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KINGDOM OF LESOTHO

July 2014

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE KINGDOM OF 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 2014 Article IV consultation with Lesotho, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 4, 2014, following discussions that ended on April 11, 2014, with the officials of Lesotho on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 19, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Debt Sustainability Analysis Update** prepared by the staffs of the IMF and the World Bank.
- A **Press Release** summarizing the views of the Executive Board as expressed during its June 4, 2014 consideration of the staff report that concluded the Article IV consultation with Lesotho.
- A **Statement by the Executive Director** for the Kingdom of Lesotho.

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

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KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

May 19, 2014

KEY ISSUES

Setting: Lesotho achieved strong economic growth in recent years, with only moderate inflation. International reserves have largely been rebuilt, thanks to a sustained period of fiscal restraint and recovery in revenues from the Southern African Customs Union (SACU). However, unemployment remains high and poverty is widespread, especially in rural areas. Since 2012, Lesotho has been led by a coalition government with a slim majority.

Outlook and risks: Growth is expected to be robust over the medium term—led by mining, construction, and services—but there are risks, mainly arising from Lesotho's heavy dependence on volatile SACU revenues. A loosening of the fiscal stance in the recently approved budget for 2014/15 threatens to erode official international reserves. The budget also indicates that recurrent expenditures—most notably the government wage bill—will remain elevated over the medium term.

Policy mix: Staff recommends a more moderate easing in the fiscal stance than the budget's and curbing recurrent expenditures to allow greater investment for inclusive growth. Preserving international reserves—to ensure a secure exchange rate peg—and debt sustainability are critical for macroeconomic stability. Over time a rules-based fiscal framework could strengthen stability.

Financial sector: Overall, indicators point to a sound banking system. Implementing the Financial Sector Development Strategy would improve access to financial services and support private sector development.

Structural agenda: An ambitious reform effort, particularly in the fiscal area, is needed to achieve a more efficient public sector and enable private sector-led growth.

Approved By
Anne-Marie Gulde-Wolf and Chris Lane

Discussions took place in Maseru during January 14–27, 2014 and in Washington, D.C. during April 8–11. The staff team consisted of Mr. Dunn (head), Ms. Koliadina, Mr. Abdychev (all AFR), Mr. Al-Sadiq (FIN), Mr. Tharkur (Resident Representative), and Ms. Nkholise (Resident Representative's office). The team met with Minister of Finance Leketekete Ketso, Central Bank Governor Rets'elisitsoe Matlanyane, as well as other government ministers, members of parliament, other high-level officials, and representatives of the financial sector, business community, civil society, and development partners. Mr. Gonzalez (World Bank) assisted the team and Mr. Tlelima (OED) participated in discussions.

CONTENTS

TABLES

Appendices

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

A. Economic Developments in 2010/11–2013/14

1. **The Lesotho economy performed well in recent years, despite being hit by a severe balance of payments and fiscal shock and periods of adverse weather conditions for agriculture.** Since fiscal year 2010/11 (April-March), real GDP growth averaged just over 5 percent a year—driven by large scale investments in the mining and water sectors—while annual inflation fluctuated between 3½ and 6 percent (Tables 1-6 and Figures 1–3). An ample stock of official international reserves, together with a large fiscal adjustment initiated in 2010/11, was critical to this positive outturn, as revenue from the Southern African Customs Union (SACU)—which is also Lesotho's main source of foreign exchange—fell by more than half (to about 15 percent of GDP a year in 2010/11 and 2011/12). The Lesotho loti's hard peg to the South African rand remained secure throughout this crisis, but a large share of international reserves was consumed in the process. Maintaining a relatively tight fiscal stance then allowed for a rapid replenishment of international reserves, when SACU revenues recovered in 2012/13. This adjustment effort was supported by the Fund with a three-year arrangement under the Extended Credit Facility (ECF), which was successfully concluded in September 2013 (Box 1).

2. **Fiscal performance slipped in 2013/14, but official gross international reserves still inched higher (to 4.8 months of imports for the following year).** The deterioration of the fiscal performance was largely the result of a dip in SACU revenues (relative to GDP) and a shortfall in domestic tax revenues,[1] while recurrent expenditure rose slightly (to over 45 percent of GDP), led by increased spending on wages. The overall fiscal balance fell into deficit (more than 1 percent of GDP), after recording a significant surplus the year before. The core SACU fiscal deficit, which helps to gauge the underlying fiscal stance, also widened (by over 2½ percentage points of GDP to nearly 8½ percent of GDP).[2] Although capital spending subsided, mainly reflecting poor project implementation, external borrowing remained elevated in 2013/14, which facilitated the increase in reserves.

[1] The authorities are investigating the unexpected tax revenue shortfall. The ongoing restructuring of the Lesotho Revenue Authority (LRA) may have temporarily disrupted collections, which fell by a percentage point of GDP relative to the previous year and were well below budget expectations.

[2] Core SACU revenues is a construct that represents the stable component of SACU revenues. They are defined as the minimum annual amount of revenues received (15 percent of GDP) over the past 20 years. The core SACU fiscal deficit excludes the volatile (non-core) component of SACU revenues, as well as spending on projects financed by external borrowing.

Box 1. IMF Policy Advice in the 2012 Article IV Consultation and Program Outcome

Lesotho's previous Article IV consultation was completed on April 12, 2012, in conjunction with the combined second and third review of its program supported by a three-year arrangement under the Extended Credit Facility (ECF).

Since then, the authorities achieved progress in the following areas recommended by staff:

- Macroeconomic stability was enhanced by rebuilding international reserves and strengthening debt sustainability; notably, a substantial fiscal surplus was achieved in 2012/13.
- Domestic arrears were audited and largely eliminated; a time-bound plan for capacity building was adopted, and the front office revenue receipting system was implemented.
- Despite fiscal adjustment various social programs were safeguarded (such as, school-feeding, old-age pensions, and the HIV/AIDS program), although there remain questions about their effectiveness at protecting the most vulnerable.
- The Financial Institutions Act, which strengthened the regulatory and supervisory frameworks for banks and non-banks, was enacted.

However, there have also been some setbacks:

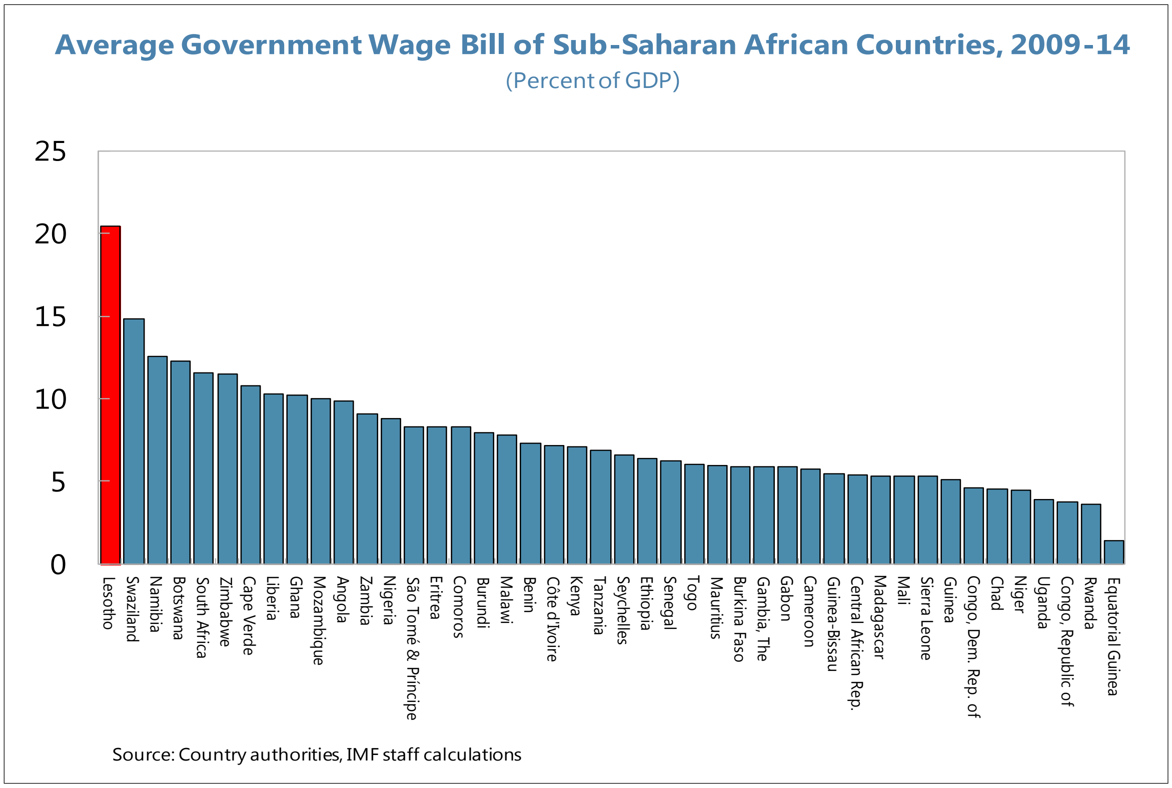
- Under execution of the National Strategic Development Plan (NSDP).
- Public financial management—specifically cash management and the integrated financial management and information system (IFMIS)—remains weak.
- Private sector development continues to be hampered by a difficult business environment, as manifested by long delays in issuing construction permits, limited access to finance, difficult property registration, obstacles to cross-border trade, and weak enforcement of contracts.
- The supervisory capacity of the Central Bank of Lesotho (CBL) needs further improvement.

The 2012 Article IV consultation provided a basis for the policy agenda for the latter part of the ECF-supported program. The sixth and final review of the program was completed on September 9, 2013. Over the course of the program all but two quantitative performance criteria (PC) were met—early in the program, net international reserves fell slightly short of the target; also, a nonconcessional external loan was contracted. As indicated above, progress on the structural agenda was mixed. Out of 19 structural benchmarks, 7 were implemented as programmed, 10 with delays, and two—the monthly reconciliation of all Treasury accounts and submission to Parliament of the amendments of the Loans and Guarantees Act—remain outstanding.

3. Despite robust economic growth, unemployment remains high and poverty is widespread, particularly in rural areas. Moreover, several indicators point to worrisome conditions, such as the low quality of primary and secondary education and a high incidence of HIV/AIDS, which has had a devastating impact on life expectancy (Table 7).[3] While there has been progress on reducing infant, child, and maternal mortality rates in recent years, they are still high relative to the more distant past. Poor implementation of the National Strategic Development Plan (NSDP), which was officially launched in 2012, has weakened the fight against poverty. In

[3] Life expectancy in Lesotho remains low at 46 years of age, reflecting a 23 percent incidence of HIV/AIDS.

addition, low capacity has impaired planning and implementation of government investment projects intended to support more inclusive growth. Meanwhile, the public sector wage bill (relative to GDP) is the highest in sub-Saharan Africa, partly due to political pressures to expand employment.



4. Given that Lesotho had episodes of difficult political transition prior to 2012, the NSDP places a high priority on strengthening the democratic process. In this context the peaceful transfer of power to a coalition government following the elections in May 2012 was an important milestone. Moreover, the government has made progress in fighting corruption and strengthening governance, as evidenced by Lesotho's moving up to the 55th place out of 177 countries in the Corruption Perception Index by Transparency International. To further reduce corruption the government has emphasized compliance with public service regulations that require senior officials to declare their assets. In addition, to improve accountability, the government has been introducing performance contracts for cabinet ministers. However, with only a slim (one-seat) majority in the National Assembly, there is some fragility in the coalition government, which adds to the challenge of policy making. In late March 2014, the National Assembly was adjourned indefinitely following the submission by the opposition of a no-confidence motion against the Prime Minister and coalition government.

B. Outlook and Risks for 2014/15 and the Medium Term

5. The underlying strength of the Lesotho economy is expected to support robust growth over the medium term. After dipping to 4 percent in 2014/15, real GDP growth is projected to pick up to 5–5½ percent a year over the medium term, driven by projected strong expansions in construction, mining, and private sector services. In particular, construction is expected to receive a major boost from large infrastructure projects—most notably, the second phase of the Lesotho Highlands Water Project (LHWP-2) and a large mining project is expected to begin production.[4] At the same time, inflation is projected to remain moderate, in line with that of South Africa.

6. However, over the medium term, the economy is likely to become more vulnerable to risks. In particular, based on the recently approved government budget for 2014/15 and the authorities' fiscal projections, persistent government deficits would consume existing buffers and contribute to a rundown in official international reserves. Tax revenues are projected to grow only slightly over the medium term, while government employee compensation is projected to remain at about 20 percent of GDP. In addition, SACU revenues are projected to steadily decline during this period, contributing to an increasing overall fiscal deficit. With net external financing projected to hold steady at 3–3½ percent of GDP a year, the government would eventually start drawing down on its deposits in the CBL. Correspondingly, official international reserves are projected to decline to about 4 months of the following year's imports over the medium term.

7. Staff's risk assessment identified the possibility of a sudden and permanent drop in SACU revenues as a serious potential threat to the Lesotho economy (Table 8). While the likelihood of a collapse in SACU revenues is considered to be low-to-medium in the near term, recent experience has shown that the impact can be severe, especially if a drop in revenues is prolonged or permanent. Staff also explored the impact of the possible expiration of Lesotho's trade preferences under the United States' African Growth and Opportunity Act (AGOA) and

[4] Investment in LHWP-2 is expected to total USD 1½–2 billion (or roughly 75–100 percent of today's GDP) over several years. Following a roughly USD 250 million investment, the expansion of the Liqhobong diamond mine is expected to begin production within the upcoming year. These activities are conservatively projected to raise GDP growth about 1 percentage point above Lesotho's long-term average growth trend of 4½ percent a year over the latter half of this decade.

spillover effects from a possible prolonged growth slowdown in South Africa and other emerging markets.[5]

POLICY DISCUSSIONS

Policy discussions centered on stepping-up implementation of the NSDP to achieve more inclusive, private sector-led economic growth, while maintaining macroeconomic stability. Four main themes emerged: (i) balancing macroeconomic policies for growth and stability; (ii) strengthening public financial management (PFM); (iii) deepening the financial sector and maintaining its soundness; and (iv) enhancing competitiveness and private sector development.

A. Policy Theme 1: Balancing Macroeconomic Policies to Support Stability and Inclusive Growth

Ensuring macroeconomic stability

8. **Lesotho's macroeconomic stability is anchored upon the loti's hard peg to the rand, which has helped to contain inflation and strengthened the country's close economic and financial ties with South Africa**. To preserve confidence in the peg, it is critical for Lesotho to maintain an ample stock of international reserves and sound fiscal policies, including debt sustainability. Over the medium term, risks to macroeconomic stability could be mitigated by moving toward a rules-based fiscal framework.

9. **The medium-term target for gross international reserves of the past few years (equivalent to 5 months of the following year's imports) remains appropriate.** In addition to fulfilling Lesotho's commitments under the Southern Africa Common Monetary Area (CMA),[6] this target provides a fiscal cushion (equivalent to about 1½ months of imports or about 15 percent of GDP). This cushion is much needed in light of the government's heavy dependence on volatile SACU revenues. Indeed, experience from the 2010/11-2011/12 SACU revenue crisis—when reserves fell from over 6 months to about 3½ months of imports—demonstrated that the additional fiscal cushion is warranted. Staff recommended that the authorities strive to achieve the medium-term reserve target by end-2015/16, while SACU revenues are projected to still be relatively strong. This would require a moderately tighter fiscal stance than the approved 2014/15 budget (Table 9).

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[5] The Fund's Global Risk Assessment Matrix (G-RAM) updated in March 2014 places a high likelihood on the possibility of a prolonged slowdown in emerging market economies. It is widely expected that the AGOA program would be renewed.

[6] The CMA requires members to maintain rand reserves equivalent to 100 percent of narrow money (M1). The Central Bank of Lesotho (CBL) adheres to a more conservative minimum of 120 percent of M1, which is roughly equivalent to 3½ months of imports.

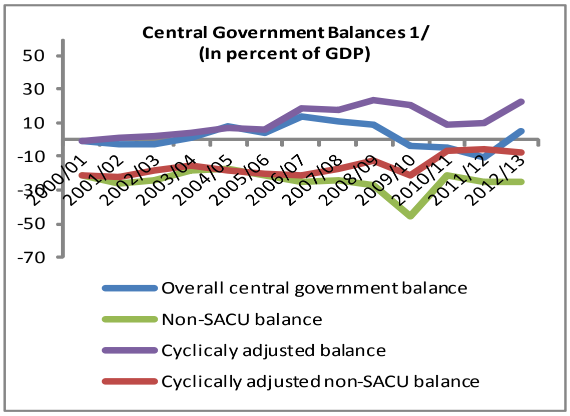
10. Lesotho remains at moderate risk of external debt distress, implying that the authorities will need to exercise caution to maintain debt sustainability.[7] Under the approved 2014/15 budget, it is anticipated that government's net external financing would be 3–3½ percent of GDP a year over the foreseeable future, which together with the large financing needs of the forthcoming LHWP-2 project, would drive debt indicators toward their corresponding thresholds for debt sustainability. Government external borrowing would need to be limited largely to loans on concessional terms; although there is some scope for domestic borrowing. Staff recommended limiting government annual net external borrowing to 1½–2 percent of GDP on concessional terms to provide a more comfortable margin for debt indicators and macroeconomic stability. Staff also encouraged the authorities to submit the new Public Debt Management Bill to parliament without further delay and to make the medium term debt strategy operational.

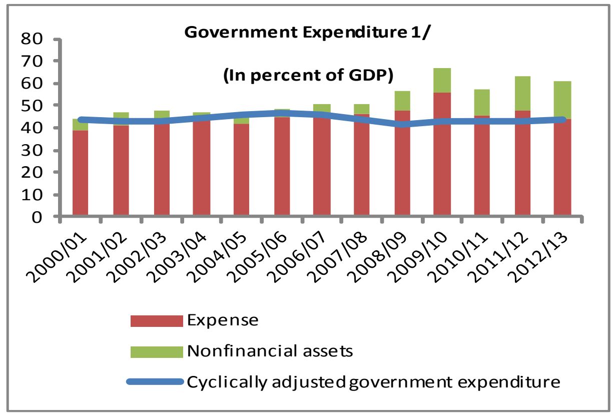
11. Over the medium term, moving toward a rules-based fiscal policy framework could reduce Lesotho's vulnerability to volatile SACU revenue (Box 2). That is, a rules-based approach could reduce the pro-cyclicality of government spending and, by budgeting appropriately for the volatility of revenues, reduce the exposure to revenue shortfalls. While it would take some time to gain sufficient experience to determine and employ a firm rule, staff recommended extending the current practice of segmenting SACU revenues between core (permanent) and non-core (volatile) components, and targeting the core-SACU fiscal balance such that eventually a surplus that is consistent with maintaining an adequate level of international reserves, is generated. The volatile non-core component of SACU revenues could then be directed toward capital spending, possibly using some averaging or a "permanent income" approach to determine annual expenditures. The mission recommended researching options, noting that lessons from countries with exhaustible natural resources might be relevant, given that SACU revenues are volatile and expected to decline over time. Finally, because a well-functioning rules-based fiscal framework would mitigate much of the risk associated with volatile SACU revenues, an analysis of reserve adequacy suggests that, once such a framework would be in place, a lower level of reserves could be optimal (Appendix 1), thus freeing up resources for additional capital spending down the road. Staff emphasized that transparency and quality public financial management (PFM) are critical to the success of a rules-based approach.

[7] Debt Sustainability Analysis (DSA) Update (Country Report No. XX , Supplement 1) prepared by World Bank and IMF staffs.

Box 2. Lesotho: Developing a Rules-Based Fiscal Framework

Discretionary fiscal policy has led to significant swings in fiscal performance in Lesotho. Relaxed spending constraints during periods of high SACU revenue required abrupt adjustment when SACU revenue declined. This pro-cyclical pattern was temporarily broken in 2012/13, when fiscal policy focused on maintaining a given fiscal deficit, excluding SACU revenues, so that the recovery in these revenues reduced fiscal and external imbalances and secured international reserves and broadly sustainable debt.





1/ Cyclically adjusted expenditure grow at the rate of a 10-year average historical GDP growth.
Source: Data from the authorities and staff estimates.

A rules-based fiscal policy framework could help to balance immediate and medium-term fiscal priorities with available resources.

- *Macroeconomic stability requires that fiscal balances support the reserve target.* To this end, Lesotho would need to maintain an overall surplus, consistent with a borrowing constraint. Over the medium term, Lesotho could aim to finance recurrent spending and reserve accumulation with domestic revenue, and channel SACU revenue toward development needs. This would require broadening the tax base and streamlining recurrent spending. To mitigate the effects of volatile SACU revenue on fiscal policy Lesotho could manage the fiscal stance by controlling a core SACU balance, which excludes the volatile part.

- *Debt sustainability—the inter-temporal resource constraint—ensures government solvency.* Lesotho does not face an imminent risk of debt distress, but excessive spending when SACU revenues are high could undermine fiscal stability. Imposing a debt ceiling and translating it into an annual borrowing constraint would help ensure fiscal sustainability.

- *Refraining from pro-cyclical fiscal policy could help avoid abrupt fiscal adjustments.* Countercyclical policy may lead to savings in excess of those required by a reserve target, improving economy's resilience to shocks. Keeping expenditures constant or reducing them in percent of GDP during the time of robust economic growth would allow the government to streamline recurrent spending and raise capital expenditure. Once expenditures reached their optimal level, their growth could be constrained by a numerical rule.

Authorities' view

12. The authorities confirmed that the exchange rate peg has served Lesotho well, particularly as the anchor for macroeconomic stability. They agreed that the medium-term target for gross international reserves of five months of import coverage is still appropriate and expressed concern over the deterioration of reserve under the budget projections. In particular, they agreed that a somewhat tighter fiscal stance would be appropriate and that revenue and spending measures would be needed. They emphasized, however, the CBL's statutory requirement to maintain reserves of 120 percent of narrow money (M1) is already a conservative sum for safeguarding the loti's parity with the rand, given the lower requirement under the CMA. Over time, the authorities may want to explore if part of the fiscal cushion could be used to finance development needs. They welcomed the implication that under an effective rules-based fiscal framework, which requires strong public financial management, the optimal level of reserves could be lower and agreed that further research on this issue is needed.[8]

13. The authorities agreed with the conclusions of the DSA and the importance of debt sustainability for macroeconomic stability. They will continue to seek low-cost sources of external financing, including grants and concessional loans, to contain the debt burden, but noted that the hydro-power component of the forthcoming LHWP-2 project would likely require substantial financing on commercial terms, as assumed in the DSA. They agreed that the next DSA update should take the findings of the ongoing LHWP-2 feasibility study into account, but noted that staff should be open to various financing options that limit Lesotho's exposure to risk.

Enhancing the inclusiveness of growth

14. In line with the NSDP, the authorities envisage a multi-pronged approach to generate more inclusive growth and reduce poverty. First, the government aims to step up its investment spending to support growth in priority sectors (manufacturing, tourism, information technology (IT), and commercial agriculture), which have the potential to create employment opportunities. Second, the government allocates substantial resources to education, health, and social transfers—such as pensions. Third, the authorities seek to create a more enabling environment for private sector growth. While progress on these three fronts has been limited, the authorities are trying to reinvigorate their efforts. In January 2014, a National Economic Workshop was held to draw attention to some key issues, but further work is needed to form an implementable action plan.

[8] The authorities agreed that shifting to a rules-based fiscal framework should be a gradual process, which would involve testing various options, such as limiting SACU revenues to financing government investment projects.

15. However, under the approved budget, there is little scope for stepping up government investment to support inclusive growth, despite the excessive loosening of the fiscal stance. This is mainly because of a weakening in revenue collections and the further expansion of recurrent expenditures. Staff recommended taking both immediate and medium-term actions that could generate fiscal space for investment. On the revenue side, further tax policy measures, including unification of the value-added tax rates, could be taken to build upon the steps approved in the 2014/15 budget—notably, the elimination of the zero income tax rate for non-SACU manufacturing companies, which would create a more level playing field in manufacturing and simplify tax administration. In addition, based on recent Fund technical assistance (TA), the authorities should prepare an action plan for tax reform, including taxation of the mining sector and the introduction of a property tax. The Lesotho Revenue Authority (LRA) must also strive to reverse the recent slippage in revenue collections by steadfastly implementing a medium-term action plan to strengthen the LRA.[9]

16. Ongoing efforts to rationalize the civil service are critical not only for generating savings, but also for improving the delivery of government services. During the second half of 2013/14, the government embarked upon pilot payroll audits in three line ministries (Education, Health, and Local Government). Although there have been delays, the audits have revealed large numbers of "ghost" employees. Staff urged the authorities to strengthen public resource management by completing the pilot payroll audits and extending them to all ministries during 2014/15, eliminating ghost employees, and strengthening management and control of the public service. Once a clear picture of the civil service has been established, a functional review is needed to ensure efficiency and the delivery of much needed services.[10] Staff recommends that after achieving greater efficiency in the civil service, the total wage bill be kept constant in real terms to maintain discipline and create further fiscal savings that could be directed to capital spending. Finally, an assessment is also needed for other recurrent expenditures beyond the wage bill—such as keeping recurrent spending fixed in real terms. Despite high levels of spending relative to GDP, progress on improving social indicators has been weak.

17. On capital spending, staff welcomed the authorities' recent initiative to appraise all new projects before including them in the budget. This would not only improve execution of the capital budget, but could generate a higher rate of return on government investment and

[9] Fund technical assistance has provided a basis for an action plan.

[10] The authorities indicated that they will work more closely with the World Bank on rationalizing the civil service.

help focus scarce resources on the strategic sectors that enhance inclusiveness and employment. Finally, whereas under execution of the capital budget has been an issue in recent years, staff recommended that underutilized portions of capital budgets be retained exclusively for future capital spending on priority needs.

18. Taking these fiscal recommendations together demonstrates the potential to strike a balanced macroeconomic policy framework that generates space for investment to promote inclusive growth, while maintaining adequate international reserves and preserving debt sustainability (see illustrative scenario in Table 9). Staff's projections assume that the above revenue measures could increase domestic revenue collections by ½ percentage point of GDP a year over the medium term. Holding recurrent expenditures constant in real terms would then open space for a gradual increase in capital spending of about 5 percentage points of GDP by 2019/20, while achieving an overall fiscal surplus of about ½–2 percent of GDP a year. This would be consistent with the target for international reserves and improved debt sustainability.

Authorities' view

19. The authorities agreed that actions are needed to generate fiscal space for capital spending and development projects to support inclusive growth. They have begun to investigate the recent shortfall in tax collections, with a view toward correcting problem areas in the LRA. With further TA support from the Fund, they also hope to implement an action plan for tax reform. The authorities indicated that they would refrain from issuing mining licenses until after a new mining tax regime is in place. Moreover, they agreed that addressing high recurrent expenditures—and the wage bill in particular—is a matter of urgency. They are pressing ahead with the pilot payroll audits, including an ongoing verification process whereby civil servants need to collect their paychecks in person with the proper identification, and will expand the audit to the rest of the civil service shortly.[11] They also agree that the Ministry of Public Service urgently needs to regain management control of the establishment list (hirings). While the authorities did not commit to putting any ceiling on the wage bill over the medium term, they explained that the 2014/15 budget does not include any real wage increases, except for police officers (M25 million).[12] Finally, with a view toward rationalizing public sector employment, they

[11] The authorities will request TA for the payroll audit from the World Bank. Progress on the audit will be an important factor for future budget support from the Bank.

[12] Most of the increase in the wage bill in 2014/15 is a reclassification of wage payments that had previously been classified as grants.

will conduct a functional review of the entire civil service, once the payroll audits have been completed.

20. The authorities emphasized that the new policy on project appraisals is an important step forward to improve the effectiveness and implementation of the capital budget. They have stepped up the appraisal of projects, to minimize any delays in including new projects in the budget. The authorities acknowledged the need to address the unspent capital appropriations.

Mitigating risks to the medium-term outlook

21. A significant and, possibly, permanent reduction in SACU revenues is the major risk facing Lesotho. For instance, a permanent decline in SACU revenue to 15 percent of GDP would require substantial fiscal adjustment to preserve macroeconomic stability. To mitigate other risks, it is necessary that the authorities maintain an ample stock of international reserves and a relatively disciplined fiscal policy. In particular, the estimated magnitude of the potential slowdown in South Africa is relatively modest.[13] In addition, spillovers affecting Lesotho from a weakening of South Africa's economy (and the global economy more generally) can have offsetting effects, such as lower prices for imported fuel and lower interest rates. Nevertheless, possible layoffs of Basotho miners in South Africa would reduce remittances and lead to a modest widening of the current account deficit and slower accumulation of reserves. Lesotho's medium-term economic growth, however, is driven primarily by construction and the domestic mining sector, which would slow down only slightly. Given the relatively low value added of textile manufacturing in Lesotho, the main risk from adverse developments to AGOA would be the fiscal impact of worker layoffs, since the net impact on the balance of payments and tax revenue side are small.

Authorities' view

22. The authorities agreed with the thrust of staff's risk assessment. They agreed that a significant and permanent decline in SACU revenue would require a major shift in macroeconomic policies. They also acknowledged the importance of maintaining adequate international reserves to mitigate risks, and saw the value of moving toward a rules-based fiscal framework to reduce vulnerabilities.

[13] Based on simulations using the Fund's Vulnerability Exercise for Low-Income Countries and the G-RAM's projected slowdown in South Africa's average annual growth rate (of about ½ percentage point).

B. Policy Theme 2: Strengthening Public Financial Management to Improve Government Services

23. Public financial management in Lesotho is weak, seriously impairing budget planning, execution, and monitoring and the overall delivery of government services. Staff encouraged the authorities to build upon the PFM workshop that was held in November 2013, and actively pursue the implementation of the PFM reform action plan. Efforts need to be stepped up in the following areas: (i) strengthening the PFM Secretariat so that it can advance the reform agenda and coordinate the contributions of development partners; (ii) making the Cash Management Unit (CMU) operational and introducing the monthly reconciliation of all Treasury accounts to strengthen the auditing of government operations; (iii) implementing the IFMIS upgrade; (iv) finalizing the draft regulations for the Public Financial Management Act (PFMA); (v) strengthening the Medium Term Expenditure Framework (MTEF) to ensure meaningful medium-term expenditure ceilings to line ministries; and (vi) building government's capacity for project appraisal to enable capital spending to generate high returns. Finally, staff encouraged the authorities to submit the Public Debt Management bill to parliament without any further delay and to ensure its expedient passage and implementation in order to strengthen debt management procedures and eliminate the remaining legal loopholes, including the issuance of government guarantees to private entities. The draft law would give legal backing to the work of the Debt Management Committee which is required to review and analyze all requests for guarantees and, among other things, conduct due diligence and analysis of possible risks. The single public debt ceiling would also include guarantees granted by the government.

Authorities' views

24. The authorities acknowledged the need to step up PFM reforms and assured staff that the recently appointed Accountant General has been working on making the CMU operational, collaborating with the World Bank on implementing IFMIS upgrades and introducing monthly reconciliation of all Treasury Accounts. The weak capacity of the Drafting Office has led to a delay in a submission of the Public Debt Management Bill to parliament and the completion of drafting the PFMA regulations.

C. Policy Theme 3: Sound Deepening of the Financial Sector

25. Lesotho's financial sector is dominated by the banking system, which as a whole appears quite sound (see Table 6). There are four commercial banks, three of which are subsidiaries of South African banks and account for over 95 percent of total loans and deposits. The fourth bank, the Lesotho Post Bank, is government-owned and has long faced solvency issues. For the system as a whole, nonperforming loans are small (3.8 percent of total loans as of end-2013), much of which was covered by banks' provisions. Financial intermediation is still limited in Lesotho, especially on the credit side (below 21 percent of GDP), even though lending received a substantial boost by the passage of the Land Act in 2012, which allowed residents to use their property as collateral for bank loans.

26. The nonbank financial system continues to be dominated by pension plans and insurance companies, with assets amounting to 17 percent and 14½ percent of GDP, respectively, as of end-2012.[14] The principal challenges facing these nonbank financial institutions (NBFIs) are: (i) only about ¼ of wage earners participate in the pension plans, and these are mostly public sector employees; and (ii) the regulatory framework and supervision of the insurance sector are weak. Expanding the coverage of pension plans could generate a valuable source of long-term savings available to finance investment. For the insurance sector, there has been some progress with oversight in recent years. First, two small insurance companies that were insolvent have been absorbed by larger companies. Also, the new Insurance Bill was approved by parliament in mid-May 2014. The bill is a major improvement over the previous Insurance Act, which dates back to 1975 and is marked by excessive rigidities. However, the new bill does not cover insurance intermediaries—agencies and brokers—despite evidence of inappropriate and risky business practices. The authorities are preparing implementing regulations and amendments, including coverage of intermediaries. Also, training is needed to strengthen supervision of the industry.

27. Better access to finance, sound financial intermediation and financial sector deepening would support private sector development. Staff welcomed the authorities' efforts to strengthen banking regulation and supervision, launch a credit bureau in June 2014, and step up work on developing microfinance institutions. In line with Fund TA, staff recommended to finalize regulations supporting the implementation of the 2012 Financial Institutions Act (FIA); strengthen on- and off-site supervision; and gradually adopt pillar II of the Basel II capital accords. Given the dominant role of South Africa's banks in Lesotho, it is important to strengthen cross-border supervision by enhancing coordination with the South Africa Reserve Bank, including the updating of the memorandum of understanding for cooperation and information sharing. In addition, the CBL needs to formulate a training curriculum for staff, especially new employees, that among other things builds capacity in risk-based supervision and to pursue a

[14] Other NBFIs include licensed and informal moneylenders, burial societies, asset managers, and savings and credits cooperatives (SACCOs).

human resources policy that would increase retention of high-performers, including career advancement. The approval of the Financial Sector Development Strategy (FSDS)—an important milestone in financial sector development—needs to be followed by its expedient implementation.[15] To this end, staff recommended (i) to conduct a strategic review of the Post Bank considering options of continued stand-alone operation, seeking a strategic partner, or winding down operations; (ii) develop the interbank market and the CBL's capacity for liquidity management; and (iii) take steps to establish a yield curve, including issuance of treasury bills and bonds of various maturities.

Authorities' views

28. The authorities noted that strengthening financial sector supervision and the implementation of the FSDS are major priorities. They acknowledged that the completion of financial regulation facilitating the implementation of the FIA has been delayed, due to the low capacity of the Drafting Office. They expect that approval by parliament of the Insurance Bill would strengthen the regulatory framework for the insurance industry and noted that they have been strengthening the regulatory framework for pension funds. The CBL has been closely monitoring non-performing loans and the risks remain contained, since banks are cautious in their lending and maintain high loan-loss provisions.

D. Policy Theme 4: Enhancing Competitiveness and Enabling Private Sector Development

29. A sustained structural reform effort will be needed to support the growth strategy. Staff recommended stepping up structural reforms promoting international competitiveness and private sector development, in collaboration with the World Bank, in the context of the Second Growth and Competitiveness Development Policy Grant (Box 3). This work should aim at addressing the shortcomings of the business environment by drafting the Business Registration Bill and accompanying regulations; regulations for the Industrial Licensing Bill; streamlining the construction permit system within the Maseru City Council; modernizing the Insolvency Proclamation to facilitate debt enforcement collective creditor recovery; and further strengthening anti-corruption efforts.

[15] The FSDS is a comprehensive plan that covers financial inclusion and literacy, creditors' rights, the strengthening of institutions, financial innovations and payments systems, resource mobilization, as well as strategies to strengthen the regulatory and supervisory frameworks for banking, insurance, and pensions. The FSDS benefitted from extensive World Bank and Fund TA.

Box 3. External Stability Assessment: Exchange Rate and Competitiveness

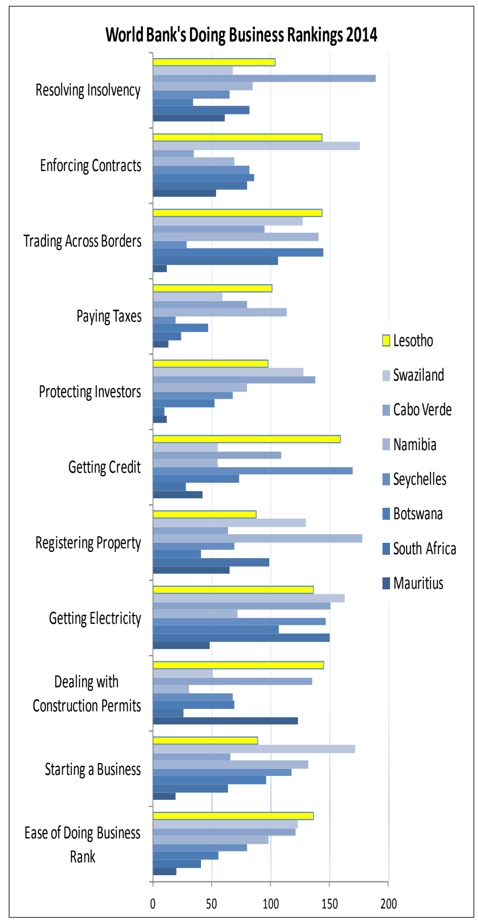
Staff's exchange rate assessment exercise suggests that the Lesotho loti is broadly in line with medium term fundamentals (Appendix 2). The approaches used yielded the following results:

- External sustainability - undervalued by about 5 percent.
- Equilibrium real exchange rate (ERER) - undervalued by about 16 percent.
- Macroeconomic balance - the real exchange rate is in line with equilibrium.

In view of data weaknesses, staff finds the macroeconomic balance approach to be the most reliable. Results from the ERER approach are skewed towards undervaluation by Lesotho's high levels of government consumption (due in part to large SACU revenue transfers) and remittance inflows.

Recent surveys indicate that Lesotho has a poor environment for private sector growth and place it among the world's less competitive countries. The World Bank's 2014 Doing Business Report ranks Lesotho 136th (out of 185), identifying major problems in all important stages of business—obtaining construction permits, access to land and electricity, registering property, access to credit, trading across borders, and enforcing contracts. The 2013-14 Global Competitiveness Index (WEF) places Lesotho in 123rd place (out of 148), citing among the greatest problems access to finance, inadequate infrastructure, inefficient government bureaucracy. Areas where Lesotho has made progress in recent years include streamlining procedures for property registration and business licenses. For example, the number of days to start a business was reduced to 29 days (from 73 days).

Ongoing initiatives to improve the business climate include implementing the Land Act, Land Administration Act, and the Companies Act. These acts will facilitate land access, including through subleases, and reduce the time needed to obtain a construction permit (currently 330 days). The authorities are also seeking to simplify cross-border trade. The authorities are setting up a credit reference bureau and instituting the national ID system, which are critical for increasing access to financing.



Authorities' views

30. The authorities acknowledged impediments to doing business, such as relatively high costs, border controls, a narrow production base, and the dominant role of the government in the economy. Moreover, structural issues, including cumbersome regulation and legislation have made Lesotho less attractive for domestic and foreign investment, hindering the transfer of knowledge and skills. The implementation of the NSDP, according to the authorities, would help closing infrastructure gaps and improving labor skills, potentially strengthening Lesotho's international competitiveness and expanding economy's capacity. The authorities plan to continue collaborating with the World Bank on improving business environment.

E. Other Surveillance Issues

31. Data provision is broadly adequate for surveillance with some key data shortcomings in fiscal and external sector statistics. The mission welcomed the recent release of GDP data. To build further on this development the mission encouraged the authorities to take steps to produce quarterly GDP data and GDP by expenditures. Production of monthly and quarterly fiscal data would allow much better monitoring of government operations.

Authorities' views

32. The authorities acknowledged the need to improve the quality, coverage and timeliness of data, including monthly and quarterly fiscal data, and noted that they have been working with the developing partners on improving the quality and timeliness of data.

STAFF APPRAISAL

33. Lesotho's economy performed well in recent years, despite being hit by a severe balance of payments and fiscal shock and adverse weather conditions for agriculture. In addition, since the crisis in 2010/11 and 2011/12, international reserves have largely been rebuilt thanks to a period of fiscal adjustment and recovery in SACU revenues. However, progress toward a sound macroeconomic policy framework stalled in 2013/14, due to fiscal slippages. In addition, despite robust GDP growth, unemployment is still high and poverty remains widespread, particularly in rural areas.

34. The government budget recently approved by parliament has gone too far in loosening the fiscal stance. This would lead to a rundown of international reserves and greater exposure to risks over the medium term. Moreover, the budget continues to favor recurrent expenditures, most notably the wage bill, rather than capital spending to support inclusive growth. Instead, staff recommends a more balanced fiscal policy (small overall surpluses) that is consistent with a gradual buildup of international reserves and debt sustainability, while also creating space for increased capital spending to support inclusive growth. In particular, staff recommends that the authorities take immediate action to get the wage bill under control by completing the ongoing payroll audits being piloted in the Ministries of Education, Health, and Local Government and eliminating "ghost" workers. The payroll audit would then need to be extended to the entire civil service. At the same time, it is critical that the Ministry of Public Service regain its management control of the establishment list (hirings). Following the payroll audits, the government could conduct a functional analysis of the civil service to ensure that personnel are used most effectively. Fiscal savings achieved in this exercise could usefully be directed to increase capital spending.

35. **Reversing the recent drop in government revenues is also important to achieve an appropriate fiscal stance.** This will require tax policy measures as well as a strengthening of revenue administration, areas that have both benefitted from recent Fund TA. It is particularly urgent that reform of mining taxation is implemented before any new mining licenses are granted.

36. **Maintaining debt sustainability is critical to macroeconomic stability.** Given the large financing needs of the LHWP-2 project, it will be necessary for government to contain its own borrowing needs—and to limit this borrowing to concessional loans—to ensure sustainability. Submission to parliament of the new Public Debt Management Bill, which has been held up in the Drafting Office, is critical for ensuring that the Ministry of Finance has full control of the debt.

37. **The loti's hard peg to the South African rand has served Lesotho well by anchoring macroeconomic stability, reducing the transactions cots, and facilitating financial integration.** Maintaining an ample stock of international reserves has helped to mitigate risks and secure the peg. Staff recommends that the authorities explore moving toward a transparent and predictable rules-based fiscal framework, which would further reduce risks and could eventually reduce the need for international reserves, thus opening up more fiscal space for scaling up capital spending.

38. **PFM reform is critical to a successful macroeconomic policy framework in Lesotho.** At this time, there are serious difficulties with budget planning, execution, and monitoring, which not only impair macroeconomic policies but also weaken the effectiveness of government services. Staff urges the authorities to make the Cash Management Unit operational and to conduct monthly reconciliation of all Treasury accounts as soon as possible.

39. **Deepening the financial sector, while maintaining its soundness, would be an important contribution to an enabling environment for private sector led growth.**

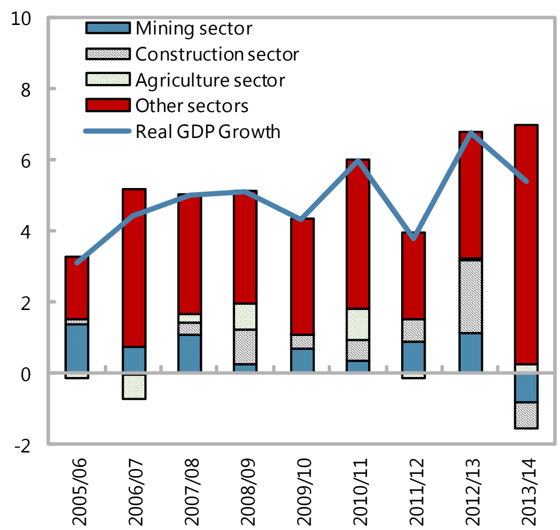
Strengthening the regulatory and supervisory framework, including effective cross-border supervision with South Africa, would enhance financial sector stability. Establishing a functional credit reference bureau could also be help reduce intermediation costs and increase access to credit. Good progress on the comprehensive reform agenda to enhance private sector competitiveness will also be critical for employment-creating inclusive growth.

40. Staff recommends that the next Article IV consultation with Lesotho take place on the standard 12-month cycle.

Figure 1. Lesotho: Economic Developments

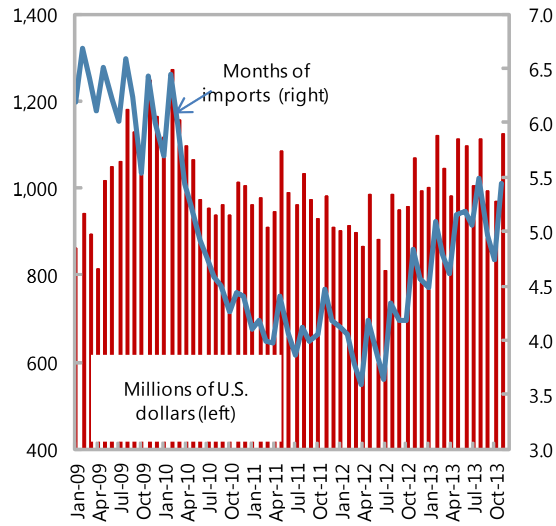
Economic growth has been robust, averaging 5 percent…

Contributions to Real GDP Growth by Sector
(Annual percent change of beginning period stock)



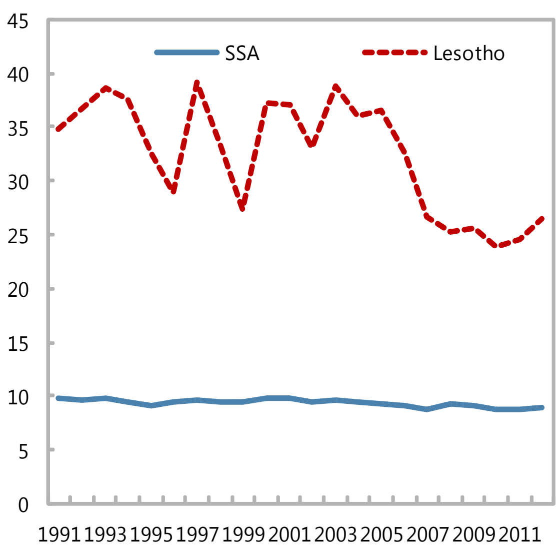
… and international reserves have largely recovered.

Gross International Reserves



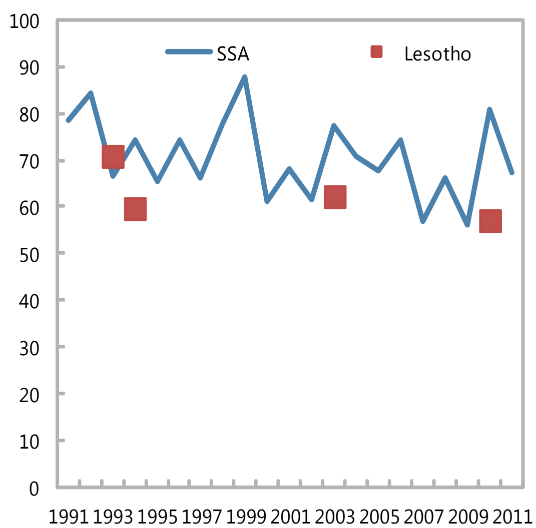
The unemployment rate remains high…

Implied Unemployment Rate
(Percent of population 15+)



…and poverty unyielding.

Poverty Rates, $2 per day PPP
(Percent of population)

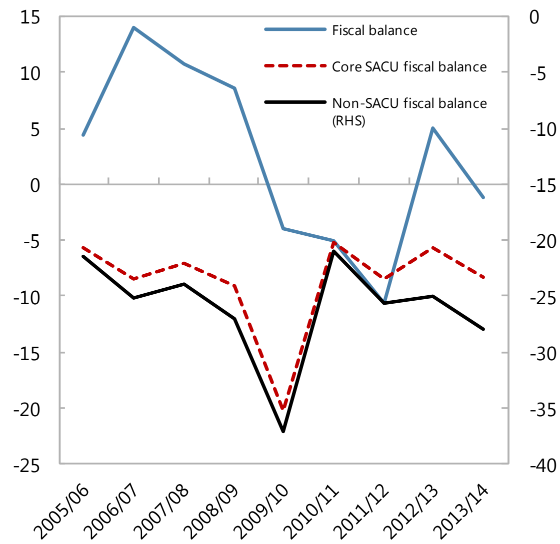


Sources: Lesotho authorities, World Bank, IMF staff estimates.

Figure 2. Lesotho: Fiscal Sector Developments

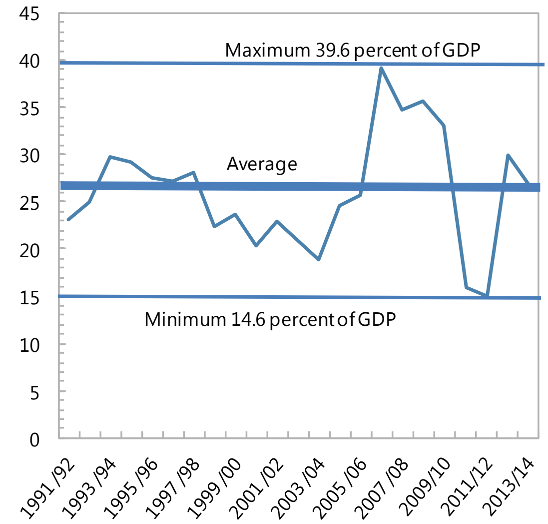
Fiscal balances improved on the heels of frontloaded consolidation which was sustained…

Fiscal Balance
(in percent of GDP)



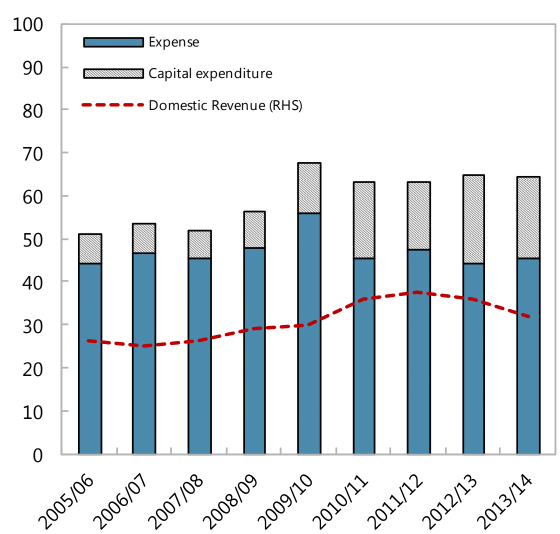
…as highly volatile SACU revenue recovered..

SACU revenue
(Percent of GDP)



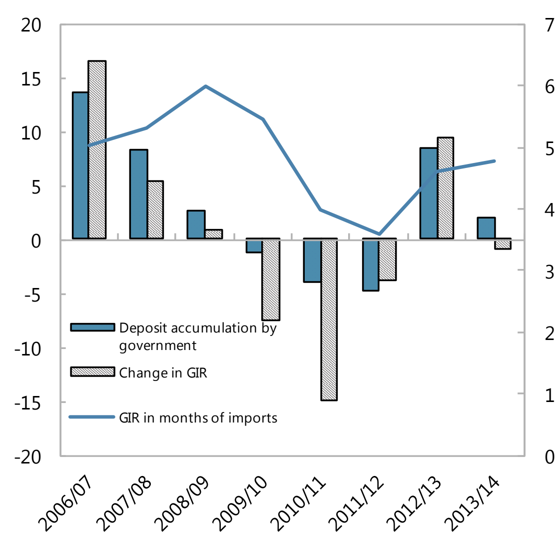
Domestic revenue is not sufficient to finance recurrent expenditure, which is partly financed by SACU revenue…

Central Government Expenditure
(In percent of GDP)



…affecting government deposit and reserve accumulation.

Domestic Financing and International Reserves
(In percent of GDP, unless otherwise indicated)

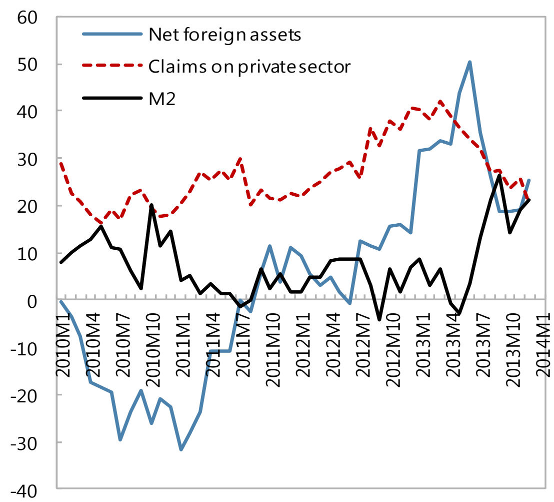


Sources: Lesotho Authorities, IMF staff estimates.

Figure 3. Monetary and Financial Sector Developments

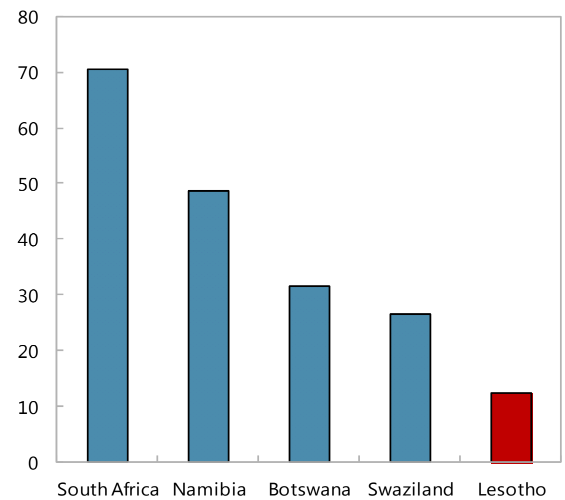
Strong private sector credit growth was financed by deposits, while excess liquidity contributed to NFA growth.

Monetary and Financial Sector Developments
(in percent change, year-on-year)



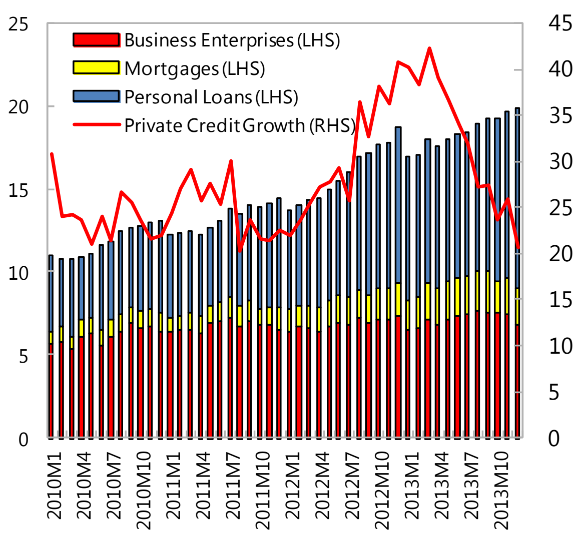
Credit market remains shallow.

SACU: Private Sector Credit
(Percent of GDP, 2013)



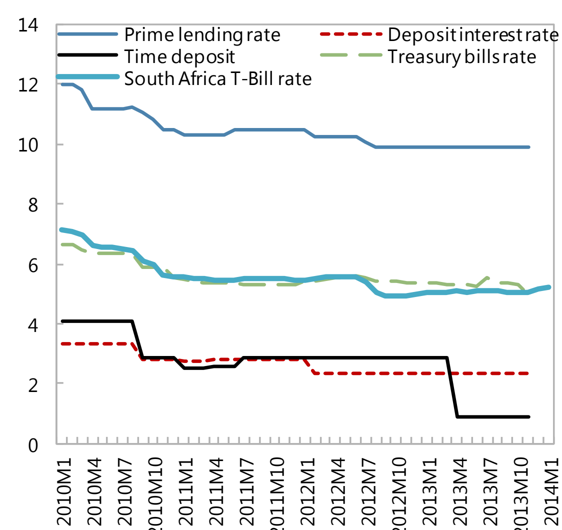
Consumer credit and mortgages are the major drivers of credit growth ...

Lesotho: Composition of Loans
(Percent of GDP)



Interest rates follow those of South Africa, and the interest rate spread remains high ....

Lesotho: Interest Rates
(Percent)



Sources: Lesotho authorities, IMF staff estimates.

Table 1. Lesotho: Selected Economic Indicators, 2010/11–2019/20 [1]

Population (1,000; 2011 est.)	2194
GNI per capita (U.S. dollars; 2011 est.):	1220
Poverty rate (Percent, 2005 est.):	56.6

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Act.	Prel.	Projections					
	(Percentage changes; unless otherwise indicated)									
National account and prices										
GDP at constant prices	6.0	3.8	6.7	5.4	4.0	4.9	5.0	5.5	5.5	5.6
GDP deflator	4.6	7.4	1.7	7.6	5.2	6.1	5.1	4.8	4.8	4.8
GDP at market prices										
(Maloti millions)	16,455	18,330	19,893	22,556	24,665	27,453	30,282	33,480	37,031	40,971
Consumer prices (average)	3.4	6.0	5.6	5.0	5.5	5.5	5.0	5.0	5.0	5.0
External sector										
Terms of trade (deterioration -)	4.0	9.1	-9.5	0.7	8.0	1.4	0.1	1.0	1.0	1.0
Average exchange rate										
(Local currency per U.S. dollar)	7.2	7.4	8.6	9.6	…	…	…	…	…	…
Nominal effective exchange rate change (– = depreciation) [2]	4.0	-7.1	-14.4	-11.5	…	…	…	…	…	…
Real effective exchange rate (– = depreciation) [2]	5.4	-3.6	-12.1	-9.3	…	…	…	…	…	…
Current account balance										
(Including official transfers, percent of GDP)	-7.5	-9.0	-2.7	-1.0	-1.0	-9.0	-10.4	-8.5	-10.3	-11.1
(Excluding official transfers, percent of GDP)	-29.3	-29.0	-36.6	-32.7	-33.1	-39.1	-37.2	-35.8	-36.9	-37.7
Gross international reserves										
(Months of imports) [3]	4.0	3.6	4.6	4.8	4.7	4.1	3.8	3.8	3.8	3.9
(Percent of M1)	144	139	179	160	162	156	145	151	154.4	159.5
Money and credit										
Domestic credit to the private sector	26.9	25.1	42.2	20.0	17.0	…	…	…	…	…
Broad money	1.1	5.0	6.1	24.9	9.0	…	…	…	…	…
Interest rate (percent) [4]	3.2	2.8	2.4	2.3	…	…	…	…	…	…
	(Percent of GDP; unless otherwise indicated)									
Savings and investment										
Gross capital formation [5]	29.0	34.9	35.6	33.3	36.4	37.7	38.0	38.4	39.8	42.5
Public	12.2	20.0	20.7	18.4	21.6	23.0	23.4	23.9	25.3	27.9
Private	15.1	14.6	14.6	14.5	14.4	14.3	14.2	14.2	14.2	14.2
National savings	21.5	25.9	32.8	32.3	35.4	28.8	27.6	29.9	29.6	31.3
Public	5.8	10.2	24.7	16.7	17.3	16.7	14.6	14.2	14.1	13.6
Private	15.8	15.8	8.1	15.6	18.1	12.0	13.0	15.7	15.4	17.8
Public debt	34.9	37.6	39.7	41.9	40.5	40.7	41.3	42.7	45.0	48.8
External public debt	30.2	31.5	36.5	39.0	37.9	38.3	39.2	40.8	43.1	46.1
Domestic debt	4.8	6.1	3.2	2.9	2.6	2.4	2.1	1.9	1.9	2.7
Central government fiscal operations										
Net lending/borrowing	-5.0	-10.6	5.0	-1.2	-1.8	-1.3	-3.1	-3.6	-3.8	-4.5
(Excluding grants)	-12.3	-18.4	-3.6	-6.6	-6.1	-5.1	-6.7	-7.3	-7.5	-8.1
Non-SACU fiscal balance [6]	-20.2	-23.5	-20.7	-23.4	-25.8	-23.3	-22.4	-22.2	-21.8	-21.3
Revenue	52.0	52.5	66.1	58.9	60.5	58.2	55.2	54.5	53.9	52.8
Of which: grants	7.3	7.8	8.6	5.3	4.2	3.8	3.6	3.7	3.7	3.6
Expenses	45.3	47.4	44.1	45.5	46.5	44.9	43.7	43.6	43.2	42.7
Nonfinancial assets	11.7	15.7	17.1	14.6	15.8	14.6	14.5	14.5	14.5	14.5

Sources: Lesotho authorities and IMF staff estimates and projections.

[1] The fiscal year runs from April 1 to March 31.

[2] IMF Information Notice System trade-weighted; end of period. For 2013/14 it is the latest observation as of October 2013.

[3] Reserve coverage of 5 months of imports is estimated as adequate for maintaining the exchange rate peg and providing a fiscal cushion to avoid abrupt adjustment. Reserves in excess of 5 months of imports constitute savings for future capital budget expenditure.

[4] 12-month time deposits rate. The 2013/14 interest rate is as of end-December 2013.

[5] Excluding changes in inventories.

[6] Excluding externally financed capital project.

Table 2. Lesotho: Fiscal Operations of the Central Government, 2010/11–2019/20 [1]

(Maloti millions)

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Est.	Prel.	Projections					
Revenue	8,559	9,616	13,150	13,280	14,915	15,974	16,706	18,235	19,959	21,616
Tax revenue [2]	3,499	4,283	4,595	4,996	5,493	6,167	6,880	7,622	8,437	9,359
Taxes on income, profits, and capital gain	1,957	2,395	2,349	2,680	2,944	3,333	3,720	4,111	4,547	5,057
Taxes on property	106	125	150	196	257	282	313	347	384	423
Taxes on goods and services	1,414	1,590	1,819	1,882	2,053	2,288	2,550	2,822	3,123	3,460
Taxes on international trade	18	151	277	235	232	257	289	334	375	413
Grants	1,200	1,437	1,703	1,198	1,044	1,044	1,097	1,224	1,364	1,490
Budget support	372	290	196	300	150	150	150	177	206	217
Project grants	828	1,147	1,507	898	894	894	947	1,047	1,158	1,273
Of which: MCC	295	575	1,122	347	…	…	…	…	…	…
Non-tax revenue	1,232	1,143	885	1,031	1,344	1,387	1,465	1,616	1,788	1,987
Property Income	652	419	109	142	355	353	364	398	440	483
Sales of goods and services	530	692	772	886	946	1,007	1,079	1,193	1,319	1,471
Other non-tax revenue	50	32	4	2	43	27	22	25	29	33
SACU	2,628	2,753	5,966	6,055	7,034	7,376	7,264	7,774	8,371	8,780
Of which: volatile component	160	3	2,982	2,671	3,334	3,258	2,722	2,752	2,816	2,634
Expense	7,459	8,680	8,764	10,269	11,469	12,317	13,242	14,586	16,014	17,514
Compensation of employees	3,199	3,638	3,749	4,492	5,104	5,558	6,067	6,685	7,298	7,942
Wages and salaries	2,881	3,136	3,226	3,855	4,372	4,819	5,273	5,822	6,357	6,919
Social contributions	319	503	522	637	731	738	795	863	941	1,023
Use of goods and services	1,918	2,177	2,356	2,825	3,320	3,608	3,853	4,215	4,620	5,054
Interest payments	96	137	166	232	240	272	287	357	407	447
Domestic	43	68	85	132	112	130	130	160	210	210
External	53	69	81	99	128	142	157	197	197	237
Subsidies	232	237	253	235	275	266	274	290	306	344
Grants	707	960	882	898	696	744	798	891	1,001	1,101
Social benefits	600	587	611	817	886	918	964	1,068	1,183	1,312
Other expenses	707	943	747	771	949	951	999	1,080	1,198	1,315
Gross operating balance	1,100	936	4,386	3,011	3,446	3,656	3,463	3,649	3,946	4,102
Nonfinancial assets	1,923	2,877	3,396	3,290	3,896	4,000	4,404	4,855	5,355	5,936
Net lending/borrowing	-822	-1,941	989	-279	-450	-344	-941	-1,206	-1,409	-1,834
Transactions in financial assets and liabilities	-218	-1,370	1,496	-279	-450	-344	-941	-1,206	-1,409	-1,834
Financial assets	-663	-870	1,670	463	368	578	57	-85	-109	-99
Domestic	-663	-870	1,670	462	367	577	56	-86	-111	-101
Deposits	-666	-870	1,670	462	367	577	56	-86	-111	-101
Central bank	-646	-870	1,670	462	367	577	56	-86	-111	-101
Commercial banks	-21	0	0	0	0	0	0	0	0	0
Loans	3	0	0	0	0	0	0	0	0	0
Financial liabilities	-446	500	173	742	818	922	998	1,121	1,300	1,735
Domestic	-373	334	-474	0	0	0	0	0	69	380
Foreign	-73	166	647	742	818	922	998	1,121	1,232	1,355
Disbursements	128	388	866	1,052	1,123	1,327	1,433	1,556	1,715	1,889
Amortization	-201	-222	-220	-310	-305	-405	-434	-435	-484	-534
Statistical discrepancy [3]	-605	-572	-507	0	0	0	0	0	0	0
Memorandum items:										
Recurrent expenditure	6,385	7,492	7,806	9,388	10,364	10,769	11,735	13,004	14,248	15,536
Capital expenditure	2,996	4,065	4,355	4,171	5,002	5,548	5,911	6,437	7,120	7,914
Domestically financed	1,884	2,530	1,981	2,221	2,984	3,328	3,532	3,835	4,247	4,752
Externally financed	956	1,534	2,374	1,951	2,017	2,221	2,379	2,602	2,873	3,162
Non-SACU fiscal balance, including foreign-financed capital projects	-3,450	-4,694	-4,977	-6,334	-7,485	-7,720	-8,205	-8,979	-9,780	-10,614
Non-SACU fiscal balance, excluding foreign-financed capital projects	-3,323	-4,307	-4,111	-5,282	-6,361	-6,393	-6,773	-7,424	-8,065	-8,725
Core SACU fiscal balance (ex. volatile SACU and foreign project loans) [4]	-854	-1,557	-1,127	-1,898	-2,662	-2,275	-2,230	-2,402	-2,510	-2,579

Sources: Lesotho authorities and IMF staff estimates and projections.

[1] The fiscal year runs from April 1 to March 31.

[2] Other taxes are not shown in the table.

[3] The remaining balances on non-Treasury accounts at the end of the fiscal year explain the bulk of the statistical discrepancy.

[4] Core SACU revenue is set at 15 percent of GDP, close to the lowest historical level, far below the historical average (26 percent of GDP for the last 20 years).

Table 3. Lesotho: Fiscal Operations of the Central Government, 2010/11–2019/20 [1]

(Percent of GDP)

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Est.	Prel.	Projections					
Revenue	52.0	52.5	66.1	58.9	60.5	58.2	55.2	54.5	53.9	52.8
Tax revenue[2]	21.3	23.4	23.1	22.2	22.3	22.5	22.7	22.8	22.8	22.8
Taxes on income, profits, and capital gain	11.9	13.1	11.8	11.9	11.9	12.1	12.3	12.3	12.3	12.3
Taxes on property	0.6	0.7	0.8	0.9	1.0	1.0	1.0	1.0	1.0	1.0
Taxes on goods and services	8.6	8.7	9.1	8.3	8.3	8.3	8.4	8.4	8.4	8.4
Taxes on international trade	0.1	0.8	1.4	1.0	0.9	0.9	1.0	1.0	1.0	1.0
Grants	7.3	7.8	8.6	5.3	4.2	3.8	3.6	3.7	3.7	3.6
Budget Support	2.3	1.6	1.0	1.3	0.6	0.5	0.5	0.5	0.6	0.5
Project grants	5.0	6.3	7.6	4.0	3.6	3.3	3.1	3.1	3.1	3.1
Of which: MCC	1.8	3.1	5.6	1.5	0.0	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	7.5	6.2	4.4	4.6	5.4	5.1	4.8	4.8	4.8	4.8
Property income	4.0	2.3	0.5	0.6	1.4	1.3	1.2	1.2	1.2	1.2
Sales of goods and services	3.2	3.8	3.9	3.9	3.8	3.7	3.6	3.6	3.6	3.6
Other non-tax revenue	0.3	0.2	0.0	0.0	0.2	0.1	0.1	0.1	0.1	0.1
SACU	16.0	15.0	30.0	26.8	28.5	26.9	24.0	23.2	22.6	21.4
Of which: volatile component	1.0	0.0	15.0	11.8	13.5	11.9	9.0	8.2	7.6	6.4
Expense	45.3	47.4	44.1	45.5	46.5	44.9	43.7	43.6	43.2	42.7
Compensation of employees	19.4	19.8	18.8	19.9	20.7	20.2	20.0	20.0	19.7	19.4
Wages and salaries	17.5	17.1	16.2	17.1	17.7	17.6	17.4	17.4	17.2	16.9
Social contributions	1.9	2.7	2.6	2.8	3.0	2.7	2.6	2.6	2.5	2.5
Use of goods and services	11.7	11.9	11.8	12.5	13.5	13.1	12.7	12.6	12.5	12.3
Health care	0.7	1.8	3.2	4.0	3.8	3.8	3.8	3.8	3.8	3.8
Interest payments	0.6	0.7	0.8	1.0	1.0	1.0	0.9	1.1	1.1	1.1
Domestic	0.3	0.4	0.4	0.6	0.5	0.5	0.4	0.5	0.6	0.5
External	0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.6	0.5	0.6
Subsidies	1.4	1.3	1.3	1.0	1.1	1.0	0.9	0.9	0.8	0.8
Grants	4.3	5.2	4.4	4.0	2.8	2.7	2.6	2.7	2.7	2.7
Social benefits	3.6	3.2	3.1	3.6	3.6	3.3	3.2	3.2	3.2	3.2
Other expenses	4.3	5.1	3.8	3.4	3.8	3.5	3.3	3.2	3.2	3.2
Gross operating balance	6.7	5.1	22.0	13.3	14.0	13.3	11.4	10.9	10.7	10.0
Non-financial assets	11.7	15.7	17.1	14.6	15.8	14.6	14.5	14.5	14.5	14.5
Net lending(+)/borrowing (-)	-5.0	-10.6	5.0	-1.2	-1.8	-1.3	-3.1	-3.6	-3.8	-4.5
Transactions in financial assets and liabilities	-1.3	-7.5	7.5	-1.2	-1.8	-1.3	-3.1	-3.6	-3.8	-4.5
Financial assets	-4.0	-4.7	8.4	2.1	1.5	2.1	0.2	-0.3	-0.3	-0.2
Domestic	-4.0	-4.7	8.4	2.0	1.5	2.1	0.2	-0.3	-0.3	-0.2
Deposits	-4.0	-4.7	8.4	2.0	1.5	2.1	0.2	-0.3	-0.3	-0.2
Central bank	-3.9	-4.7	8.4	2.0	1.5	2.1	0.2	-0.3	-0.3	-0.2
Commercial banks	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities	-2.7	2.7	0.9	3.3	3.3	3.4	3.3	3.3	3.5	4.2
Domestic	-2.3	1.8	-2.4	0.0	0.0	0.0	0.0	0.0	0.2	0.9
Foreign	-0.4	0.9	3.3	3.3	3.3	3.4	3.3	3.3	3.3	3.3
Disbursements	0.8	2.1	4.4	4.7	4.6	4.8	4.7	4.6	4.6	4.6
Amortization	-1.2	-1.2	-1.1	-1.4	-1.2	-1.5	-1.4	-1.3	-1.3	-1.3
Statistical discrepancy [3]	-3.7	-3.1	-2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Recurrent expenditure	38.8	40.9	39.2	41.6	42.0	39.2	38.8	38.8	38.5	37.9
Capital expenditure	18.2	22.2	21.9	18.5	20.3	20.2	19.5	19.2	19.2	19.3
Domestically financed	11.5	13.8	10.0	9.8	12.1	12.1	11.7	11.5	11.5	11.6
Externally financed	6.8	8.4	11.9	8.6	8.2	8.1	7.9	7.8	7.8	7.7
Non-SACU fiscal balance, including foreign financed capital projects	-21.0	-25.6	-25.0	-28.1	-30.3	-28.1	-27.1	-26.8	-26.4	-25.9
Non-SACU fiscal balance, excluding foreign financed capital projects	-20.2	-23.5	-20.7	-23.4	-25.8	-23.3	-22.4	-22.2	-21.8	-21.3
Core SACU fiscal balance (ex. volatile SACU and foreign project loans) [4]	-5.2	-8.5	-5.7	-8.4	-10.8	-8.3	-7.4	-7.2	-6.8	-6.3

Sources: Lesotho authorities and IMF staff estimates and projections.

[1] The fiscal year runs from April 1 to March 31.

[2] Other taxes are not shown in the table.

[3] The remaining balances on non-Treasury accounts at the end of the fiscal year explain the bulk of the statistical discrepancy.

[4] Core SACU revenue is set at 15 percent of GDP, close to the lowest historical level, far below the historical average (26 percent of GDP for the last 20 years).

Table 4. Lesotho: Monetary Accounts, 2010–15 [1, 2]

(Maloti millions; unless otherwise indicated)

	2010	2011	2012	2013				2014	2015
	Mar.	Mar.	Mar.	Mar.	Jun	Sept.	Dec.	Mar.	Mar.
	Act.	Act.	Act.	Act.	Act.	Act.	Est.	Proj.	Proj.
	Depository corporations survey								
Net foreign assets	10,937	9,304	8,801	10,123	10,908	11,476	12,835	11,605	12,420
Central bank	7,591	5,801	5,975	7,985	8,877	8,339	9,599	8,726	9,833
Commercial banks	3,346	3,503	2,827	2,138	2,031	3,137	3,237	2,879	2,587
Net domestic assets	-4,791	-3,091	-2,277	-3,201	-3,845	-3,028	-4,162	-2,959	-2,998
Claims on central government (net)	-3,762	-2,922	-1,729	-3,423	-3,752	-3,358	-4,166	-3,564	-3,931
Central bank	-4,149	-3,477	-2,568	-4,238	-4,542	-4,207	-4,830	-4,379	-4,746
Commercial banks	387	555	839	815	790.4	849	664	815	815
Claims on private sector	1,832	2,326	2,909	4,136	4,213	4,424	4,556	4,964	5,809
Other items (net)	-2,892	-2,501	-3,458	-3,926	-4,318	-4,106	-4,564	-4,372	-4,889
Broad money	6,146	6,213	6,525	6,922	7,063	8,448	8,673	8,646	9,421
Currency outside banks	499	529	643	792	808	864	953	997	1,289
Deposits	5,647	5,683	5,881	6,130	6,255	7,584	7,720	7,648	8,132
Memorandum items:	(12–month percentage change; unless otherwise indicated)								
Reserve money	5.8	-12.3	45.5	-1.9	22.7	12.6	25.2	23.9	26.3
Broad money	11.9	1.1	5.0	6.1	3.1	26.3	21.3	24.9	9.0
Credit to the private sector	20.7	26.9	25.1	42.2	34.0	27.4	20.6	20.0	17.0
Credit to the private sector (percent of GDP)	12.3	14.1	15.9	20.8	20.5	20.8	20.8	22.0	22.8
Velocity (GDP/broad money)	2.4	2.6	2.8	2.9	2.9	2.5	2.5	2.6	2.7

Sources: Lesotho authorities and IMF staff estimates and projections.

[1] The fiscal year runs from April 1 to March 31.

[2] Including valuation changes.

Table 5. Lesotho: Balance of Payments, 2010/11–2019/20 [1]

(US$ millions; unless otherwise indicated)

	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Act.	Prel.	Projections					
Current account	-171	-221	-64	-24	-26	-242	-299	-262	-337	-391
Trade balance	-1,089	-1,087	-1,167	-1,109	-1,136	-1,324	-1,345	-1,348	-1,436	-1,632
Exports, f.o.b.	953	1,096	979	912	985	1,031	1,160	1,275	1,359	1,418
Imports, f.o.b	-2,042	-2,183	-2,147	-2,021	-2,122	-2,355	-2,505	-2,623	-2,795	-3,050
Of which: LHWP2	0	0	0	0	-25	-60	-111	-155	-184	-272
Of which: oil	-120	-157	-166	-173	-172	-179	-165	-154	-150	-148
Services (net)	-405	-417	-364	-343	-358	-397	-423	-448	-488	-501
Income (net)	657	614	523	530	517	515	526	511	512	599
Of which: interest on public debt	-7	-8	-10	-10	-13	-14	-15	-16	-17	-18
Transfers	667	668	944	899	951	965	942	1,022	1,074	1,143
Official transfers	498	493	785	736	798	812	770	839	878	934
Of which: SACU revenue	365	370	696	624	709	723	690	715	743	753
Other transfers	168	176	159	163	153	153	172	184	196	209
Capital and financial account	118	216	365	123	161	177	284	365	435	529
Capital account	176	182	151	69	91	142	205	235	250	301
Financial account	-58	34	214	54	70	35	79	131	184	228
Foreign direct	10	9	8	8	8	8	9	11	14	17
Portfolio investment	-2	-2	-2	-2	-2	-1	-1	-1	-1	-1
Other investment	-65	27	208	48	63	28	71	121	172	212
Medium and long-term	-65	27	208	48	63	28	71	121	172	212
Of which:										
Public sector (net)	-10	22	75	77	82	90	95	129	155	201
Disbursements	18	52	101	108	113	130	136	169	203	259
Central government	18	52	101	108	113	130	136	143	152	162
Other public sector	0	0	0	0	0	0	0	26	50	97
Amortization	-28	-30	-26	-32	-31	-40	-41	-40	-47	-58
Short-term	0	0	0	0	0	0	0	0	0	0
Errors and omissions	-198	33	-60	0	0	0	0	0	0	0
Overall balance	-250	28	242	99	135	-64	-15	103	97	137
Financing	250	-28	-242	-99	-135	64	15	-103	-97	-137
Memorandum items:				(Percent of GDP)						
Current account	-7.5	-9.0	-2.7	-1.0	-1.0	-9.0	-10.4	-8.5	-10.3	-11.1
Trade balance	-47.6	-44.2	-50.3	-47.7	-45.7	-49.2	-46.7	-43.8	-43.7	-46.5
Capital and financial account	5.2	8.8	15.7	5.3	6.5	6.6	9.9	11.9	13.2	15.1
Overall balance	-11.0	1.2	10.4	4.3	5.4	-2.4	-0.5	3.3	3.0	3.9
Gross international reserves										
(US$ millions) [2]	961	858	990	982	1,121	1,047	1,019	1,107	1,184	1,298
(Months of imports)	4.0	3.6	4.6	4.8	4.7	4.1	3.8	3.8	3.8	3.9

Sources: Lesotho authorities and IMF staff estimates and projections.

[1] The fiscal year runs from April 1 to March 31.

[2] Including the SDR allocation in 2009.

Table 6. Lesotho: Commercial Bank Performance Ratios, 2005–13
(As of end-December; percent)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
I. Capital adequacy									
a) Basel capital ratio	22.0	19.0	14.2	13.7	13.5	14.9	16.0	14.1	12.6
b) Nonperforming loans net of provisions to capital	0.3	-5.4	-13.4	-13.5	-9.3	0.5	-6.3	-6.6	7.6
c) Top 20 exposures to statutory capital and reserves	220	386	465	306	359	522	528	456	495
II. Asset quality									
a) Loans to deposit ratio	29	25	29	29	32	35	44	57	56
b) Earning assets to total assets	93	90	90	88	86	91	92	87	89
c) Nonperforming loans to total assets	2.0	2.0	1.4	2.1	3.2	3.1	2.2	2.5	3.9
d) Reserve for losses to total loans	3.0	2.8	2.6	4.0	4.3	3.1	2.7	3.0	3.5
e) Reserve for losses to nonperforming loans	167	132	193	196	136	98	124	117	90
III. Liquidity									
a) Liquid assets to total deposits	120	101	92	95	95	99	96	76	89
b) Available reserves to total deposits	8.0	3.5	3.4	1.9	3.5	3.6	2.3	3.0	3.7
c) Liquid assets to total assets	77	78	73	72	70	72	68	56	61
d) Current assets to current liabilities	86	105	107	106	107	108	109	111	109
IV. Profitability									
a) Net interest margin	…	4.5	5.6	6.8	6.2	5.2	5.4	6.7	6.5
b) Cost to income	…	65	63	58	56	56	58	59	58
c) Return on assets (ROA)	2.0	0.3	1.7	2.8	2.8	2.7	2.8	3.0	3.0
d) Return on equity	15	5	21	38	33	31	29	30	33

Source: Central Bank of Lesotho.

Table 7. Lesotho: Millennium Development Goals

	1990	1995	2000	2005	2012
Goal 1: Eradicate extreme poverty and hunger					
Employment to population ratio, 15+, total (%)	48	50	46	43	48
Employment to population ratio, ages 15–24, total (%)	39	40	34	29	29
GDP per person employed (constant 1990 PPP $)	..	..	..	..	..
Income share held by lowest 20%	..	1	..	3	..
Malnutrition prevalence, weight for age (% of children under 5)	..	..	15	17	..
Poverty gap at $1.25 a day (PPP) (%)	..	26	..	21	..
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	..	46	..	43	..
Vulnerable employment, total (% of total employment)	..	..	69	..	..
Goal 2: Achieve universal primary education					
Literacy rate, youth female (% of females ages 15–24)	..	..	97	..	..
Literacy rate, youth male (% of males ages 15–24)	..	..	85	..	..
Persistence to last grade of primary, total (% of cohort)	..	..	55	63	..
Primary completion rate, total (% of relevant age group)	58	64	60	60	72
Total enrollment, primary (% net)	71	68	78	75	82
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliaments (%)	..	5	4	12	27
Ratio of female to male primary enrollment (%)	122	112	104	100	98
Ratio of female to male secondary enrollment (%)	146	142	132	127	139
Ratio of female to male tertiary enrollment (%)	125	112	162	134	151
Goal 4: Reduce child mortality					
Immunization, measles (% of children ages 12–23 months)	80	83	74	85	85
Mortality rate, infant (per 1,000 live births)	72	77	88	83	74
Mortality rate, under-5 (per 1,000)	89	99	127	121	100
Goal 5: Improve maternal health					
Adolescent fertility rate (births per 1,000 women ages 15–19)	83	91	91	90	90
Births attended by skilled health staff (% of total)	..	..	60	..	..
Contraceptive prevalence (% of women ages 15–49)	..	29	30	37	47
Maternal mortality ratio (modeled estimate, per 100,000 live births)	520	540	690	720	620
Pregnant women receiving prenatal care (%)	..	88	85	90	93
Unmet need for contraception (% of married women ages 15–49)	..	..	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Condom use, population ages 15-24, female (% of females ages 15–24)	..	..	..	..	..
Condom use, population ages 15-24, male (% of males ages 15–24)	..	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	184	323	553	639	630
Prevalence of HIV, female (% ages 15–24)	..	..	..	..	11
Prevalence of HIV, male (% ages 15–24)	..	..	..	..	6
Prevalence of HIV, total (% of population ages 15–49)	1	12	23	23	23
Tuberculosis case detection rate (%, all forms)	86	91	95	88	83
Goal 7: Ensure environmental sustainability					
CO2 emissions (kg per PPP $ of GDP)	..	..	..	..	..
CO2 emissions (metric tons per capita)	..	..	..	..	..
Forest area (% of land area)	1.3	1.4	1.4	1.4	..
Improved sanitation facilities (% of population with access)	..	24	25	26	..
Improved water source (% of population with access)	80	80	80	79	..
Marine protected areas (% of territorial waters)	..	..	..	..	2
Net ODA received per capita (current US$)	87	64	20	35	..
Goal 8: Develop a global partnership for development					
Debt service (PPG and IMF only, % of exports, excl. workers' remittances)	4	6	7	6	..
Internet users (per 100 people)	0	0	0	3	5
Mobile cellular subscriptions (per 100 people)	0	0	1	12	59
Telephone lines (per 100 people)	1	1	1	2	2
Fertility rate, total (births per woman)	5	5	4	4	3
Other					
GNI per capita, Atlas method (current US$)	550	660	580	910	1,380
GNI, Atlas method (current US$) (billions)	1	1	1	2	3
Gross capital formation (% of GDP)	56	72	41	22	32
Life expectancy at birth, total (years)	59	57	48	44	..
Literacy rate, adult total (% of people ages 15 and above)	..	..	86	..	..
Population, total (billions)	0	0	0	0	0
Trade (% of GDP)	140	144	170	170	155

Source: World Development Indicators.

Table 8. Lesotho: Risk Assessment Matrix[1]

Nature/source of main risks	Likelihood of realization in the next three years	Expected impact on economy if risk is realized	Possible Remedial Policy
Protracted period of slower growth in emerging market economies	*MEDIUM* • Protracted slow economic growth in South Africa could lower South Africa's imports and weaken demand for Lesotho's exports and labor.	*LOW to MEDIUM* • Lower remittances would widen the current account deficit. Economic growth, driven by the construction and mining sectors, would not be significantly affected. International reserves would remain adequate.	• Step up structural reforms to strengthen domestic sources of growth.
A permanent decline in SACU revenue	*LOW to MEDIUM* • A permanent decline in SACU revenue to 15 percent of GDP illustrates Lesotho's dependence on SACU revenue.	*HIGH* • A decline in SACU revenue would worsen the fiscal balance. The current account would widen and international reserves would decline below their adequate level. • Economic growth would slow down, as financing constraint tightens.	• Substantial restructuring of the public sector to tighten fiscal policy and sustain international reserves. • Reduce dependence on SACU revenue through domestic revenue mobilization.
The expiration of AGOA in 2015	*LOW to MEDIUM* • The expiration of AGOA would create political uncertainty.	*MEDIUM* • The fiscal surplus would narrow, as the pressure on government spending intensifies and welfare payments and subsidies to companies rise. International reserves would decline. • The implications for growth and the current account deficit would be modest, given the low value added generated by the sector.	• Tighten fiscal policy to rebuild international reserves. • Step up structural reforms to generate private sector jobs.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Table 9. Alternative Fiscal Scenario

(In percent of GDP, unless otherwise indicated)

	2013/14 Prelim.	2014/15 Proj.	2015/16 Proj.	2016/17 Proj.	2017/18 Proj.	2018/19 Proj.	2019/20 Proj.
Baseline scenario							
Revenue and grants	58.9	60.5	58.2	55.2	54.5	53.9	52.8
Of which: Tax revenue	22.2	22.3	22.5	22.7	22.8	22.8	22.8
Total expenditure	60.1	62.3	59.4	58.3	58.1	57.7	57.2
Expense	45.5	46.5	44.9	43.7	43.6	43.2	42.7
Nonfinancial assets	14.6	15.8	14.6	14.5	14.5	14.5	14.5
Overall balance	-1.2	-1.8	-1.3	-3.1	-3.6	-3.8	-4.5
Financing							
Domestic financial assets ("-" accumulation of assets)	-2.1	-1.5	-2.1	-0.2	0.3	0.5	1.2
Net external financing	3.3	3.3	3.4	3.3	3.3	3.3	3.3
International reserves (in months of next year's imports)	4.8	4.7	4.1	3.8	3.8	3.8	3.9
External government debt	39.0	37.9	38.3	39.2	40.8	43.1	46.1
Alternative scenario							
Revenue and grants	58.9	60.5	58.5	55.7	55.5	55.4	54.7
Of which: Tax revenue [1/]	22.2	22.3	22.8	23.3	23.8	24.3	24.8
Total expenditure	60.1	59.4	56.6	55.4	54.2	53.5	53.3
Expense [2/]	45.5	43.9	41.6	39.6	37.6	35.7	33.9
Nonfinancial assets	14.6	15.5	15.0	15.8	16.6	17.8	19.4
Overall balance	-1.2	1.1	1.9	0.3	1.3	1.9	1.4
Financing							
Domestic financial assets ("-" accumulation of assets)	-2.1	-4.4	-3.9	-2.3	-3.3	-3.9	-3.4
Net external financing [3/]	3.3	3.3	2.0	2.0	2.0	2.0	2.0
International reserves (in months of next year's imports)	4.8	4.9	5.0	5.0	5.0	5.0	5.0
External government debt	39.0	37.9	37.0	36.6	36.2	35.9	35.4
Memorandum item:							
SACU revenue (baseline and alternative scenarios)	26.8	28.5	26.9	24.0	23.2	22.6	21.4

Source: Data provided by the authorities and IMF staff estimates.

[1/] The difference in "Revenue and grants" in the two scenarios is explained by the difference in tax revenue. In the alternative scenario tax revenues increase by 0.5 percent of GDP per annum because of tax policy reforms and improved tax administration.

[2/] Recurrent expenditures are kept constant in real terms.

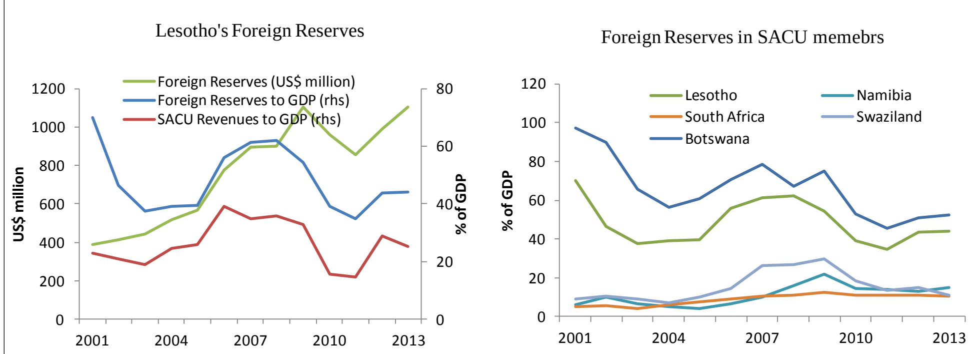
[3/] The alternative scenario assumes net external borrowing of 2 percent of GDP over the medium term to improve debt sustainability.

Appendix I. Reserve Adequacy in Lesotho[1]

1. Lesotho's foreign reserves have increased significantly from about US$380 million in 2001 to about US$1100 million (43% of GDP) at end-2013. In comparison with other countries in the Southern African Customs Union (SACU), Lesotho has the second highest stock of foreign reserves as a percentage of GDP (**Figure 1**).[2] The substantial accumulation of reserves in recent years has been the result of the authorities' desire to support their exchange rate policy and to mitigate the impact of the volatility of SACU revenues on the economy.[3] As a result, reserves have been largely driven by the fluctuations in the SACU receipts over time.

2. Despite the decline during the recent global financial crisis, Lesotho's foreign reserves remained above the minimum threshold of the traditional metrics (3 months of import, 100 percent of short-term debt, and 20 percent of broad money), as well as those for the ARA risk-weighted metrics suggested in the 2011 IMF policy paper. Indeed, as of 2013, the stock of reserves represent almost 5 months of next year's imports, 1.5 times broad money, 2 times M1, and 24.7 times short-term debt. The risk-weighted approach suggests that the adequate level of reserves for Lesotho was between US$411 million and US$616 million—roughly one-third to one-half actual reserves.

Figure 1. Evolution of Lesotho's Foreign Reserves



Sources: Authorities data; staff estimates.

3. To determine the optimal level of reserves for Lesotho, we applied a cost-benefit analysis proposed by Dabla-Norris *et al.* (2011). In this framework, the optimal reserve level balances the expected benefits of holding reserves against the opportunity cost associated with such holdings. In order to simulate "worst case" conditions, shocks were applied to two

[1] Prepared by Ali Al-Sadiq (FIN).

[2] Under the recent ECF-supported program, the medium-term target for international reserves was five months of imports.

[3] By virtue of its membership of the Common Monetary Area (CMA), the Lesotho loti, is pegged one-for-one to the South African rand. CMA members are required to maintain net international reserves (NIR) of at least 100 percent of the narrow definition of money supply (M1). The Central Bank of Lesotho, however, sets its floor at 120 percent of M1.

scenarios. In the first one, a "weak fiscal position", we use the average of the fundamental and external shock variables over the past five years (2009–13). In the second scenario, a "strong fiscal position", forward looking projections over the period 2014–18 are used. Since, Lesotho is not heavily dependent on foreign aid, the foreign aid shocks are set at zero (Table 1).

4. Given Lesotho's large infrastructure investment needs, the opportunity costs of reserve holdings could be relatively high (4 percent). Under the weak fiscal position scenario, a reserves level covering 4.3 months of imports (43 percent of GDP) is considered adequate as a precautionary motive against potential external shocks. As the fiscal position improves, a projected level of reserves covering 3.6 months of imports (31 percent of GDP) would be appropriate.

Table 1. Baseline Assumptions	2009-2013	2014-2018
Fundamental Variables		
Government balance, percent of GDP 1/	-10.0	3.4
World Bank CPIA 2/	3.5	3.5
Flexible ER regime dummy	No	No
External Shock Variables		
External Demand Growth	3.0	3.0
Terms of Trade Growth 3/	-7.3	-1.0
Change in FDI to GDP 3/	0.01	-1.2
Change in Foreign Aid to GDP	0	0

1/ Overall fiscal balance for 2010 data and the average of 2014-2017, respectively
2/ Average during 2009-2012
3/ Bottom 10th percentile of the distribution durign 2009-2013 and 2014-2018, respectively

5. It should be noted, however, that this estimated optimal level constitutes a lower bound for precautionary motives that can be rationalized in terms of self-insurance against adverse potential external shocks faced by the country. Furthermore, since Lesotho has limited access to international markets and it is difficult to ascertain the opportunity costs of holding reserves due to the low implementation capacity for investment projects, the country may aim for a level of reserves beyond this estimated level.

Figure 2. Optimal and Average Level of Reserves 2009-13
(Months of Next year's imports)

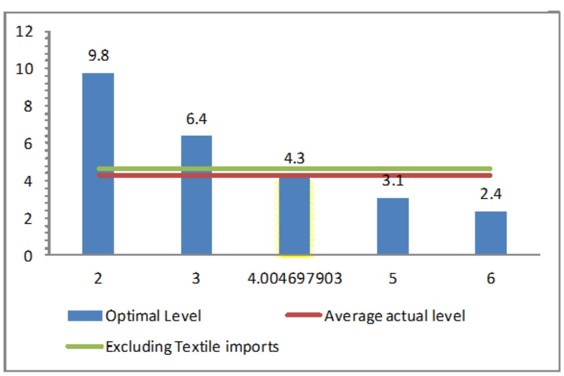
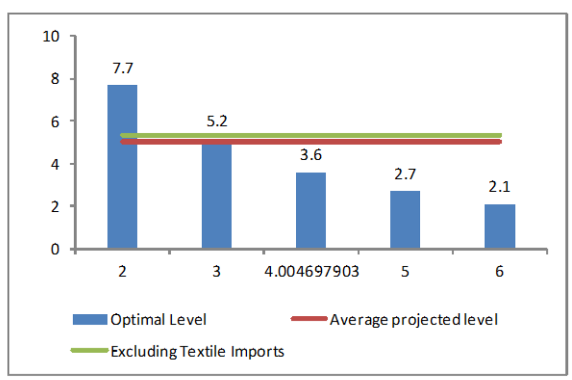


Figure 3. Optimal and Average Level of Reserves 2014-18
(Months of Next year's imports)



Source: Lesotho authorities and IMF staff estimates

Appendix II. Lesotho: External Stability Assessment[1]

Exchange Rate Assessment

1. Based on the methodologies adopted by CGER[2] and applying updated coefficients from the relevant econometric models, the exchange rate assessment exercise suggests that the Loti is broadly in line with medium term fundamentals.

2. Under the macroeconomic balance approach, the current account balance norm (as modeled by the determinants of the country's savings and investment in medium run equilibrium) has been identified at -6.2 percent of nominal output, while, the underlying current account balance (as determined by the exports and imports functions of the current real effective exchange rate) was at -6.1 percent, implying that the real exchange rate is in line with equilibrium.

3. Under the equilibrium real exchange rate approach, the current real exchange rate appears to be undervalued by about 16 percent. This test places higher degree of significance on relative government consumption and remittance inflows as compared to other indicators (such as terms of trade, relative productivity, aid inflows) in determining the medium run equilibrium real effective exchange rate (REER). The current high levels of government consumption (due in part to high level of SACU revenue transfers) and remittance inflows in the case of Lesotho skew the equilibrium towards undervaluation. In the long run, more moderate inflows from SACU and remittances would imply a smaller deviation of the REER from the long run equilibrium REER.

4. Under the external sustainability approach, the degree of undervaluation of the real exchange rate is estimated at about 5 percent, indicating that the present ratio of the current account balance to nominal output is broadly consistent with the norm for the ratio of the net foreign asset position to nominal output, which is determined based on the recently observed values.

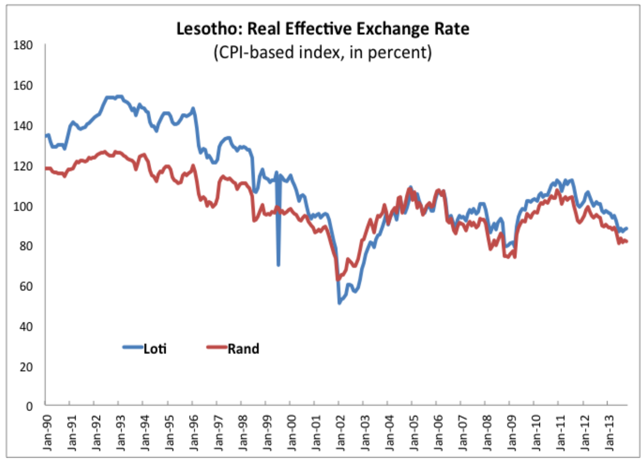
5. Of the three methods, the most reliable for Lesotho is deemed to be the macroeconomic balance approach, which suggests that the exchange rate is in line with the medium term macroeconomic fundamentals.

[1] Prepared by Aidar Abdychev and Christian Gonzalez (World Bank).

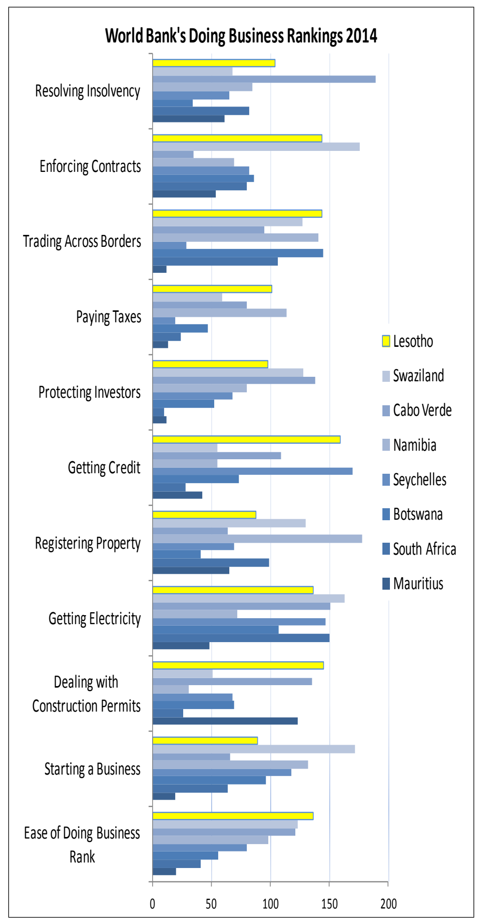
[2] See Lee, J., G. Milesi-Ferretti, J. Ostry, A. Prati and L. Ricci (2008), Exchange Rate Assessments: CGER methodologies, *IMF Occasional Paper*, 261 and F. Vitek (2013) Exchange Rate Assessment Tools for Advanced, Emerging, and Developing Economies, IMF.

Competitiveness Assessment

6. Given that the Loti is hard-pegged to the South African Rand and due to strong economic ties of Lesotho to South Africa, real effective exchange rate changes are largely driven by economic developments in South Africa. For example, recent nominal depreciation of the Rand (by about 20 percent in 2013) led to the depreciation of the REER of the Loti by about 10 percent. However, preliminary data suggest that exports have not picked up as a result of the depreciation, implying limited elasticity of exports to exchange rate changes. This could be explained by the structural impediments that constrain export competitiveness of the Lesotho's economy.



7. Lesotho continues to be lacking a viable private sector, capable of competing regionally and internationally. The National Strategic Development Plan (NSDP) identified an "uncompetitive business environment" as one of the most binding constraints on the growth of private enterprises, adversely affecting both FDI and local SMEs. The 2014 Doing Business Report ranks Lesotho in the lower range of countries at 136th place (out of 185), in particular indicating biggest problems in all important stages of business – obtaining construction permits, access to land and electricity, registering property, access to credit, trading across borders with South Africa, and enforcing contracts. For example, it may take more than two years for a foreigner to establish a firm in Lesotho; it takes less than a year in such countries as South Africa, Rwanda, and Vietnam.



8. In recent years Lesotho has made important steps in improving business climate, notably in streamlining the process of registering a property and obtaining business licenses. In particular, they have begun implementing the Land Act of 2010, Land Administration Act of 2010, and the Companies Act of 2010.

9. The Government is taking steps to reduce barriers to land access by investors. Lack of availability of factory shells and serviced industrial sites has often been cited by potential investors as a constraint to establishing a business in Lesotho. The Land Act of 2010 allows land subleasing (which could facilitate provisioning of factory shells), but the act does not specify the rights of sub-lessees. The Government plans to submit to Parliament Amendments Land Bill to address this issue. The authorities have also submitted to Parliament a Sectional Title Bill, which allows citizens to sell or transfer a section of their property with an accompanying title for ownership.

10. The Government is also taking measures to reduce the number of days to obtain a construction permit. According to the World Bank (2013), it takes 330 days to obtain a construction permit, including 65 days to obtain a building permit from the Maseru City Council (MCC) and another 180 days to request and obtain telecommunications connections. The two most important bottlenecks in the process are getting an environmental assessment for construction of buildings, which are 550 square meters or more, and getting consent from the utility companies to issue a building permit. The Government has issued regulations to require environmental impact assessments only for construction projects for industries that pose high environmental risk, rather than for all projects. This would be in line with international best practices, which recommend a risk-based approach. This single measure will shave 25 days off the process of obtaining construction permits for most firms. For MCC building permits, the Government will introduce streamlined procedures and an automated electronic workflow system to better integrate approvals from various utility bodies.

11. The process of starting a business in Lesotho has improved recently. According to the 2014 Doing Business, starting a business requires seven procedures, takes 29 days, and costs 11.4 percent of per capita income. Over the past few years, the Government has taken important steps to reduce the number of days to start a business (down from 73 days in 2008); however, it is still high compared to other countries. The new Industrial Licensing Act will facilitate and promote industrial development and micro, small, and medium enterprises (MSMEs) through a new regulatory regime that is simple, short, and cost effective. The Industrial Licensing Act reduces the time it takes to obtain a license from five days to one day.

12. Access to finance for SMEs is a severe constraint. Credit is largely provided through micro lenders and informal mechanisms rather than formal financial institutions. With a view to increase access to SMEs, the Central Bank of Lesotho is working on establishing a credit bureau, which is expected to go live in June 2014. The establishment of a national identity system is crucial to setting up a credit bureau. On June 2013, the Government launched the national ID system and currently covers about 5 percent of the population.

13. Trading across borders has improved, and further reforms are being prepared. The time required to import has fallen from 49 days in 2007 to 33 days in 2013, and to export from 44 days in 2007 to 31 days in 2013. Despite the improvements, trade transactions costs are high. To improve cross-border trading, the Government has drafted a Customs Modernization Strategy. It provides a longer-term framework for coordinating and aligning customs-related activities, including the introduction of an integrated border management approach to align numerous border agencies. With the implementation of the strategy, which is planned for the end of 2014, the Government will reduce the number of days for export and import clearances from 4.6 days to one.

14. In addition to institutional impediments, the trade is constrained by the small size of Lesotho's economy and its very narrow export base, having to rely on diamonds and textiles as the

main sources of exports, which account for about 27 and 43 percent of total imports in 2012/13. While domestic diamond industry has experienced a strong growth in recent years, it remains to be seen whether this could be sustained and expanded to other natural resources. At the moment, as the country intends to undertake a number of exploratory projects there are no significant identified deposits.

15. Textile industry proved to be limited mainly to the exports to the US under the AGOA arrangements, which is set to expire in 2015. In the absence of its extension, there is a significant risk that the textile exports could sharply decline. In the past, uncertainties about the extension of this arrangement led to the decline in production as investors awaited the political decision before making longer-term investment plans. Amidst the lack of useful data on labor market and wages in Lesotho, available research suggests that in addition to remote location of the country from main markets and key disadvantages identified in the WB's Doing Business Report, Lesotho lacks competitive advantage in the labor market. A post-AGOA comparative study of Lesotho's textile factories with seven similar factories in Asia indicates that labor productivity is 30-70 (with average of 50) percent below in Lesotho than in Asia. The industry is governed by a statutory minimum wage requirement, which played a role in recent rising labor costs. For the past decade or so, the minimum wages have been set broadly indexed to the domestic inflation.

16. In addition, the country has arrangements with South Africa on the supply of water, which contributed an additional 8 percent of total receipts from exports in 2012/13.

17. In conclusion, while the real exchange rate appears to be broadly in line with medium term fundamentals, numerous structural issues prevent the development of the private sector capable of competing regionally and globally.

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 19, 2014

Prepared By

Staff of the International Monetary Fund in Consultation with the World Bank.

CONTENTS

RELATIONS WITH THE FUND

(As of March 31, 2014)

Membership status: Joined 07/25/1968; accepted the obligations of Article VIII, Sections 2, 3, and 4: 03/05/1997.

General resources account:	SDR Million	Percent Quota
Quota	34.90	100.00
Fund holdings of currency	31.13	89.19
Reserve position in Fund	3.81	10.91

SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	32.88	100.00
Holdings	34.82	142.41

Outstanding purchases and loans:	SDR Million	Percent Quota
ECF[1] arrangements	50.96	146.00

Financial arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF	06/02/2010	09/17/2013	50.61	50.61
ECF[1]	03/09/2001	10/31/2004	24.50	24.50
Stand-By	09/23/1996	9/22/1997	7.17	0.0

Projected obligations to fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal	0.35	0.78	2.13	4.70	8.42
Charges/Interest	0.00	0.13	0.12	0.12	010
Total	**0.35**	**0.91**	**2.25**	**4.82**	**8.52**

[1] Formerly PRGF.

Safeguards Assessment

An update safeguards assessment of the Central Bank of Lesotho was completed in November 2012 in connection with the augmentation of access under the ECF arrangement approved in April 2012. The assessments confirmed that the CBL has taken steps to strengthen safeguards since the 2010 assessment, but also that risks remain. In 2010, Deloitte (South Africa) was appointed as the CBL's external auditor. The firm has since completed the audits of financial years 2010, 2011, and 2012 within the three-month statutory deadline and issued an unqualified audit opinion following each audit. Since the 2012 assessment, aspects of the monetary data reporting process have been strengthened with IMF technical assistance.

Exchange arrangement:

Lesotho is a member of the Common Monetary Area (CMA) and the Lesotho loti is both *de facto and de jure* pegged at par to the South African Rand, which is also legal tender in the country. Lesotho has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. Staff is currently assessing whether certain exchange measures maintained by Lesotho and recently identified by LEG are consistent with Article VIII of the IMF's Articles of Agreement. As of March 31, 2014, the maloti rate per U.S. dollar was M10.2.

Article IV consultation:

The 2012 Article IV consultation was concluded by the Executive Board on April 19, 2012. Lesotho is on the standard 12-month Article IV consultation cycle.

Technical assistance

The Fund has been providing Lesotho with technical assistance and training to help authorities strengthen their capacity to design and implement effective policies. Technical assistance covers wide range of areas in macroeconomic, fiscal, and monetary. Specific technical assistance projects since 2008 are the following:

Fiscal Affairs Department

Improving Revenue administration fundamentals	Short-term	2014
Resources and non-mining taxation	Short-term	2013
tax policy and mining fiscal regimes	Short-term	2013
Developing cash management	Short-term	2013
Large taxpayers	Short-term	2012
Develop the post control audit function in customs	Short-term	2012
Develop risk management function	Short-term	2012
Public financial management	Short-term	2011
Revenue administration	Short-term	2011
Strengthening arrears management and expenditure central	Short-term	2011
Public financial management	Short-term	2010

Legal Department		
Banking laws and regulation	Short-term	2008
Financial sector regulations	Short-term	2008
Monetary and Capital Markets Department		
Financial stability	Short-term	2014
Risk management framework	Short-term	2014
Payment system modernization	Short-term	2014
Enhancing banking supervision	Short-term	2014
Payment systems oversight	Short-term	2014
Strengthening insurance supervision	Short-term	2014
Financial soundness indicators	Short-term	2014
Strengthening liquidity management and capacity building for financial stability analysis and reporting	Short-term	2013
Establishment of a risk management function	Short-term	2012
Assessing Banking system stability	Short-term	2012
Financial statistics	Short-term	2013
Risk management framework	Short-term	2013
Monetary and financial statistics	Short-term	2013
Financial stability assessment	Short-term	2012
Liquidity management framework	Short-term	2012
National payment systems	Short-term	2012
Money market development and capacity building for financial stability analysis and reporting	Short-term	2012
Strengthening Insurance supervision	Short-term	2012
Banking system stability	Short-term	2012
Financial supervision	Short-term	2012
Monetary and Financial Statistics	Short-term	2011
Monetary and financial statistics	Short-term	2011
Financial sector supervision	Short-term	2011
Money markets	Short-term	2009
Money markets	Short-term	2008
Payment systems modernization	Short-term	2008
Bank supervision	Short-term	2008
Payment systems	Short-term	2008
Payment systems	Short-term	2008
Nonbank supervision	Short-term	2008
Bank supervision	Short-term	2008
Monetary operations/Bank supervision	Short-term	2008

Statistics Department

External sector statistics	Short-term	2014
External sector statistics	Short-term	2013
National accounts statistics-follow up	Short-term	2013
External sector statistics	Short-term	2012
National accounts statistics	Short-term	2011
SRF data development	Short-term	2011
Balance of payments	Short-term	2010
Monetary and financial statistics	Short-term	2009
Balance of payment	Short-term	2008
Government Finance Statistics: GDDS Project for Anglophone African Countries	Short-term	2008

Resident Representatives:

The IMF maintains the Office of Resident Representative in Lesotho. Mr. Michael Tharkur was appointed the Fund's Resident Representative to Lesotho in April 2012.

THE JMAP BANK-FUND MATRIX

(As of March 31, 2013)

Title	Products	Provisional Timing of missions	Expected Delivery date
A. Mutual information on relevant work programs			
Bank work program in next 12 months	• Second Growth and Competitiveness DPO	• Ongoing regular missions	• November 2014
	• Second Private Sector competitiveness and Economic Diversification project	• Ongoing regular missions	• Implementation ongoing
	• Water Sector Improvement Project Phase 2	• Ongoing regular missions	• June 2014 (closing date)
	• Smallholder Agriculture project	• Ongoing regular missions	• Implementation ongoing
	• Maternal and Newborn Health PBF	• Ongoing regular missions	• Implementation ongoing
	• Public Financial Management Reform Project	• Ongoing regular missions	• Implementation starts in a few months
	• Integrated Transport Project	• Ongoing regular missions	• Implementation ongoing.
IMF work program in next 12 months	**Macroeconomic policy analysis and advice and IMF program**		
	• Program discussion and negotiations missions	• June ; September, 2014	• May 2015
	Technical assistance		
	• Evaluation of off-site supervision	• January 2014	• Ongoing
	• Monetary statistics	• February 2014	• Ongoing
	• Revenue Administration	• February 2014	• Ongoing
	• Risk Management Framework	• February 2014	• Ongoing
	• Financial Stability	• February 2014	• Ongoing
	• Payment system	• March 2014	• Ongoing
	• Balance of payments statistics	• April 2014	• Ongoing
	• Risk-based supervision	• April 2014	• Ongoing
	• PFM reform	• Missions in 2014	• Ongoing
	• Financial Soundness Indicators	• April 2014	• Ongoing
	• Review of debt legislation	• Mid-2013	• Ongoing
	• Review of mining taxation code	• Mid-2013	• Ongoing
B. Requests for work program inputs			
Fund request to Bank	• Periodic updates on the business climate; private sector development; the review of civil service; and capacity building in project appraisal.	Ongoing	
	• Periodic updates on budget support.	• Ongoing	
Bank request to Fund	• Periodic updates on macroeconomic framework; the status of Fund relations with Lesotho, and a follow-up program	• Ongoing	
C. Agreements on joint products and missions			
Joint products in next 12 months	• Debt sustainability analysis	• Ongoing	• June 2014

Lesotho—Statistical Issues Appendix
As of end-April 2014

Assessment of Data Adequacy for Surveillance

General: Data provision is broadly adequate for surveillance with some key data shortcomings in fiscal and external sector statistics.

National Accounts: Bureau of Statistics (BOS) compiles and reports national accounts statistics on an annual basis. Statistical methods used to derive GDP have improved and new sources of data were developed, although serious challenges remain. National accounts were revised and rebased in 2008 and 2009. New sources of data, including VAT records, the 2008 labor force survey, 2010-11 household budget survey, household consumption surveys, and ongoing economic census (business survey) have improved the quality of the national accounts. Annual GDP estimates in current prices and volume terms from the production, expenditure, and income sides are currently produced and published by the BLS. Other macroeconomic indicators, such as high-frequency industrial production/trade indices, are used to monitor developments during the year. The source data needs to be improved by developing high quality data on intermediate consumption for key economic activities, intra-SACU exports and imports, and gross fixed capital formation in machinery and equipment, and formal and informal construction activities. Private consumption and gross fixed capital formation are now estimated within the framework of a supply and use table, although a discrepancy between supply and use leads to a discrepancy between GDP by activity and expenditure. BOS, with the help of Fund's TA, intends to begin compiling quarterly national account series.

Price Statistics: The official monthly consumer price index (CPI), a composite of urban and rural price data, is available on a timely basis. The index has been re-referenced to March 2010=100, using 2002/03 Household Budget Survey. The work on developing producer and export price indices is ongoing. In the meantime, the national accounts rely on South Africa's producer price index and import price indices, used as deflators for imports from SACU- and non-SACU countries, respectively.

Government Finance Statistics (GFS): The compilation of GFS is consistent with GFSM 2001, although the quality, timelines, and periodicity of data have shortcomings. GFS are not provided on a regular basis and the quality of data remains poor, as indicated by significant discrepancies between transactions above and below the line. GFS are compiled from the Integrated Financial Management Information System (IFMIS), supplemented with data from the Lesotho Revenue Authority (LRA), other government departments and units and the banking system. Teething problems experienced with phasing in the IFMIS and in the absence of monthly reconciliation of all Treasury accounts, the coverage of revenue and expenditure data could be incomplete The authorities have been working with international partners, including the EU, the World Bank, and FAD on improving the functionality of the IFMIS and launching monthly reconciliation of all Treasury accounts. GFS is compiled for central government and general government statistics are not available.

Monetary and Financial Statistics (MFS): The Central Bank of Lesotho (CBL) reports monetary data on a regular basis based on Standardized Report Forms (SRFs), with monthly data disseminated through the *IFS*. Improved data sources helped improve classification and sectorization of accounts. The institutional coverage of MFS needs to be expanded to include other depository and other financial corporations.

Financial sector surveillance: The CBL has begun the process of compiling FSIs on a consistent basis and started by recreating consistent FSIs since 2006. FSIs on depository corporations are reported on a quarterly basis with a lag. However, FSIs on non-financial corporations, households, and real estate markets are not available. A recent mission visited Maseru during April 7–April 11, 2014 to assist CBL staff in the compilation of FSIs according to the FSIs Compilation Guide and work with CBL staff to disseminate the FSI data and metadata on the IMF's FSI website.

External Sector statistics: Lesotho benefited from technical assistance provided by STA on the compilation of external sector statistics. Until recently, the CBL compiled and disseminated detailed quarterly balance of payments data in accordance with *BPM5*. The April 2014 technical assistance mission assisted the CBL in converting the quarterly balance of payments and international investment position (IIP) to the *BPM6* framework, which eliminated a number of errors and inconsistencies in data. From the subsequent release, data will be published under BPM6 format. External debt database includes outstanding and contracted loans, their currency composition, debt service and amortization, as well as scheduled future disbursements and debt servicing. The centralized database for external grants has not been regularly updated.

Data Standards and Quality

Lesotho is a GDDS participant. GDDS metadata have been posted on the Fund's Dissemination Standards Bulletin Board since August 2003. Pending metadata updates in GDDS include those referring to recent/prospective revisions of the national accounts, government finance, and balance of payments statistics.

Lesotho: Table of Common Indicators Required for Surveillance

As of April 30, 2014

	Date of Latest Observation	Date Received	Frequency of Data[1]	Frequency of Reporting[1]	Frequency of Publication[1]	Memo Items: Data Quality – Methodological Soundness[8]	Memo Items: Data Quality – Accuracy and Reliability[9]
Exchange Rates	Apr-16-2014	Apr-16-2014	D	D	I		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[2]	Apr-16-2014	Apr-16-2014	D	D	Q		
Reserve/Base Money	Apr-16-2014	Apr-16-2014	D	D	Q		
Broad Money	Feb-28-2014	Apr-11-2014	M	M	Q		
Central Bank Balance Sheet	Apr-16-2014	Apr-16-2014	D	D	Q		
Consolidated Balance Sheet of the Banking System	Feb-28-2014	Apr-11-2014	M	M	Q		
Interest Rates[3]	Feb-28-2014	Apr-11-2014	M	M	Q		
Consumer Price Index	Feb-28-2014	Apr-11-2014	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing[4]—General Government (GG)[5]	N.A.	N.A.	N.A.	N.A.	N.A.		
Revenue, Expenditure, Balance and Composition of Financing[4] – Central Government	Dec-31-2013	Apr-2014	A	I	A		
Stocks of Central Government and Central Government-Guaranteed Debt[6]	Dec-31-2013	Jan-16-2014	M	I	A		
External Current Account Balance	Dec-31-2013	Mar-7-2014	Q	Q	Q		
Exports and Imports of Goods and Services	Dec-31-2013	Mar-7-2014	Q	Q	Q		
GDP/GNP			A	A	A		
Gross External Debt	Dec-31-2013	Jan-16-2014	M	I	A		
International Investment Position[7]	Dec-31-2013	Mar-7-2014	Q	Q	Q		

[1] Daily (D); Weekly (W); Monthly (M); Bi-monthly (B); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

[2] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[3] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[4] Foreign, domestic bank, and domestic nonbank financing.

[5] The GG consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[6] Including currency and maturity composition. Due to capacity constraints the authorities do not report revenue, expenditure, balance and financing composition for general government.

[7] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[8] Reflects the assessment provided in the data ROSC published in October 2006 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

DEBT SUSTAINABILITY ANALYSIS UPDATE

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Approved By
Anne-Marie Gulde-Wolf and Chris Lane (IMF); Marcelo Giugale and Jeffrey D. Lewis (IDA)

Prepared jointly by the staffs of the International Monetary Fund (IMF) and the International Development Agency (IDA).

This debt sustainability analysis (DSA) updates the joint IMF/IDA DSA from September 2013. It incorporates macroeconomic projections consistent with the government budget for 2014/15, which was recently approved by parliament, and employs the 5 percent discount rate that is now standard for present value calculations. Results indicate that Lesotho remains at moderate risk of external debt distress.[1] *However, these results are sensitive to the assumptions concerning the financing of the hydropower plant under the second phase of the Lesotho Highlands Water Project and projections of government's annual financing needs. Given the low level of domestic public debt, the debt indicator for total public debt remains well below its relevant benchmark.*

[1] The low-income country debt sustainability framework (LIC DSF) recognizes that better policies and institutions allow countries to manage higher levels of debt, and thus the threshold levels are policy-dependent. Lesotho's policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessment (CPIA), place it as a "medium performer", with an average rating of 3.45 during 2010-12. The relevant indicative thresholds for this category are: 40 percent for the present value (PV) of debt-to-GDP ratio, 150 percent for the PV of debt-to-exports ratio, 250 percent for the PV of debt-to-revenue ratio, 20 percent for the debt service-to-exports ratio, and 20 percent for the debt service-to-revenue ratio. These thresholds are applicable to public and publicly guaranteed external debt.

UNDERLYING ASSUMPTIONS

1. **Based on recent revisions to historical national accounts data and revised assumptions concerning the timeline for construction of the water and hydropower components of the second phase of the Lesotho Highlands Water Project (LHWP-2),** real GDP growth is projected to dip in 2014 before picking up over the medium term. On average, growth rates are slightly higher in 2015–17, compared with projections for the previous DSA. Over the long term, the average annual growth rate was revised downwards from 4.8 percent to 4.5 percent, mainly reflecting a lower share of capital spending in the government's budget. For imports, the underlying long-term trend anticipates a slight import substitution effect with growth, while over the medium term increases in imports would outpace GDP growth because of imported inputs for LHWP-2 construction. Export growth over the medium term is largely determined by expected developments in the mining and manufacturing sectors. Over the long term exports would receive a boost from the completion of LHWP-2.

Macroeconomic Assumptions, 2012-2033

	2012	2013	2014	2015	2016	2017	2018	2019-33 Average
	Act.	Est.	Projections					
Real GDP Growth (percent)	6.7	5.4	4.0	4.9	5.0	5.5	5.5	4.7
GDP deflator in U.S. dollar terms (change, in percent)	-11.6	-4.9	2.9	3.2	1.8	1.5	1.2	1.9
Effective interest rate (percent)	1.2	1.3	1.8	2.3	2.7	2.4	2.4	1.7
Growth of exports of goods and services (U.S. dollar terms, percent	-9.2	-6.9	7.8	4.5	12.1	9.6	6.5	7.0
Growth of imports of goods and services (U.S. dollar terms, percent	-2.9	-5.9	4.9	10.8	6.3	4.9	6.8	6.2
Grant element of new public sector borrowing (percent)	...	0.0	40.4	34.0	33.7	28.9	26.1	37.7
Government revenue (excluding grants, percent of GDP)	57.5	53.6	56.2	54.4	51.5	50.8	50.2	48.3
Government expenditure (percent of GDP)								
Primary (noninterest) expenditure	60.3	59.5	61.5	58.4	57.1	57.1	56.7	56.1
Interest payments								
Aid flows (millions of U.S. dollars)	942	928	855	824	800	780	758	520
of which:								
Grants	199	124	105	102	104	113	121	207
Concessioanl loans	744	804	750	721	695	668	637	313
Grant equivalent financing (percent of GDP)	...	5.3	6.5	5.9	5.5	5.6	5.7	5.6
Grant equivalent financing (percent of external financing)	...	100.0	66.0	59.1	59.8	53.8	50.0	62.2

2. **On the fiscal side, the government revenue (excluding grants) was revised upward on average by 2 percent of GDP a year over the long run**, largely reflecting higher revenue projections from the Southern African Customs Union (SACU) – compared with projections in the previous DSA. Primary (noninterest) expenditure projections have also been increased to reflect the latest projections in the authorities' medium-term fiscal framework, resulting in an average primary deficit of 4.3 percent of GDP per annum, which is assumed to be financed mostly through external concessional borrowing.

3. **The assumptions regarding the hydropower component of LHWP-2 remain broadly the same as those in the previous DSA** with respect to costs ($500 million) and financing terms and conditions (80 percent commercial, 20 percent grants). Only the timeline has been pushed back to 2019–26, in light of recent delays.[2] However, these assumptions are tentative as the project's feasibility

[2] As before, construction under the water component is expected to begin in 2014-15 and would run through 2021/22. The total cost of this component (US$900 million) will be financed by grants from South Africa.

study is still underway (expected to be completed by end-2014). The actual size of the project could be larger and the terms of the financing could differ.

4. **In line with the current policy, this update also uses a discount rate of 5 percent.**

EXTERNAL DEBT SUSTAINABILITY

A. Baseline

5. **All external debt sustainability indicators remain below their corresponding thresholds in the baseline scenario** (Table 1a). For example, the present value (PV) of external debt to GDP ratio is expected to fall to below 30 percent in 2016, after which time it is expected to rise to 39 percent in 2022, before subsiding to 34 percent in the early 2030s. The temporary rise in the debt ratio is driven by the construction of a hydropower plant under LHWP-2 and related financing needs. Moreover, in the long run the looser fiscal outlook (higher primary deficits) raises the PV of external debt to GDP ratio by more than 10 percent of GDP, compared with the previous DSA.

6. **These results are sensitive to the assumptions concerning the amount and concessionality of LHWP-2 financing, the future of SACU revenues, and the concessionality of external borrowing in general.** The temporary increase in PV of external debt to GDP ratio is driven entirely by higher nonconcessional borrowing for the LHWP-2. The increased borrowing during the construction of the power plant does make Lesotho temporarily more vulnerable to external shocks. The authorities are currently undertaking a feasibility study, results of which would provide a better idea about the financing options. While the baseline assumes that the government revenue would gradually decline from 56 percent of GDP in 2014 to 48 percent of GDP in 2023 and onwards, largely due to a decline in SACU revenue, a more abrupt and permanent decline of these revenues—as discussed in the risk assessment matrix in the staff report for Lesotho's Article IV consultation (EBS/14/[ ])—would require a major fiscal adjustment to maintain macroeconomic stability rather than additional borrowing.

B. Sensitivity Analysis

7. **Stress tests show that Lesotho's external debt vulnerabilities would increase significantly, in particular in the event of a worsening of borrowing terms, a major exchange rate depreciation, or if the export growth turned out to be lower than the historical average.** (Table 1b). A 200 basis point increase in interest rates for new public sector loans in 2013–33 (A2) would increase the PV of external debt-to-GDP ratio to 55 percent in 2024 and beyond. Similarly, in the event of a one-time 30 percent depreciation of the nominal exchange rate (B6) in 2014, the PV of external debt-to-GDP ratio would increase to 55 percent by 2021/22, gradually falling thereafter to 50 percent by 2028 and staying at about 48 percent thereafter. In both of these stress tests, the 40-percent threshold would be breached throughout the projection period. In a scenario where export value grows (B2) at one standard deviation lower than the historical average, the PV of external debt-to-export ratio would rise from 2018 and peak in 2021 at 142 percent, before easing to 100 percent in 2030s. In a scenario in which the key variables are set at their average of the past 10 years, Lesotho's external debt ratios actually fall relative to the baseline, reflecting an average fiscal surplus over the past years thanks to the large SACU revenue in 2006–09. However, given the structural break, the historical scenario could be considered less relevant for the analysis.

C. Including Remittances[3]

8. When remittances are included in the analysis, a key external debt indicator would be briefly breached, albeit by a small margin. (Figure 2). The PV of external debt to GDP plus remittances ratio is expected to fall to 28 percent by 2017, after which time it is expected to rise, reaching nearly 36½ percent in 2021–23 (the relevant threshold is 36 percent), and then fall to 32 percent by the end of the projection period. Other indicators behave similarly to the analysis excluding remittances.

PUBLIC SECTOR DEBT SUSTAINABILITY

9. Public debt indicators largely mirror those of external debt, because domestic debt remains low throughout the projection period (2–4 percent of GDP). Domestic debt is projected to fall to about 2 percent of GDP by 2018/19, and thereafter to gradually increase to about 4 percent of GDP in 2032/33. The PV of public sector debt stood at 37 percent in 2012/13.

10. The standard sensitivity tests for public debt distress point to higher degree of vulnerability of public debt to lower long-run GDP growth (Table 2b). In the case of permanently lower GDP growth (A3) the PV of debt to GDP ratio would increase permanently throughout the projection period to 56 percent. The permanently-lower-GDP-growth test has a similar effect on the PV of debt-to-revenue and debt service-to-revenue ratios.

CONCLUSION

11. Lesotho remains at moderate risk of external debt distress. All external debt and debt service indicators for the base case remain below their respective thresholds. However, there is a permanent breach in the sensitivity tests. Compared with the previous DSA, the primary fiscal deficit has deteriorated throughout the projection period by an average of about 4 percent of GDP a year, increasing the PV of external debt to GDP ratio by 12 percentage points at the end of the projection period. The risks appear manageable, provided that the fiscal stance does not deteriorate further and that government's external borrowing is largely on concessional terms. Uncertainty about the parameters of the LHWP-2 project and its financing could also create some risk to debt sustainability. For the next DSA, these parameters should be updated based on the conclusions of the project's feasibility study currently underway.

12. The authorities broadly agreed with the assessment of moderate risk of external debt distress. They appreciated that the PV of external debt ratio rises owing to the construction of the LHWP-2 and agreed that care would be needed to ensure that the financing arrangements do not increase the risk of external debt distress.

[3] Presenting the analysis including remittances is mainly for illustrative purposes. With declining migrant employment in South Africa's mining sector, Lesotho's dependence on remittances continues to diminish. In the long term, the ratio of remittances to GDP is expected to fall well below 10 percent.

Table 1a .Lesotho: External Debt Sustainability Framework, Baseline Scenario, 2011–33 [1]

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/	Standard 6/	Projections								
				Average	Deviation						2013-18			2019-33
	2011	2012	2013			2014	2015	2016	2017	2018	Average	2023	2033	Average
External debt (nominal) 1/	**31.5**	**36.5**	**38.9**			**37.8**	**38.3**	**39.1**	**41.0**	**43.8**		**53.2**	**49.4**	
of which: public and publicly guaranteed (PPG)	31.5	36.5	38.9			37.8	38.3	39.1	41.0	43.8		53.2	49.4	
Change in external debt	31.5	5.0	2.5			-1.1	0.5	0.8	1.9	2.8		0.2	-0.4	
Identified net debt-creating flows	...	4.3	-1.2			-0.7	7.0	8.3	6.2	7.7		4.1	-1.4	
Non-interest current account deficit	**8.6**	**2.4**	**0.6**	**-9.3**	**13.5**	**0.4**	**8.2**	**9.5**	**7.7**	**9.3**		**5.9**	**2.2**	4.7
Deficit in balance of goods and services	61.1	66.0	62.5			60.1	63.9	61.4	58.3	58.5		53.6	49.4	
Exports	46.3	44.5	41.4			41.7	40.3	42.3	43.2	43.1		41.8	45.0	
Imports	107.4	110.5	103.9			101.8	104.2	103.7	101.5	101.6		95.3	94.4	
Net current transfers (negative = inflow)	-27.2	-40.7	-38.7	-38.6	7.1	-38.3	-35.8	-32.7	-33.2	-32.6		-32.5	-34.4	-33.2
of which: official	-20.0	-33.8	-31.7			-32.1	-30.1	-26.8	-27.2	-26.7		-26.5	-27.9	
Other current account flows (negative = net inflow)	-25.3	-22.9	-23.2			-21.4	-19.9	-19.3	-17.5	-16.5		-15.1	-12.8	
Net FDI (negative = inflow)	**-0.4**	**-0.4**	**-0.3**	**-2.2**	**1.6**	**-0.3**	**-0.3**	**-0.3**	**-0.4**	**-0.4**		**-0.7**	**-2.0**	-1.1
Endogenous debt dynamics 2/	**...**	**2.3**	**-1.5**			**-0.8**	**-0.9**	**-0.8**	**-1.1**	**-1.2**		**-1.1**	**-1.6**	
Contribution from nominal interest rate	...	0.4	0.5			0.6	0.8	1.0	0.9	0.9		1.1	0.5	
Contribution from real GDP growth	0.0	-2.2	-2.0			-1.4	-1.7	-1.8	-2.0	-2.1		-2.2	-2.1	
Contribution from price and exchange rate changes	0.0	4.1	...			...	...	...	...	...		...	...	
Residual (3-4) 3/	**...**	**0.7**	**1.8**			**0.7**	**-5.3**	**-6.8**	**-3.7**	**-4.4**		**-2.8**	**2.0**	
of which: exceptional financing	...	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	33.4	32.7			30.6	29.9	29.6	30.5	32.3		38.1	34.2	
In percent of exports	...	75.1	79.1			73.2	74.2	70.0	70.5	74.9		91.3	76.1	
PV of PPG external debt	**...**	**33.4**	**32.7**			**30.6**	**29.9**	**29.6**	**30.5**	**32.3**		**38.1**	**34.2**	
In percent of exports	**...**	**75.1**	**79.1**			**73.2**	**74.2**	**70.0**	**70.5**	**74.9**		**91.3**	**76.1**	
In percent of government revenues	**...**	**58.1**	**61.1**			**54.3**	**54.9**	**57.4**	**60.0**	**64.3**		**79.1**	**71.0**	
Debt service-to-exports ratio (in percent)	**3.3**	**3.2**	**4.2**			**4.2**	**5.5**	**5.0**	**4.6**	**4.8**		**9.0**	**5.6**	
PPG debt service-to-exports ratio (in percent)	**3.3**	**3.2**	**4.2**			**4.2**	**5.5**	**5.0**	**4.6**	**4.8**		**9.0**	**5.6**	
PPG debt service-to-revenue ratio (in percent)	**3.4**	**2.5**	**3.3**			**3.1**	**4.1**	**4.1**	**3.9**	**4.1**		**7.8**	**5.2**	
Total gross financing need (Billions of U.S. dollars)	241	80	47			47	272	323	287	361		413	237	
Non-interest current account deficit that stabilizes debt ratic	-22.8	-2.6	-1.9			1.6	7.7	8.6	5.8	6.6		5.7	2.6	
Key macroeconomic assumptions														
Real GDP growth (in percent)	3.8	6.7	5.4	4.5	1.3	4.0	4.9	5.0	5.5	5.5	4.5	4.5	4.5	4.7
GDP deflator in US dollar terms (change in percent)	3.7	-11.6	-4.9	9.7	18.3	2.9	3.2	1.8	1.5	1.2	4.2	2.0	2.0	1.9
Effective interest rate (percent) 5/	...	1.2	1.3	1.2	...	1.8	2.3	2.7	2.4	2.4	2.0	2.3	1.1	1.7
Growth of exports of G&S (US dollar terms, in percent)	15.3	-9.2	-6.9	10.1	15.5	7.8	4.5	12.1	9.6	6.5	7.4	5.6	7.0	7.0
Growth of imports of G&S (US dollar terms, in percent)	6.5	-2.9	-5.9	11.1	15.1	4.9	10.8	6.3	4.9	6.8	6.7	2.7	7.0	6.2
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	40.4	34.0	33.7	28.9	26.1	32.6	38.5	42.3	37.7
Government revenues (excluding grants, in percent of GDP)	44.6	57.5	53.6			56.2	54.4	51.5	50.8	50.2		48.2	48.2	48.3
Aid flows (in Billions of US dollars) 7/	893	942	928			855	824	800	780	758		594	368	520
of which: Grants	193	199	124			105	102	104	113	121		165	312	207
of which: Concessional loans	700	744	804			750	721	695	668	637		429	56	313
Grant-equivalent financing (in percent of GDP) 8/	...	...	5.3			6.5	5.9	5.5	5.6	5.7		5.9	5.6	5.6
Grant-equivalent financing (in percent of external financing)	...	...	100.0			66.0	59.1	59.8	53.8	50.0		61.1	67.2	62.2
Memorandum items:														
Nominal GDP (Billions of US dollars)	2,461	2,321	2,325			2,486	2,692	2,877	3,081	3,289		4,620	8,747	
Nominal dollar GDP growth	7.6	-5.7	0.2			6.9	8.3	6.9	7.1	6.8	6.0	6.6	6.6	6.7
PV of PPG external debt (in Billions of US dollars)		731	721			760	804	851	939	1,062		1,762	2,993	
(PVt-PVt-1)/GDPt-1 (in percent)			-0.4			1.7	1.8	1.7	3.1	4.0	2.0	1.9	2.0	2.6
Gross workers' remittances (Billions of US dollars)	298	260	240			227	203	185	170	160		283	583	
PV of PPG external debt (in percent of GDP + remittances)	...	30.1	29.7			28.0	27.8	27.8	28.9	30.8		35.9	32.1	
PV of PPG external debt (in percent of exports + remittance	...	60.0	63.3			60.1	62.5	60.8	62.6	67.3		79.6	66.3	
Debt service of PPG external debt (in percent of exports + r	...	2.5	3.4			3.5	4.7	4.3	4.1	4.3		7.9	4.8	

Sources: Country authorities; and staff estimates and projections.

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 PV 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.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 1b. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014–33

(In percent)

	Projections						
	2014	2015	2016	2017	2018	**2023**	2033
PV of debt-to GDP ratio							
Baseline	31	30	30	30	32	**38**	34
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	21	7	-7	-17	-27	**-63**	-56
A2. New public sector loans on less favorable terms in 2013-2033 2	30	32	33	36	40	**55**	54
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	31	31	30	31	33	**39**	35
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	34	39	38	39	40	**45**	35
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	34	38	38	39	41	**48**	43
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	35	37	36	37	39	**43**	35
B5. Combination of B1-B4 using one-half standard deviation shocks	35	39	38	39	41	**46**	37
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	43	42	42	43	46	**54**	48
PV of debt-to-exports ratio							
Baseline	73	74	70	71	75	**91**	76
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	50	16	-17	-40	-62	**-150**	-123
A2. New public sector loans on less favorable terms in 2013-2033 2	73	79	79	84	93	**132**	121
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	73	74	70	70	75	**91**	76
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	93	121	114	113	118	**136**	97
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	73	74	70	70	75	**91**	76
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	84	91	86	86	90	**104**	77
B5. Combination of B1-B4 using one-half standard deviation shocks	86	97	91	91	96	**111**	83
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	73	74	70	70	75	**91**	76
PV of debt-to-revenue ratio							
Baseline	54	55	57	60	64	**79**	71
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	37	12	-14	-34	-53	**-130**	-115
A2. New public sector loans on less favorable terms in 2013-2033 2	54	59	65	71	80	**115**	112
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	55	56	59	61	66	**81**	73
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	60	71	74	77	81	**94**	72
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	61	70	73	76	82	**101**	90
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	62	68	70	73	77	**90**	72
B5. Combination of B1-B4 using one-half standard deviation shocks	62	71	74	76	81	**95**	76
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	77	78	81	85	91	**112**	100

Sources: Country authorities; and staff estimates and projections.

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/ 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.

Table 1b. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2014-33 (concluded)

(In percent)

Debt service-to-exports ratio							
Baseline	4	6	5	5	5	**9**	6
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	4	4	3	2	2	**0**	-8
A2. New public sector loans on less favorable terms in 2013-2033 2	4	6	5	5	5	**9**	10
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	4	6	5	5	5	**9**	6
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	5	7	7	6	6	**13**	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	4	6	5	5	5	**9**	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	4	6	5	5	5	**10**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	4	6	6	5	5	**11**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	4	6	5	5	5	**9**	6
Debt service-to-revenue ratio							
Baseline	3	4	4	4	4	**8**	5
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	3	3	3	2	1	**0**	-8
A2. New public sector loans on less favorable terms in 2013-2033 2	3	4	4	4	5	**8**	9
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	3	4	4	4	4	**8**	5
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	3	4	4	4	4	**9**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	4	5	5	5	5	**10**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	3	4	4	4	4	**9**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	3	4	5	4	5	**9**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	4	6	6	6	6	**11**	7
Memorandum item:							
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	33	33	33	33	33	**33**	33

Sources: Country authorities; and staff estimates and projections.

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/ 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.

Table 2a. Lesotho: Public Sector Debt Sustainability Framework, Baseline Scenario, 2011–33

(In percent of GDP, unless otherwise indicated)

	Actual					Projections								
	2011	2012	2013	Average 5/	Standard Deviation 5/	2014	2015	2016	2017	2018	2013-18 Average	2023	2033	2019-33 Average
Public sector debt 1/	37.6	39.7	41.8			40.4	40.6	41.3	43.0	45.8		56.3	53.4	
of which: foreign-currency denominated	31.5	36.5	38.9			37.8	38.3	39.1	41.0	43.8		53.2	49.4	
							2.4	2.1	1.9	1.9		3.0	4.0	
Change in public sector debt	32.8	2.1	2.1			-1.4	0.2	0.6	1.7	2.8		0.3	-0.3	
Identified debt-creating flows	...	-2.5	0.6			-2.9	-1.9	0.4	0.8	1.0		2.1	1.7	
Primary deficit	9.9	-5.8	0.6	-3.4	7.5	1.0	0.3	2.0	2.6	2.8	1.7	4.3	4.3	4.2
Revenue and grants	52.5	66.1	58.9			60.5	58.2	55.2	54.5	53.9		51.8	51.8	51.9
of which: grants	7.8	8.6	5.3			4.2	3.8	3.6	3.7	3.7		3.6	3.6	
Primary (noninterest) expenditure	62.4	60.3	59.5			61.5	58.4	57.1	57.1	56.7		56.1	56.1	56.1
Automatic debt dynamics	...	3.3	0.0			-3.9	-2.2	-1.5	-1.8	-1.7		-2.2	-2.6	
Contribution from interest rate/growth differential	...	-2.1	-2.1			-1.4	-1.6	-1.5	-1.9	-2.1		-2.2	-2.6	
of which: contribution from average real interest rat	...	0.3	-0.1			0.2	0.3	0.4	0.2	0.2		0.2	-0.3	
of which: contribution from real GDP growth	-0.2	-2.4	-2.0			-1.6	-1.9	-1.9	-2.1	-2.2		-2.4	-2.3	
Contribution from real exchange rate depreciation	...	5.3	2.1			-2.5	-0.6	-0.1	0.2	0.3		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	...	4.7	1.5			1.5	2.1	0.2	0.9	1.8		-1.8	-2.0	
Other Sustainability Indicators														
PV of public sector debt	...	36.7	35.6			33.2	32.2	31.7	32.4	34.2		41.2	38.2	
of which: foreign-currency denominated	...	33.4	32.7			30.6	29.9	29.6	30.5	32.3		38.1	34.2	
of which: external	...	33.4	32.7			30.6	29.9	29.6	30.5	32.3		38.1	34.2	
PV of contingent liabilities (not included in public secto	...	...	...			...	...	...	...	...		...	...	
Gross financing need 2/	12.5	-3.6	2.9			3.2	2.9	4.4	4.9	5.1		8.7	7.6	
PV of public sector debt-to-revenue and grants ratio (in perc	...	55.5	60.5			54.9	55.4	57.5	59.5	63.5		79.5	73.9	
PV of public sector debt-to-revenue ratio (in percent)	...	63.7	66.5			59.0	59.3	61.5	63.8	68.1		85.4	79.3	
of which: external 3/	...	58.1	61.1			54.3	54.9	57.4	60.0	64.3		79.1	71.0	
Debt service-to-revenue and grants ratio (in percent) 4/	4.9	3.2	3.9			3.7	4.6	4.4	4.3	4.4		8.5	6.3	
Debt service-to-revenue ratio (in percent) 4/	5.8	3.7	4.3			3.9	4.9	4.8	4.6	4.7		9.2	6.8	
Primary deficit that stabilizes the debt-to-GDP ratio	-22.9	-7.9	-1.5			2.4	0.1	1.4	0.9	0.0		4.0	4.6	
Key macroeconomic and fiscal assumptions														
Real GDP growth (in percent)	3.8	6.7	5.4	4.5	1.3	4.0	4.9	5.0	5.5	5.5	4.5	4.5	4.5	4.7
Average nominal interest rate on forex debt (in percent)	...	1.2	1.3	1.2	...	1.8	2.3	2.7	2.4	2.4	2.0	2.3	1.1	1.7
Average real interest rate on domestic debt (in percent)	0.4	5.8	0.0	3.1	3.8	2.7	1.8	2.8	3.0	3.0	2.5	2.9	2.9	2.9
Real exchange rate depreciation (in percent, + indicates dep	7.5	18.1	6.1	-1.5	13.9	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	7.4	1.7	7.6	6.3	3.3	5.2	6.1	5.1	4.8	4.8	5.4	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, i	14.7	3.3	3.8	0.8	6.1	7.5	-0.3	2.7	5.3	4.8	3.8	4.5	4.5	4.6
Grant element of new external borrowing (in percent)	...	...	0.0	...	...	40.4	34.0	33.7	28.9	26.1	27.2	38.5	42.3	...

Sources: Country authorities; and staff estimates and projections.

1/ Gross debt is used. The public sector comprises the central government, the Central Bank of Lesotho, and all enterprises with majority state ownership.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b. Lesotho: Sensitivity Analysis for Key Indicators of Public Debt 2014–33
(In percent)

	Projections						
	2014	2015	2016	2017	2018	2023	2033
PV of Debt-to-GDP Ratio							
Baseline	33	32	32	32	34	41	38
A. Alternative scenarios							
A1. Real GDP growth and primary balance are at historical averages	30	27	23	20	19	5	-33
A2. Primary balance is unchanged from 2013	33	32	31	30	31	27	6
A3. Permanently lower GDP growth 1/	33	33	33	34	36	47	56
B. Bound tests							
B1. Real GDP growth is at historical average minus one standard deviations in 2014-20	34	34	34	36	38	49	51
B2. Primary balance is at historical average minus one standard deviations in 2014-201	35	37	36	37	38	45	40
B3. Combination of B1-B2 using one half standard deviation shocks	33	32	32	33	35	44	44
B4. One-time 30 percent real depreciation in 2014	45	42	41	40	41	46	43
B5. 10 percent of GDP increase in other debt-creating flows in 2014	40	39	38	38	40	46	41
PV of Debt-to-Revenue Ratio 2/							
Baseline	55	55	58	60	63	80	74
A. Alternative scenarios							
A1. Real GDP growth and primary balance are at historical averages	50	46	42	37	35	9	-64
A2. Primary balance is unchanged from 2013	54	55	56	55	57	53	12
A3. Permanently lower GDP growth 1/	55	56	59	62	67	90	108
B. Bound tests							
B1. Real GDP growth is at historical average minus one standard deviations in 2014-20	56	59	62	66	71	94	97
B2. Primary balance is at historical average minus one standard deviations in 2014-201	58	63	66	67	71	87	78
B3. Combination of B1-B2 using one half standard deviation shocks	54	55	58	61	66	85	84
B4. One-time 30 percent real depreciation in 2014	74	73	74	74	77	88	83
B5. 10 percent of GDP increase in other debt-creating flows in 2014	66	67	69	71	74	89	79
Debt Service-to-Revenue Ratio 2/							
Baseline	4	5	4	4	4	9	6
A. Alternative scenarios							
A1. Real GDP growth and primary balance are at historical averages	4	4	4	4	3	7	-3
A2. Primary balance is unchanged from 2013	4	5	4	4	4	8	3
A3. Permanently lower GDP growth 1/	4	5	5	4	4	9	8
B. Bound tests							
B1. Real GDP growth is at historical average minus one standard deviations in 2014-20	4	5	5	5	5	9	8
B2. Primary balance is at historical average minus one standard deviations in 2014-201	4	5	5	5	5	9	7
B3. Combination of B1-B2 using one half standard deviation shocks	4	5	4	4	4	9	7
B4. One-time 30 percent real depreciation in 2014	4	6	6	6	6	12	10
B5. 10 percent of GDP increase in other debt-creating flows in 2014	4	5	6	5	5	9	7

Sources: Country authorities; and staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.

2/ Revenues are defined inclusive of grants.

Table 3a. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt (including remittances), 2014-33
(In percent)

	Projections						
	2014	2015	2016	2017	2018	**2023**	2033
PV of debt-to-GDP+remittances ratio							
Baseline	28	28	28	29	31	**36**	32
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	19	6	-7	-16	-26	**-61**	-55
A2. New public sector loans on less favorable terms in 2013-2033 2	28	30	31	34	38	**52**	51
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	28	28	28	30	31	**37**	33
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	31	36	36	37	39	**42**	33
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	31	35	35	36	39	**45**	40
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	32	34	34	35	37	**41**	32
B5. Combination of B1-B4 using one-half standard deviation shocks	32	36	36	37	39	**43**	34
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	38	38	38	40	43	**50**	44
PV of debt-to-exports+remittances ratio							
Baseline	60	62	61	63	67	**80**	66
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	41	14	-15	-36	-57	**-139**	-119
A2. New public sector loans on less favorable terms in 2013-2033 2	60	67	69	74	84	**115**	105
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	60	62	61	63	67	**80**	66
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	74	98	96	98	104	**115**	82
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	60	62	61	63	67	**80**	66
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	71	78	75	76	81	**91**	67
B5. Combination of B1-B4 using one-half standard deviation shocks	71	81	78	80	85	**95**	71
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	60	62	61	63	67	**80**	66
PV of debt-to-revenue ratio							
Baseline	54	55	57	60	64	**79**	71
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	37	12	-14	-34	-53	**-130**	-115
A2. New public sector loans on less favorable terms in 2013-2033 2	54	59	65	71	80	**115**	112
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	55	56	59	61	66	**81**	73
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	60	71	74	77	81	**94**	72
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	61	70	73	76	82	**101**	90
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	62	68	70	73	77	**90**	72
B5. Combination of B1-B4 using one-half standard deviation shocks	62	71	74	76	81	**95**	76
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	77	78	81	85	91	**112**	100

Sources: Country authorities; and staff estimates and projections.

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/ 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.

Table 3a. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt (including remittances), 2014–33 (concluded)

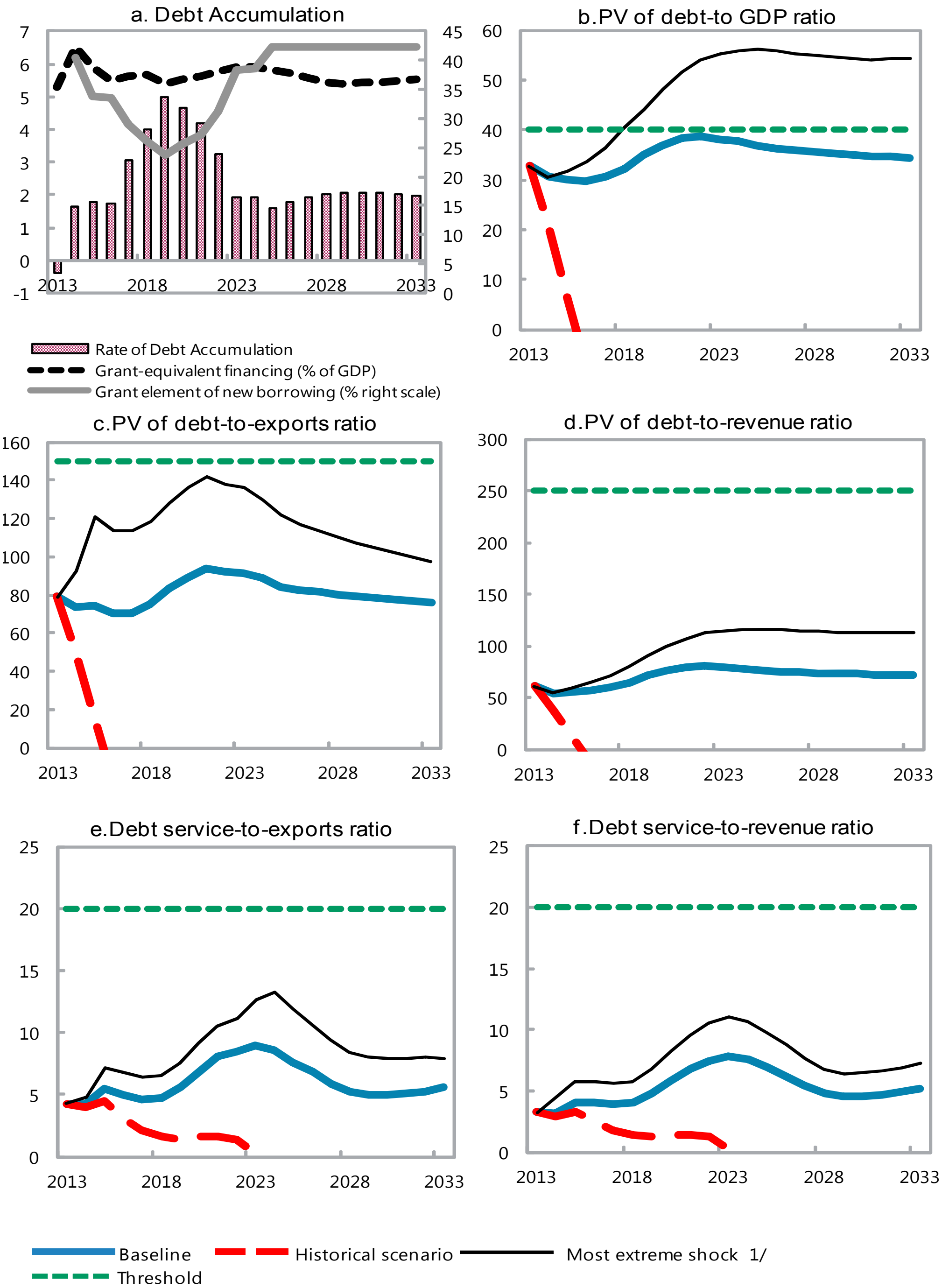
(In percent)

Debt service-to-exports+remittances ratio							
Baseline	3	5	4	4	4	**8**	5
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	3	4	3	2	1	**0**	-8
A2. New public sector loans on less favorable terms in 2013-2033 2	3	5	5	5	5	**8**	9
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	3	5	4	4	4	**8**	5
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	4	6	6	5	6	**11**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	3	5	4	4	4	**8**	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	4	5	5	4	5	**9**	5
B5. Combination of B1-B4 using one-half standard deviation shocks	4	5	5	5	5	**9**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	3	5	4	4	4	**8**	5
Debt service-to-revenue ratio							
Baseline	3	4	4	4	4	**8**	5
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2013-2033 1/	3	3	3	2	1	**0**	-8
A2. New public sector loans on less favorable terms in 2013-2033 2	3	4	4	4	5	**8**	9
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2014-2015	3	4	4	4	4	**8**	5
B2. Export value growth at historical average minus one standard deviation in 2014-2015 3/	3	4	4	4	4	**9**	6
B3. US dollar GDP deflator at historical average minus one standard deviation in 2014-2015	4	5	5	5	5	**10**	7
B4. Net non-debt creating flows at historical average minus one standard deviation in 2014-2015 4/	3	4	4	4	4	**9**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	3	4	5	4	5	**9**	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2014 5/	4	6	6	6	6	**11**	7
Memorandum item:							
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	33	33	33	33	33	**33**	33

Sources: Country authorities; and staff estimates and projections.

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/ 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.

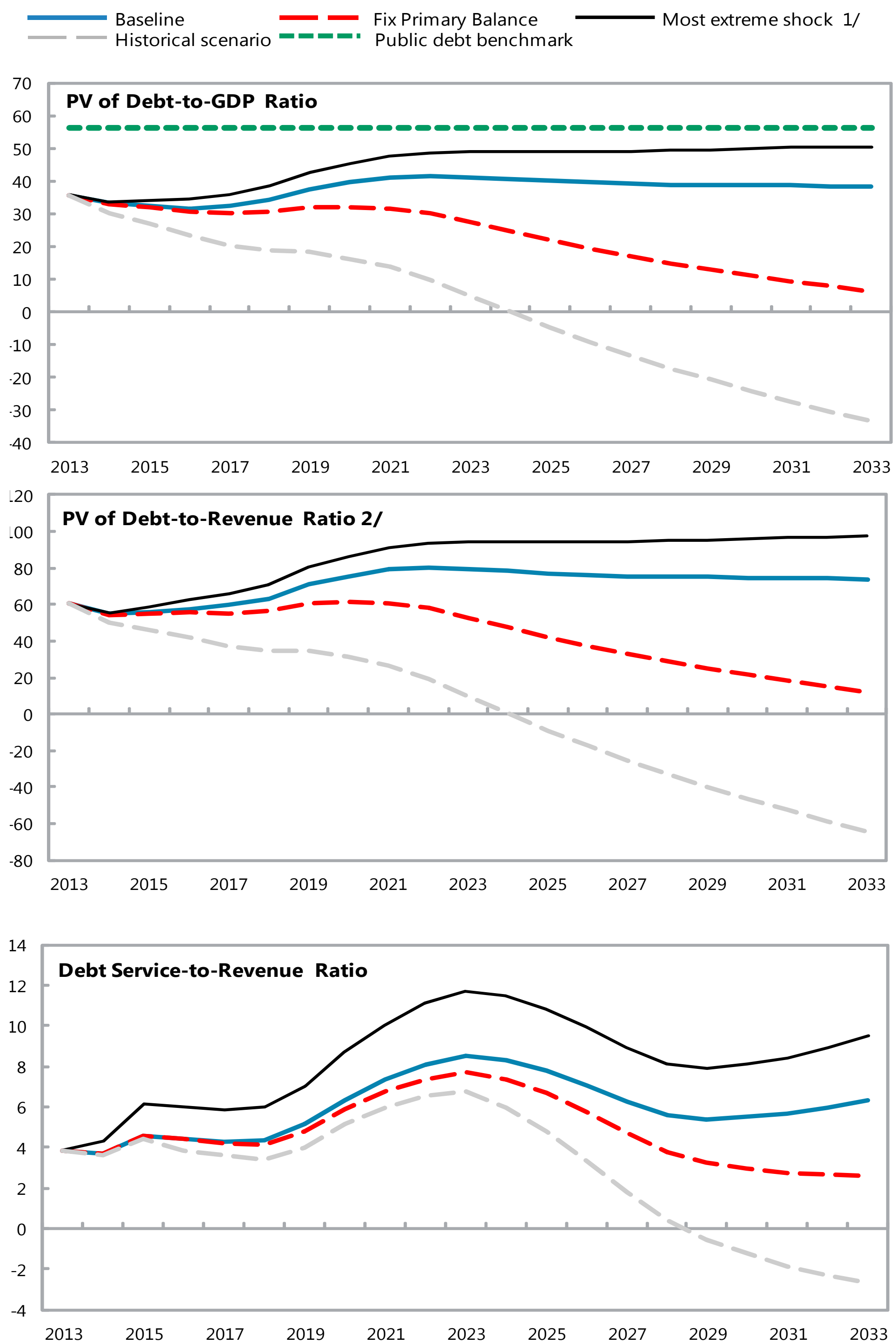
Figure 1a. Lesotho: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2013-2033 1/



Sources: Country authorities; and staff estimates and projections.

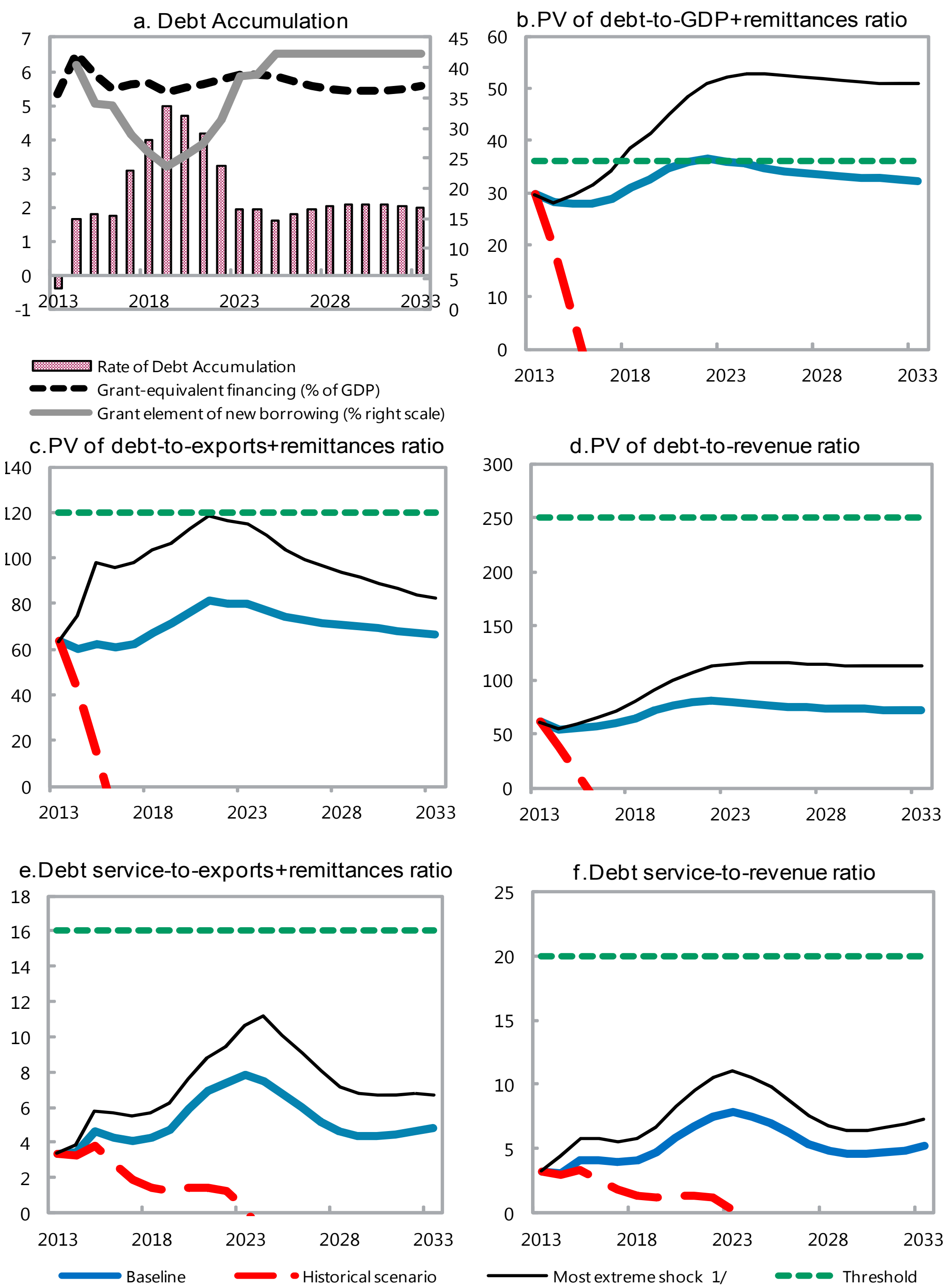
1/ The most extreme stress test is the test that yields the highest ratio on or before 2023. In figure b. it corresponds to a Terms shock; in c. to a Exports shock; in d. to a Terms shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock.

Figure 1b.Lesotho: Indicators of Public Debt Under Alternative Scenarios, 2013–33 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio on or before 2023.
2/ Revenues are defined inclusive of grants.

Figure 2. Lesotho: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios (including remittances), 2013–33 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2023. In figure b. it corresponds to a Terms shock; in c. to a Exports shock; in d. to a Terms shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock.

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

IMF Executive Board Concludes 2014 Article IV Consultation with the Kingdom of Lesotho

On June 4, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Kingdom of Lesotho. [1]

Background

Since 2010, the economy performed well with the growth of real Gross Domestic Product averaging over 5 percent a year and inflation held to single-digit levels. International reserves have recovered to close to 5 months of import coverage after dipping to 3½ months of imports in 2012 in the wake of the balance of payments and fiscal crisis caused by the sharp drop in revenues from the Southern African Customs Union (SACU) in fiscal years 2010/11 and 2011/12. The recovery from the crisis was achieved with the help of a sustained fiscal adjustment effort supported by the IMF with a three-year arrangement under the Extended Credit Facility (ECF), which was successfully concluded in September 2013.

The economic outlook for Lesotho is positive with strong economic growth and low inflation. Economic activity is expected to be supported by large public investment projects, including the second phase of Lesotho Highland Water Project. The authorities are also taking steps to strengthen the role of the private sector. However, there are risks, most notably from the high volatility of SACU revenues.

Despite the recent strong growth, unemployment remains high and poverty is widespread, while some social indicators on primary and secondary education and HIV/AIDS highlight the future challenges.

In the near term, the authorities are faced with the issue of domestic tax performance. In 2013/14, the domestic tax revenue experienced a shortfall of 4 percent of GDP and resulted in the overall fiscal deficit of more than 1 percent of GDP, compared with a strong surplus the

[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.

previous year. On the spending side, Lesotho is faced with an extraordinarily high government wage bill—the highest in sub-Saharan Africa (relative to GDP)—which to some extent crowds out public investment projects needed to promote inclusive growth under the National Strategic Development Plan (NSDP).

Executive Board Assessment[2]

Executive Directors commended Lesotho's robust economic growth with moderate inflation, and welcomed the recovery of international reserves on the back of a period of fiscal adjustment. The outlook is positive, but the economy faces risks from the volatility of revenues from the Southern African Customs Union, while unemployment remains high and poverty widespread. A strengthening of fiscal policies and stepped up reform implementation will therefore be needed to enhance resilience and promote private sector-led inclusive growth.

Directors saw a need for a tighter fiscal stance consistent with maintaining an adequate level of international reserves and creating space for priority social and capital spending. They encouraged the authorities to improve revenue administration and tax policy, including in mining, and to contain recurrent expenditure, notably the wage bill. In this regard, Directors urged completion of the ongoing pilot payroll audits and extension of the exercise to the entire civil service while strengthening control over hirings. They also encouraged the authorities to step up public financial management reforms.

Directors noted that substantial financing will be needed for the second phase of the Lesotho Highlands Water Project, and encouraged the authorities to pursue a prudent debt policy to ensure sustainability. They recommended prompt submission of the new public debt management bill to parliament.

Directors observed that the loti's peg to the South African rand has successfully anchored Lesotho's macroeconomic stability. They encouraged the authorities to consider moving toward a transparent and predictable rules-based fiscal framework, which, in addition to maintaining a sufficient stock of international reserves to secure the peg, would further reduce risks.

Directors welcomed the soundness of the banking sector. They emphasized the need for financial sector deepening to enable private sector-led growth, and recommended further strengthening the regulatory and supervisory framework, including effective cross-border supervision with South Africa, and establishing a functional credit reference bureau. Implementation of the Financial Sector Development Strategy will be important in this regard.

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors encouraged the authorities to step up implementation of the National Strategic Development Plan to improve the business climate, raise competitiveness, and promote broad-based growth and poverty reduction.

Lesotho: Selected Economic Indicators, 2010/11–2013/14 [1]	2010/11 Act.	2011/12 Act.	2012/13 Act.	2013/14 Prel.
(Percentage changes; unless otherwise indicated)				
National account and prices				
GDP at constant prices	6.0	3.8	6.7	5.4
GDP deflator	4.6	7.4	1.7	7.6
GDP at market prices (Maloti millions)	16,455	18,330	19,893	22,556
Consumer prices (average)	3.4	6.0	5.6	5.0
External sector				
Terms of trade (deterioration -)	4.0	9.1	-9.5	0.7
Average exchange rate (Local currency per U.S. dollar)	7.2	7.4	8.6	9.6
Nominal effective exchange rate change (– = depreciation) [2]	4.0	-7.1	-14.4	-11.5
Real effective exchange rate (– = depreciation) [2]	5.4	-3.6	-12.1	-9.3
Current account balance				
(Including official transfers, percent of GDP)	-7.5	-9.0	-2.7	-1.0
(Excluding official transfers, percent of GDP)	-29.3	-29.0	-36.6	-32.7
Gross international reserves				
(Months of imports) [3]	4.0	3.6	4.6	4.8
(Percent of M1)	144	139	179	160
Money and credit				
Domestic credit to the private sector	26.9	25.1	42.2	20.0
Broad money	1.1	5.0	6.1	24.9
Interest rate (percent) [4]	3.2	2.8	2.4	2.3
(Percent of GDP; unless otherwise indicated)				
Savings and investment				
Gross capital formation [5]	29.0	34.9	35.6	33.3
Public	12.2	20.0	20.7	18.4
Private	15.1	14.6	14.6	14.5
National savings	21.5	25.9	32.8	32.3
Public	5.8	10.2	24.7	16.7
Private	15.8	15.8	8.1	15.6
Public debt	34.9	37.6	39.7	41.9
External public debt	30.2	31.5	36.5	39.0
Domestic debt	4.8	6.1	3.2	2.9
Central government fiscal operations				
Net lending/borrowing	-5.0	-10.6	5.0	-1.2
(Excluding grants)	-12.3	-18.4	-3.6	-6.6
Non-SACU fiscal balance [6]	-20.2	-23.5	-20.7	-23.4
Revenue	52.0	52.5	66.1	58.9
Of which: grants	7.3	7.8	8.6	5.3
Expenses	45.3	47.4	44.1	45.5
Nonfinancial assets	11.7	15.7	17.1	14.6

Sources: Lesotho authorities and IMF staff estimates and projections.
[1] The fiscal year runs from April 1 to March 31.
[2] IMF Information Notice System trade-weighted; end of period. For 2013/14 it is the latest observation as of October 2013.
[3] Reserve coverage of 5 months of imports is estimated as adequate for maintaining the exchange rate peg and providing a fiscal cushion to avoid abrupt adjustment.
[4] 12-month time deposits rate. The 2013/14 interest rate is as of end-December 2013.
[5] Excluding changes in inventories.
[6] Excluding externally financed capital project.

Statement by Mr. Momodou Bamba Saho, Executive Director
for the Kingdom of Lesotho
June 4, 2014

The Lesotho authorities are appreciative of the constructive engagement they shared with staff during 2014 Article IV consultation in January 2014.

Lesotho's economic performance remained significantly healthy despite being hit by severe shocks in 2009/10. Sound economic management prior to the global financial crisis provided sufficient policy space for the authorities in the aftermath of the global financial crisis. Following the crisis, government revenue from the Southern African Customs Union (SACU), which had previously accounted for about half of total government revenue, fell to about 30 percent of total revenue (about 15 percent of GDP) in 2010/11 and 2011/12 . In response the budget deficit increased to 5 percent of GDP in 2010/11 and almost 11 percent of GDP in 2011/12.

Despite the deterioration in the fiscal position that was driven by the decline in SACU revenue, the authorities were able to maintain the loti (domestic currency) peg to the South African rand and overall macroeconomic stability. This was made possible largely by strong accumulation of international reserves prior to the crisis that stood at over 5 months of imports in 2009/10. The authorities' prudent policies received a boost from the Fund-supported ECF arrangement in June 2010 and were subsequently reinforced by a rebound in SACU revenue, which rose from 15 percent to 30 percent of GDP in 2012/13.

Against this background, while the authorities and staff largely share similar policy concerns, several issues in the staff report need further clarity. The rest of this statement is devoted to clarifying some of these issues; and follows up with a brief summary of the authorities' policy priorities as set out in the budget speech that was presented to Parliament on February 20, 2014.

Recent Economic Developments and Outlook

Despite a history of solid macroeconomic performance, the authorities share staff's concern about the need for a gradual rebuilding of international reserves to create space for increased investment spending. However**,** the gloomy picture painted in the staff report, particularly in the appraisal section, is not consistent with Lesotho's strong macroeconomic performance. Hence, it is difficult to justify on the basis of the data and the authorities' reform efforts, staff's assessment that "progress toward a sound macroeconomic policy framework stalled in 2013/14, due to fiscal slippages". For example, Table 3 of the main staff report shows a budget deficit for 2013/14 as 1.2 percent of GDP and, according to Table 5, gross international reserves were estimated at 4.8 months of imports. These data compare much favorably with their levels in 2010/11 and 2011/12, with fiscal deficits of 5 percent and 10.6 percent of GDP and reserve coverage of 4 months and 3.6 months of imports, respectively.

Furthermore, it is hard to justify the basis for staff's suggestion that the recently approved budget (with a deficit of 1.8 percent of GDP) has loosened the fiscal stance too far**.** As explained in the Budget Speech by the Minister of Finance to Parliament on February 20, 2014, proposals for 2014/15 budget allocations were, to the extent possible, based on their potential to contribute towards (a) facilitating job creation, inclusive growth and economic diversification; (b) reducing economic and social vulnerabilities; and (c) improving public sector delivery and efficiency. It is expected that future budgets will become progressively tighter as low priority activities are weeded out. Supported by ongoing public financial management reforms, these efforts have the potential to further improve Lesotho's fiscal position.

In addition, at the time of the Article IV mission, the authorities were already pursuing various reform measures that were aimed at improving the fiscal position, by controlling increases in current expenditure to create room for increased capital spending going forward. These measures included the payroll audit of the civil service that was being piloted in the three largest ministries. As indicated in the staff report, the authorities' intention was to, subsequently, extend the audit to other government ministries.

According to the staff report, in paragraph 3, "poor implementation of the National Strategic Development Plan (NSDP), which was officially launched in 2012, has weakened the fight against poverty." However, the implementation of the NSDP has been delayed mainly on account of resource shortages. In addition, as was re-emphasized during the staff visit in January, the authorities have been working on measures to strengthen their capacity to plan, evaluate and execute projects. In this context, the Government of Lesotho, in partnership with the IMF, held a consultative conference on January 27, 2014. The conference, which was attended by various stakeholders, aimed at informing the country's development agenda and refocusing structural reforms towards sustainable and inclusive growth. Moreover, as highlighted in the 2014/15 Budget Speech, the authorities remain concerned that economic progress achieved thus far has not translated into job creation and poverty reduction and are committed to addressing these challenges.

The authorities have repeatedly expressed their desire for leaner and more efficient civil service, to improve government's ability to deliver services to the citizens. However, the point made by staff in paragraph 3 that the size of the wage bill is driven, in part, by "political pressure to expand employment" is inaccurate. In contrast, in Lesotho, the government is the largest formal employer because the private sector is relatively small and unable to absorb the skilled workforce. In addition, wages in Lesotho are driven in part by competition for skilled labor in South Africa, the region's largest economy.

Financial Sector Developments

The financial system remains sound and adequately capitalized, and the authorities remain committed to enhancing financial sector stability. To mitigate risks presented by the non-bank sector, the authorities will continue to expand supervision and oversight of the sector. In this context, the passage of the insurance act by Parliament has been a step in the right direction.

The authorities also welcome staff's recommendation to deepen the financial sector. Hence the implementation of the Financial Sector Development Strategy will be critical for the achievement of this objective. However, it is important to note that the dominant role of South African banks and the funding links they share with their parent banks have tended to depress demand for an inter-bank market in Lesotho.

National Strategic Development Plan 2012/13 – 2016/17

Promotion of peace, democratic governance and building of effective institutions is only one of the six strategic goals of the NSDP. While the authorities acknowledge that, like in many other developing countries, there is always room for improvement of democratic institutions and processes, it is not clear why staff describes Lesotho's history of political transitions difficult. Nonetheless, political transitions in Lesotho, at least since the restoration of multi-party democracy in 1993, have often not resulted in significant macroeconomic policy changes. More importantly, as it may be recalled, the coalition government came to power, following the national elections in May 2012, at the time when Lesotho was in the middle of an ECF arrangement with the Fund. Contrary to expectations, the coalition government kept policy commitments made by the previous administration under the ECF, despite an expanded cabinet that had a potential to put pressure on financial resources. Therefore, any perceived fears that a potential collapse of the coalition government will result in significant changes in government policies are misplaced. Furthermore, we are surprised by staff's assertion that the coalition government's "slim majority in the National Assembly adds to the challenge of policy making" as there is no clear evidence of this claim.

On the whole, the authorities consider political assertions made in paragraph 4 difficult to substantiate. For example, it is not clear why the introduction of performance contracts for cabinet ministers, intended to improve service delivery by government ministries, is attributed by staff to efforts to reduce corruption.

Policy Priorities for 2014/15

In 2014/15, the authorities will continue to pursue policy priorities that are consistent with the NSDP and the National Vision 2020. These priorities will put particular emphasis on economic transformation to promote sustainable and broad-based growth and reduce poverty. Specifically, as detailed in the budget speech, efforts will be geared towards (a) facilitating job creation, inclusive growth and economic diversification; (b) creating enabling investment climate and regulatory framework; (c) development of a minimum infrastructure platform; and (d) improving public sector efficiency and effectiveness. Thus, interventions implied in the budget proposals for 2014/15 are based on their potential to contribute toward these broad objectives.