector development and intermediation through improvements in the legal and regulatory framework**. In this connection, the authorities should press ahead with the planned reforms to promote leasing and microfinance activities, and remove legal obstacles to bank lending (especially those unfavorably affecting women, and land transfer procedures). The authorities should support these efforts by taking steps to improve the payments system and banking supervision, for which they are receiving technical assistance from the Fund.

45. **The authorities' plans to strengthen regional trade and investment links, especially with South Africa, are commendable**. The envisaged structural reforms and the various sectoral strategies to exploit Lesotho's potential for expanding tourism, horticulture, diamond and sandstone mining, and agro-industries could not only enhance the country's opportunities for strengthening regional trade and investment links, but also help it achieve the product and market diversification that the authorities are seeking. In this context, the authorities are urged to avoid fiscal subsidies that could distort incentives, entail large fiscal costs, and possibly weaken fiscal transparency and accountability.

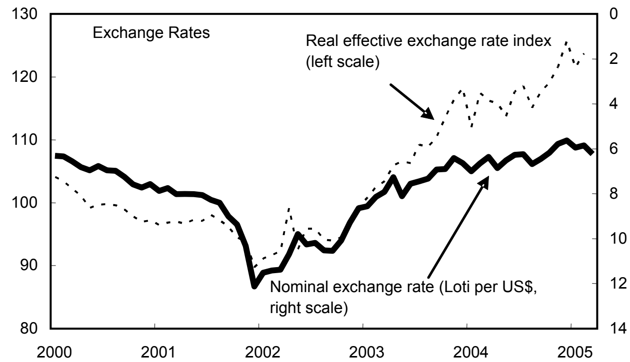
46. **It is proposed that Lesotho remain on the standard 12-month consultation cycle.**

Appendix Figure 1. Lesotho: Macroeconomic Indicators

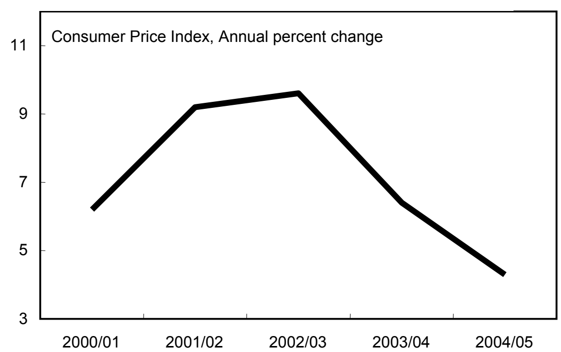
Growth weakened in 2004/05 ...



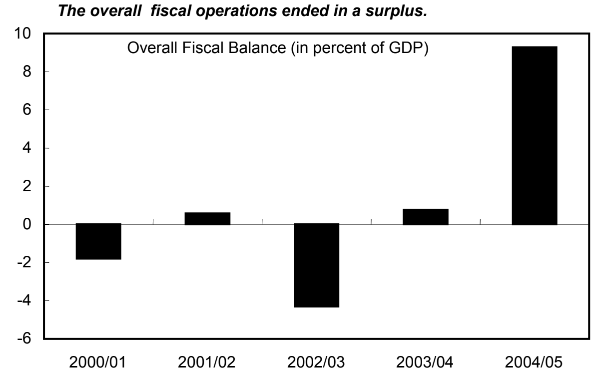
... as the real exchange rate appreciation continued to hurt export competitiveness.



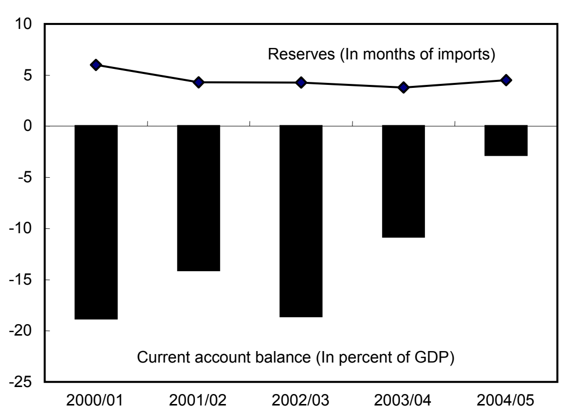
The inflation rate declined further.



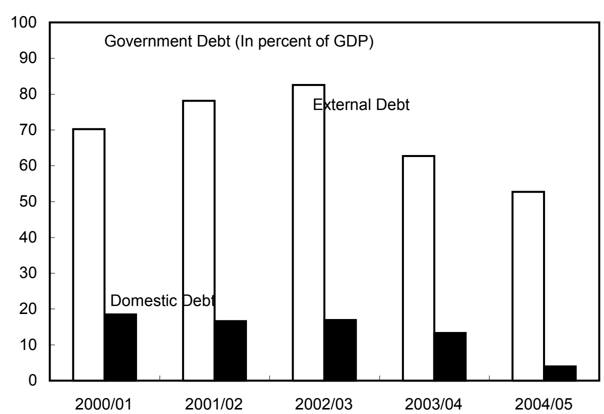
The overall fiscal operations ended in a surplus.



The external current account improved markedly and international reserves increased....



... and gross government debt in percent of GDP declined.



Source: Lesotho authorities and Fund staff estimates.

Table 1. Lesotho: Selected Economic and Financial Indicators, 2002/03-2009/10 [1/]

			Est.	Projections				
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
	(Annual percentage change, unless otherwise specified)							
National income and prices								
Real GDP	3.2	3.3	2.0	-0.7	2.2	1.7	2.1	2.5
Real GNP	3.4	3.6	2.3	0.3	1.8	1.1	1.5	1.6
Consumer price index (period average)	9.6	6.4	4.3	5.0	5.0	5.0	5.0	5.0
Consumer price index (end of period)	7.7	5.2	3.7	5.0	5.0	5.0	5.0	5.0
GDP (in millions of maloti)	7,564	8,251	8,644	8,771	9,361	9,969	10,688	11,538
GNP (in millions of maloti)	9,303	10,184	10,701	10,965	11,661	12,355	13,170	14,104
External sector								
Exports, f.o.b .2/	29.8	32.0	36.4	-11.6	3.5	-2.3	1.0	4.4
Imports, f.o.b. 2/	22.6	27.2	24.9	-2.0	1.5	0.6	2.7	1.9
Net labor income 2/	25.3	27.1	26.0	0.1	1.5	0.6	2.7	1.9
Nominal effective exchange rate 3/	13.0	15.0	...	...	...	...	...	...
Real effective exchange rate 3/	12.0	12.0	...	...	...	...	...	...
Government budget								
Revenue (excluding grants)	8.9	13.3	12.1	17.3	-6.9	5.9	4.4	4.9
Total expenditure and net lending	24.5	-2.9	5.8	16.3	5.3	5.8	5.6	5.5
Current expenditure	23.6	2.5	5.7	9.1	3.9	5.3	5.4	5.2
Capital expenditure and net lending	28.2	-22.0	6.3	49.6	10.3	7.6	6.2	6.6
Money and credit								
Net foreign assets 4/	-70.6	-11.1	34.1	6.9	...	...	...	...
Net domestic assets 4/	73.4	16.5	-27.9	-4.1	...	...	...	...
Credit to the government 4/	15.0	-5.8	-27.8	-7.4	...	...	...	...
Credit to the rest of the economy 5/	-45.8	16.0	8.8	4.3	...	...	...	...
Broad money	2.7	5.3	6.2	2.8	...	...	...	...
Velocity (GNP/average broad money)	4.3	4.5	4.5	4.4	...	...	...	...
Interest rate 6/	12.1	12.0	9.0	...	...	...	...	...
	(In percent of GDP, unless otherwise specified)							
Investment and saving								
Investment	42.9	40.5	34.9	35.4	35.8	36.0	36.0	36.0
Public	11.0	7.7	7.5	11.4	11.7	11.8	11.7	11.6
Private	24.5	27.2	24.0	24.0	24.1	24.2	24.3	24.4
Lesotho Highlands Water Project	7.4	5.6	3.4	0.0	0.0	0.0	0.0	0.0
Gross national savings (including remittances)	24.3	29.8	32.1	28.9	26.7	26.8	25.6	26.5
Public	9.2	11.0	13.2	18.0	12.0	12.3	11.8	11.5
Private	15.1	18.8	18.9	10.9	14.7	14.5	13.8	15.0
Government budget								
Revenue	40.1	41.7	44.6	51.6	45.0	44.7	43.6	42.3
Total grants	3.9	2.2	2.6	3.1	3.1	3.1	3.1	3.1
Total expenditure and net lending	48.4	43.1	43.5	49.9	49.2	48.9	48.2	47.1
Overall balance (excluding grants)	-8.3	-1.4	6.5	1.7	-4.3	-4.2	-4.6	-4.8
Overall balance (including grants)	-4.3	0.8	9.1	4.8	-1.1	-1.1	-1.5	-1.7
Domestic balance	3.8	3.8	11.8	8.3	2.4	2.6	2.1	1.9
Domestic primary balance	-2.9	2.3	5.5	6.7	0.4	0.5	0.2	0.1
Government debt 7/	99.4	76.0	60.6	64.9	61.4	57.1	53.3	51.4
Domestic debt	16.9	13.3	7.5	9.6	7.8	5.4	3.5	2.9
External debt 7/	82.5	62.7	53.1	55.2	53.6	51.7	49.9	48.5
Domestic debt, net of deposits	0.8	-2.2	-3.7	-3.8	-2.3	-1.2	-0.2	0.2
External debt-service ratio 8/	11.8	9.1	7.3	12.5	7.9	7.7	6.9	5.3
Current account balance								
Excluding official transfers	-35.1	-25.7	-22.2	-28.4	-26.1	-26.1	-26.3	-24.5
Including official transfers	-18.6	-10.8	-2.8	-6.6	-9.1	-9.3	-10.4	-9.5
Gross official reserves (end of period)								
(In millions of U.S. dollars)	408.4	436.9	507.7	474.4	442.6	418.7	384.3	379.4
(In months of imports of goods and services)	4.3	3.8	4.5	4.1	3.8	3.5	3.2	3.1

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, new trade weights from 2004. A minus sign indicates 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 services.

Table 2. Lesotho: Central Government Operations, 2002/03-2009/10 [1/]

	2002/03	2003/04	Est. 2004/05	Budget 2005/06	Staff Proj. 2005/06	Projections 2006/07	2007/08	2008/09	2009/10
	(In millions of maloti)								
Revenue	3,034.7	3,439.3	3,856.0	4,680.6	4,524.4	4,211.2	4,460.9	4,658.4	4,884.8
Tax revenue	2,575.9	2,887.5	3,376.3	4,120.0	3,963.8	3,612.9	3,823.7	3,975.3	4,147.4
Customs revenue (SACU) 2/	1,470.0	1,421.6	2,012.4	2,413.9	2,413.9	1,961.6	2,062.2	2,082.8	2,103.0
Noncustoms tax revenue	1,105.9	1,465.9	1,363.9	1,706.1	1,549.9	1,651.3	1,761.5	1,892.5	2,044.4
Income taxes	663.3	852.5	729.2	922.3	798.1	851.7	907.1	972.5	1,049.8
Sales tax / value-added tax (VAT)	343.7	519.3	541.7	688.2	656.2	697.8	746.4	804.6	870.7
Petrol levy	86.3	80.6	35.8	61.4	61.4	65.3	69.2	73.7	79.0
Other tax revenues	12.6	13.5	57.2	34.2	34.2	36.5	38.9	41.6	44.9
Nontax revenue	458.8	551.8	479.7	560.6	560.6	598.3	637.2	683.1	737.5
Grants	296.3	177.8	224.3	272.6	272.6	290.9	309.8	332.2	358.6
Total expenditure and net lending	3,659.1	3,554.7	3,762.3	4,780.7	4,375.3	4,609.2	4,877.8	5,150.8	5,436.5
Current expenditure	2,856.9	2,929.3	3,097.7	3,746.4	3,381.1	3,512.8	3,697.9	3,898.3	4,101.9
Wages and salaries	1,082.1	1,123.2	1,176.9	1,325.9	1,271.1	1,334.6	1,401.3	1,471.4	1,545.0
Interest payments	219.7	216.4	156.2	170.3	170.3	141.5	158.0	181.4	199.2
External	109.5	90.5	91.1	83.6	83.6	62.2	58.2	57.7	58.0
Domestic	110.2	125.9	65.1	86.7	86.7	79.3	99.8	123.8	141.3
Other expenditure	1,555.1	1,589.7	1,764.6	2,250.2	1,939.7	2,036.7	2,138.5	2,245.5	2,357.7
Goods and services	1,045.7	958.4	985.5	1,260.5	1,034.8	1,086.5	1,140.8	1,197.9	1,257.8
Other spending on goods and services	696.3	728.5	708.3	...	...	...	...	...	...
Transfer and subsidies	509.4	631.3	779.1	989.7	904.9	950.2	997.7	1,047.6	1,099.9
Pensions and gratuities	...	118.9	194.5	291.1	291.1	305.7	320.9	337.0	353.8
Of which: old age pensions	...	0.0	45.0	135.0	135.0	141.8	148.8	156.3	164.1
Subventions and transfers	...	512.4	584.6	698.6	613.8	644.5	676.7	710.6	746.1
Of which: scholarships	...	215.1	203.4	...	...	...	...	...	...
Capital expenditure	833.9	634.9	650.5	1,043.4	1,003.4	1,096.4	1,179.9	1,252.5	1,334.5
Domestically funded	322.0	314.3	298.7	495.8	495.8	520.6	566.6	595.0	624.7
Externally funded	511.9	320.6	351.8	547.6	507.6	575.8	613.3	657.5	709.8
Grant funded	235.9	140.2	168.5	272.6	272.6	290.9	309.8	332.2	358.6
Loan funded	276.0	180.4	183.3	275.0	235.0	284.9	303.5	325.4	351.2
Net lending	-31.7	-9.5	14.1	-9.1	-9.1	0.0	0.0	0.0	0.0
Unexplained net revenue 3/	0.0	...	470.1	...	...	...	...	...	...
Overall balance, before grants 3/	-624.4	-115.4	563.8	-100.1	149.1	-398.0	-417.0	-492.4	-551.6
Overall balance, after grants 3/	-328.1	62.4	788.1	172.5	421.7	-107.1	-107.1	-160.2	-193.0
Domestic balance 4/	-1.0	309.7	1,020.8	522.0	731.1	221.7	254.6	222.8	216.2
Total financing	328.1	-62.4	-788.1	-172.5	-421.7	107.1	107.1	160.2	193.0
External financing	56.4	-25.7	-60.2	-158.2	-240.7	-13.9	11.0	59.3	145.3
Loan drawings	276.0	180.4	183.3	275.0	235.0	284.9	303.5	325.4	351.2
Amortization	-219.6	-206.1	-243.5	-433.2	-475.7	-298.8	-292.5	-266.0	-206.0
Domestic financing	271.9	-37.3	-727.9	-14.3	-181.0	121.0	96.1	100.9	47.8
Bank	320.8	-129.6	-638.6	…	…	…	…	…	…
Nonbank	-48.9	92.3	-89.3	…	…	…	…	…	…
Financing gap	0.0	0.0	0.0	…	…	…	…	…	…

Table 2. Lesotho: Central Government Operations, 2002/03-2009/10 1/ (concluded)

			Est.	Budget	Staff Proj.	Projections			
	2002/03	2003/04	2004/05	2005/06	2005/06	2006/07	2007/08	2008/09	2009/10
	(In percent of GDP, unless otherwise indicated)								
Revenue	40.1	41.7	44.6	53.4	51.6	45.0	44.7	43.6	42.3
Customs revenue (SACU) 2/	19.4	17.2	23.3	27.5	27.5	21.0	20.7	19.5	18.2
Noncustoms tax revenue	14.6	17.8	15.8	19.5	17.7	17.6	17.7	17.7	17.7
Nontax revenue	6.1	6.7	5.5	6.4	6.4	6.4	6.4	6.4	6.4
Grants	3.9	2.2	2.6	3.1	3.1	3.1	3.1	3.1	3.1
Total expenditure and net lending	48.4	43.1	43.5	54.5	49.9	49.2	48.9	48.2	47.1
Current expenditure	37.8	35.5	35.8	42.7	38.5	37.5	37.1	36.5	35.6
Wages and salaries	14.3	13.6	13.6	15.1	14.5	14.3	14.1	13.8	13.4
Interest payments	2.9	2.6	1.8	1.9	1.9	1.5	1.6	1.7	1.7
External	1.4	1.1	1.1	1.0	1.0	0.7	0.6	0.5	0.5
Domestic	1.5	1.5	0.8	1.0	1.0	0.8	1.0	1.2	1.2
Other expenditure	20.6	19.3	20.4	25.7	22.1	21.8	21.5	21.0	20.4
Goods and services	13.8	11.6	11.4	14.4	11.8	11.6	11.4	11.2	10.9
Transfers and subsidies	6.7	7.7	9.0	11.3	10.3	10.2	10.0	9.8	9.5
Pensions and gratuities	...	1.4	2.3	3.3	3.3	3.3	3.2	3.2	3.1
Subventions and transfers	...	6.2	6.8	8.0	7.0	6.9	6.8	6.6	6.5
Capital expenditure	11.0	7.7	7.5	11.9	11.4	11.7	11.8	11.7	11.6
Of which: domestically funded	...	3.8	3.5	5.7	5.7	5.6	5.7	5.6	5.4
Net lending	-0.4	-0.1	0.2	-0.1	-0.1	0.0	0.0	0.0	0.0
Unexplained net revenue 3/		... .	5.4	...	...	...	...	...	...
Overall balance, before grants 3/	-8.3	-1.4	6.5	-1.1	1.7	-4.3	-4.2	-4.6	-4.8
Grants from abroad	3.2	1.7	2.1	2.5	2.5	2.5	2.5	2.5	2.5
Overall balance, after grants 3/	-4.3	0.8	9.1	2.0	4.8	-1.1	-1.1	-1.5	-1.7
Domestic balance 4/	0.0	3.8	11.8	6.0	8.3	2.4	2.6	2.1	1.9
Total financing	4.3	-0.8	-9.1	-2.0	-4.8	1.1	1.1	1.5	1.7
External financing	0.7	-0.3	-0.7	-1.8	-2.7	-0.1	0.1	0.6	1.3
Domestic financing	3.6	-0.5	-8.4	-0.2	-2.1	1.3	1.0	0.9	0.4
Financing gap	0.0	0.0	0.0	0.0	...	...	...	...	...
	(In millions of maloti, unless otherwise indicated)								
Memorandum items:									
GNP at current prices	9,303	10,184	10,701	10,965	10,965	11,661	12,355	13,170	14,104
GDP at current prices	7,564	8,251	8,644	8,771	8,771	9,361	9,969	10,688	11,538

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

1/ Fiscal year from April to March.

2/ In 2005/06, M430 million in one-off windfall revenue was added to the trend SACU revenue

3/ The budget is on a cash basis. In 2004/05, net revenue was underrecorded in the authorities' fiscal accounts by M470.1 million. The amount has been added to the overall balance to match Central Bank of Lesotho data (the domestic financing requirement)

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

Table 3. Lesotho: Monetary Survey, 2002 - 2006

	2002	2003	2004				2005	2006
		Mar.	Mar.	Jun.	Sep	Dec	Mar.	Mar.
							Act.	Proj.
	(In millions of maloti)							
Net foreign assets	5,229.0	3,722.3	3,478.3	3,858.2	4,005.9	3,972.4	4,266.3	4,436.0
Central bank	4,474.6	2,949.7	2,565.9	2,822.7	2,772.9	2,846.8	2,949.6	3,096.2
Commercial banks	754.4	772.6	912.4	1,035.5	1,233.0	1,125.6	1,316.7	1,339.8
Net domestic assets	-3,095.9	-1,530.9	-1,169.9	-1,504.7	-1,531.6	-1,599.4	-1,814.5	-1,916.2
Domestic credit	432.3	321.4	275.9	74.6	30.5	-133.9	-312.4	-465.4
Claims on central government (net)	-511.0	-190.3	-317.5	-538.9	-539.5	-742.7	-958.1	-1,139.1
Central bank	-1,297.0	-792.2	-1,018.9	-1,205.0	-1,066.1	-1,228.3	-1,143.8	-1,324.8
Commercial banks	786.0	602.0	701.5	666.1	526.6	485.7	185.7	185.7
Claims on the rest of the economy	943.3	511.6	593.4	613.5	570.0	608.7	645.7	673.4
Other items (net)	-3,528.2	-1,852.3	-1,445.8	-1,579.3	-1,562.2	-1,465.4	-1,502.0	-1,450.5
Money and quasi money (M2)	2,133.1	2,191.3	2,308.4	2,353.5	2,474.3	2,373.0	2,451.8	2,519.8
Money	1,413.2	1,443.9	1,539.1	1,588.8	1,662.6	1,589.4	1,698.4	1,745.4
Of which: currency outside deposit money banks	164.1	178.6	207.6	189.7	219.6	204.5	212.6	218.5
demand deposits	1,032.4	1,103.4	1,163.2	1,230.3	1,272.7	1,197.5	1,296.9	1,332.8
Quasi money	719.9	747.5	769.3	764.6	811.7	783.6	753.4	774.3
Of which: time and savings deposits	719.9	747.5	769.3	764.6	811.7	783.6	753.4	774.3
	(Annual change in percent of beginning-of-year M2, unless otherwise specified)							
Net foreign assets	85.5	-70.6	-11.1	9.9	25.7	22.3	34.1	6.9
Central bank	76.8	-71.5	-17.5	-10.5	3.9	0.4	16.6	6.0
Commercial banks	8.7	0.9	6.4	20.4	21.8	21.9	17.5	0.9
Net domestic assets	-68.5	73.4	16.5	-5.5	-13.8	-19.0	-27.9	-4.1
Claims on central government (net)	3.7	15.0	-5.8	-20.1	-15.1	-25.1	-27.8	-7.4
Claims on the rest of the economy	-3.3	-20.2	3.7	3.2	0.3	2.7	2.3	1.1
Claims on the rest of the economy (yearly change)	-6.0	-45.8	16.0	13.5	1.1	11.1	8.8	4.3
Other items (net)	-68.9	78.6	18.6	11.4	1.1	3.4	-2.4	2.1
Money and quasi money (M2)	17.0	2.7	5.3	4.4	11.9	3.3	6.2	2.8
Quasi money (yearly change)	6.2	3.8	2.9	-10.9	2.9	3.1	-2.1	2.8
Memorandum item:								
Money multiplier (M2/reserve money)	7.8	7.0	7.7	8.2	7.1	6.4	5.6	5.6

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

Table 4. Lesotho: Commercial Banks' Quarterly Performance Ratios, 2004 - 2005

	2004			2005
	June	Sept.	Dec.	March
	(In percent)			
Performance ratios				
Capital adequacy				
Basel capital ratio	24	22	22	26
Nonperforming loans to total capital	5	1	1	1
Top 20 exposures to total capital	128	115	72	70
Asset quality				
Loans to deposit ratio	19	20	22	23
Earning assets to total assets	95	95	94	92
Nonperforming loans to total loans	2	1	1	1
Reserve for losses to total loans	4	4	3	3
Reserve for losses to non-performing loans	148	682	449	545
Liquidity Ratios				
Liquid assets to total deposits	100	86	100	129
Available reserves to total deposits	4	5	6	8
Liquid assets to total assets	69	61	65	82
Current assets to total current liabilities	76	67	73	97
Profitability ratios				
Net Income to average total assets (return on assets) 1/	1	2	3	1
Net Income to average total equity (return on equity) 1/	14	20	27	3
Total expenses to total income	70	72	69	80
Solvency ratios				
Total debt ratio	6	6	10	10

Source: Central Bank of Lesotho.

1/ In 2005, affected by the operations of two new banks.

Table 5. Lesotho: Balance of Payments, 2002/03 - 2009/10 1/
(In millions of U.S. dollars)

	2002/03	2003/04	2004/05 Est.	2005/06 Proj.	Proj. 2006/07	2007/08	2008/09	2009/10
Trade balance	-433.5	-533.5	-607.9	-661.1	-658.6	-680.2	-708.6	-706.9
Exports, f.o.b.	381.1	503.0	686.2	606.5	627.7	613.4	619.7	646.7
of which : garments	269.3	350.5	520.9	416.1	416.1	378.6	359.7	359.7
Imports, f.o.b.	-814.7	-1,036.5	-1,294.1	-1,267.7	-1,286.3	-1,293.5	-1,328.2	-1,353.6
Services (net)	-22.3	-39.2	-36.9	-37.4	-37.2	-36.9	-37.6	-37.7
Receipts	38.6	51.1	65.9	62.1	64.9	67.2	69.8	72.6
Of which : water royalties (and power sales)	11.6	15.3	17.6	19.4	20.3	21.2	22.3	23.6
Payments	-61.0	-90.2	-102.8	-99.5	-102.1	-104.1	-107.4	-110.3
Income (net)	178.5	269.3	328.9	323.0	332.8	338.5	345.1	349.9
Labor income (net)	178.8	269.7	316.1	294.1	301.2	308.2	316.3	323.3
Receipts	201.7	296.4	344.7	308.9	317.8	325.6	334.6	342.6
Of which : miners' wages	162.5	242.1	279.8	245.2	250.8	255.2	261.2	266.3
Payments	-22.9	-26.7	-28.6	-14.7	-16.6	-17.4	-18.3	-19.3
Investment income (net)	-0.3	-0.4	12.8	28.9	31.6	30.3	28.8	26.5
Receipts	24.3	29.3	43.8	47.5	47.9	46.0	44.6	42.6
Payments	-24.6	-29.7	-31.0	-18.7	-16.3	-15.8	-15.8	-16.0
Of which : interest on debt	-12.4	-13.2	-12.0	-13.3	-10.8	-10.0	-9.7	-9.6
Unrequited transfers	133.1	179.8	277.4	290.6	239.5	247.1	246.4	245.8
Official	128.5	171.8	268.5	281.7	230.4	237.8	236.9	236.2
Southern African Customs Union nonduty receipts	113.6	145.0	245.2	260.1	207.8	214.2	212.1	209.9
Rand compensation	6.0	18.1	11.7	7.4	7.7	8.1	8.5	9.0
Other	8.9	8.7	11.5 `	14.2	14.9	15.6	16.3	17.2
Private	4.7	8.0	8.9	8.9	9.1	9.3	9.5	9.7
Current account (including official transfers)	-144.2	-123.6	-38.6	-84.9	-123.5	-131.5	-154.7	-149.0
Current account (excluding official transfers)	-272.7	-295.4	-307.1	-366.6	-353.9	-369.3	-391.6	-385.1
Of which: LHWP 2/	-42.7	-54.7	-36.0	18.4	19.6	20.6	22.1	23.6
Capital and financial account	98.2	60.1	-0.9	105.0	125.8	133.7	156.7	150.8
Capital account (transfers received)	17.8	16.5	21.5	26.7	28.1	29.3	30.8	32.6
Financial account	80.4	43.6	-22.3	78.3	97.7	104.4	125.9	118.2
Direct investment (excl. LHDA) 3/	30.2	45.1	56.0	72.2	68.8	79.7	83.8	94.1
Financing LHWP (net)	58.6	75.8	66.8	0.0	0.0	0.0	0.0	0.0
Other investment	0.3	-48.9	-74.3	-27.2	-2.9	0.8	7.6	19.3
Assets 4/	-33.4	-62.8	-58.4	16.8	0.8	0.8	0.8	0.7
Liabilities	33.7	14.0	-15.9	-44.1	-3.6	0.1	6.8	18.5
Loans	0.2	-4.9	-8.5	-35.3	-1.9	1.8	8.5	20.2
Public and publicly guaranteed	0.6	-4.9	-8.5	-35.4	-2.0	1.6	8.3	19.8
Disbursements	24.2	23.7	31.0	34.6	41.2	43.1	45.3	47.9
Repayments	-23.5	-28.6	-39.5	-70.0	-43.2	-41.5	-37.0	-28.1
Private (net)	-0.4	-0.1	0.0	0.1	0.2	0.2	0.3	0.4
Other liabilities	33.5	18.9	-7.4	-8.8	-1.8	-1.7	-1.7	-1.7
Central Bank liabilities	31.7	1.5	2.1	-7.3	-1.5	-1.4	-1.4	-1.4
Commercial banks' liabilities	1.8	17.3	-9.5	-1.5	-0.3	-0.3	-0.3	-0.3
Change in reserve assets 4/	-8.7	-28.5	-70.8	33.3	31.8	23.9	34.4	4.9
Valuation adjustment	21.6	46.0	11.3	-20.1	-2.4	-2.1	-2.0	-1.8
Errors and omissions	24.4	17.5	28.2					
Memorandum items:			(In percent of GDP, unless otherwise indicated)					
Trade balance	-55.9	-46.4	-44.0	-51.2	-48.6	-48.1	-47.7	-44.9
Current account (including official transfers)	-18.6	-10.8	-2.8	-6.6	-9.1	-9.3	-10.4	-9.5
Current account (excluding official transfers)	-35.1	-25.7	-22.2	-28.4	-26.1	-26.1	-26.3	-24.5
Gross off. reserves (in months of imports GNFS)	4.3	3.8	4.5	4.1	3.8	3.5	3.2	3.1

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

1/ Financial year is April-March.
2/ Lesotho Highlands Water Project.
3/ Direct investment has been revised downwards owing to reclassification of some flows in the financial account.
3/ Lesotho Highlands Development Authority.
4/ Transaction based data, a minus sign indicates an increase in reserves.

Table 6. Lesotho Medium-Term Scenarios, 2004/05-2009/10

		Projections				
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Baseline Scenario:						
	(Annual percentage change, unless otherwise indicated)					
National income and prices						
GDP at constant prices	2.0	-0.7	2.2	1.7	2.1	2.5
GDP deflator, percent change	2.2	3.0	4.4	4.7	5.0	5.4
Nominal GDP (millions of US dollars)	1,382	1,291	1,355	1,414	1,487	1,573
Nominal GDP (millions of maloti)	8,644	8,771	9,361	9,969	10,688	11,538
	(In percent of GDP, unless otherwise indicated)					
Investment - Savings						
Investment	34.9	35.4	35.8	36.0	36.0	36.0
Gross National Savings	32.1	28.9	26.7	26.8	25.6	26.5
Inverse incremental capital-output ratio (In US dollars)	0.13	0.04	0.18	0.17	0.19	0.20
External sector						
Net textile exports (millions of US dollars)	293	234	234	213	202	202
Current account balance (percent of GDP)	-2.8	-6.6	-9.1	-9.3	-10.4	-9.5
	(In percent of GDP, unless otherwise indicated)					
Central government finance						
Total revenue and grants	47.2	54.7	44.7	47.9	46.7	45.4
Total expenditure and net lending	43.5	49.9	49.2	48.9	48.2	47.1
Overall balance (including grants) 1/	9.1	4.8	-1.1	-1.1	-1.5	-1.7
Overall balance (excluding grants) 1/	6.5	1.7	-4.3	-4.2	-4.6	-4.8
Domestic balance 2/	11.8	8.3	2.4	2.6	2.1	1.9
Reform Scenario: 3/						
	(Annual percentage change, unless otherwise indicated)					
National income and prices						
GDP at constant prices	2.0	-0.6	2.8	2.6	3.4	4.1
GDP deflator, percent change	2.2	3.0	4.5	4.8	5.0	5.8
Nominal GDP (millions of US dollars)	1,382	1,271	1,322	1,393	1,482	1,633
Nominal GDP (millions of maloti)	8,644	8,771	9,422	10,125	10,992	12,110
	(In percent of GDP, unless otherwise indicated)					
Investment - Savings						
Investment	34.9	35.5	37.8	37.7	37.6	37.7
Gross National Savings	32.1	29.2	28.7	28.6	27.4	28.2
Inverse incremental capital-output ratio (In US dollars)	0.13	0.04	0.18	0.18	0.21	0.24
External sector						
Net textile exports (millions of US dollars)	293.1	234	236	219	213	220
Current account balance (percent of GDP)	-2.8	-6.2	-9.1	-9.2	-10.3	-9.5
	(In percent of GDP, unless otherwise indicated)					
Central government finance (fiscal year)						
Total revenue and grants	47.2	55.4	50.7	49.8	49.1	47.4
Total expenditure and net lending	43.5	50.9	51.7	51.0	50.6	49.0
Overall balance (including grants) 1/	9.1	4.5	-1.0	-1.2	-1.5	-1.6
Overall balance (excluding grants) 1/	6.5	1.4	-5.0	-5.3	-6.0	-6.1
Domestic balance 2/	11.8	8.2	1.5	1.6	1.1	1.0

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

1/ The budget is on a cash basis. In 2004/05, net revenue was underrecorded in the authorities' fiscal accounts by M 470.1 million. The amount has been added to the overall balance to match Central Bank of Lesotho data (the domestic financing requirement)

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

3/ The reform scenario assumes the implementation of structural reform policies.

Table 7. Lesotho: Selected Social and Demographic Indicators

Population	
Population (2002, in millions):	2.2
Annual rate of growth (2000-02):	0.97
Population 14 years and under (2002):	42 percent of total population
Density (2002):	59 people per square kilometer

Population characteristics (2002)		Health	
Life expectancy at birth (years)	53	Population per physician (1995)	18,519
Male	49	Immunization rate	
Female	56	(percent of children ages 12-23 months)	
Infant mortality (per thousand)	81	Measles (2002)	70
Crude death rate (per thousand)	23.3	DPT (2002)	79
Crude birth rate (per thousand)	33.1		
Fertility rate	4.3		
Access to safe water (2000)		Distribution of land	
Percentage of population:	78	Percentage of arable land:	
Urban	88	1960	13.0
Rural	74	2001	10.9
Education (2001)		Labor force (2002)	
Adult literacy rate (in percent)	81	Total (thousands)	736
Male	74	Female (percent in total)	37.0
Female	90		
Enrollment rate (in percent)			
Primary school (net)	84		
Male	81		
Female	86		
Secondary school (gross)	34		
Pupil-teacher ratio in primary school	47		

Sources: Lesotho Demographic Survey, 2001; Governement of Lesotho; and
World Development Indicaotrs, 2004; World Bank

Table 8. Lesotho: Millennium Development Goals

	1990	1995	2001	2002
1. Eradicate extreme poverty and hunger	2015 target = halve 1990 1 U.S. dollar a day poverty and malnutrition rates			
Population below US $1 a day (percent)	..	36	..	..
Poverty gap at US $1 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-5 mortality rate.

Goal 5 target: Reduce by three-fourths 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.

LESOTHO: RELATIONS WITH THE FUND
(As of July 31, 2005)

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	31.34	89.80
Reserve position in Fund	3.56	10.21

III. **SDR Department**:	SDR million	Percent Allocation
Net cumulative allocation	3.74	100.0
Holdings	0.39	10.37

IV. **Outstanding Purchases and Loans**:	SDR million	Percent Quota
PRGF arrangements	24.50	70.20

V. **Financial Arrangements**:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
PRGF	03/09/2001	10/31/2004	24.50	24.50
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				
	2005	2006	2007	2008	2009
Principal	0.00	0.35	1.75	3.15	3.85
Charges/Interest	0.10	0.21	0.20	0.19	0.17
Total	0.10	0.56	1.95	3.34	4.02

VII. **Safeguards Assessments**:

An updated Safeguards Assessment of the Central Bank of Lesotho (CBL) in July 2003 concluded that the CBL has made commendable progress in strengthening its safeguards, as recommended in the previous Safeguards Assessment of July 2001. The assessment noted that there are 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.

VIII. Exchange Arrangements:

Lesotho's currency, the loti (plural maloti), is pegged to the South African rand at par. The Central Bank of Lesotho (CBL) deals with commercial banks mainly in South African rand. As of July 31, 2005, the rand (maloti) rate per U.S. dollar was M6.58.

IX. Article IV Consultation:

The Executive Board concluded the last Article IV consultation (IMF Country Report No. 04/21, February 05, 2004) 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 will be essential to bring spending in line with government priorities. Directors supported the on-going reforms to Lesotho's financial institutions and regulations, noting that these reforms are crucial to increase access to credit for the private sector, particularly for small- and medium-sized businesses.

X. **Technical Assistance**:

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: national accounts statistics	STA	short-term	2004
Mission: GDDS project for Anglophone Africa on Private capital flows, stocks and investment income	STA	short-term	2004
Mission: legislative drafting/FIU	LEG	Short-term	2005
Mission: monetary operations / payments issues / banking supervision	MFD	short-term	2005
Mission: GDDS project for Anglophone Africa on Private capital flows, stocks and investment income	STA	short-term	2005

XI. **Resident Representatives**:

The Senior Resident Representative posted in South Africa has been covering Lesotho since January 2004.

LESOTHO: RELATIONS WITH THE WORLD BANK GROUP

A. LESOTHO'S POVERTY REDUCTION STRATEGY

1. Lesotho's strategy for poverty reduction is laid out in the government's Poverty Reduction Strategy (PRS), which was formally transmitted to Bank Management in March, 2005. A Board discussion of the Joint Staff Assessment Note (JSAN) is scheduled for September 8, 2005 and September 19, 2005, at the Bank and Fund respectively.

2. The PRS was developed through a highly participatory and consultative process involving 200 communities and including a wide range of stakeholders. The PRS builds on a number of government documents and initiatives, including the I-PRSP, National Vision 2020, National Goals, and the Millennium Development Goals (MDGs). While Vision 2020 articulates the level of development that Basotho aspire to attain by 2020, and the MDGs reflect long-term goals and targets to be achieved by 2015, the PRS provides a framework for making progress toward the attainment of those goals and targets within three years.

3. Poverty diagnosis presented in the PRS is based on the analysis of quantitative data from a variety of survey sources and is backed up by qualitative data and summaries of themes emerging from the consultation process. The PRS has three interconnected goals: (i) create jobs through the establishment of an environment that facilitates private sector-led economic growth; (ii) empower the poor and the vulnerable and improve their access to health care and education; and (iii) deepen democracy and improve public sector performance, to ensure that policies and legal frameworks facilitate the full implementation of priorities. These reflect an appropriate response to the national priorities identified during the consultation process.

4. However, implementation of the PRS faces several limitations and risks related to its translation into actual work plans, possible further shocks to the economy, weak governance, and a lack of political will. These are identified in the Joint Staff Advisory Note (JSAN) and required actions relate to the need to develop a supporting medium-term macroeconomic framework, address Lesotho's external vulnerability and competitiveness concerns, and improve the monitoring and evaluation framework.

B. BANK-FUND COLLABORATION IN SPECIFIC AREAS

5. 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) and the following areas of structural reform: fiscal management and tax administration reform. The Bank will continue to lead the policy dialogue on sectoral structural reforms including public expenditure management, employment generation through private sector development, infrastructure development, education, health including, 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.

Poverty Reduction Strategy

6. The World Bank is supporting government's capacity building efforts to implement its PRS through a PRSP Trust Fund and an Institutional Development Facility grant. The former is aimed at strengthening capacity of the PRSP Secretariat and other identified agencies (including in the private sector), to manage the PRSP process. The latter is aimed at strengthening the capability of the Ministry of Finance and Development Planning to plan, manage, implement and monitor policies and programs identified in the PRS to achieve intended results on the ground. The Bank also prepared a Country Economic Memorandum as an analytical input into the preparation of the PRS. The analysis has made a strong case for scaling up public investment in infrastructure as well as seeking public private partnerships for improved service delivery.

7. As mentioned above, the PRS does not include a comprehensive macroeconomic framework, except for some fiscal projections. In the absence of a medium-term macroeconomic framework, the targeted growth rate and other economic objectives do not appear to be properly anchored. Considering the short-term risks to garment production and exports and the medium-term structural challenges, the growth rate targeted in the PRS is unrealistic. In fact, the authorities have revised the growth projections downwards for the short to medium term. Fund staff is working with the authorities in developing the existing projections into a comprehensive macroeconomic framework to underpin the PRS.

Public Sector Reform and Public Expenditure Management

8. The Bank is continuing the work on the Public Expenditure Review (PER), in close collaboration with the government, to inform and guide the reforms needed to improve the efficiency and quality of public expenditures. The PER will strengthen the analytical base for making decisions about the size and composition of public expenditure 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 implement public policies and achieve 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.

9. With support from the World Bank through the PER exercise, the government has taken important steps to begin aligning the budget with the priority programs identified in the PRS. To deepen these links and to strengthen implementation of the priority programs, the authorities have initiated a phased introduction of a medium-term expenditure framework starting with the 2005/06 budget[19]. Further, they are identifying activities in the budget that are included in the PRS, as well as other poverty-reducing activities that are not necessarily included in the PRS. Despite the limitations on the costing of the PRS, the results from the above exercises will support the government's efforts to align its budget with its PRS.

[19] Fiscal year is from April to March.

Private Sector Development (PSD)

10. The Government, with assistance of the World Bank, has developed a PSD Strategy, which identifies areas and provides specific recommendations for action to achieve the Government's objectives to increase the contribution of the private sector to GDP growth as measured by private investment in GDP, diversify the economy away from garments industry, progressively integrate Lesotho's economy with South Africa's economy and increase factor productivity. In early April 2005, a three-day PSD Strategy Forum was organized jointly by the Government of Lesotho and the World Bank and held in Maseru. The Forum facilitated the discussion between the key partners and led to prioritization of the key binding constraints as well as the development of a strategy to facilitate stronger private sector growth and support export diversification. Discussions covered a wide range of areas, including ways to (i) improve the business climate by reducing legal and administrative impediments to growth; (ii) strengthen logistics, infrastructure, trade and investment facilitation, and institutions to support areas with the highest potential for growth and exports; and (iii) strengthen domestic competitiveness through improving skill levels and strengthening linkages between training and industrial needs. To support the private sector, immediate actions need to be taken in a number of mutually-supportive areas to create a minimum infrastructure platform (MIP) for private sector-led growth. MIP consists of the combination of priority physical infrastructure investments with a specific set of investments in supporting facilities, all aiming at enhancing economic performance and productivity, attracting more private investment and diversifying the economy.[20]

11. To support the government's efforts on the PSD front, the World Bank is preparing a Private Sector Competitiveness project. The key objective of the project is to increase private sector participation in the economy by increasing its productivity and competitiveness, and hence its ability to compete. This goal will be achieved by improving the business environment and reducing the costs of doing business; strengthening the linkages with the regional economy, especially with South Africa; strengthening institutional support for employable skills and business management; and improving productivity at the firm level.

Integrated Framework (IF)

12. Recognizing the importance of the expansion of trade with other countries–especially in the region–for achieving economic growth, the government seeks to better integrate trade issues in the poverty reduction program. The framework for this integration is provided in the *Diagnostic Trade Integration Study (DTIS)* for Lesotho**.** The goal is to lower the cost of trading with South Africa and other Southern African Customs Union (SACU)[21] partners and the rest of the world by removing barriers to trade and to the movement of capital and labor. Priority actions for the achievement of this goal, mostly structural policies, are set out in the *DTIS* matrix. The DTIS has been carried out in close consultation with the Government and core agencies and donors,

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[20] MIP includes the following elements: (i) business environment; (ii) trade and investment facilitation regulations and institutions; (iii) human capital; (iv) financial services and (v) physical and support infrastructure.

[21] Members of SACU are Lesotho, Swaziland, Namibia, Botswana, and South Africa.

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 various donors have expressed interest in supporting key elements of this actions matrix through technical assistance.

Infrastructure

13. 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 has been storing water since 2002. The entire project could include five phases with a total capacity to transfer up to 70m3/ sec of water but reduced demand in South Africa may delay future phases. The new Lesotho Water Sector Improvement Project supports provision of water to the lowland areas, mainly Maseru, which at present faces shortages of water. Improvement in reliability will be achieved through strengthening the main urban utility, WASA, as well as increased access for urban and peri-urban water supply through community based approaches. A key feature of the project is the strengthening of the sector's legal and regulatory framework which is seen as essential to increase the efficiency of expected new investments.

14. Under the Utility Sector Reform project, the concession of Lesotho Electricity Corporation (LEC) is being prepared through a management contract until a strategic investor is in place later this year. This transitional arrangement has brought about significant improvements regarding new connections, collection rates, arrears reduction, global losses, etc. Additionally, the bid process for the LEC concession contract is progressing. Simultaneously, the establishment of the regulatory authority – Lesotho Electricity Authority – is taking place in a highly satisfactory manner. In the telecommunication sector, the introduction of competition and the early impact of privatization have resulted in a seven-fold increase in aggregate tele-density and a diversification of services to the end users. Regarding regulation in the telecommunications sector, the Lesotho Telecommunication Authority (LTA) has been established and is working towards developing the set of skills and capabilities to discharge its duties. In the transport sector, the Bank is supporting strategic policy and regulatory reforms; plus capacity building and performance based contracting. Support is also being provided for restructuring roads management and road and bridge rehabilitation and upgrading.

HIV/AIDS

15. In response to the high adult HIV prevalence rate in Lesotho, the Government adopted a mutli-sectoral National HIV/AIDS Strategic Plan and the National AIDS Policy Framework in 2000. 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. Political commitment in the fight against HIV/AIDS has increased and legislation to create a National AIDS Commission has been enacted. Several other development partners and agencies are active in supporting the HIV/AIDS program, including Development Corporation Ireland, the Clinton Foundation, and the Bristol Myers Squibb company.

Human Development

16. 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 Bank' support to the health sector is structured in 3 Phases of an Adaptable Program Loan. The Phase I of the APL focused on strengthening the institutional capacity of the MOHSW to refine, implement and evaluate the comprehensive Sector Reform Program, and expanding the capacity of the government to respond to HIV/AIDS. The Phase II APL, which is planned for approval by the Board in September 2005, will focus on improving access to quality health services through strengthening decentralized services delivery and improving human resources management in the sector. 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, Non-Formal Education, and MOET core functions.

Poverty Monitoring and Evaluation

17. The Bank recently concluded a review of monitoring and evaluation (M&E) in Lesotho. This review highlights cross-cutting issues across the World Bank portfolio and proposed actions. It also contains an analysis of the findings on the national M&E system linked to the Poverty Reduction Strategy (PRS). It identifies three major issues that will have to be worked out to establish a well-functioning national M&E system: (a) donors must agree among themselves and with the government on a harmonized, unified support effort for a national M&E system; (b) government must create a coordinated and transparent system that includes key data users and data generators; and (c) government and donors must make long-term commitment to enhance statistical capacity. The review and its recommendations will serve as a major input to the results-based Country Assistance Strategy (CAS) that is currently under preparation.

18. 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: establish factors affecting water consumption levels and behaviors; assess changes in the extent and nature of water supply; consider the impacts of tariffs

on the very poor; establish the informal price of water; and determine how access can be maintained for the poor without other income groups drawing free water. The findings[22] 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 non-connected 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. Also, the Bank and Fund are considering reviewing 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

19. The Bank Group's assistance strategy for Lesotho for FY 06-09 is currently under preparation. It is guided by the Government's Poverty Reduction Strategy and the Millennium Development Goals. A joint CAS retreat with the government and several development partners is planned for September 2005. The CAS will be informed by these consultations as well as other related pieces of work that have been completed or are under preparation. These include the Country Portfolio Performance Review (completed in April 2005) and the CAS completion report (CASCR) of the 1998 CAS. The objective of the CASCR is to assess the effectiveness of the 1998 CAS in achieving the expected results as well as highlight lessons learned during implementation. A Client Survey has been launched. The results from the survey will provide an assessment of the views of clients and partners, and help produce more effective strategies and programs that support development in Lesotho. 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.

20. As of June 30, 2005, IDA had approved 31 credits amounting to US$367.7 million, of which US$276.1 million was disbursed; US$59.9 million was canceled; and US$40.9 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 (due to a lower loan uptake than projected). A second IBRD loan of $45 million was approved in June 1998 for Phase IB of the Lesotho Highlands Water Project, of which US$14.4 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,

[22] 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).

the World Bank has financed six projects in education; five in roads and roads rehabilitation and maintenance; four in agriculture, three in industry, three in water supply (including highland water engineering), three in urban development, three in health, two in privatization and one in community development.

21. In July 2005, IFC signed an agreement with the Government of Lesotho to advise them on designing and implementing a public-private partnership for a new public hospital. Located in the capital city of Maseru, the new hospital will replace an existing facility, now over 50 years old, and serve as the national referral hospital. The replacement of the hospital is central to the ongoing reforms and improvements of health sector policy that the government is undertaking with the support of the World Bank's International Development Association and the donor community, an effort led by Development Cooperation Ireland and the World Health Organization. The project is a pioneering joint initiative by the World Bank and IFC in Sub-Saharan Africa. It is expected to be funded in part through International Development Association (IDA) funds on concessional terms.

22. 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. Ritva Reinikka, Country Director, at 27-12-431 3100; or Ms. Preeti Arora, Sr. Country Economist, at 202 473-8275.

LESOTHO: STATISTICAL ISSUES

Lesotho's statistical database is adequate for surveillance purposes, although there are some notable deficiencies in the quality and timeliness of core surveillance data. The staff mission worked with the Lesotho representatives to address some of these deficiencies to ensure an adequate database through 2004/05 for surveillance purposes. In light of this, it believes that Lesotho is in compliance with its obligations under Article VIII, section 5. However, potential areas of further improvements are identified below. The government should give high priority to addressing these.

National accounts

GDP and economic growth are probably underestimated. Incomplete information about external flows and value added in the Lesotho Highland Water Project (LHWP) has had significant effects on the estimates of GDP and economic growth since 1998. In theory, the value added of the water sector should include the full value of water exported, but current estimates only include royalties received by LHWP. There are also concerns that data on manufacturing activity from the Bureau of Statistics of Lesotho (BSL) is underestimated, when compared to customs data on manufactured exports.

BSL is responsible for the national accounts and compiles current price estimates of GDP economic activity, expenditure, and income. Estimates of GDP at constant prices are compiled by economic activity and expenditure. Fund missions make estimates of current year national accounts and projections of future years, in consultation with the authorities. Historical data are sometimes adjusted. Other macroeconomic indicators, such as industrial production indices, are used to monitor developments during the year.

The 1996 STA mission noted substantial shortcomings with the national accounts data, including: the non-availability of basic underlying data in a number of areas and the need to make extrapolations on partial coverage; the use of historical and outdated input/output relationships in many instances; the use of old benchmarks estimates in deriving current series; and the use of inappropriate trend indicators in a few instances. In terms of GDP by expenditure categories, major problems included estimates of household expenditure on a residual basis, and defects in the timeliness, coverage, and commodity detail on imports.

A resident advisor provided technical assistance from July 1998 to January 2000. The expert updated the base year for the national accounts to 1995, improved the methods for compiling imports at constant prices, incorporated new benchmark estimates for several industries, initiated work on simplified institutional sector accounts, implemented a new computer system for compiling the estimates, and documented the compilation methodology for the national accounts. The expert also initiated several projects for improving BSL data collection efforts, work programs, and working procedures, including improving the manufacturing production index.

Since late 2003, **a peripatetic expert has been assigned under the DFID project for Anglophone Africa** to advise on strengthening the national accounts methodology. The principal reason for limited progress has been the lack of resources and issues with the quality of source data.

Prices

BSL currently produces a consumer price index (CPI) only, largely due to staff shortages. The CPI is based on the Laspeyres index formula and is compiled with weights from the 1994/95 Household Budget Survey; it is published with a base of April 1997=100. In addition to the nationwide index, separate indices are compiled and published for high-income households (i.e., households earning more than M500 per month according to the 1994/95 HBS) in Maseru City and for low-income households (households earning less than M500) in all six lowland towns. A 1996 STA mission found that the quality of the index was, in general good, and compared favorably with the CPI for other countries in the region.

Government finance statistics

Data on government revenue and grants, current and capital expenditure, and financing are now provided by the Ministry of Finance to AFR on a monthly basis, although timeliness of reports remains problematic. There is scope for further improvement in the reporting of fiscal data. Current and capital expenditure would benefit from more disaggregated reporting, including for health and education spending; revenues should be classified according to the **Government *Finance Statistics Manual 2001* (***GFSM 2001)*; and the reporting lag of about one year for the production of the functional breakdown of expenditure should be reduced. It is also necessary to distinguish clearly between current and capital (project) grants and external loan disbursements. The Government submitted the 2001/02 fiscal accounts to the Auditor General in March 2003 and the 2002/03 fiscal accounts in December 2003. These are the first accounts to be audited since those for the 1995/96 fiscal year.

A GDDS fiscal sector mission in December 2003 was followed by a technical assistance mission in 2004, which assisted the authorities in implementing the reporting framework of *GFSM 2001*. The mission identified several shortcomings in the fiscal data. Underreporting of recurrent revenue and expenditure occurs as line ministries net revenue against unreported expenditure. Reporting of acquisition of nonfinancial assets is incomplete due to line ministries that do not fully report donor project outlays. These data are also insufficiently detailed to allow appropriate economic classifications. The mission assisted the authorities in compiling a bridge table to reclassify data according to *GFSM 2001*. This enabled the authorities to submit annual data for the general government sector through 2003 for inclusion in the *2004 Government Finance Statistics (GFS) Yearbook*. The latest quarterly fiscal data reported for *IFS* was for June 2002 only. The mission established that the data coverage did not include the activities of the National University of Lesotho, the Road Rehabilitation and Maintenance Fund and the Petroleum Fund. The mission recommended that the university be treated as an extra-budgetary fund and that the other funds be adequately sectorized and classified to further enhance the coverage of the general government.

Monetary statistics

Most TA recommendations have been adopted. Monthly reporting of data for IFS publication is timely and has improved in terms of classification of instruments, sectorization of the domestic economy, and compilation of the monetary aggregates. However, the recommended expansion of institutional coverage, valuation of financial instruments at market value, and proper recording of realized and unrealized foreign exchange gains and losses are yet to be implemented.

Balance of payments and external debt

The Central Bank of Lesotho compiles quarterly balance of payments statistics, usually with a lag of three months. However, these data are not reported to AFR or STA on a timely basis for surveillance and for dissemination in the Fund's statistical publications.

A STA mission in July-August 2002 concluded that the quality of Lesotho's balance of payments data is inadequate for policy purposes. The methodology underlying the compilation of the balance of payments data suffers from the use of outdated benchmark surveys and deterioration in the coverage and timeliness of some of the data sources needed. The main recommendations of the mission were as follows:

- **It is urgent to resolve both the inadequate coverage and the delayed reporting of data on exports and imports of goods.** The Department of Customs and Excise (DCE) does not provide data in a timely fashion. The CBL, therefore, generates its own estimates and there are significant differences between these estimates and DCE's data. For example, CBL believes that DCE is underreporting total imports and has been adjusting the level of imports upward by 30 percent. There are also differences between the trade data compiled by the CBL and the BSL.

- **Closer cooperation and new statistical surveys are needed to improve the quality of data on exports and imports of services.** Most of the data on exports of services are based on outdated benchmark estimates adjusted for movements in Lesotho's consumer price index. Data available at the line ministries and other organizations could also be of better use for estimates of balance of payments variables. Government ministries and the CBL should cooperate more and make better use of data sources in organizations like the Lesotho Highlands Development Authority, the Lesotho National Development Corporation, the South African Reserve Bank, and the Employment Bureau of South Africa.

In general, the authorities need to strengthen their institutional capacity. The CBL should be given formal institutional responsibility for the compilation of balance of payments statistics. This work is currently undertaken by the CBL but there is no legislation or official decree that designates this responsibility. Together with other members of the Common Monetary Area (CMA), Lesotho's authorities also need to consider measures to harmonize concepts, methodology, and data collection for regional balance of payments data. Lesotho participates in the General Data Dissemination System (GDDS) and its metadata has been published on the IMF website since August, 2003.

In connection with the GDDS project for Anglophone Africa, Lesotho has participated in a series of regional workshops to assist the authorities to plan and implement surveys for the recording of private capital flows and stocks.

Lesotho: Table of Common Indicators Required for Surveillance

As of July 25, 2005

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	July 2005	July 2005	D	W	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	June 2005	July 2005	W	W	M
Reserve/Base Money	June 2005	July 2005	W	W	M
Broad Money	June 2005	July 2005	W	W	M
Central Bank Balance Sheet	June 2005	July 2005	M	M	A
Consolidated Balance Sheet of the Banking System	June 2005	July 2005	M	M	M
Interest Rates[2]	June 2005	July 2005	D	M	D
Consumer Price Index	May 2005	July 2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	June 2005	July 2005	M	I	Q
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	June 2005	July 2005	M	I	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jun 2005	July 2005	M	I	Q
External Current Account Balance	Q3 2004	Jan 2005	Q	Q	Q
Exports and Imports of Goods and Services	Q3 2004	Jan 2005	Q	Q	Q
GDP/GNP	2003	Jan 2005	A	A	A
Gross External Debt	Jan 2005	Jan 2005	M	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discounts rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA)

LESOTHO— EXTERNAL DEBT SUSTAINABILITY ANALYSIS[23]

In the view of Fund and IDA staffs, Lesotho presents a moderate risk of debt distress. Lesotho's external debt burden does not appear excessive, as its external debt indicators are projected to remain well below the relevant indicative thresholds. However, the debt sustainability analysis highlights the sensitivity to changes in exchange rates and in the terms of new borrowing, as well as to shocks affecting the country's narrow export base. In particular, a potentially risky scenario could emerge in the presence of persistent and severe shocks to garment exports.

The Debt Sustainability Analysis (DSA) focuses on external debt. Gross domestic public debt is relatively low, and projected to decline further over the medium term, from 8 percent of GDP at end-March 2005 to 3 percent by 2010. Moreover, net domestic debt is negative—at minus 4 percent of GDP, reflecting sizable government deposits.

External debt situation as of end-March 2005[24]

Lesotho's public and publicly guaranteed external debt as of end-March 2005 stood at US$721.6 million, equivalent to US$485 million in NPV terms (see Statistical Appendix Table 27.[25] Almost 80 percent of this debt was owed to multilateral creditors, mainly IDA (37 percent) and the African Development Bank (26 percent). The remainder of the debt is split between bilateral and commercial creditors (13 percent and 9 percent, respectively). Virtually all public and publicly guaranteed external debt is held by the Central Government, which has taken over the debt incurred by public entities.

Concerning private sector debt, only the obligations towards countries outside the Common Monetary Area (CMA) are recorded. At end-March 2005, these obligations were estimated at US$2.2 million.

Lesotho's nominal external debt as a share of GDP amounted to 53 percent at end 2004/05, continuing the declining trend observed in recent years. The share of external debt to GDP declined from 83 percent in 2002/03 to 63 percent in 2003/04. This reduction is owed to the combined effect of strong GDP growth, very limited government borrowing, and exchange rate appreciation. The

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[23] This analysis has been prepared jointly by IDA and IMF staffs using the framework for low-income countries approved by the Boards of both institutions. Debt figures for IDA, IMF and the African Development Bank were calculated using loan-by-loan data provided by these creditors. For the remaining creditors, aggregated data provided by the country authorities were used.

[24] Lesotho's fiscal year runs from April 1st to March 31st.

[25] The implicit grant-element of Lesotho's external debt (33 percent) evidences its highly concessional nature.

latter factor alone accounted for a 20 percentage points decline, with a 50 percent (average) appreciation relative to the U.S. dollar.

The baseline scenario

The macroeconomic assumptions underlying the baseline scenario are summarized in Box 1.

Box 1. Main assumptions under the baseline scenario

- Annual real GDP growth is assumed to increase gradually from about 2 percent during 2005/06-2009/10 to 4½ percent by the end of the projection period. The latter rate would be above the 3 percent average growth rate recorded over the past decade, reflecting the beneficial effects of implementation of the PRSP and other planned structural reforms.

- Inflation (as measured by the GDP deflator) is projected to stabilize slightly above 5 percent, broadly in line with experience in recent years.

- Following the slowdown in the growth of external trade during 2004/05-2007/8, imports and exports of goods and services and (private and public) transfers are assumed to grow in line with GDP (in dollar terms). FDI grows slightly more rapidly.

- The current account deficit (including official transfers) is determined by the above trends, rising to about 10 percent of GDP by 2006/07 and broadly remaining at this level thereafter.

- Net external public sector financing is assumed to rise to about 2 percent of GDP by the end of the current decade and then to stabilize at this level. Foreign grants are assumed to remain stable at about 2 percent of GDP over the projection period. New borrowing is projected to be contracted on highly concessional terms during the first half of the projection period; however, as the country reaches the threshold for eligibility under concessional windows of financing, it is assumed that the average grant element of new borrowing gradually decreases from 45 percent to 20 percent by the end of the projection period.

Private sector debt is projected to increase only marginally in terms of GDP, to 0.6 percent by 2023/24.

Lesotho is classified as a medium performer in terms of the quality of policies and institutions.[26] The indicative thresholds for the debt burden indicators for the countries falling into this category, proposed under the framework for low-income countries, are presented in Table 1.

Table 1. Lesotho: Relevant indicative thresholds for debt burden indicators (percent)

Ratio	Relevant threshold
NPV of debt to GDP	40
NPV of debt to Exports	150
NPV of debt to Revenue	250
Debt Service to Exports	20
Debt Service to Revenue	30

Under the baseline, all debt burden indicators remain below their relevant indicative thresholds. In addition, they stabilize at very low levels despite the deterioration of the terms of new borrowing assumed for the second half of the projection period. The NPV of debt-to-GDP ratio is projected to decline by about 12 percentage points, from 37 percent as of end 2004/05 to 25 percent by 2023/24. The significant drop of the ratio observed during the initial years reflects the schedule of repayment of existing non-concessional obligations, most of which were contracted to finance the Lesotho Highland Water Project (LWHP). This is mirrored in the evolution of the debt service-to-exports ratio that increases sharply to 12 percent in 2005/06 and declines steadily thereafter to reach about 3 percent by the end of the projection period. Reflecting the adverse impact of the shocks to garment exports, the NPV of debt-to-exports ratio increases from 67 percent in 2004/05 to 70 percent in 2005/6. The ratio then follows a gradual decline to 54 percent by 2023/24. Notwithstanding the shock, the ratio remains well below the indicative threshold of 150 percent.

SENSITIVITY ANALYSIS

The standard stress tests illustrate Lesotho's vulnerability to exchange rate changes and to changes in the terms of financing. However, the debt burden indicators do not breach the relevant thresholds under any of them. In modeling the standard historical scenario,[27] the current account was set to equal its past level excluding transactions relating to the LHWP, as this project had entailed large imports that are not part of Lesotho's regular trade pattern. The results under this scenario are

[26] This classification is based on the latest World Bank's Country Policy and Institutional Assessment.

[27] Where the key variables are assumed to remain at their historical average.

somewhat more positive than the baseline, highlighting the prudence of the baseline assumptions compared to the country's historical performance. Under the financing scenario,[28] all debt burden indicators deteriorate without, however, showing an explosive behavior. The impact of a large depreciation or devaluation is visible in the third and the sixth bound tests. In the latter scenario, corresponding to a 30 percent nominal depreciation, the NPV of debt-to-GDP ratio would exceed to the 40 percent indicative threshold during most of the projection period (this exercise does not assume any resultant boost to exports and growth, however).[29]

An additional test added to the standard battery of tests illustrates the vulnerability to shocks affecting the country's narrow export base.[30] The additional test assumes that the expansion of textile exports since 1999 based on the United States' African Growth and Opportunity Act (AGOA) would be entirely reversed as of 2006/07. Under this scenario, the export to GDP ratio is assumed to return to its 1999 level (falling from 60 to 22 percent), the test also incorporates the resultant decline in GDP. In this—extreme—scenario, all debt indicators would climb to levels above the indicative thresholds, with the NPV of debt-to-export ratio peaking at more than 200 percent in 2007/08.

STAFFS ASSESSMENT

Based on the findings of this DSA, staffs are of the view that Lesotho faces a moderate risk of debt distress. Under the baseline scenario, all debt burden indicators are expected to remain below the relevant policy-indicative thresholds. Stress tests, based on the country's historical volatility, do not indicate any breach of the thresholds. However, persistent and particularly severe shocks on the country's narrow export base could increase the country's risk of debt distress to unacceptable levels.

The results of the DSA highlight the need for the authorities to implement sound macroeconomic policies and structural reforms to materialize the assumptions predicated under the baseline. Particular emphasis should be given to widening Lesotho's export base, strengthening its repayment capacity and reducing its vulnerability to shocks.

[28] Which assumes less favorable terms for new borrowing relative to the baseline.

[29] Standard bound tests under this framework have been calibrated to represent a 25 percent probability of occurrence ten years after the shock on the variables is assumed.

[30] Test B7 in Table 1b.

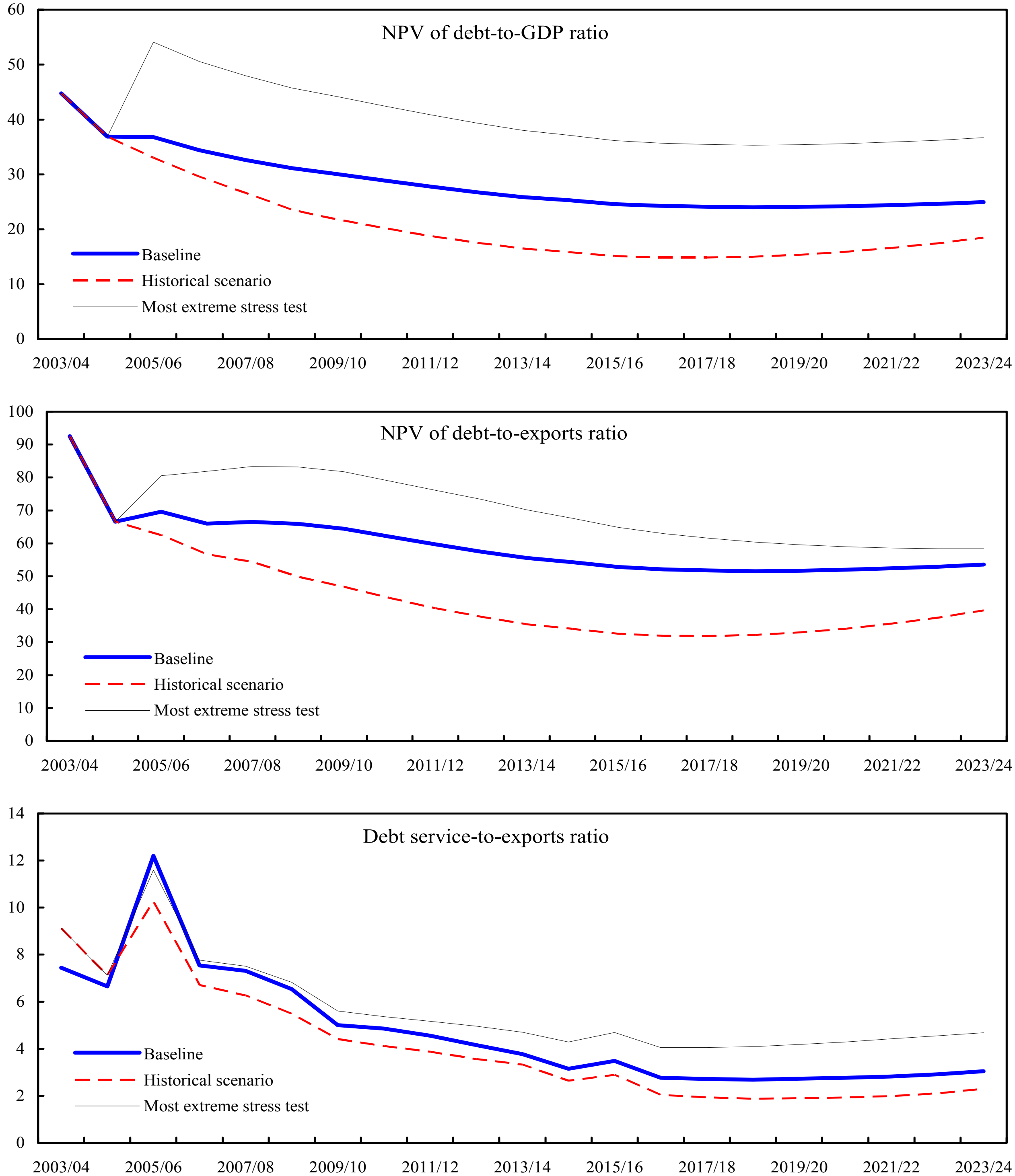
Table 1a. Lesotho External Debt Sustainability Framework, Baseline Scenario, 2000-2023 1/
(In percent of GDP, unless otherwise indicated)

	Actual					Historical Average 6/	Standard Deviation 6/	Projections								
	2000/01	2001/02	2002/03	2003/04	2004/05			2005/06	2006/07	2007/08	2008/09	2009/10	2005-10 Average	2013/14	2023/24	2010-24 Average
External debt (nominal) 1/	**70.5**	**78.4**	**82.7**	**62.9**	**53.3**			**54.6**	**52.1**	**50.3**	**48.5**	**47.2**		**41.3**	**34.6**	
o/w public and publicly guaranteed (PPG)	70.2	78.1	82.5	62.7	53.1			54.4	51.9	50.1	48.3	47.0		41.0	34.2	
Change in external debt	1.1	7.8	4.3	-19.8	-9.6			1.3	-2.5	-1.8	-1.8	-1.3		-1.4	-0.5	
Identified net debt-creating flows	22.1	22.9	8.0	-19.8	-11.2			1.4	3.0	2.9	3.9	2.5		1.6	1.3	
Non-interest current account deficit	**16.3**	**12.2**	**17.0**	**9.6**	**2.0**	**19.3**	**9.9**	**5.7**	**8.6**	**8.8**	**10.0**	**9.1**		**9.2**	**9.1**	9.2
Excl. LHWP	8.4	4.0	11.9	5.2	-0.4	5.8	4.6	7.2	10.1	10.3	11.5	10.6		10.7	10.6	10.7
Deficit in balance of goods and services	59.4	54.0	58.7	50.0	47.5			55.3	52.5	51.7	51.2	48.3		48.3	48.3	
Exports	31.8	46.4	54.1	48.4	55.4			52.8	52.1	49.0	47.3	46.6		46.6	46.6	
Imports	91.2	100.4	112.8	98.4	102.8			108.1	104.6	100.8	98.4	94.9		94.9	94.9	
Net current transfers (negative = inflow)	-15.3	-17.2	-17.2	-15.7	-20.4	-18.0	2.3	-23.0	-18.0	-17.8	-16.9	-15.9		-15.9	-15.9	-15.9
Other current account flows (negative = net inflow)	-27.8	-24.6	-24.6	-24.7	-25.1			-26.6	-25.9	-25.1	-24.3	-23.3		-23.2	-23.3	
Net FDI (negative = inflow)	**-3.7**	**-3.7**	**-3.9**	**-3.9**	**-4.1**	**-3.5**	**0.5**	**-5.8**	**-5.2**	**-5.8**	**-5.8**	**-6.1**		**-6.4**	**-7.0**	-6.6
Endogenous debt dynamics 2/	**9.5**	**14.4**	**-5.1**	**-25.5**	**-9.0**			**1.5**	**-0.3**	**-0.1**	**-0.3**	**-0.5**		**-1.2**	**-0.8**	
Contribution from nominal interest rate	2.5	1.9	1.6	1.1	0.9			1.1	0.8	0.7	0.7	0.6		0.5	0.6	
Contribution from real GDP growth	-1.2	-2.4	-2.3	-1.8	-1.1			0.4	-1.1	-0.8	-1.0	-1.1		-1.8	-1.5	
Contribution from price and exchange rate changes	8.2	14.8	-4.4	-24.8	-8.8			…	…	…	…	…		…	…	
Residual (3-4) 3/	**-21.0**	**-15.0**	**-3.7**	**0.0**	**1.6**			**-0.1**	**-5.5**	**-4.8**	**-5.7**	**-3.8**		**-3.0**	**-1.7**	
o/w exceptional financing	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	...	...	69.3	45.0	37.0			36.9	34.6	32.8	31.3	30.2		26.1	25.3	
In percent of exports	...	...	128.1	92.9	66.9			69.9	66.3	66.9	66.3	64.9		56.0	54.4	
NPV of PPG external debt	**...**	**...**	**69.1**	**44.8**	**36.9**			**36.8**	**34.4**	**32.6**	**31.1**	**30.0**		**25.9**	**25.0**	
In percent of exports	...	...	127.8	92.6	66.6			69.6	66.0	66.5	65.9	64.5		55.5	53.6	
Debt service-to-exports ratio (in percent)	27.2	12.4	8.7	7.5	6.9			12.5	7.9	7.6	6.8	5.3		4.1	3.6	
PPG debt service-to-exports ratio (in percent)	27.0	12.3	8.5	7.4	6.6			12.2	7.5	7.3	6.5	5.0		3.8	3.0	
Total gross financing need (billions of U.S. dollars)	178.0	101.2	138.1	107.1	22.3			83.1	98.9	94.4	108.8	84.0		96.8	169.1	
Non-interest current account deficit that stabilizes debt ratio	15.2	4.3	12.7	29.4	11.6			4.4	11.0	10.6	11.8	10.4		10.6	9.5	
Key macroeconomic assumptions																
Real GDP growth (in percent)	1.6	2.8	3.2	3.3	2.0	2.8	3.5	-0.7	2.2	1.7	2.1	2.5	1.5	4.5	4.5	4.3
GDP deflator in US dollar terms (change in percent)	-10.5	-17.4	6.0	42.8	16.3	3.1	17.5	-6.2	2.8	2.7	3.0	3.3	1.1	3.4	3.4	3.4
Effective interest rate (percent) 5/	3.3	2.3	2.2	2.1	1.7	2.4	0.5	1.8	1.6	1.4	1.4	1.4	1.5	1.3	2.0	1.5
Growth of exports of G&S (US dollar terms, in percent)	13.5	24.1	27.4	32.0	35.7	16.0	16.6	-11.1	3.6	-1.7	1.3	4.3	-0.7	8.1	8.1	7.9
Growth of imports of G&S (US dollar terms, in percent)	-9.7	-6.5	22.9	28.7	24.0	5.4	17.0	-2.1	1.6	0.6	2.7	2.0	1.0	8.1	8.1	7.9
Grant element of new public sector borrowing (in percent)	...	...	...	...	46.0	...	...	50.1	49.5	49.5	49.6	49.5	49.6	44.1	14.9	33.8
Memorandum item:																
Nominal GDP (millions of US dollars)	835.1	709.6	776.2	1144.7	1358.6			1265.5	1329.0	1388.0	1458.9	1544.1		2047.4	4455.5	

Source: Staff simulations.

1/ Includes both public and private sector external debt.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that NPV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

DSA Figure 1. Lesotho Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2003-2023
(In percent)



Source: Staff projections and simulations.

Table 1b. Lesotho Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2004-2023
(In percent)

		Projections					
	2 2004/05	2005/06	2006/07	2007/08	2008/09	**2013/14**	2023/24
NPV of debt-to-GDP ratio							
Baseline	37	37	34	33	31	**26**	25
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2004-23 1/	37	33	30	27	24	**17**	18
A2. New public sector loans on less favorable terms in 2004-23 2/	37	37	36	35	34	**32**	35
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2004-05	37	37	35	33	32	**26**	25
B2. Export value growth at historical average minus one standard deviation in 2004-05 3/	37	33	31	29	28	**23**	24
B3. US dollar GDP deflator at historical average minus one standard deviation in 2004-05	37	40	45	42	41	**34**	32
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 4/	37	43	43	41	39	**33**	27
B5. Combination of B1-B4 using one-half standard deviation shocks	37	33	35	33	31	**26**	26
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004 5/	37	54	51	48	46	**38**	37
B7. Loss of trade preferences (export ratio returning in 2005 to 1999 level) 6/	37	53	50	48	45	**37**	32
NPV of debt-to-exports ratio							
Baseline	67	70	66	67	66	**56**	54
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2004-23 1/	67	63	57	54	50	**35**	40
A2. New public sector loans on less favorable terms in 2004-23 2/	67	71	69	71	72	**68**	74
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2004-05	67	70	66	67	66	**56**	54
B2. Export value growth at historical average minus one standard deviation in 2004-05 3/	67	56	55	55	54	**46**	48
B3. US dollar GDP deflator at historical average minus one standard deviation in 2004-05	67	70	66	67	66	**56**	54
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 4/	67	81	82	83	83	**70**	58
B5. Combination of B1-B4 using one-half standard deviation shocks	67	52	49	49	49	**41**	42
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004 5/	67	70	66	67	66	**56**	54
B7. Loss of trade preferences (export ratio returning in 2005 to 1999 level) 6/	67	101	199	202	200	**163**	142
Debt service ratio							
Baseline	7	12	8	7	7	**4**	3
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2004-23 1/	7	10	7	6	5	**3**	2
A2. New public sector loans on less favorable terms in 2004-23 2/	7	12	8	8	7	**5**	5
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2004-05	7	12	8	7	6	**4**	3
B2. Export value growth at historical average minus one standard deviation in 2004-05 3/	7	10	7	7	6	**3**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2004-05	7	12	8	7	6	**4**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2004-05 4/	7	12	8	8	7	**5**	4
B5. Combination of B1-B4 using one-half standard deviation shocks	7	10	6	6	5	**3**	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2004 5/	7	12	8	7	6	**4**	3
B7. Loss of trade preferences (export ratio returning in 2005 to 1999 level) 6/	7	34	22	21	19	**11**	9
Memorandum item:							
Grant element assumed on residual financing (i.e., financing required above baseline) 7/	42	42	42	42	42	**42**	42

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ This test was added for Lesotho, and is not part of the standard set of bound tests.
7/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Statement by the IMF Staff Representative
September 19, 2005

The following information has become available since issuance of the staff report on August 18, 2005. The thrust of the staff's assessment remains unchanged.

- Consumer price inflation fell to 3.1 percent in June 2005, about 0.5 percentage points lower than the inflation rate at end March, 2005.

- The loti exchange rate against the US dollar moved from 6.65 at the end of June to 6.3 in the first week of September, moderating the exchange rate depreciation of the first half of 2005. The effective yield on treasury bills declined further, from 7.7 percent in March to 6.9 percent in June, while the savings deposit rate remained unchanged during the period.

- Gross international reserves rose from US$508 million, representing 4.5 months of import coverage at end-March, to US$548 million at end-June, representing 4.8 months of import coverage.

- The signing of the Millennium Challenge Corporation (MCC) compact in July was followed by the launching, in September, of feasibility studies for the various programs and projects envisaged under the compact.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 05/134
FOR IMMEDIATE RELEASE
September 29, 2005
Corrected: 1/6/06

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Lesotho

On September 19, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Lesotho.[1]

Background

Real GDP growth weakened to about 2 percent in 2004/05, from over 3 percent in the preceding two years, mainly due to the impact of adverse shocks affecting manufacturing and agriculture. The slowdown in manufacturing reflected the appreciation of the real exchange rate (by 30 percent) since February 2002, uncertainty regarding Lesotho's duty free access to the U.S. market under the U.S. African Growth and Opportunity Act, and the elimination of textile quotas in January 2005. Agricultural output declined due to a prolonged drought in the past three years, as well as structural weaknesses, such as poor farming techniques, soil erosion, lack of water in the lowlands, and lack of agro-financing. Over one quarter of the population is estimated to be in need of emergency food assistance.

In line with trends in South Africa, the CPI-based annual inflation rate declined from 7.7 percent at end-March 2003 to 3.7 percent at end-March 2005, notwithstanding increases in oil import

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

prices. The unemployment rate is estimated at 30 percent, and the HIV/AIDS prevalence rate has remained high (at about 29 percent of the adult population).

The overall fiscal balance (including grants) has turned from a deficit to an increasing surplus in the last two fiscal years. The large fiscal surplus of 9.1 percent of GDP in 2004/05 reflected mainly the temporary rise in receipts from the South African Customs Union. Domestic revenue collection has improved since the launching of the Lesotho Revenue Authority. On the expenditure side, current outlays particularly salaries and wages, were lower than projected, as the new local government administration did not take off during the fiscal year as earlier envisaged.

Monetary developments have reflected those in South Africa. The discount rate has held steady since August 2004, market yields on Treasury-bills have moved downward, influenced by the fall in the government borrowing requirement, and spreads relative to South Africa have narrowed to less than 40 basis points as of end-March 2005.

During 2003/04 and 2004/05, the external current account deficit narrowed from 11 percent of GDP to less than 3 percent, mainly owing to considerable export growth and a sharp rise in South African Customs Union (SACU) receipts in 2004/05. Remittances from South Africa also increased. These developments have led to an increase in the central bank's foreign reserves, which reached 4.5 months of imports of goods and services by end-March 2005.

Lesotho's debt indicators have improved markedly. With the strengthening of its fiscal position, the government reduced the stock of outstanding Treasury bills from 17 percent of GDP in 2002/03 to 8 percent in 2004/05. Lesotho's external public debt as a share of GDP has declined from 83 percent of GDP at end-March 2003 to 53 percent two years later, largely due to exchange rate appreciation. In net present value terms, the stock has fallen below 40 percent of GDP.

The authorities have strengthened their efforts to address poverty and HIV/AIDS. They have prepared a Poverty Reduction Strategy (PRS) through a highly participatory process involving the private sector, civil society and the donor community. The PRS identifies key areas that are important for making progress toward the Millennium Development Goals. Particular attention has recently been paid to strengthening institutional and implementation capacity to speed up the use of government and donor funding for the fight against the HIV/AIDS pandemic.

Executive Board Assessment

Executive Directors welcomed the marked improvement in the economic performance of Lesotho over the past two fiscal years, with a lower fiscal deficit, a stronger external current account position, a further decline in inflation, and an increase in net international reserves. The authorities' prudent policies had helped to contain government debt at manageable levels. However, persistent drought conditions, weakened external competitiveness, a continued worsening of the terms of trade, and job losses from the phasing out of textile quotas by industrial countries had caused real GDP growth to slow in 2004/5. Against this background, Directors considered that finding the basis for consistent high growth over the medium term, to help address widespread poverty, achieve the Millennium Development Goals, and confront the high incidence of HIV/AIDS, will be the primary challenge for the authorities in the period ahead.

Directors observed that the further loss of trade preferences, declining revenues from the South African Customs Union SACU, and contraction of inward remittances from migrant workers were likely to be durable economic shocks. They considered that faster economic growth in the future is therefore likely to depend on raising efficiency and broadening the production and export base. In that light, Directors urged the authorities to implement ambitious structural reforms aimed at restoring competitiveness and fostering private sector development.

Directors observed that, as Lesotho's membership in the Common Monetary Area constrains the use of the monetary policy lever, an appropriate fiscal policy will be the key to preserving financial viability. They recommended limiting future fiscal deficits to levels that can be financed largely by foreign grants and concessional loans. Also, the government's net creditor position vis-à-vis the banking system should be maintained, and the official net international reserve position protected. Directors noted that a continued prudent fiscal stance will provide room to expand credit to the private sector without pushing domestic interest rates higher than those prevailing in South Africa.

Given the decline in receipts from SACU, Directors called for a strengthening of revenues through a broadening of the tax base and improved tax administration. They encouraged the authorities to proceed with their plans to upgrade the hardware and provide training to the staff of the Lesotho Revenue Authority, to implement the planned Automated System for Customs Data project, and ensure that government entities comply with VAT payment and refund procedures.

Directors welcomed the authorities' efforts to strengthen the execution, monitoring and evaluation of public expenditure programs, which will support the alignment of expenditures with poverty reduction strategy priorities and the phase-out of nonpriority outlays. They emphasized the importance of ensuring that planned increases in outlays for poverty reduction are consistent with medium-term fiscal sustainability and the absorptive capacity, and take into account the recurrent cost implications of such spending. Directors encouraged the authorities to expedite implementation of the Public Sector Reform and Improvement Program so as to contain the public sector wage bill and improve public services.

Directors welcomed the progress made in strengthening the institutional framework to address the incidence of HIV/AIDS, especially the steps taken to improve the management and coordination of HIV/AIDS-related programs and to set up monitoring and evaluation systems. They encouraged the authorities to accelerate similar efforts in the other priority areas related to poverty reduction.

Directors stressed that, in order to promote private sector-led growth, a comprehensive structural reform agenda needs to be formulated and implemented without delay. Key reforms should aim to enhance labor productivity through training and skill-enhancing programs, address bottlenecks in infrastructure and public service delivery, eliminate the legal and administrative impediments to investment, and promote financial intermediation through the removal of legal obstacles to bank lending.

Directors supported the authorities' objective of strengthening regional trade and investment links, especially with South Africa, through structural reforms and sectoral strategies, which could help to diversify Lesotho's export products and markets. In this context, they advised the authorities to avoid creating subsidies for certain sectors that could distort incentives, entail large fiscal costs, or weaken fiscal transparency and accountability.

Lesotho: Selected Economic and Financial Indicators [1/]

	2001/02	2002/03	2003/04	Est. 2004/05	Proj. 2005/06
	(Annual percentage change, unless otherwise specified)				
Real Economy					
GDP at 2003 prices	2.8	3.2	3.3	2.0	-0.7
GDP at current market prices (in millions of maloti)	6,766	7,564	8,251	8,644	8,771
Consumer price index (period average)	9.2	9.6	6.4	4.3	5.0
National Accounts					
Gross Domestic Investment	40.8	42.9	40.5	34.9	35.4
Gross national savings	26.7	24.3	29.8	32.1	28.9
Foreign Saving	14.1	18.6	10.8	2.8	6.6
Central Government					
Revenue and grants	44.0	44.0	43.8	47.2	54.7
Revenue	41.2	40.1	41.7	44.6	51.6
Total grants	2.8	3.9	2.2	2.6	3.1
Total expenditure and net lending	43.4	48.4	43.1	43.5	49.9
Overall balance (excluding grants)	-2.2	-8.3	-1.4	6.5	1.9
Overall balance	0.6	-4.3	0.8	9.1	5.0
Money and credit					
Domestic assets (net) 2/	-68.5	73.4	16.5	-27.8	-4.1
Of which					
Government 2/	3.7	15.0	-5.8	-27.8	-7.4
Rest of the economy 3/	-6.0	-45.8	16.0	8.8	4.3
Money and quasi-money (M2)	17.0	2.7	5.3	6.2	2.8
	(In percent of GDP, unless otherwise specified)				
External sector					
Current account balance					
Excluding official transfers	-30.8	-35.1	-25.7	-22.2	-28.4
Including official transfers	-14.1	-18.6	-10.8	-2.8	-6.6
External debt 4/	78.1	82.5	62.7	53.1	55.2
External debt-service ratio 5/	17.8	11.8	9.1	7.3	12.5
Gross official reserves (end of period)					
(In millions of U.S. dollars)	399.7	408.4	436.9	507.7	474.4
(In months of imports of goods and services)	4.3	4.3	3.8	4.5	4.1

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

1/ Fiscal year beginning in April.
2/ Change in percent of M2 at the beginning of the period.
3/ Credit to the rest of the economy affected by a write-off of bad loans in 2002/03.
4/ Government only. The appreciation of the loti had a significant effect on the debt-to-GDP ratio in 2003/04.
5/ In percent of exports of goods and services.

Statement by Peter Ngumbullu, Executive Director for the Kingdom of Lesotho and Joseph Kanu, Advisor to Executive Director
September 19, 2005

1. Introduction

On behalf of the Kingdom of Lesotho authorities, we thank Management and staff for their continued involvement and support and for the technical assistance provided. Lesotho's macroeconomic performance over the years has consistently improved, largely as a result of the authorities' commitment to ensure that their macroeconomic objectives are achieved. Going forward, the authorities are keen on implementing policies aimed at promoting sustainable economic growth, improving the delivery of public services as well as the investment environment. The authorities have identified several key areas for development in the recently concluded PRSP, to guide the country's vision and efforts towards achieving the Millennium Development Goals.

2. Recent Economic Developments

Lesotho has continued to record improvements in its overall financial situation, despite a mixed macroeconomic performance and sluggish real economic activity. However, marked improvements have been experienced in the fiscal and external current account positions, with a decline in inflation and a substantial increase in international reserves. Domestic and foreign debts have been contained at manageable levels. The appreciation of the exchange rate, however, has impacted on economic growth, coupled with the phasing out of textile quotas by industrial countries, thereby resulting in declining terms of trade. These adverse developments have been compounded by the cumulative effects of external shocks on manufacturing and the ongoing drought on agricultural output.

The overall fiscal balance has during the past years, shown a surplus reflecting a 6.1 percentage points increase of GDP in SACU receipts arising from the 2002 revision of import data. As Lesotho is a member of the CMA, monetary developments reflected those in South Africa. The fall in the domestic borrowing requirement by government has led to a downward movement of market yield on treasury bills. The interest rate spread also narrowed, while banks' financial soundness remains strong. In addition, the authorities will submit the draft anti-money laundering legislation to Parliament this year, while implementation of the recommendations of the 2001 FSAP has commenced.

There has been significant reduction in the external current account deficit accompanied by a corresponding increase in net international reserves. This was facilitated by several factors including a boost in exports, the reopening of a diamond mine, rise in SACU receipts and a strong flow of remittances from Lesotho's migrant workers in South Africa. These effects have been able to offset the adverse impact of a worsening terms of trade. There has also been a marked improvement in debt indicators due to the strengthening of the fiscal situation. However, the share of external public debt to GDP fell to 53 percent in 2005 from 83 percent in 2003, due to exchange rate appreciation thereby resulting in the net present value of debt declining to below 40 percent of GDP.

The authorities have made more efforts towards tackling poverty and the HIV/AIDS pandemic. Important reforms have also been identified in the PRS, while more efforts are being taken towards achievement of the MDGs. The authorities have aligned the budget with the PRS and have taken measures to strengthen institutional and implementation capacity.

3. Medium and Long-Term Outlook, Challenges and Strategy

The authorities are cognisant of the country's vulnerability to a range of potential and permanent adverse developments over the medium term as well as the cumulative impact of several shocks, that include the erosion of trade preferences and the real effective appreciation of the exchange rate. In this context, they are committed to taking actions to deal with the ongoing challenges facing the country. They will implement measures to address immediate trade shocks, consolidate the gains already achieved in macroeconomic stability, and promote both domestic and external private sector development. A strong export diversification strategy that will generate higher growth and reduce the country's vulnerability to external shocks will be pursued. Because of the urgency in restoring external competitiveness, the authorities will endeavor to maintain exchange rate parity in view of the benefits arising from the CMA and the intimacy of trade and financial ties with South Africa. Heavy reliance will be placed on structural reforms to ensure achievement of strengthened competitiveness. The authorities will also embark on implementation of the second medium-term scenario as identified by staff to achieve the above objectives.

Fiscal Policy

The burden of safeguarding macroeconomic stability under the exchange rate parity arrangement will fall on fiscal policy. In view of this, the authorities will address the envisaged weakening of the fiscal position in the immediate and medium term. The authorities are aware of the potential for the country's underlying revenue performance to deteriorate with weaker economic growth. The increase in civil service wages would result in an expected 5 percent increase in individual income tax threshold and increased expenditures. As a result, the authorities will maintain an overall balance consistent with macroeconomic stability, which will include repayment of two high interest rate loans to reduce the burden on future debt service. In the event that any domestic financing of fiscal deficits in excess of grants and concessional loans could weaken the external current account and worsen the reserve position, efforts will be made to minimize loss of foreign exchange reserves. The authorities will also limit fiscal deficits over the medium term to 2-3 percent of GDP and will undertake a periodic review of this position based on realistic assessments of the country's prospects for mobilizing grants and concessional loans. This includes the potential for any domestic financing that will be raised in the case that demand for expenditure increases. In addition, the authorities will implement other measures that will include strengthening revenue mobilization, while pursuing reforms in the allocation mechanism of the development component of SACU in view of the concerns raised by the poorest members.

External Sector Policies and the Monetary framework

The current exchange rate parity has facilitated regional trade and progress is expected to be made towards achieving fiscal and monetary discipline as well as reduce inflationary pressures. Because of the weakening of external competitiveness due to large adverse exogenous exchange rate movements that were not offset by wage adjustments, the authorities, in association with other CMA partners will also take action to modify the common exchange rate arrangements to promote long-term growth in smaller member countries. They will also implement sound macroeconomic policies that would include prudent fiscal restraints and structural reforms that will enhance competitiveness. In addition, the authorities will continue to maintain an open trade and exchange system, in view of the fact that trade policies are largely dictated through the SACU arrangements.

As the exchange rate is at par with the South African rand, there is currently no space for the authorities in determining monetary policy. This implies a virtual absence of exchange controls on capital movements within CMA. Given this development, the authorities are determined to have an indicative monetary policy framework for the current period that will target international reserves which are currently at about four months of imports. This would include projections for money demand, while taking into account projected declines in real GDP and inflation. The authorities are fully aware of the benefits of such a mechanism in determining the limits to be observed especially with regards to net domestic assets and net creditor position of government in the banking system. More prudence will be undertaken to lower the NPV of external debt below the 40 percent of GDP threshold, currently an appropriate indicative threshold for the debt to GDP ratio.

Structural Reforms

The authorities will continue to implement measures that will increase labor productivity and contain domestic cost pressures. In view of the current high unemployment in the manufacturing sector, they will ensure that parties involved in wage negotiations are encouraged to take into account productivity and terms of trade movements. They will also continue to exercise constraints on any increases in public sector wages to avoid spill-over effects in the economy. In order to stimulate production and eliminate further declines in employment, the authorities will provide subsidies to the textile sector, that will be properly designed to protect against any downside risks. Such action will be weighed against the expected benefits in investment flows, output and employment. The investment climate will be improved to further attract foreign investment and will entail accelerating reforms that will eliminate legal and regulatory impediments towards private sector development, including improvements in infrastructure facilities and completion of the privatization of the Lesotho Electricity Corporation (LEC).

The authorities will also strengthen institutional framework for the development, execution, monitoring, and evaluation of new programs for scaling up poverty reduction expenditures. They will continue to pursue public-private partnerships, aimed at improving infrastructure and public service delivery in health and education sectors.

Financial Sector Issues

The authorities will implement measures that will lead to improvements in the financial sector, especially with regards to enabling competition and private sector access to bank credit. They will develop a three-tier banking system that will consist of foreign-owned banks, local cooperatives and small banks, and microfinance institutions. Measures will also be taken to strengthen banking regulation, amend the Matrimonial and Land Acts, and remove obstacles to bank lending as well as ensure a proper and well functioning payments system that will involve revision of the current legislation and facilitate electronic transfer payments.

4. The PRS Process

The authorities are fully aware that the PRS is an important step toward sustained growth and poverty reduction in the country as well as meeting the MDGs. The process has been conducted through broad based consultations with key stakeholders and civil society. The authorities have fully outlined their priorities with a program of actions that has facilitated preparation of a set of cost matrices and performance indicators. The key limitations and risks to the PRS relate to its operationalization, possible further shocks to the economy and governance. Given the goals and objectives identified in the PRS, the authorities are ready and committed to transfer this into actual work plans. They will also exercise expenditure restraints as dictated by the fiscal framework, especially in non-priority areas that have been identified. There will be improvements in monitoring and evaluation which will help to identify existing capacity constraints in the public sector.

While ensuring that these challenges are overcome and risks mitigated, the authorities will give priority to developing and implementing a comprehensive medium-term macroeconomic framework and an action plan for sustained growth to address external vulnerability and competitiveness concerns. In addition, the authorities will address the designation of an action plan to improve the allocation of resources and public expenditure management, including civil service reform and address the HIV/AIDS pandemic more vigorously.

5. Conclusion

The authorities have taken appropriate measures to ensure achievement of macroeconomic objectives. Given this development, the authorities have expressed strong interest in continued Fund involvement and support through capacity building and technical assistance. They are requesting Fund assistance and involvement in crucial areas of fiscal and public resource management, financial sector reform and prudential supervision, as well as the designing of an appropriate macroeconomic framework. They have also shown interest in securing the necessary assistance in drafting an appropriate law for electronic banking, review of the study conducted to determine an adequate level of foreign reserves and provision of field training to personnel in financial programming.