November 2006
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Kingdom of Lesotho: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; 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 2006 Article IV consultation with the Kingdom of Lesotho, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 12, 2006 with the officials of the Kingdom of Lesotho on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 20, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of October 6, 2006 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 6, 2006 discussion of the staff report that concluded the Article IV consultation; and

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

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

Statistical Appendix

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

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

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INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Lesotho

Approved by Jean Clément and Mark Plant

September 18, 2006

- The Article IV consultation discussions were held in Maseru during June 28–July 12, 2006. The mission met with Finance Minister Thahane, Central Bank of Lesotho Governor Matekane, other senior officials, and representatives of the private sector and donor community.
- The staff team comprised Messrs. Wang (Head), Gons, and Haacker, and Ms. Masha (all AFR). Mr. Burgess, Deputy Resident Representative for South Africa and Lesotho, participated in the concluding discussions. Ms. Lephoto (OED) attended most meetings.
- At the conclusion of the 2005 Article consultation on September 19, 2005, Executive Directors considered finding the bases for consistent high growth over the medium term as the primary policy challenge for Lesotho. While urging the authorities to implement structural reforms to restore competitiveness and foster private sector development, Directors emphasized the importance of continued fiscal prudence in coping with future shocks and achieving sustained growth.
- 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 payments and transfers for current international transactions.
- Lesotho has participated in the Fund's General Data Dissemination System since August 2003. Data provision is generally adequate for surveillance purposes, although weaknesses remain in national accounts and balance of payments statistics.

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ABBREVIATIONS AND ACRONYMS

AGOA	African Growth and Opportunity Act
CBL	Central Bank of Lesotho
CMA	Common Monetary Area
CPI	Consumer price index
DSA	Debt sustainability analysis
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
FDI	Foreign direct investment
GDP	Gross domestic product
GNI	Gross national income
IFMIS	Integrated Financial Management Information System
LHDA	Lesotho Highlands Development Authority
LNDC	Lesotho National Development Corporation
LRA	Lesotho Revenue Authority
MDGs	Millennium Development Goals
MTFF	Medium-Term Fiscal Framework
PRS	Poverty Reduction Strategy
SACU	Southern African Customs Union
SADC	Southern African Development Community
UN	United Nations
WFP	World Food Program

EXECUTIVE SUMMARY

Background

In recent years, Lesotho has made good progress toward macroeconomic stability. Its fiscal and external positions have improved markedly. However, economic activity has remained sluggish and poverty is widespread. With an anticipated large increase in receipts from the South African Customs Union, public expenditure is projected to rise sharply in 2006/07. Lesotho's medium-term outlook is clouded by several downside risks, including a further loss of trade preferences for the export sector and a decline in SACU receipts relative to GDP.

Key Policy Issues

Discussions focused on the key policy challenges facing Lesotho:

- Achieving more rapid and broad-based economic growth to reduce poverty, through acceleration of structural reforms. Lesotho also needs to strengthen its trade and investment links with the regional market;

- Strengthening the medium-term fiscal position to maintain macroeconomic stability, given the uncertainty about future SACU inflows and Lesotho's vulnerability to exogenous shocks.

Surveillance and Technical Assistance

The authorities appreciated the Fund's role in providing policy advice through surveillance. They intend to continue strengthening institutions and policy implementation capacity and noted that the international community, including the Fund, can make important contributions through timely provision of technical assistance and capacity building support.

I. Background

1. **Lesotho is a small, landlocked, low-income country, with limited natural resources and a narrow production and export base.**[1] Aside from subsistence agriculture, the garment sector plays a critical role in generating employment, output, and exports. The economy is highly open, with imports amounting to about 90 percent of GDP, and depends heavily on inflows of workers' remittances and receipts from the Southern African Customs Union (SACU).[2] Lesotho is also a member of the Common Monetary Area (CMA). The Lesotho loti is pegged at par to the South African rand, which is also legal tender in the country. The country is ranked 149th out of 177 countries on the 2005 UN Human Development Index.

2. **The political situation is relatively stable**. Local government elections were held for the first time in April 2005. Parliamentary elections are scheduled for May 2007.

3. **In recent Article IV consultations, staff has emphasized the importance of ensuring that increases in outlays for poverty reduction are consistent with fiscal sustainability and absorptive capacity**. They also noted that a comprehensive structural reform agenda should be implemented without delay. The authorities have increased poverty reduction spending but implementation of structural reforms has proven more difficult.

II. Recent Developments

4. **In recent years, Lesotho has made good progress toward macroeconomic stability**. Its fiscal balance has been in surplus since 2003/04 (April-March), owing mainly to rapidly rising SACU receipts and improved domestic revenue collection following the launch of the Lesotho Revenue Authority (LRA) in 2003. Reflecting the sizable SACU receipts and fiscal surpluses, the external current account deficit has narrowed and gross international reserves increased to the equivalent of about five months of imports of goods and nonfactor services by the end of 2005/06. In line with price trends in South Africa, the inflation rate fell in 2003-05 despite rising oil import prices. The spread on treasury bills relative to South Africa has fallen to almost zero due to the strengthened fiscal position. The government used part of the SACU windfalls to retire nonconcessional debt, reducing the net present value of public external debt to levels significantly below the relevant indicative debt sustainability threshold.[3]

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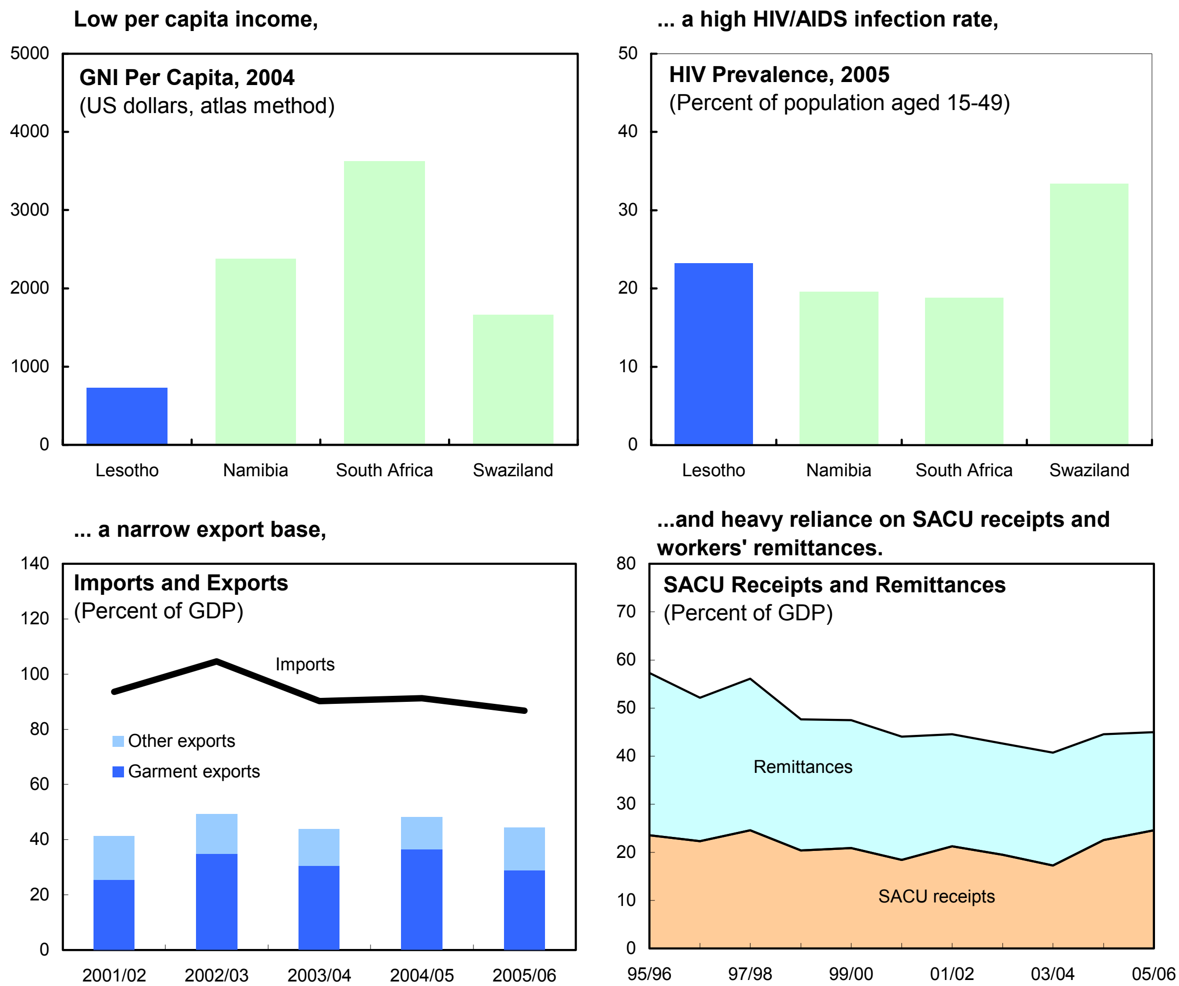
[1] Less than 10 percent of the land area is suitable for crop cultivation and water is abundant only in non-populated areas. Other natural resources include clay and sandstone.

[2] The SACU revenue sharing agreement gives the small member countries (Lesotho, Namibia, Swaziland, and Botswana) a majority share in the customs revenue pool, to which South Africa is the predominant contributor.

[3] See Appendix IV for an updated DSA.

Figure 1. Income, HIV/AIDS, and External Dependence



Sources: World Bank, *World Development Indicators*, for GNI per capita; UNAIDS, 2006, *2006 Report on the Global AIDS Epidemic* (Geneva: UNAIDS); for HIV/AIDS prevalence; national authorities, and IMF staff estimates.

5. **However, economic activity has remained sluggish, reflecting the adverse impact of exogenous shocks**. Agricultural production was hit in 2002-05 by droughts and in early 2006 by excessive rainfalls that also damaged roads and bridges in the rural areas where about 70 percent of the population lives.[4] In the last few years, the World Food Program provided food aid to about 15 percent of the population. The manufacturing sector was adversely affected by a substantial real effective appreciation of the loti in 2002-2004 and the removal of textile quotas by industrial countries in early 2005, which led to the loss of about a quarter of jobs in the garment sector.[5] The garment sector saw a moderate recovery recently with the entry of new investors following a halt of the loti appreciation and the signing of a bilateral agreement that restrains exports from China to the U.S. market. The number of Lesotho miners in South Africa continued to decline in 2005 as mining became more capital intensive.

6. **Fiscal management is becoming more challenging**. In the context of the 2006/07 budget, the authorities have reduced the company income tax rate to attract foreign investment.[6] With SACU receipts projected to reach record levels, spending pressures are intense. The government has resisted pressure from various groups for subsidies and spending that are inconsistent with the Poverty Reduction Strategy (PRS). Nevertheless, total spending is budgeted to increase sharply. A supplementary budget raises expenditure further and largely eliminates the initially targeted budget surplus of 2.7 percent of GDP. While the budget includes prepayment of nonconcessional external debt[7] and a significant increase in capital expenditure (4.8 percent of GDP), the wage bill and other noninterest current outlays are also projected to increase relative to GDP (by 0.6 and 3.8 percent of GDP respectively).

7. **The authorities are making efforts to implement their Poverty Reduction Strategy**. Budgetary allocations for the AIDS Commission, free elementary education, and other social programs have been significantly increased for 2006/07. However, the execution rate for donor-funded investment projects was low in the past year. A national census was conducted in April 2006, which is expected to assist in the preparation of the first annual PRS progress report. The authorities plan to hold a donor conference in late 2006 to seek further assistance.

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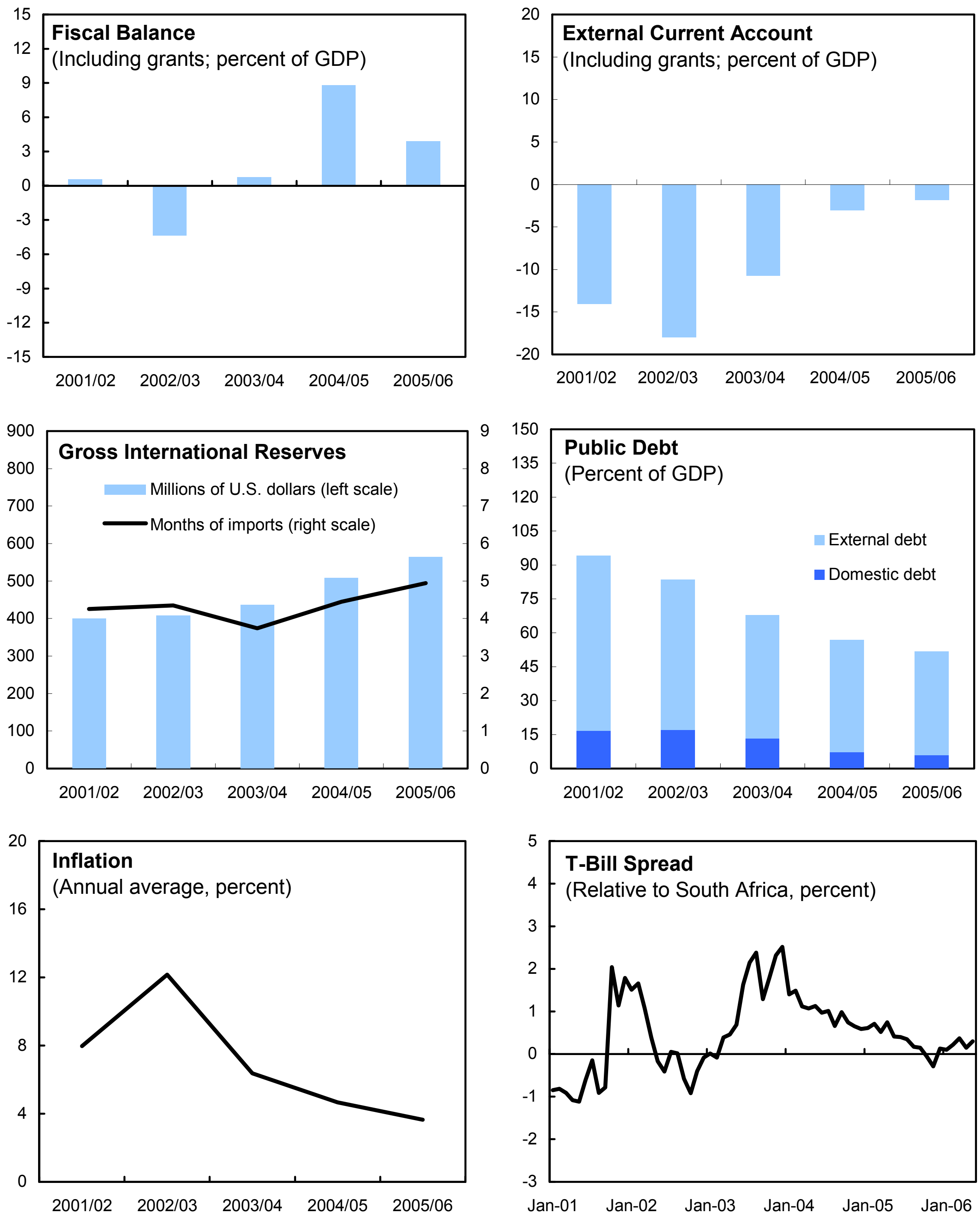
[4] Foreign investment has revived a diamond mine, which contributed to GDP and exports in the last two years but has had limited impact on employment.

[5] Garment exports, which are mostly to the U.S., have benefited since 2000 from preferences under the U.S. African Growth and Opportunity Act (AGOA).

[6] The tax rate has been cut across the board from 35 percent to 25 percent, below the rate prevailing in South Africa and Swaziland, and from 15 percent to 10 percent for manufacturing with a zero rate for companies exporting to non-SACU markets.

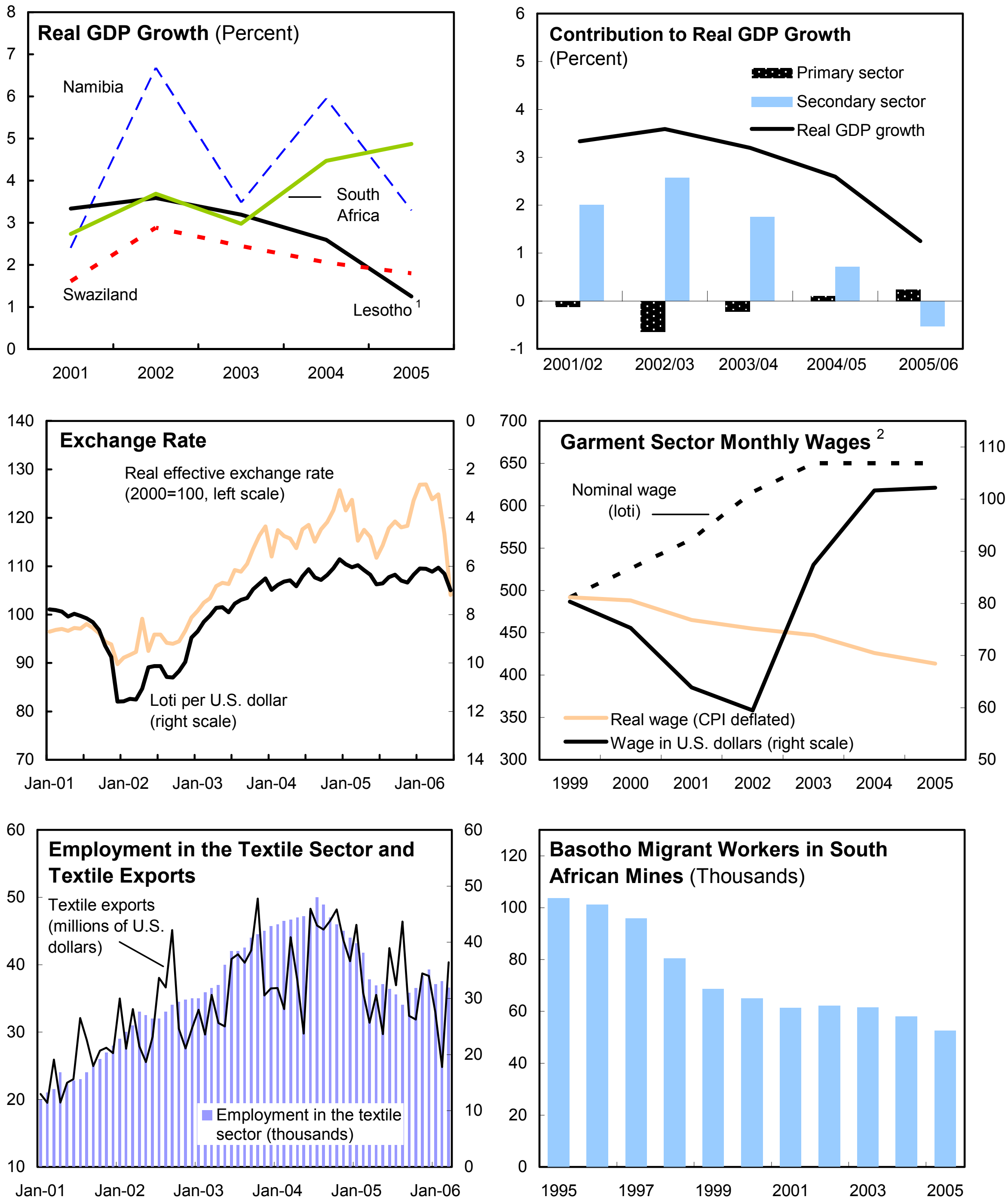
[7] Debt to South Africa incurred by the LHDA.

Figure 2. Recent Progress Towards Macroeconomic Stability



Sources: National authorities and IMF staff estimates.

Figure 3. Shocks and Growth Performance

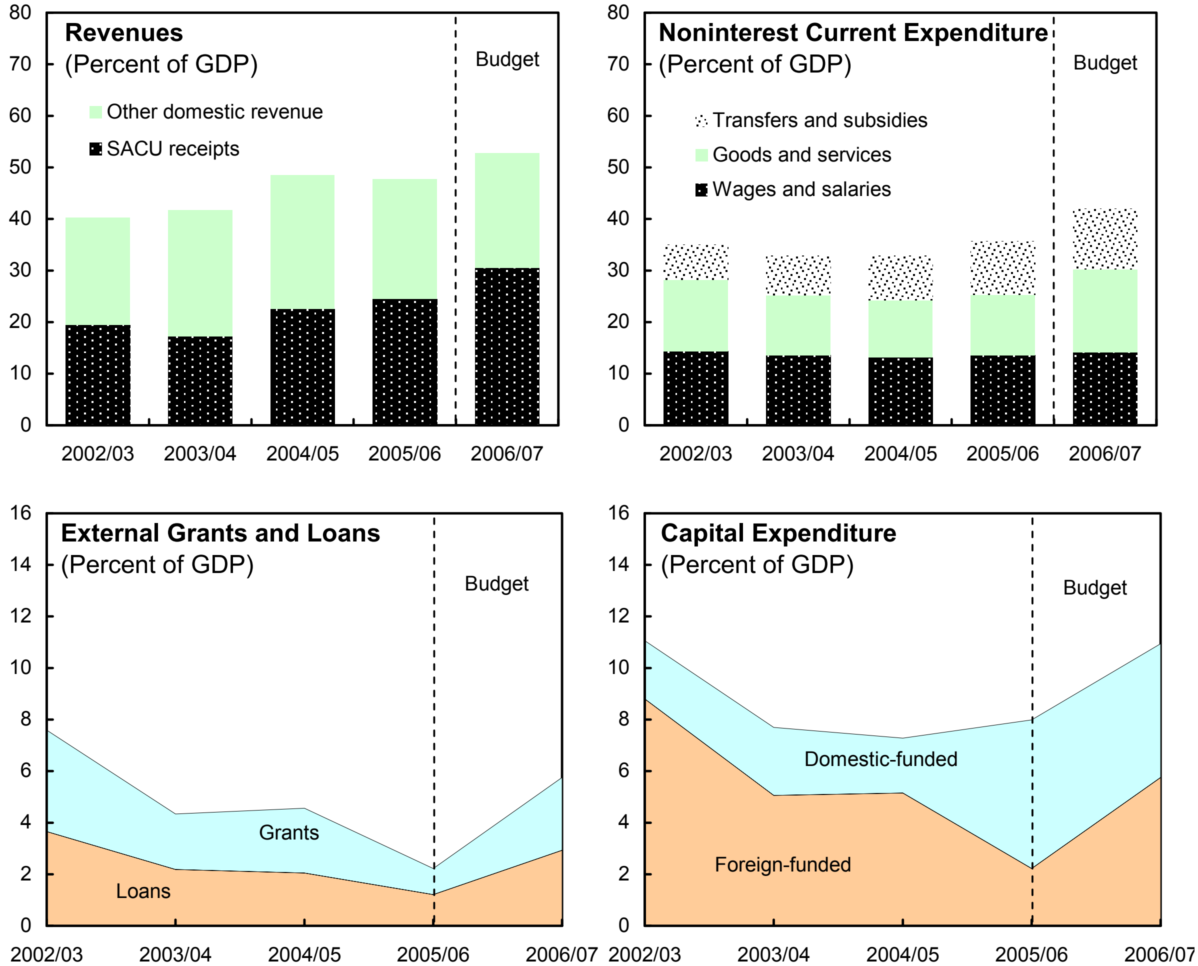


Sources: National authorities, U.S. Department of Commerce, and IMF staff estimates.

[1] Lesotho data is fiscal year (April-March).

[2] Minimum wage for unskilled workers.

Figure 4. Fiscal Developments



Sources: National authorities, and IMF staff estimates.

III. POLICY DISCUSSIONS

A. Economic Outlook and Key Challenges

8. **Lesotho's medium-term economic prospects are clouded by several downside risks**:

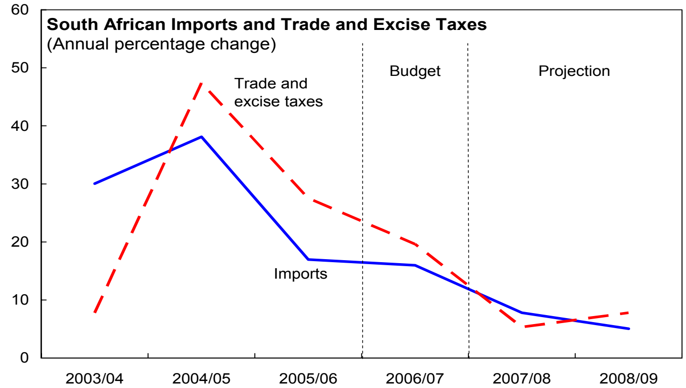
- SACU receipts, while remaining buoyant in 2007/08, are expected to decrease in subsequent years (Box 1).
- Trade preferences for garment exports are expected to be further reduced when the AGOA third-country provision and the bilateral agreement restricting China's exports to the U.S. expire in 2007/08.[8]
- The export sector would be adversely affected in the event of a sustained appreciation of the rand, to which the loti is pegged.
- Workers' remittances are likely to decline with a further tightening of the employment conditions for unskilled workers in South African mines.
- Finally, the high HIV prevalence rate could cause further losses in productivity and real income.

9. **The authorities agreed that the key policy challenges facing Lesotho are to achieve more rapid and broad-based economic growth and strengthen the medium-term fiscal position**. They acknowledged that under the exchange rate parity arrangement, the burden of safeguarding macroeconomic stability would fall on fiscal policy and structural reforms. The authorities raised questions, however, about Lesotho's long-term sources of growth, given the precarious outlook for its garment sector. In the staff's view, a strategy for long-term growth will have to be based on Lesotho's endowments (mainly labor) and driven by private initiatives. The core elements of such a strategy should include increasing the efficiency of using public resources, given the large size of the budget relative to GDP, and attracting private investment through enhancing labor skills, infrastructure, and institutions. Efforts to diversify products and markets would help reduce vulnerability to external shocks.

[8] The third-country provision allows Lesotho garment exporters to import fabric from the cheapest available suppliers while enjoying duty-free access to the U.S. market.

Box 1. Are Recent Increases in SACU Receipts Permanent?

The recent increase in SACU receipts appears to be transitory on account of: (i) a deceleration of South African imports (South Africa has been the predominant contributor to both the customs and excise components of the SACU revenue pool); (ii) expected trade liberalization initiatives; which would lower tariffs; and (iii) developments in intra-SACU trade and GDP; which determine each country's share in the pool under the new formula agreed in 2002.



Source: South African Revenue Service (SARS), *Estimate of National Revenue, 2006*.

SACU receipts, which are expected to increase in 2007/08 due to an adjustment based on actual collections two years before, would decline in subsequent years. The proposed establishment of a customs union in the Southern African Development Community, which includes SACU member states, raises further question marks about the future of the SACU revenue sharing arrangements.*

SACU Revenue 2004/05 - 2009/10 [1]

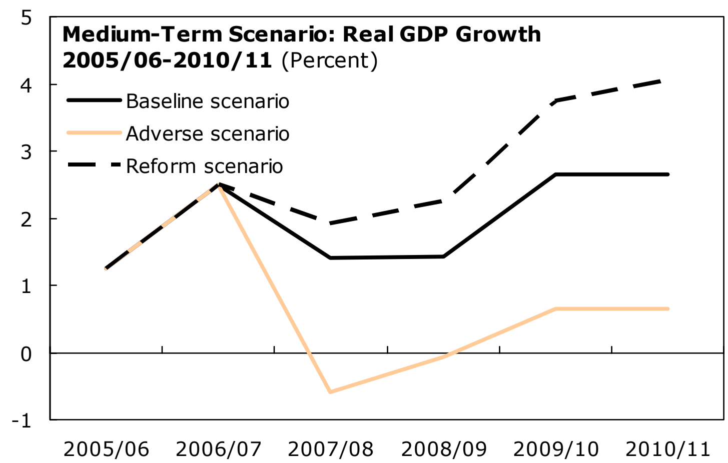
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
			Projections			
	(Billions of maloti, unless otherwise indicated)					
SACU receipts						
Initial budget forecast	1.6	2.0	2.8	...	...	...
Windfall/Adjustment payments	0.4	0.3	0.3	...	...	...
Total receipts	2.0	2.3	3.1 [2]	4.0	3.5	3.1
In percent of GDP	22.5	24.5	30.4	36.6	29.7	24.6
Assumptions						
Growth rate				(Percent)		
Customs Pool			12.9	3.0	3.0	3.0
Excise Pool			13.6	8.0	8.0	8.0
Lesotho's share						
Customs Pool			12.2	11.0	10.5	10.0
Excise Pool [3]			3.7	3.7	3.7	3.7

[1] New SACU revenue formula effective from 2005/06.
[2] Includes adjustment under the old formula decided in 2005/06 but disbursed in 2006/07.
[3] Average of excise and development components.

* Leaders of the 14-nation SADC signed a protocol in August 2006, reaffirming their commitment to achieve a free-trade area by 2008 and a customs union by 2010.

10. **To illustrate potential adverse developments and policy choices, the staff discussed with the authorities three medium-term scenarios**:

- **The baseline scenario** takes into account the anticipated erosion of trade preferences and a decline in SACU revenue after 2007/08. Textile exports are projected to decline. Fiscal deficits would reemerge in 2009/10 and widen quickly thereafter, unless there are major policy changes. Growth will remain significantly below that in South Africa over the medium term.



Sources: Lesotho authorities and IMF staff estimates.

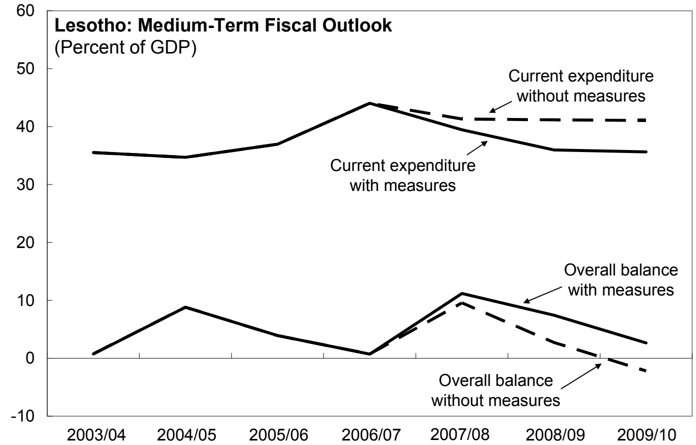
- **The adverse scenario** illustrates the country's vulnerabilities. It combines a significant appreciation of the rand, a sharper drop in SACU receipts and workers' remittances from South Africa, and inclement weather. Prolonged economic stagnation would seriously hold back progress toward the MDGs.

- **The reform scenario** assumes strengthened fiscal management that will help keep recurrent expenditure at sustainable levels and speed up donor disbursements for growth-enhancing projects. Strong implementation of structural reforms (Box 2) would accelerate growth through higher inflows of foreign direct investment (FDI) and more private initiatives to broaden the production and export bases.

B. Strengthening the Medium-Term Fiscal Position

11. **The authorities agreed that a prudent fiscal strategy is needed in view of the high uncertainty regarding future SACU receipts and Lesotho's vulnerability to external shocks**. Noting the country's large expenditure needs, the authorities emphasized that they would work closely with other SACU members to enhance the predictability of SACU receipts and strive to improve the composition of expenditures in order to make progress toward the MDGs. Staff supported the use of exceptional SACU receipts to reduce debt and increase poverty reducing spending, but argued strongly against ramping up recurrent expenditure because, given the limited scope to increase domestic revenue, this would undermine fiscal sustainability. Staff supported the authorities' intention to contain the fiscal deficit over the medium term to levels that can be financed by external grants and highly concessional loans.

12. **For 2006/07, staff stressed the need to contain the wage bill and other recurrent expenditures**. It encouraged the authorities to meet justifiable additional spending within the existing budget envelope, not to spend the savings if the amount negotiated to settle LHDA debt is lower than the budget appropriation, and strengthen tax administration to offset over time the revenue impact of the company tax cut.[9] While receptive to these recommendations, the authorities explained that the 2006/07 budget includes large one-off items (e.g., for the elections) and that the supplementary budget was needed to initiate the donor-supported Metolong Dam project. They also noted that in the past budgeted expenditures tended to be significantly underimplemented (by about 5 percent of GDP in 2005/06).



Source: National authorities and IMF Staff estimates.

Lesotho: Key Fiscal Indicators

	2005/06	2006/07	2007/08	
			Without	With
	Est.	Proj.	measures	measures
		(Percent of GDP)		
Total revenue and grants	48.8	55.6	61.7	61.7
SACU revenue	24.5	30.4	36.6	36.6
Domestic revenue	23.2	22.3	22.3	22.3
Grants	1.0	2.8	2.8	2.8
Total expenditure	44.9	54.9	52.3	50.5
Current expenditure	37.0	42.1	41.3	39.5
Wages and salaries	13.6	14.2	14.2	14.0
Capital expenditure	8.0	12.8	11.0	11.0
Overall balance, incl. grants	3.9	0.8	9.5	11.2

Sources: Ministry of Finance, and IMF staff estimates and projections.

13. **The authorities and staff shared the view that, with mounting spending pressures in an election year, the 2007/08 budget should aim at maintaining fiscal sustainability**. Staff supported the authorities' intention to use additional SACU receipts to pay off expensive domestic bonds and proposed additional measures to reduce current expenditure.[10] In this context, staff noted that wages for both central and local governments plus pensions and other entitlement programs (18 percent of GDP in the 2006/07 budget) are relatively high by international standards.[11] The envisaged pension reform and a

[9] The LRA launched a new computerized system in April 2006 to improve tax processing and administration.

[10] Key measures include keeping the wage bill constant in real terms, a reduction of subsidies to parastatals, and partial cost recovery of the scholarship scheme. The authorities' earlier projections for 2007/08, which did not take into account adjustment of SACU receipts based on actual collections in 2005/06, show a small budget surplus. They planned to update the projections in late 2006 based on discussions with the staff.

[11] Includes transfers to local councils for salaries, civil service pension payments, and the old-age allowance program started in 2004.

medical aid scheme for civil servants could further increase personnel-related expenditure.[12] While supporting the pension reform in principle, staff advised against its introduction and of the medical aid scheme without a thorough analysis of their costs. Staff underscored the need to put personnel-related budgetary expenditure on a sustainable path through a civil service reform. The authorities broadly agreed with the approach, but noted that they were under pressure because medical assistance schemes had been introduced in neighboring countries.

14. **The authorities are taking steps to improve public financial management**. These include applying the Medium-Term Fiscal Framework (MTFF) more widely, introducing the Integrated Financial Management Information System, and improving public service delivery at the local level. Regarding the latter, staff expressed concern that while resource transfers were budgeted for 2006/07, and about 45 percent of civil servants are to be transferred to newly elected local governments, the functions and expenditure responsibilities of the local governments are yet to be clearly specified. Furthermore, the legal and operational frameworks for taxation and borrowing by local governments have not been clarified. The authorities made clear that they do not intend to decentralize borrowing authority and will intensify efforts to ensure that expenditure devolution is commensurate with revenue transfers.

15. **The authorities and staff agreed that increasing the execution rate of capital expenditure, particularly concerning donor-funded projects, would contribute to higher growth, and help absorb more aid**. To this end, the newly established Cabinet Budget Committee would, in addition to other mandates, monitor aid disbursements and project implementation. To reduce red tape, the authorities are reforming the procurement system, improving project cycle management, and streamlining project reviews as agreed with donors. Staff encouraged the authorities to continue their efforts to restructure and realign expenditure priorities in line with the PRS and work with donors to increase investment in areas that are important for growth, particularly infrastructure and agriculture.

16. To maintain debt sustainability, the authorities intend to rely on grants and highly concessional loans to finance development projects, including the Metolong Dam.[13] Staff advised the authorities to carefully analyze projects funded by public-private partnerships to avoid incurring future liabilities that would be inconsistent with the repayment capacity of the budget.

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[12] The pension reform aims to replace the current unfunded defined benefits scheme for civil servants with a funded defined benefit or defined contribution scheme. The unfunded civil servant pension liabilities were estimated at 29 percent of GDP, based on an actuarial evaluation in 2005. As reform plans are still being developed, no reliable cost estimates are available.

[13] The project is expected to provide water for the Lowlands. The authorities are seeking grant financing from the U.S. Millennium Challenge Corporation and have reached preliminary agreements with some bilateral and multilateral creditors on concessional loans.

C. Facilitating Adjustment to Shocks Under the CMA

17. **The authorities continued to be of the view that Lesotho has benefited from the exchange rate peg under the CMA**. They noted that such an arrangement has helped maintain price stability and lowered the costs of cross-border trade and investment. However, with a flexible exchange rate of the rand, maintaining competitiveness in the face of asymmetric shocks is a serious challenge for Lesotho as its exports are largely to markets outside the CMA. They shared the staff's view that strengthening fiscal policy, accelerating structural reforms, and increasing labor market flexibility would help maintain external competitiveness.

18. **The CBL has conducted a study on reserve adequacy**. Currently, the CBL's international reserves are more than adequate to back the total amount of loti it issued, or to cover three months of imports or 100 percent of short-term debt. Noting the pressures to spend, staff pointed out that the reserves have served the role of a stabilization fund in recent years as SACU windfalls were deposited into government accounts at the CBL. Because SACU inflows are highly volatile and uncertain, staff encouraged the CBL to maintain and prudently manage its reserves.

19. **Lesotho's trade policies are largely shaped by its membership in SACU**. In that context, Lesotho is actively pursuing free trade arrangements and trade partnerships, including with the European Union, the United States, and within SADC. While the negotiations for a SACU-U.S. free trade agreement are ongoing, Lesotho and its SACU partners are striving to conclude an Economic Partnership Agreement with the European Union by the end of 2007.

D. Promoting Private Sector-Led Growth

20. **The authorities recognized the need to reduce the cost of investing and doing business in Lesotho**. The government has set up the Trade and Investment Facilitation Center, a one-stop shop as part of its reforms to reduce the regulatory impediments and red tape. This center, which has been handling customs clearance since April 2006, is expected to also cover company registration and licensing. In addition, the LRA has made some progress in shortening the time for processing corporate and value-added tax returns. Staff urged the authorities to further improve the investment climate by implementing without delay other regulatory reforms as agreed with the World Bank and bilateral donors (Box 2).

21. **Staff encouraged the authorities to accelerate financial sector reforms to improve access of the private sector to bank credit**. Lesotho's banking sector, dominated by three South African banks, is well capitalized but much less developed in terms of infrastructure, credit culture, and legal framework, as evidenced from the low lending-to-deposit ratio. The CBL has embarked on a reform program to remove legal and informational

impediments. It is also taking steps to modernize the payments system. In addition, the Anti-Money Laundering bill is expected to be enacted in September 2006.[14] To safeguard the stability of the financial system, the authorities are also working to strengthen the regulatory framework for the nonbank financial sector.

22. The authorities intend to buttress workers' training, upgrade infrastructure, and strengthen product and market diversification to reduce Lesotho's vulnerability to shocks and to achieve higher long-term growth. They would build on progress already made in skills development.[15] To improve competitiveness and attract labor-intensive industries, staff encouraged the parties to wage negotiations to take into account developments in labor productivity and terms of trade so as to increase downward flexibility in real wages. It also supported the authorities' efforts to diversify the country's production and export base by providing an enabling environment that would be conducive to the development of key sectors, including horticulture, mining, and tourism.

23. **The authorities pointed out that there are issues that are important for long-term growth, which will have to be tackled jointly with regional partners.** As a land-locked country with a long history of cross-border trade and labor movements, Lesotho depends on neighboring countries for access to world markets. Keeping qualified civil servants, health workers, and university graduates, many of whom leave for higher pay in neighboring countries, is increasingly a challenge. Priorities include development of infrastructure and agriculture, retaining skilled labor, and the fight against HIV/AIDS. The revenue impact of a SADC customs union would also need to be addressed.

IV. Staff Appraisal

24. **Lesotho has made commendable progress in strengthening its fiscal and external positions but economic growth has remained low**. The authorities' policy response to the large SACU receipts in the last two fiscal years—saving some and using the rest to reduce nonconcessional debt—has been broadly appropriate and has contributed to a narrowing external current account deficit and higher international reserves. However, as a result of several shocks that adversely affected output and exports and the high HIV prevalence, a sizable number of people still need food aid and poverty remains widespread.

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[14] Lesotho's Anti-Money Laundering regime was evaluated by ESAAMLG in 2004.

[15] The training programs supported by donors and the LNDC have raised labor productivity of textile workers by an average of 25 percent for the 34 participating companies.

Box 2. Key Structural Measures

Key elements of the reform program developed jointly with the World Bank and bilateral donors include:

Removing Regulatory Impediments

- Restructure and consolidate company registration processes to reduce the time it takes to register a company to under one week;
- Convert mandatory trade licensing to a reporting requirement, eliminate the Licensing Boards and the Pioneer Industries Board to significantly reduce the time and costs of obtaining both trade and industrial licenses;
- Simplify and streamline immigration, customs and work permit procedures;
- Reduce the compliance costs to tax payers; and
- Make the commercial court functioning.

Improving the Private Sector's Access to Bank Credit

- Put in place a comprehensive and easily accessible property registry;
- Introduce a national identification system;
- Establish a credit information registry;
- Amend the Matrimonial Act to allow married women access to bank credit without their husbands' permission;
- Simplify and streamline land transfer procedures; and
- Develop leasing facilities.

Assisting Adjustment of Private Investors

- Develop a strategy for a competitive textile sector—emphasizing product and market diversification—in the context of the "Multi-Fiber Agreement Forum";
- Attract new FDI through public-private cooperation in the inter-ministerial task force;
- Improve labor productivity through industry-led, demand-driven skills development programs;
- Invest in utilities, roads, and solid waste and waste water facilities; and
- Launch outreach marketing programs to secure and improve market access.

25. **Key policy challenges facing the authorities are to raise economic growth and to strengthen the medium-term fiscal position**. Lesotho is facing several permanent shocks. Although there is considerable uncertainty about the timing and extent of the decline in SACU receipts, the downside risks are high. An adverse scenario, combining a fall in SACU revenue, shocks to the export sector, falling workers' remittances, and inclement weather, while not a high probability at present, is not inconceivable and serves to highlight the need to strengthen economic policies and reform.

26. **A conservative fiscal strategy is needed**. Under the exchange rate parity arrangement, the burden of safeguarding macroeconomic stability falls on fiscal policy and structural reforms. Large spending increases based on temporary revenue windfalls pose serious risks to fiscal sustainability. Staff call on the authorities to resist pressures to further increase total expenditure and strictly contain the wage bill and other recurrent outlays for the rest of this fiscal year. Locking in a prudent fiscal framework for 2007/08 before the elections is going to be challenging and will require measures to reduce recurrent expenditure. The pension reform and a medical aid scheme should not be introduced unless they are part of a broader civil service reform that would set total budgetary personnel costs (wages plus pension and medical aid contributions) on a sustainable path. The recent cut in company income tax would help attract private investment but the revenue impact needs to be offset through sustained improvement in tax administration.

27. **Staff strongly support the authorities' efforts to improve public financial management and increase the execution rate of capital expenditure**. As public expenditure amounts to over half of GDP, improving the efficiency of the use of these resources can make a key contribution to raising growth. Staff support the objective of improving public service delivery at the local level and encourage the authorities to take prompt actions to ensure that the implementation is broadly budget-neutral. Significant progress should be made to accelerate the execution rate of capital expenditure, especially concerning donor-funded projects, as it would help strengthen the growth orientation of the budget and increase aid absorption.

28. **To raise economic growth and broaden its base, structural reforms need to be accelerated to make Lesotho one of the most competitive places in the region for private investment**. The exchange rate peg under the CMA has provided important benefits to Lesotho, but in light of the real effective appreciation of the loti in recent years, Lesotho needs to redouble its efforts to improve the investment climate, reduce structural impediments to private sector development, and increase competitiveness by enhancing labor productivity, infrastructure, and institutions. In this regard, Lesotho also needs to work with its regional partners on cross-country issues that are important for growth. Staff support the CBL's efforts to improve the private sector access to bank credit and to strengthen the regulatory framework for the nonbank financial sector.

29. **To make progress toward the MDGs, Lesotho will continue to need international support, both financial resources and technical assistance**. The recent national census should provide valuable information for economic and poverty analysis and help prepare the first annual PRS progress report. Significant progress in improving fiscal management and aid absorption capacity is needed to mobilize more support for implementing the PRS.

30. **It is proposed that the next Article IV consultation be held on the standard 12-month cycle**.

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

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
				Est.		Projections		
	(Annual percentage change, unless otherwise indicated)							
National income and prices								
Real GDP	3.6	3.2	2.6	1.3	2.5	1.4	1.4	2.6
Real GNP	3.9	3.5	2.0	0.4	2.8	0.9	1.2	2.1
Consumer price index (period average)	12.2	6.4	4.7	3.6	4.5	4.8	4.5	4.5
Consumer price index (end of period)	7.9	5.2	3.6	4.8	5.2	5.2	5.1	4.5
GDP (millions of maloti)	7,541	8,249	8,930	9,405	10,141	10,891	11,652	12,517
GNP (millions of maloti)	9,281	10,181	10,961	11,449	12,382	13,232	14,120	15,089
External sector								
Exports, f.o.b.[2]	29.8	32.0	36.9	-5.2	9.6	3.6	6.1	4.3
Imports, f.o.b.[2]	21.9	28.0	25.8	-2.1	15.4	1.9	3.3	3.5
Nominal effective exchange rate[3]	12.7	14.7	-9.1	11.6	…	…	…	…
Real effective exchange rate[3]	12.0	12.4	-0.8	8.9	…	…	…	…
Money and credit								
Net foreign assets[4]	-70.6	-11.1	34.1	4.9	15.1	…	…	…
Net domestic assets[4]	73.4	16.5	-27.9	-0.2	-8.4	…	…	…
Credit to the government[4]	15.0	-5.8	-27.8	-2.8	2.2	…	…	…
Credit to the rest of the economy[5]	-20.2	3.7	2.3	7.8	3.3	…	…	…
Broad money	2.7	5.3	6.2	4.7	6.7	…	…	…
Velocity (GNP/average broad money)	4.3	4.5	4.6	4.6	4.7	…	…	…
Interest rate[6]	12.1	12.0	9.0	7.1	…	…	…	…
	(Percent of GDP, unless otherwise indicated)							
Investment and saving								
Investment	43.0	43.9	34.4	28.1	30.0	30.0	30.1	30.0
Public	11.5	7.8	7.1	8.1	11.0	11.0	11.1	11.0
Private	24.1	30.4	24.0	20.0	19.0	19.0	19.0	19.0
Lesotho Highlands Water Project	7.4	5.6	3.3	0.0	0.0	0.0	0.0	0.0
Gross national savings (including remittances)	25.0	33.1	31.3	26.2	25.3	31.2	27.9	24.5
Public	9.2	11.0	18.0	13.1	13.6	21.5	14.7	9.7
Private	15.8	22.1	13.3	13.2	11.7	9.7	13.2	14.9
Government budget								
Revenue	40.2	41.7	48.4	47.7	52.8	58.9	52.0	46.9
Total grants	3.9	2.2	2.5	1.0	2.8	2.8	2.8	2.8
Total expenditure and net lending	48.5	43.1	42.1	44.8	54.8	52.2	52.1	51.9
Overall balance (excluding grants)	-8.3	-1.4	6.3	2.9	-2.1	6.7	-0.1	-5.0
Overall balance (including grants)	-4.4	0.8	8.8	3.9	0.8	9.6	2.7	-2.2
Government debt[7]	98.8	74.7	57.1	53.1	53.2	40.8	35.8	36.5
Domestic debt	17.0	13.3	7.3	5.9	6.0	-5.0	-9.1	-7.6
External debt[7]	81.8	61.4	49.8	47.2	47.1	45.8	44.8	44.1
External debt-service ratio[8]	11.8	9.2	7.3	10.9	1.9	6.2	4.9	4.7
Current account balance								
Excluding official transfers	-34.6	-25.7	-21.9	-22.3	-28.4	-27.1	-25.3	-25.0
Including official transfers	-18.0	-10.8	-3.0	-1.8	-4.7	1.1	-2.1	-5.5
Gross official reserves (end of period)								
Millions of U.S. dollars	408.4	436.9	507.7	564.0	626.2	739.2	807.5	817.0
Months of imports of goods and services	4.3	3.7	4.4	4.9	4.8	5.5	5.8	5.7

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

[1] Fiscal year beginning in April.
[2] U.S. dollars.
[3] Based on partner-country data, new trade weights from 2004; a minus sign indicates a depreciation.
[4] Change in percent of broad money at the beginning of the period.
[5] Credit to the rest of the economy affected by a write-off of bad loans in 2002/03.
[6] The average effective rate on three-month treasury bills.
[7] The appreciation of the loti had a significant effect on the debt-to-GDP ratio in 2003/04.
[8] Percent of exports of goods and nonfactor services.

Table 2. Lesotho: Central Government Operations, 2003/04-2010/11 [1]

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
			Est.	Projections			
	(Millions of maloti)						
Revenue	3,439.3	4,326.1	4,489.8	5,352.7	6,413.5	6,057.7	5,872.2
Tax revenue	2,887.5	3,376.3	4,000.3	4,794.8	5,817.6	5,413.4	5,184.5
Customs revenue (SACU)[2]	1,421.6	2,012.4	2,305.9	3,087.8	3,984.9	3,457.5	3,078.4
Noncustoms tax revenue	1,465.9	1,363.9	1,694.4	1,707.0	1,832.7	1,955.9	2,106.1
Income taxes	852.5	729.2	924.6	892.9	953.4	1,023.6	1,109.6
Sales tax / value-added tax (VAT)	519.3	541.7	655.7	692.8	753.4	801.8	856.8
Petrol levy	80.6	35.8	77.0	86.5	88.6	90.8	97.0
Other tax revenues	13.5	57.2	37.1	34.8	37.2	39.7	42.6
Nontax revenue	551.8	479.7	489.5	557.9	596.0	644.3	687.6
Grants	177.8	224.3	95.3	286.6	310.0	330.0	355.0
Total expenditure and net lending	3,554.7	3,762.3	4,217.3	5,560.7	5,682.1	6,069.9	6,501.4
Current expenditure	2,929.3	3,097.7	3,476.2	4,272.3	4,497.4	4,796.1	5,137.8
Wages and salaries	1,123.2	1,176.9	1,275.8	1,437.0	1,550.0	1,650.8	1,773.4
Interest payments	216.4	156.2	120.6	205.7	116.6	123.6	118.3
External	90.5	91.1	74.8	151.8	68.1	82.4	83.3
Domestic	125.9	65.1	45.8	53.9	48.5	41.2	35.0
Other expenditure	1,589.7	1,764.6	2,079.8	2,629.6	2,830.8	3,021.7	3,246.0
Goods and services	958.4	985.5	1,103.8	1,418.4	1,530.0	1,630.0	1,751.0
Transfer and subsidies	631.3	779.1	976.0	1,211.2	1,300.8	1,391.7	1,495.0
Capital expenditure	634.9	650.5	751.0	1,297.5	1,193.8	1,282.9	1,372.8
Domestically funded	314.3	298.7	541.5	525.5	563.1	606.6	652.1
Externally funded	320.6	351.8	209.5	583.5	630.7	676.3	720.7
Grant funded	140.2	168.5	95.3	286.6	310.0	330.0	355.0
Loan funded	180.4	183.3	114.2	296.9	320.7	346.3	365.7
Capital transfers	96.3	108.8	191.3	188.5	198.4	212.3	228.0
Net lending	-9.5	14.1	-9.9	-9.1	-9.1	-9.1	-9.1
Overall balance, before grants	-115.4	563.8	272.5	-208.0	731.4	-12.2	-629.3
Overall balance, after grants	62.4	788.1	367.8	78.6	1,041.4	317.8	-274.3
Domestic balance[3]	309.7	1,020.8	546.9	518.2	1,421.1	737.4	165.6
Total financing	-62.4	-788.1	-367.8	-78.6	-1,041.4	-317.8	274.3
External financing	-25.7	-60.2	-274.8	-136.3	114.3	196.6	169.9
Loan drawings	180.4	183.3	114.2	296.9	370.7	386.3	365.7
Amortization	-206.1	-243.5	-389.0	-433.2	-256.4	-189.7	-195.8
Domestic financing	-37.3	-727.9	-93.0	57.7	-1,155.7	-514.4	104.3
Bank	-129.6	-638.6	-102.1	…	…	…	…
Nonbank	92.3	-89.3	9.1	…	…	…	…

continued

Table 2. Lesotho: Central Government Operations, 2003/04-2009/10 [1] (concluded)

	2003/04	2004/05	2005/06 Est.	2006/07 Projections	2007/08	2008/09	2009/10
	(Percent of GDP, unless otherwise indicated)						
Revenue	41.7	48.4	47.7	52.8	58.9	52.0	46.9
Customs revenue (SACU)[2]	17.2	22.5	24.5	30.4	36.6	29.7	24.6
Noncustoms tax revenue	17.8	15.3	18.0	16.8	16.8	16.8	16.8
Nontax revenue	6.7	5.4	5.2	5.5	5.5	5.5	5.5
Grants	2.2	2.5	1.0	2.8	2.8	2.8	2.8
Total expenditure and net lending	43.1	42.1	44.8	54.8	52.2	52.1	51.9
Current expenditure	35.5	34.7	37.0	42.1	41.3	41.2	41.0
Wages and salaries	13.6	13.2	13.6	14.2	14.2	14.2	14.2
Interest payments	2.6	1.7	1.3	2.0	1.1	1.1	0.9
External	1.1	1.0	0.8	1.5	0.6	0.7	0.7
Domestic	1.5	0.7	0.5	0.5	0.4	0.4	0.3
Other expenditure	19.3	19.8	22.1	25.9	26.0	25.9	25.9
Goods and services	11.6	11.0	11.7	14.0	14.0	14.0	14.0
Transfers and subsidies	7.7	8.7	10.4	11.9	11.9	11.9	11.9
Capital expenditure	7.7	7.3	8.0	12.8	11.0	11.0	11.0
Of which: domestically funded	3.8	3.3	5.8	5.2	5.2	5.2	5.2
Net lending	-0.1	0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Overall balance, before grants	-1.4	6.3	2.9	-2.1	6.7	-0.1	-5.0
Overall balance, after grants	0.8	8.8	3.9	0.8	9.6	2.7	-2.2
Domestic balance[3]	3.8	11.4	5.8	5.1	13.0	6.3	1.3
Total financing	-0.8	-8.8	-3.9	-0.8	-9.6	-2.7	2.2
External financing	-0.3	-0.7	-2.9	-1.3	1.0	1.7	1.4
Domestic financing	-0.5	-8.2	-1.0	0.6	-10.6	-4.4	0.8
Memorandum items:							
GNP at current prices (Millions of maloti)	10,181	10,961	11,449	12,382	13,232	14,120	15,089
GDP at current prices (Millions of maloti)	8,249	8,930	9,405	10,141	10,891	11,652	12,517

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

[1] Fiscal year from April to March.
[2] Adjustment receipts of M 330 million in 2005/06 included.
[3] Domestic balance excludes grants, foreign-financed capital spending, foreign interest payments, and exceptional factors.

Table 3. Lesotho: Balance of Payments, 2003/04 - 2009/10 [1]
(Millions of U.S. dollars)

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
			Est.	Projections			
Trade balance	-533.5	-615.1	-623.8	-757.7	-760.5	-765.1	-785.0
Exports, f.o.b.	503.0	688.4	652.7	715.1	740.6	785.6	819.7
Of which: garments	350.5	520.9	423.8	442.4	424.4	414.9	402.5
Imports, f.o.b.	-1,036.5	-1,303.4	-1,276.6	-1,472.8	-1,501.1	-1,550.6	-1,604.7
Of which: garment inputs	-153.2	-227.7	-185.3	-193.4	-178.1	-166.7	-154.6
Services (net)	-39.2	-31.3	-38.4	-45.3	-46.9	-48.8	-50.2
Receipts	51.1	67.1	54.7	57.0	58.4	60.3	62.5
Of which: water royalties (and power sales)	15.3	17.6	18.2	19.0	19.8	20.7	22.2
Payments	-90.2	-98.4	-93.0	-102.3	-105.3	-109.1	-112.7
Income (net)	269.3	324.7	319.9	344.7	350.3	363.4	369.6
Labor income (net)	269.7	314.4	300.5	305.4	314.4	320.7	322.9
Receipts	296.4	344.7	314.5	325.6	333.7	339.6	342.7
Of which: miners' wages	242.1	279.8	249.0	251.1	250.7	246.9	240.5
Payments	-26.7	-30.3	-14.0	-20.2	-19.3	-18.9	-19.8
Investment income (net)	-0.4	10.3	19.3	39.3	36.0	42.7	46.7
Receipts	29.3	43.8	49.0	49.7	52.1	61.1	65.2
Payments	-29.7	-33.5	-29.7	-10.3	-16.2	-18.4	-18.4
Of which: interest on debt	-13.2	-14.5	-18.4	-5.5	-11.1	-13.0	-12.8
Unrequited transfers	179.8	278.4	315.3	385.2	475.7	413.9	366.4
Official	171.8	270.1	300.7	370.2	460.2	398.1	350.3
Southern African Customs Union nonduty receipts	145.0	245.2	287.2	347.8	436.7	372.7	323.9
Rand compensation	18.1	11.7	12.2	8.3	8.7	9.9	10.1
Other	8.7	13.2	1.3	14.1	14.9	15.6	16.4
Private	8.0	8.3	14.6	15.0	15.5	15.8	16.1
Current account (including official transfers)	-123.6	-43.2	-27.0	-73.1	18.7	-36.6	-99.1
Current account (excluding official transfers)	-295.4	-313.3	-327.7	-443.3	-441.5	-434.7	-449.4
Of which: LHWP[2]	-54.7	-36.0	-8.5	15.8	18.2	20.5	22.2
Capital and financial account	60.1	1.0	20.3	77.5	-14.3	39.8	104.1
Capital account (transfers received)	16.5	24.7	11.2	29.4	30.9	32.4	34.0
Grants in government budget	16.5	24.7	11.2	29.4	30.9	30.1	32.3
Financial account	43.6	-23.8	9.1	48.1	-45.2	7.4	70.1
Direct investment (excl. LHDA)[3]	45.1	56.0	57.0	55.8	57.0	58.5	59.4
Financing LHWP (net)	75.8	66.8	33.4	13.5	5.6	0.0	0.0
Other investment	-48.9	-75.8	-25.1	41.1	5.5	17.5	20.5
Assets[4]	-62.8	-58.4	25.0	7.5	-1.2	-3.4	-1.9
Liabilities	14.0	-17.3	-50.2	33.5	6.7	20.8	22.4
Change in reserve assets	-28.5	-70.8	-56.3	-62.3	-113.3	-68.6	-9.8
Valuation adjustment	44.8	11.1	-15.7	-4.4	-4.4	-3.2	-5.1
Errors and omissions	18.7	31.1	22.5	0.0	0.0	0.0	0.0
Memorandum items:	(Percent of GDP, unless otherwise indicated)						
Trade balance	-46.4	-43.1	-42.4	-48.6	-46.6	-44.6	-43.6
Net remittances	23.5	22.0	20.4	19.6	19.3	18.7	18.0
Current account (including official transfers)	-10.8	-3.0	-1.8	-4.7	1.1	-2.1	-5.5
Current account (excluding official transfers)	-25.7	-21.9	-22.3	-28.4	-27.1	-25.3	-25.0
Excluding LHWP	-21.3	-19.7	-21.8	-29.5	-28.2	-26.5	-26.2
Gross official reserves (Millions of U.S. dollars)	436.9	507.7	564.0	626.2	739.5	808.1	817.8
Gross official reserves (Months of imports of goods and services)	3.7	4.4	4.9	4.8	5.5	5.8	5.7

Sources: Central Bank of Lesotho (CBL), and IMF staff estimates and projections.

[1] Financial year is April-March.

[2] Lesotho Highlands Water Project.

[3] Lesotho Highlands Development Authority.

[4] Transaction-based data; a minus sign indicates an increase in reserves.

Table 4. Lesotho: Monetary Survey, March 2004-March 2007

	2004		2005				2006	2007
	Mar.	Dec	Mar.	June	Sep	Dec	Mar.	Mar. Proj.
	(Millions of maloti)							
Net foreign assets	3,478.3	3,972.4	4,266.3	4,151.0	4,305.0	4,231.4	4,387.4	4,776.3
Central bank	2,565.9	2,846.8	2,949.6	2,991.4	2,985.5	3,076.2	3,238.4	3,634.6
Commercial banks	912.4	1,125.6	1,316.7	1,159.6	1,319.5	1,155.2	1,149.0	1,141.7
Net domestic assets	-1,169.9	-1,599.4	-1,814.5	-1,830.1	-1,760.5	-1,641.4	-1,820.5	-2,036.8
Domestic credit	275.9	-133.9	-312.4	-159.9	-213.2	-100.5	-191.5	-50.3
Claims on central government (net)	-317.5	-742.7	-958.1	-817.2	-865.0	-910.1	-1,027.2	-969.5
Central bank	-1,018.9	-1,228.3	-1,143.8	-1,193.3	-1,179.8	-1,199.9	-1,354.2	-1,296.5
Commercial banks	701.5	485.7	185.7	376.1	314.9	289.8	327.0	327.0
Claims on the rest of the economy	593.4	608.7	645.7	657.3	651.8	809.6	835.7	919.2
Other items (net)	-1,445.8	-1,465.4	-1,502.0	-1,670.2	-1,547.4	-1,540.9	-1,629.0	-1,986.4
Money and quasi-money (M2)	2,308.4	2,373.0	2,451.8	2,320.9	2,544.4	2,590.0	2,566.9	2,739.5
Money	1,539.1	1,589.4	1,698.4	1,514.2	1,756.1	1,829.5	1,864.8	1,989.5
Of which: currency outside dep. mon. banks	207.6	204.5	212.6	202.5	232.0	212.8	247.4	...
demand deposits	1,163.2	1,197.5	1,296.9	1,123.4	1,335.4	1,427.9	1,428.0	...
Quasimoney	769.3	783.6	753.4	806.7	788.3	760.5	702.2	750.0
Of which: time and savings deposits	769.3	783.6	753.4	806.7	788.3	760.5	702.2	...
	(Annual change in percent of beginning-of-year M2, unless otherwise indicated)							
Net foreign assets	-11.1	22.3	34.1	12.4	12.1	10.9	4.9	15.1
Central bank	-17.5	0.4	16.6	7.2	8.6	9.7	11.8	15.4
Commercial banks	6.4	21.9	17.5	5.3	3.5	1.2	-6.8	-0.3
Net domestic assets	16.5	-19.0	-27.9	-13.8	-9.3	-1.8	-0.2	-8.4
Claims on central government (net)	-5.8	-25.1	-27.8	-11.8	-13.2	-7.1	-2.8	2.2
Claims on the rest of the economy	3.7	2.7	2.3	1.9	3.3	8.5	7.8	3.3
Claims on the rest of the econ. (yearly change)	16.0	11.1	8.8	7.1	14.3	33.0	29.4	10.0
Other items (net)	18.6	3.4	-2.4	-3.9	0.6	-3.2	-5.2	-13.9
Money and quasimoney (M2)	5.3	3.3	6.2	-1.4	2.8	9.1	4.7	6.7
Quasi money (yearly change)	2.9	3.1	-2.1	5.5	-2.9	-2.9	-6.8	6.8

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

Table 5. Lesotho: Commercial Banks' Quarterly Performance Ratios, 2004-06

	2004	2005				2006
	Dec.	Mar.	Jun	Sep.	Dec.	Mar.
	(Percent)					
Performance ratios						
Capital adequacy						
Basel capital ratio	22	26	29	26	22	25
Nonperforming loans to total capital	1	1	2	1	3	2
Top 20 exposures to total capital	72	70	75	73	100	84
Asset quality						
Loans to deposits ratio	22	23	25	23	29	30
Earning assets to total assets	94	92	94	88	93	94
Nonperforming loans to total loans	1	1	1	1	2	1
Reserve for losses to total loans	3	3	3	3	3	2
Reserve for losses to nonperforming loans	449	545	272	529	167	242
Liquidity Ratios						
Liquid assets to total deposits	100	129	127	124	120	112
Available reserves to total deposits	6	8	5	7	8	6
Liquid assets to total assets	65	82	82	79	77	75
Current assets to total current liabilities	73	97	92	88	86	85
Profitability ratios[1]						
Net income to average total assets (return on assets)	3	1	1	1	2	1
Net income to average total equity (return on equity)	27	3	6	12	15	7
Total expenses to total income	69	80	84	73	73	75
Solvency ratios						
Total debt ratio	10	10	11	10	10	12

Source: Central Bank of Lesotho.
[1] Since 2005, affected by the operations of two new banks.

Table 6. Lesotho: Medium-Term Scenarios, 2005/06-2010/11

	2005/06	2006/07	2007/08	2008/09	2009/10
	(Percent of GDP, if not otherwise indicated)				
Baseline					
GDP growth (annual rate of growth)	1.3	2.5	1.4	1.4	2.6
Investment	28.0	29.9	30.0	30.0	30.0
Gross national savings	26.2	25.3	31.2	27.9	24.5
Fiscal balance	3.9	0.7	9.6	2.7	-2.2
SACU revenues	24.5	30.4	36.6	29.7	24.6
Total government expenditure	44.8	54.9	52.2	52.1	51.9
Public debt	53.1	53.2	40.8	35.8	36.5
Current account	-1.8	-4.7	1.2	-2.1	-5.4
Remittances	21.4	20.9	20.5	19.8	19.1
Official reserves (months of imports)	4.9	4.8	5.5	5.8	5.7
Official reserves (millions of U.S. dollars)	564.0	626.2	739.2	807.5	817.0
Reform Scenario					
GDP growth (annual rate of growth)	1.3	2.5	2.2	2.4	3.7
Investment	28.0	30.1	31.4	31.9	32.3
Gross national savings	26.2	25.2	32.8	31.1	29.0
Fiscal balance	3.9	0.7	11.5	7.4	2.6
SACU revenues	24.5	30.4	36.3	29.1	23.9
Total government expenditure	44.8	54.8	49.9	46.8	46.4
Public debt	53.1	53.1	38.5	28.6	24.6
Current account	-1.8	-4.9	1.4	-0.9	-3.3
Remittances	21.4	20.9	20.3	19.4	18.5
Official reserves (months of imports)	4.9	4.9	5.7	6.4	6.7
Official reserves (millions of U.S. dollars)	564.0	627.5	760.2	874.7	956.3
Adverse Scenario					
GDP growth (annual rate of growth)	1.3	2.5	-1.2	-0.1	0.6
Investment	28.0	29.9	29.4	28.0	27.4
Gross national savings	26.2	25.2	27.7	23.5	19.7
Fiscal balance	3.9	0.7	8.5	1.1	-3.8
SACU revenues	24.5	30.4	33.6	26.6	21.4
Total government expenditure	44.8	54.9	51.1	51.4	51.4
Public debt	53.1	53.2	43.4	40.6	43.4
Current account	-1.8	-4.7	-1.6	-4.5	-7.7
Remittances	21.4	20.9	19.1	18.3	17.6
Official reserves (months of imports)	4.9	4.9	5.3	5.6	5.5
Official reserves (millions of U.S. dollars)	564.0	626.2	672.1	711.2	695.3

Source: Fund staff estimates and projections.

Table 7. Lesotho: Indicators of External Vulnerability, 2001/02-2005/06
(Percent of GDP, unless otherwise indicated)

	2001/02	2002/03	2003/04	2004/05	2005/06
Financial indicators					
Public sector debt [1]	77.4	81.8	61.4	49.8	47.2
Broad money (M2; percent change, 12-month basis)	17.0	2.7	5.3	6.2	4.7
Private sector credit (percent change, 12-month basis)	-5.4	-47.4	15.2	6.5	38.3
Domestic credit	5.4	5.2	3.8	-3.5	-2.1
Treasury-bill yield (percent) [2]	11.0	13.1	8.8	7.7	6.9
Treasury-bill yield (real, percent) [3]	4.1	0.6	1.6	2.7	3.5
External indicators					
Exports of goods and services (U.S. dollars, percentage change)	24.1	27.4	32.0	36.4	-6.4
Imports of goods and services (U.S. dollars, percentage change)	-6.5	22.2	29.4	24.4	-2.3
Current account balance	-14.1	-18.0	-10.8	-3.0	-1.8
Capital and financial account balance	16.8	12.7	5.2	0.1	1.4
Of which: inward foreign direct investment	3.7	3.9	3.9	3.9	3.9
Net foreign assests of the banking sector (millions of U.S. dollars)	66.3	97.5	143.2	211.2	185.2
Foreign assets of the banking sector (millions of U.S. dollars)	73.2	106.3	169.4	227.8	202.8
Foreign liabilities of the banking sector (millions of U.S. dollars)	7.0	8.8	26.1	16.6	17.6
Gross official reserves (millions of U.S. dollars)	399.7	408.4	436.9	507.7	564.0
Gross official reserves (months of imports of goods and services)	4.3	4.3	3.7	4.4	4.9
Ratio of reserve money to reserves (percent)	6.0	9.7	10.8	13.9	13.2
Ratio of broad money to reserves (percent)	46.9	67.7	83.0	77.5	73.4
Ratio of reserves to short-term debt	554	348	364	524	826
Total external debt [4]	77.7	82.0	61.6	50.0	47.3
Ratio of total external debt to exports of goods and services (percent)	166.8	150.9	127.4	94.2	98.1
Nominal exchange rate (maloti per U.S. dollar, period average)	9.5	9.7	7.2	6.3	6.4
REER depreciation (-) (period average, CPI-based)	-0.2	12.0	12.4	-0.8	8.9
Memorandum items:					
GDP (millions of U.S. dollars)	710	774	1,149	1,428	1,472
Nominal exchange rate (maloti per U.S. dollar, end-of-period)	11.4	7.9	6.4	6.2	6.2

Sources: Lesotho authorities, and Fund staff estimates and projections.
[1] National government debt.
[2] End of period.
[3] Backward-looking with actual CPI.
[4] Excludes private debt within the Common Monetary Area.

APPENDIX I. LESOTHO: RELATIONS WITH THE FUND

(As of July 31, 2006)

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

II. **General Resources Account**:	SDR million	Percent Quota
Quota	34.90	100.0
Fund holdings of currency	31.32	89.75
Reserve position in Fund	3.60	10.32

III. **SDR Department**:	SDR million	Percent Allocation
Net cumulative allocation	3.74	100.0
Holdings	0.23	6.14

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

V. **Financial Arrangements**:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
PRGF	03/09/2001	10/31/2004	24.50	24.5
Stand-By	09/23/1996	9/22/1997	7.17	0.0
Stand-by	07/31/1995	7/30/1996	7.17	0.0

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	0.35	1.75	3.15	3.85	4.90
Charges/Interest	0.13	0.25	0.24	0.22	0.20
Total	0.48	2.00	3.39	4.07	5.10

VII. **Exchange Arrangement**:

Lesotho's currency, the loti (plural maloti), is pegged to the South African rand at par. The Central Bank of Lesotho (CBL) deals with commercial banks mainly in South African rand. As of August 31, 2006, the rand (maloti) rate per U.S. dollar was M 7.08.

VIII. **Article IV Consultation**:

The Executive Board concluded the last Article IV consultation (EBM/05/81; 09/19/05) on September 19, 2005. Executive Directors welcomed the marked improvement in the economic performance of Lesotho, with the overall fiscal deficit turning from deficit into surplus, a stronger external current account position, a further decline in inflation, and an increase in net international reserves. Directors noted however, that persistent drought conditions, weakened external competitiveness, a continued worsening of the terms of trade, and job losses from the phasing out of textile quotas by industrial countries had caused real GDP growth to slow in 2004/5. Directors considered that finding the basis for consistent high growth over the medium term, to help address widespread poverty, achieve the Millennium Development Goals, and confront the high incidence of HIV/AIDS, will be the primary challenge for the authorities in the period ahead.

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

IX. **Technical Assistance Missions**:

Monetary policy implementation	MAE	short-term	2001
Public accounts	FAD	short-term	2002
GDDS project for Anglophone Africa	STA	short-term	2002
Balance of payments	STA	short-term	2002
Safeguards assessment	FIN	short-term	2003
Monetary policy and AML/CFT	MFD	short-term	2003
Government finance statistics	STA	short-term	2003
National accounts	STA	short-term	2003
National accounts statistics	STA	short-term	2004
GDDS project for Anglophone Africa	STA	short-term	2004
Legislative drafting/FIU	LEG	Short-term	2005
Monetary operations / payments issues / banking supervision	MFD	short-term	2005
Government finance statistics /GDDS	STA	short-term	2005
Banking law	LEG	short-term	2005
National accounts statistics / GDDS	STA	short-term	2005
Monetary operations	MFD	short-term	2005
Payments issues	MFD	short-term	2005
Banking law	LEG	short-term	2005
BOP statistics / GDDS	STA	short-term	2005
GDDS consultation	STA	short-term	2005

Missions planned for 2006

Government Finance Statistics: GDDS Project for Anglophone African Countries	STA	short-term
Banking Law and Payments System Reform	LEG	short-term
Central Banking Law	LEG	short-term
Bank Supervision/Monetary Operations/Payments & Settlements	MFD	short-term
Legal drafting, AML/CFT, FIU, supervisory and institutional	LEG	short-term

XI. **Resident Representatives**:

The Senior Resident Representative posted in South Africa has been covering Lesotho since January 2004. In January 2006, a Deputy Resident Representative was appointed to cover regional issues.

APPENDIX II. LESOTHO: RELATIONS WITH THE WORLD BANK GROUP

A. Partnership in Lesotho's Development Strategy

1. Lesotho's strategy for poverty reduction is laid out in the government's Poverty Reduction Strategy (PRS), which was finalized in 2005 following an extensive nationwide participatory consultation process. The PRS builds on a number of government documents and initiatives, including the I-PRSP, National Vision 2020, National Goals, and the Millennium Development Goals (MDGs). The PRS has three interconnected goals: (i) create jobs through the establishment of an environment that facilitates private sector-led economic growth; (ii) empower the poor and the vulnerable and improve their access to health care and education; and (iii) deepen democracy and improve public sector performance to ensure that policies and legal frameworks facilitate the full implementation of priorities.

2. Implementation of the PRS faces several limitations and risks related to its translation into actual work plans, possible further shocks to the economy, weak governance, and a lack of political will. The development of a comprehensive medium-term macroeconomic framework, taking into account Lesotho's external vulnerability and competitiveness, and improving the monitoring and evaluation framework would facilitate PRS implementation.

B. Bank-Fund Collaboration in Specific Areas

3. The World Bank and the IMF continue to cooperate closely in assisting the Government of Lesotho to implement its poverty reduction and development strategy, with each institution taking the lead in the policy dialogue in its areas of expertise. The IMF leads on macroeconomic policy (fiscal, monetary and exchange rate policies) and on the following areas of structural reforms: fiscal management and tax administration reform. The Bank will continue to lead the policy dialogue on sectoral reforms, including public expenditure management, employment generation through private sector development, infrastructure development, education, health, combating HIV/AIDS, and poverty monitoring and evaluation. Areas of close collaboration include the PRS, public sector reform, financial sector reform and trade. The Bank and Fund staffs routinely exchange views on these and other issues.

The Bank Group's Country Assistance Strategy

4. The Bank Group's assistance strategy (CAS) for Lesotho for FY 06-09 was approved in April 2006 and is guided by the government's PRS and the MDGs. The CAS proposes four key strategic objectives which will frame the Bank Group's assistance over the coming years: (i) fighting HIV/AIDS; (ii) employment and income generation through higher economic growth; (iii) improving human development outcomes; and (iv) decentralization, public service delivery, and monitoring and evaluation. To achieve enhanced impact, the CAS proposes a results framework that sets out desired outcomes and defines key intermediate indicators. In terms of instruments, the Bank will continue to invest in high quality analytic work to underpin a strategic IDA lending program. The proposed program draws on the lessons of the last CAS and is designed to mitigate risks that could hinder the effectiveness of Bank support.

Poverty Monitoring and Evaluation

5. The Bank recently concluded a review of monitoring and evaluation in Lesotho. The review includes an assessment on the national M&E system linked to the PRS. It identifies three major issues that will have to be addressed to establish a well-functioning national M&E system: (a) donors must agree among themselves and with the government on a harmonized, unified support effort for a national M&E system; (b) the government must create a coordinated and transparent system that includes key data users and data generators; and (c) the government and donors must make a long-term commitment to enhance statistical capacity. The Bank is supporting the establishment of a national M&E system under a trust fund for the support of the PRS.

6. A Poverty, Gender and Social Assessment is being initiated with the objective of providing an analysis of the key opportunities, constraints, and risks to sustainable poverty reduction from the perspective of households, communities, the government and institutions by analyzing the past and present and drawing lessons for the future. The assessment will provide policy and program recommendations on how to achieve more inclusive and accountable institutions and sustainable poverty reduction. During a recent mission the assessment was introduced and preliminary discussions were held with major donors and the Ministry of Finance and Development Planning. The poverty assessment was welcomed by all parties as current poverty analytics are weak and outdated. The findings from the report will feed into the annual PRS progress report.

Public Sector Reform and Public Expenditure Management

7. The government of Lesotho recognizes that strengthening public expenditure management is critical to improving service delivery and make progress towards attaining its development goals. In an effort to enhance the effectiveness of public services, the government has launched an ambitious public sector improvement reform program (PSIRP) to be implemented over the next 3–5 years. The program is being supported by Lesotho's key development partners and its successful implementation is expected to provide a sound basis for future budget support to Lesotho's PRS.

8. The Bank is finalizing work on the Public Expenditure Management and Financial Accountability Review (PEMFAR), in close collaboration with the Government, to inform and guide the reforms needed to improve the efficiency and quality of public expenditures. The PEMFAR aims to strengthen the analytical base for making decisions about the size and composition of public expenditure to have maximum impact on growth and poverty reduction. The PEMFAR also includes an assessment using the approach developed under the multi-donor Public Expenditure and Financial Accountability (PEFA) program. The PEFA assessment confirms that progress has been made in the planning and formulation aspects of budgeting, but also confirms persistent problems relating to long-standing weakness in internal control, accounting delays, audit backlogs and poor fiscal reporting.

Private Sector Development (PSD)

9. To support the government's efforts on the PSD front, the World Bank has prepared a Private Sector Competitiveness project. The key objective of the project is to increase private sector participation in the economy by increasing its productivity and competitiveness. The project will consist of three components aimed at: (i) improving the business environment through reducing cost of doing business and strengthening legal framework; (ii) supporting economic diversification through development of skills, institutions and market linkages; and (iii) improving MSMEs' access to finance. The task team expects to present it to the Bank's Board in November 2006.

Integrated Framework (IF)

10. Recognizing the importance of the expansion of trade with other countries–especially in the region–for achieving economic growth, the government seeks to better integrate trade issues in the poverty reduction program. The framework for this integration is provided in the *Diagnostic Trade Integration Study (DTIS)* for Lesotho**.** The goal is to lower the cost of trading with South Africa and other Southern African Customs Union (SACU) partners and the rest of the world by removing barriers to trade and to the movement of capital and labor. Priority actions for the achievement of this goal, mostly structural policies, are set out in the DTIS matrix. The DTIS has been carried out in close consultation with the Government and core agencies and donors and has benefited from several ongoing projects, including the Bank's growth and employment options study, UNCTAD's Investment Policy Review, and the Government's PRSP and National Vision documents. Background papers for the IF study were prepared by the IMF, ITC, UNCTAD and WTO. Several donors, including the Bank, are supporting pilot projects in the agro-industry sector.

Infrastructure

11. Bank support to the infrastructure sector is directed to institutional strengthening as well as physical works. The Bank contributed to the financing of the Lesotho Highlands Water Project. In addition to its ongoing portfolio in the water and utilities sectors, the Bank has prepared an Integrated Transport Project (ITP) in collaboration with other development partners. In that context, the Bank will take a leadership role in supporting ongoing road sector reforms, capacity building and commitments for developing the road network and addressing isolation problems. In addition, the ITP will support the formulation of policies and strategies for air, rail, and intermediate means of transport (IMT) and water transport subsectors with a view towards more integrated and coordinated transport sector management.

HIV/AIDS

12. In response to the high adult HIV prevalence rate in Lesotho, the Government adopted the multi-sectoral National HIV/AIDS Strategic Plan and the National AIDS Policy Framework in 2000. To support the Government's efforts in fighting HIV/AIDS and in effectively using the resources made available by other donors, including the Global Fund, the Bank is providing a technical assistance grant to increase the capacity of government and

nongovernmental institutions responsible for the national response to HIV/AIDS. Political commitment in the fight against HIV/AIDS has increased and legislation to create a National AIDS Commission has been enacted. Several other development partners and agencies are active in supporting the HIV/AIDS program, including Development Corporation Ireland, the Clinton Foundation, and Bristol Myers Squibb.

Human Development

13. The Bank is supporting a Health Sector Reform Program with the objective of achieving a sustainable increase in access to quality preventive, curative and rehabilitative health care services. The Bank's support to the health sector is structured in three Phases of an Adaptable Program Loan (APL). Currently in Phase II, the focus is on improving access to quality health services through strengthening decentralized service delivery and improving human resources management in the sector. The education sector is supported through an APL which began in 1999 and extends to 2011. Its broad objective is to assist the Government of Lesotho in its efforts to increase access to quality education and the efficiency of the education system. In that context, it aims to: (a) increase enrollment in and completion of primary education; (b) improve learning achievement in primary education; (c) increase enrollment in secondary education; (d) build capacity in the education sector, including for early childhood care and development, technical and vocational education and training, higher education, Non-Formal Education, and Ministry of Education and Training core functions.

C. Bank Group Assistance Summary

14. The World Bank's first operation in Lesotho was approved in February, 1966. As of May 31, 2006, IDA had approved 33 credits amounting to US$ 362.9 million, of which US$ 222.1 was disbursed; US$77.1 million was canceled; and US$ 63.7 million remains undisbursed. To date, the World Bank has financed six projects in education; five in roads and road rehabilitation and maintenance; four in agriculture; three in industry; three in water supply (including support to the Lesotho Highlands Water Project); three in urban development; five in health, two in privatization; and one in community development.

15. The World Bank has six ongoing IDA projects, as well as a Global Environment Facility (GEF) project and the Lesotho Highlands Water Project. Active projects include the Health Sector Reform Project, the HIV/AIDS Capacity Building and Technical Assistance Project; Phase 2 of the Education Sector Development Project the Utilities Sector Reform Project; the Lesotho Highlands Water Project – Phase 1B and the Water Sector Improvement Project. Planned credits during FY07 are the Integrated Transport Project and the Private Sector Competitiveness Project, expected to be US$ 23.5 million and US$ 8.0 million, respectively. In addition, the World Bank will be working with other donors over the next several years to assess the possibility of and to prepare Government systems for budget support for Lesotho's Poverty Reduction Strategy.

16. Currently, the IFC has no outstanding investments in Lesotho. However, IFC is advising the Government of Lesotho on the structure and implementation of a public-private

partnership for the replacement of the Queen Elizabeth II hospital. The project has been undertaken in cooperation with the World Bank's ongoing health sector reform project.

Contact Persons

Questions may be addressed to Ms. Ritva Reinikka, Country Director, at 27-12-431 3100; or Ms. Preeti Arora, Sr. Country Economist, at 202 473-8275.

APPENDIX III. LESOTHO: STATISTICAL ISSUES

Lesotho's statistical database is adequate for surveillance, although there are some deficiencies in the quality of core surveillance data.

As one of fifteen countries participating in the Fund's General Data Dissemination System (GDDS) Project for Anglophone African Countries, Lesotho has undertaken to use the GDDS as a framework for the development of national statistical systems. The Anglophone Africa project (funded by the U.K. Department for International Development (DFID)) aims to assist participating countries to implement plans for improvement identified in the metadata, to meet GDDS recommended statistical practices. GDDS metadata for Lesotho have been posted on the Fund's Dissemination Standards Bulletin Board since August 25, 2003. Since the original posting the metadata have not been updated by the authorities, except for the metadata on the fiscal sector, which were updated in November 2004.

National accounts

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

BSL is responsible for the national accounts and compiles annual current price estimates of GDP economic activity, expenditure, and income. Annual estimates of GDP at constant (1995) prices are compiled by economic activity and expenditure. Annual estimates are published on their web site for 1993 to 2004. Fund missions prepare estimates of current year national accounts and sometimes adjust historical data. Other macroeconomic indicators, such as industrial production indices, are used to monitor developments during the year.

Since late 2003, **a peripatetic expert has been assigned under the DFID project for Anglophone Africa** to advice on strengthening the national accounts. The principal reason for limited progress has been the lack of resources and issues with the quality of source data. In particular, the December 2003 mission noted that, except in the case of agriculture statistics, there was no regular annual survey program for economic statistics. Particular note was made of the need for, and resources to be devoted to, an up-to-date business register. The absence of easily tapped administrative data compounded the problem arising from the lack of survey data. A Household Budget Survey was conducted in 2002/3 though the results are not available/used for compiling economic statistics. A November 2004 mission reiterated the lack of timely and relevant source data to be the major obstacle in implementing the *System of National Accounts 1993.* A September 2005 mission reported continuing severe staffing problems in national accounts and concomitant problems with source data. The mission also noted the need to re-benchmark and rebase the GDP estimates, but emphasized that shortcomings in source data may preclude this from being done effectively.

Prices

Since January 2001, BSL produces a monthly consumer price index (CPI) that covers Maseru, the capital city, and six urban towns. With effect from December 2006 the coverage is to be increased by three additional urban towns. While the index has a reference period of April 1997 = 100, the weights are still based on the 1994/95 Household Budget Survey (HBS). In addition, a separate CPI is compiled and published for Maseru City. A HBS was conducted for 2002/3 though the results have yet to be used to derive new weights.

Government finance statistics

Data on government revenue and grants, current and capital expenditure, and financing are now provided by the Ministry of Finance to AFR on a monthly basis, although timeliness of reports remains problematic. There is scope for further improvement in the reporting of these data. Current and capital expenditure would benefit from more disaggregated reporting, including for health and education; revenues should be classified according to the ***Government Finance Statistics Manual 2001*** *(GFSM 2001)*; and the reporting lag of about one year for the production of the functional breakdown of expenditure should be reduced. It is also necessary to distinguish clearly between current and capital (project) grants and external loan disbursements.

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

Another GFS mission that visited Maseru in March 2006 found that progress with the implementation of the previous missions' recommendations had been impeded by lack of resources and high turnover of staff. More specifically, no progress has been observed in implementing the recommendation to expand coverage of the fiscal statistics to include extrabudgetary units of government, or in aligning the classification of transactions in the source accounting systems with *GFSM 2001* classifications. A revision of the chart of accounts was envisaged with the introduction of the Integrated Financial Management Information System.

Annual cash data to 2004 have been published in the *Government Finance Statistics Yearbook 2005.* Revenue and expenses are classified by limited *GFSM 2001* economic type classifications, and outlays by a limited *Classification of the Functions of Government*

(COFOG). *Only a*nnual government finance data to 2003 have been published in *International Finance Statistics*.

Monetary statistics

Most TA recommendations have been adopted. Monthly reporting of data for *IFS* publication is timely and has improved in terms of classification of instruments, sectorization of the domestic economy, and compilation of the monetary aggregates. Lesotho started compiling monetary statistics based on the Standardized Report Forms (SRFs), which provide improved classification and sectorization of the accounts, and reported these data to STA beginning in December 2004. However, the recommendations to expand the institutional coverage of the other depository corporation sector and to value all financial instruments at market value are yet to be implemented.

Balance of payments and external debt

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

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

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

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

Progress in implementation of these recommendations is unclear.

In general, the authorities need to strengthen their institutional capacity. The CBL should be given formal institutional responsibility for the compilation of balance of payments statistics. This work is currently undertaken by the CBL but there is no legislation or official decree that designates this responsibility. Together with other members of the Common Monetary Area (CMA), Lesotho’s authorities also need to consider measures to harmonize concepts, methodology, and data collection for regional balance of payments data.

Under the GDDS project for Anglophone Africa, Lesotho has participated in a series of regional workshops to plan and implement surveys for the recording of private capital flows and stocks. Currently, the authorities are in the process of preparing to run a full-scale survey in respect of calendar year 2005.

Lesotho: Table of Common Indicators Required for Surveillance

(As of August 29, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	July 2006	July 2006	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2006	July 2006	M	Q	Q
Reserve/Base Money	June 2006	August 10, 2006	M	Q	Q
Broad Money	June 2006	August 10, 2006	M	Q	Q
Central Bank Balance Sheet	June 2006	August 10, 2006	M	Q	Q
Consolidated Balance Sheet of the Banking System	June 2006	August 10, 2006	M	Q	Q
Interest Rates[2]	June 2006	July 2006	M	M	M
Consumer Price Index	Apr 2006	Jun 2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar 2006	Jun 2006	M	I	Q
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Mar 2006	Jun 2006	M	I	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	May 2006	Jun 2006	M	I	Q
External Current Account Balance	Mar 2006	June 2006	Q	Q	Q
Exports and Imports of Goods and Services	Mar 2006	June 2006	Q	Q	Q
GDP/GNP	2005	July 2006	A	A	A
Gross External Debt	May 2005	July 2006	M	Q	Q

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

Appendix IV. Lesotho: External Debt Sustainability Analysis[16]

In the view of Fund and IDA staffs, Lesotho presents a moderate risk of debt distress. External debt in NPV terms is projected to remain well below 40 percent of GDP, both in the baseline scenario and under a set of adverse shocks. However, the DSA also highlights the country's vulnerability to exchange rate changes and other shocks, given the country's narrow export base.

Lesotho's nominal external debt declined from 82 percent of GDP in 2002/03 to 47 percent of GDP (US$694 million) at the end of 2005/06, as a result of the combined effects of limited new borrowing, an appreciation of the exchange rate, and the early repayment of nonconcessional loans in 2005. The NPV of external debt stood at 31 percent of GDP at end-March 2006. About 85 percent of the debt is owed to multilateral creditors, mainly IDA (75 percent). The remainder is split between bilateral and commercial creditors (10 percent and 3 percent, respectively). Virtually all public and publicly-guaranteed external debt is held by the central government, which has taken over the debt incurred by other public entities. For private sector debt, only obligations towards countries outside the Common Monetary Area are recorded. At end-March 2006, these obligations were estimated at US$2.2 million.

Macroeconomic projections and financing terms are summarized below in Box 1. Compared to the 2005 DSA (see CR05/437), the current account balance is significantly improved, on account of larger than previously expected SACU revenues to 2009/10 and stronger export performance in the non-garment sector, primarily due to diamonds. Real GDP growth is projected to average about 2 percent to 2011 and to increase to 4.5 percent over the long term, driven by growth in non-traditional exports and reflecting the effects of the implementation of the PRS and other planned structural reforms.

The baseline scenario assumes that the authorities would contain the fiscal deficit over the medium term to levels that can be financed with grants and highly concessional loans. Gross domestic public debt currently stands at 6 percent of GDP, and is projected to decline further over the medium term. Moreover, net domestic debt is currently negative—at minus 10 percent of GDP, reflecting sizable government deposits.

Under the baseline scenario, all debt burden indicators remain below their relevant indicative thresholds.[17] Debt level indicators stabilize at low levels under the terms of new

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[16] Jointly updated with the World Bank staff. The Debt Sustainability Analysis (DSA) focuses on external debt. Domestic debt is not expected to significantly increase the total public debt burden in the long term.

[17] The latest World Bank Country Policy and Institutional Assessment (CPIA) ranks Lesotho as a "medium performer" in terms of policy and institutions. The applicable indicative thresholds for debt sustainability, proposed under the framework for low-income countries, are an NPV of debt of 40 percent of GDP, 150 percent

(continued)

borrowing assumed for the second half of the projection period. Reflecting in part the growth of nontextile exports including diamonds, the NPV of external debt in terms of exports declines steadily under the baseline scenario, with the ratio remaining well below the indicative threshold of 150 percent over the medium term.

Under the standard stress tests, based on the volatility of key macroeconomic variables, the debt burden remains below the indicative thresholds. In case of a large nominal devaluation (30 percent), the NPV of debt would exceed 40 percent of GDP, but only over the initial five years of the projection period (Table 1b, Scenario B6). In all other scenarios the level of debt consistently remains below the indicative thresholds. An additional test, designed to illustrate the vulnerabilities arising from the country's narrow export base,

Box 1. Main Assumptions Under the Baseline Scenario

- Annual Real GDP growth is assumed to increase gradually from about 2 percent in 2005/06 to 4.5 percent by the end of the projection period.
- Inflation (as measured by the GDP deflator) is projected to stabilize slightly above 4 percent, broadly in line with experience in recent years.
- Fiscal deficits are projected to remain contained at a level that can be financed through external donors' assistance. The government is assumed to pursue a fiscal policy that would help maintain low domestic debt relative to GDP
- Imports and exports of goods and services and transfers are assumed to grow in line with GDP (in U.S. dollar terms). FDI is assumed to grow slightly more rapidly, taking into account the reduction of the corporate income tax rate in 2006 to attract foreign investment.
- The current account deficit (including official transfers) is determined by the above trends, widening to about 5 percent of GDP in 2006/07 and broadly remaining at this level over the medium term.
- Net external public sector financing is assumed to rise to about 2 percent of GDP by the end of the current decade and then to stabilize at this level. Foreign grants are assumed to remain stable at about 3 percent of GDP over the projection period. The DSA assumes that new borrowing would be contracted on highly concessional terms during the first half of the projection period; however, as the country reaches the threshold for eligibility under concessional windows of financing, it is assumed that the average grant element of new borrowing gradually decreases from 45 percent to 20 percent by the end of the projection period.
- Private sector debt is projected to increase only marginally in terms of GDP, to 0.6 percent by 2024/25.

assumes that the expansion of textile exports since 1999 based on the United States' African Growth and Opportunity Act (AGOA) would be entirely reversed in 2006/07.[18] Under this extreme scenario, the debt sustainability indicators would rise sharply, with the NPV of debt-

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of exports, and 250 percent of government revenues, and debt service of 20 percent of exports and 30 percent of government revenues.

[18] Test B7 in Table 1b.

to-exports ratio peaking at about 174 percent in 2007/08, but drop below their indicative thresholds over the medium term.

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

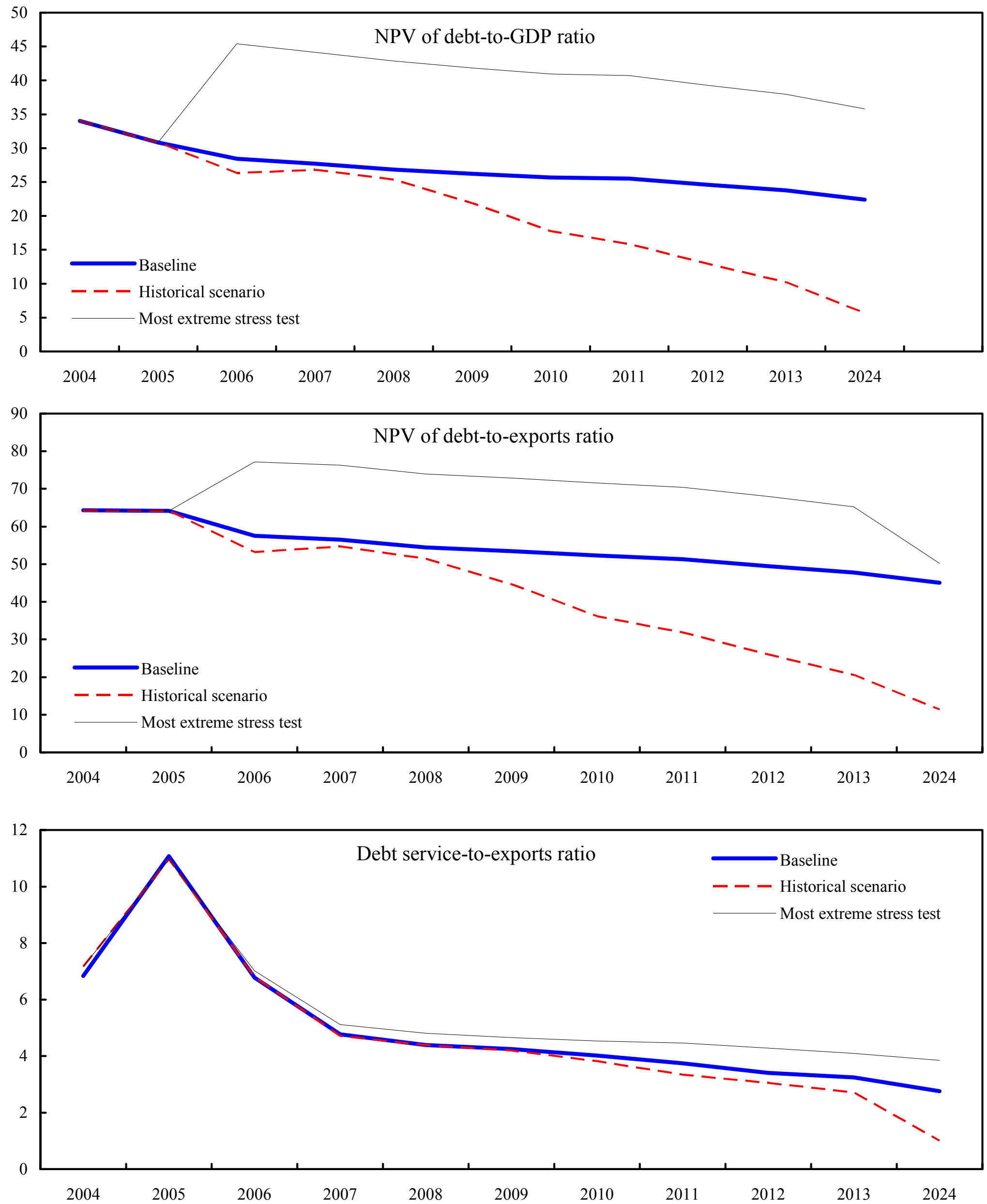
Table 1a. Lesotho External Debt Sustainability Framework, Baseline Scenario, 2001-2025 [1]
(In percent of GDP, unless otherwise indicated)

	Actual					Historical Average [6]	Standard Deviation [6]						2006-11			2011-25
	2001/02	2002/03	2003/04	2004/05	2005/06			2006/07	2007/08	2008/09	2009/10	2010/11	Average	2014/15	2024/25	Average
External debt (nominal)[1]	**77.7**	**82.0**	**61.6**	**50.0**	**47.3**			**47.3**	**46.0**	**45.0**	**44.3**	**43.8**		**39.4**	**31.7**	
o/w public and publicly guaranteed (PPG)	77.4	81.8	61.4	49.8	47.2			47.1	45.8	44.8	44.1	43.6		39.1	31.3	
Change in external debt	8.0	4.3	-20.4	-11.6	-2.7			0.0	-1.3	-1.0	-0.7	-0.5		-1.2	-0.5	
Identified net debt-creating flows	22.7	7.6	-20.0	-12.9	-2.6			0.0	-5.3	-2.0	1.0	2.3		0.0	0.1	
Non-interest current account deficit	**12.2**	**16.5**	**9.7**	**2.0**	**1.0**	**17.2**	**10.4**	**3.2**	**-1.8**	**1.4**	**4.7**	**6.0**		**4.5**	**4.5**	4.5
Excl. LHWP	-1.9	-1.5	-1.1	-1.0	-0.8	-1.5	0.7	-1.5	-0.6	-0.7	-0.7	-0.6		-0.4	-0.5	-0.4
Deficit in balance of goods and services	54.0	58.2	49.8	45.3	45.0			51.5	49.5	47.4	46.3	45.1		43.2	43.2	
Exports	46.4	54.2	48.2	52.9	48.1			49.5	49.0	49.3	49.0	49.1		49.7	49.7	
Imports	100.4	112.5	98.1	98.2	93.1			101.0	98.5	96.7	95.4	94.2		93.0	93.0	
Net current transfers (negative = inflow)	-17.2	-17.2	-15.6	-19.5	-21.4	-18.0	2.1	-24.7	-29.2	-24.1	-20.4	-18.8		-17.7	-17.7	-17.8
Other current account flows (negative = net inflow)	-24.6	-24.5	-24.5	-23.8	-22.5			-23.6	-22.1	-21.9	-21.2	-20.3		-21.0	-21.0	
Net FDI (negative = inflow)	**-3.7**	**-3.9**	**-3.9**	**-3.9**	**-3.9**	**-3.4**	**0.5**	**-3.6**	**-3.5**	**-3.4**	**-3.3**	**-3.2**		**-3.2**	**-3.5**	-3.3
Endogenous debt dynamics[2]	**14.2**	**-5.0**	**-25.7**	**-11.0**	**0.2**			**0.4**	**0.0**	**0.1**	**-0.5**	**-0.5**		**-1.3**	**-0.8**	
Contribution from nominal interest rate	1.9	1.5	1.1	1.0	0.8			1.5	0.6	0.7	0.7	0.6		0.4	0.5	
Contribution from real GDP growth	-2.7	-2.6	-1.8	-1.3	-0.6			-1.1	-0.6	-0.6	-1.1	-1.1		-1.7	-1.3	
Contribution from price and exchange rate changes	15.1	-3.9	-25.0	-10.7	-0.9			...	...	...	...	...		...	...	
Residual (3-4) [3]	**-14.7**	**-3.3**	**-0.5**	**1.3**	**0.0**			**0.0**	**4.0**	**1.0**	**-1.7**	**-2.8**		**-1.3**	**-0.7**	
o/w exceptional financing	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
NPV of external debt[4]	...	67.8	43.6	34.2	31.0			28.6	27.8	27.0	26.4	25.9		23.5	22.8	
In percent of exports	...	125.0	90.4	64.6	64.5			57.8	56.8	54.8	53.8	52.7		47.2	45.9	
NPV of PPG external debt	**...**	**67.6**	**43.4**	**34.0**	**30.9**			**28.5**	**27.7**	**26.9**	**26.2**	**25.7**		**23.2**	**22.4**	
In percent of exports	...	124.7	90.1	64.3	64.2			57.5	56.5	54.5	53.5	52.3		46.7	45.1	
Debt service-to-exports ratio (in percent)	12.3	8.0	7.5	7.1	10.3			7.0	4.9	4.6	4.4	4.2		2.9	3.0	
PPG debt service-to-exports ratio (in percent)	12.2	7.9	7.4	6.8	11.1			6.8	4.8	4.4	4.2	4.0		2.8	2.8	
Total gross financing need (billions of U.S. dollars)	101.0	131.4	107.2	26.1	30.9			83.9	-37.8	4.9	66.1	92.2		68.2	132.7	
Non-interest current account deficit that stabilizes debt ratio	4.2	12.2	30.1	13.6	3.7			3.2	-0.5	2.3	5.5	6.5		5.8	5.0	
Key macroeconomic assumptions																
Real GDP growth (in percent)	3.3	3.6	3.2	2.6	1.3	3.0	3.3	2.5	1.4	1.4	2.6	2.7	2.1	4.5	4.5	4.2
GDP deflator in US dollar terms (change in percent)	-17.8	5.3	43.9	21.1	1.8	2.6	17.6	3.4	3.0	3.7	2.2	2.2	2.9	3.4	3.4	3.2
Effective interest rate (percent)[5]	2.3	2.0	2.0	2.1	1.6	2.2	0.6	3.4	1.4	1.6	1.6	1.5	1.9	1.1	1.7	1.2
Growth of exports of G&S (US dollar terms, in percent)	24.1	27.4	32.0	36.4	-6.4	14.0	17.2	9.2	3.5	5.9	4.3	5.0	5.6	8.1	8.1	7.6
Growth of imports of G&S (US dollar terms, in percent)	-6.5	22.2	29.4	24.4	-2.3	4.8	16.4	15.0	1.9	3.3	3.4	3.6	5.5	8.1	8.1	7.4
Grant element of new public sector borrowing (in percent)	...	...	...	46.5	43.8	...	...	49.5	46.5	47.3	47.4	47.5	47.6	42.5	15.0	31.8
Memorandum item:																
Nominal GDP (millions of US dollars)	709.6	773.9	1149.1	1427.8	1471.8			1560.2	1630.2	1715.5	1798.8	1887.4		2275.5	5352.1	

Source: Staff simulations.

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

Figure 1. Lesotho: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2004-2024
(In percent)



Source: Staff projections and simulations.

Table 1b. Lesotho Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005-2025
(In percent)

		Projections					
	2005/06	2006/07	2007/08	2008/09	2009/10	2014/15	2024/25
NPV of debt-to-GDP ratio							
Baseline	31	28	28	27	26	**23**	22
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2006-25 [1]	31	26	27	25	22	**8**	6
A2. New public sector loans on less favorable terms in 2006-25 [2]	31	30	30	30	30	**29**	32
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	31	30	29	28	27	**24**	23
B2. Export value growth at historical average minus one standard deviation in 2006-07 [3]	31	28	28	27	26	**23**	22
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	31	41	40	39	38	**34**	33
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 [4]	31	38	37	36	36	**31**	25
B5. Combination of B1-B4 using one-half standard deviation shocks	31	42	41	40	39	**34**	29
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 [5]	31	45	44	43	42	**37**	36
B7. Loss of trade preferences (export ratio returning to 1999 level in 2006) [6]	31	40	39	37	36	**31**	28
NPV of debt-to-exports ratio							
Baseline	64	57	56	54	53	**47**	45
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2006-25 [1]	64	53	55	51	45	**16**	11
A2. New public sector loans on less favorable terms in 2006-25 [2]	64	60	61	60	61	**59**	64
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	64	57	56	54	53	**47**	45
B2. Export value growth at historical average minus one standard deviation in 2006-07 [3]	64	63	62	59	58	**51**	49
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	64	57	56	54	53	**47**	45
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 [4]	64	77	76	74	73	**63**	50
B5. Combination of B1-B4 using one-half standard deviation shocks	64	65	64	62	61	**53**	45
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005 [5]	64	57	56	54	53	**47**	45
B7. Loss of trade preferences (export ratio returning in 2005 to 1999 level) [6]	64	80	174	168	164	**137**	123
Debt service ratio							
Baseline	11	7	5	4	4	**3**	3
A. Alternative Scenarios							
A1. Key variables at their historical averages in 2006-25 [1]	11	7	5	4	4	**2**	**1**
A2. New public sector loans on less favorable terms in 2006-25 [2]	11	7	5	5	5	**4**	4
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	11	7	5	5	4	**3**	3
B2. Export value growth at historical average minus one standard deviation in 2006-07 [3]	11	8	5	5	5	**3**	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	11	7	5	5	4	**3**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 [4]	11	7	5	5	5	**4**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	11	6	5	4	4	**3**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 [5]	11	7	5	5	4	**3**	3
B7. Loss of trade preferences (export ratio returning to 1999 level in 2006) [6]	11	34	22	15	14	**10**	8
Memorandum item:							
Grant element assumed on residual financing (i.e., financing required above baseline) [7]	38	38	38	38	38	**38**	38

Source: Staff projections and simulations.

[1] Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

[2] Assumes that the interest rate on new borrowing is 2 percentage points higher than in the baseline, while grace and maturity periods are the same.

[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 assumming an offsetting adjustment in import levels).

[4] Includes official and private transfers and FDI.

[5] Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

[6] This test was added for Lesotho, and is not part of the standard set of bound tests.

[7] Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

APPENDIX V. LESOTHO: SOCIAL AND DEMOGRAPHIC INDICATORS

Population		**Geographical features**	
Total Population	1.8 million	Area (sq. km.)	30,350
Population growth rate	0.9	Population density (per sq. km.)	59.6
Life expectancy at birth (in years)	37.2	Arable land (2002, percent of total)	10.9
Infant mortality rate (per thousand)	79		
Urban Population (% total)	18.1	**Health**	
Population younger than 15 (Percent of total population)	41.1		
		Population per physician (2000)	16,436
		Public health expenditure (2002, in percent of GDP)	5.3
GDP per capita (in US dollars)	600		
		HIV prevalence rate (ages 15-49)	28.9
Access to safe water (2002)			
Percent of total population	76	**Education (2002)**	
Urban	88		
Rural	74	Adult literacy rate (percent)	81.4
		Primary school enrollment (net, percent)	85.8
Labor Statistics (in thousands)			
Labor force (thousands)	756	**Poverty Indicators (1995)**	
Public sector employment (thousands, FY 2004/05)	35.9		
		Share of income, lowest 20 percent (percent)	1.5
Unemployment rate (percent)	30		
		GINI Index	63.2

Sources: World Bank, 2005, *World Development Indicators 2005*, and national authorities. Data refer to 2003, unless otherwise indicated.

Statement by the IMF Staff Representative
October 6, 2006

This statement provides an update on economic developments since the issuance of the staff report. These developments do not change the thrust of the staff appraisal.

- The Southern African Customs Union (SACU) Council has indicated its intention to distribute additional windfall SACU revenue during fiscal year 2006/07. The magnitude and timing of the receipts are expected to be determined in October 2006. The authorities stated that they plan to pursue a prudent fiscal policy and resist pressures to spend.

- The exchange rate of the loti against the US dollar moved from M7.0 at the end of July 2006 to M7.6 at end-September 2006, in line with the weakening of the South African rand/US dollar exchange rate.

- Gross international reserves rose from US$564 million, representing about 5 months coverage of import of goods and nonfactor services at end-March, to US$604 million at end-September 2006, representing 5.2 months of coverage.

INTERNATIONAL MONETARY FUND
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October 12, 2006

International Monetary Fund
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IMF Executive Board Concludes 2006 Article IV Consultation with the Kingdom of Lesotho

On October 6, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Kingdom of Lesotho.[1]

Background

Lesotho has made good progress toward macroeconomic stability in recent years. Its fiscal balance has been in surplus since 2003/04, owing mainly to rapidly rising receipts from the South African Customs Union (SACU) and improved domestic revenue collection. Reflecting the sizable SACU inflows and fiscal surpluses, the external current account deficit has narrowed and gross international reserves increased to the equivalent of about five months of imports of goods and nonfactor services by the end of the fiscal year 2005/06. In line with price trends in South Africa, the inflation rate fell in 2003–05 despite rising oil import prices. Market yields on treasury bills have moved downward and the spread relative to South Africa has virtually vanished, due to the strengthened fiscal position. The government used part of the SACU windfalls to retire nonconcessional debt, reducing the net present value of public external debt to levels significantly below the relevant indicative debt sustainability threshold.

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

However, economic activity has remained sluggish, reflecting the adverse impact of exogenous shocks, and poverty remains widespread. Agricultural production was hit by drought in 2002-05 and excessive rainfall in early 2006, which has also damaged roads and bridges in the rural areas where about 70 percent of the population lives.
The manufacturing sector was adversely affected by a substantial real effective appreciation of the loti in 2002–2004 and the removal of textile quotas by industrial countries in early 2005, which led to the loss of about a quarter of jobs in the garment sector. Following a halt of the loti appreciation and the signing of a bilateral agreement that restrains exports from China to the U.S. market, the garments sector saw a modest recovery recently.

In the context of the 2006/07 budget, the authorities have reduced the company income tax rate to attract investment. With SACU revenue projected to reach a record level, total spending is budgeted to increase sharply. A supplementary budget raises expenditure further and largely eliminates the initially targeted budget surplus of 2.7 percent of GDP. While the 2006/07 budget includes a significant increase in expenditures on infrastructure and for reduction of nonconcessional external debt, the wage bill and other recurrent outlays are also projected to increase relative to GDP. The execution rate of capital expenditure, particularly concerning donor-funded projects, was low in the past year.

Lesotho’s medium-term outlook is clouded by considerable downside risks, including a further loss of trade preferences for the export sector and a decline in SACU receipts relative to GDP.

Executive Board Assessment

Directors commended the Lesotho authorities for their continued efforts to maintain macroeconomic stability under difficult circumstances. In particular, they noted the marked improvement in the fiscal and external positions in recent years, and welcomed the authorities’ prudent use of the large receipts from the Southern African Customs Union (SACU) in the last two years for debt reduction and the accumulation of international reserves.

Directors cautioned, however, that economic growth is still low and that much remains to be done to reduce poverty in view of Lesotho’s narrow resource and production base, susceptibility to shocks, and high HIV/AIDS prevalence rates. Directors also identified several downside risks for Lesotho over the medium term, including a further loss of trade preferences and a decline in receipts from the SACU. Against this background, Directors considered that the key policy challenges facing the authorities are to achieve more rapid and broad-based economic growth through an acceleration of structural reforms and to strengthen the medium-term fiscal position. International assistance would continue to be essential for further improving fiscal management and overcoming absorptive capacity constraints.

Directors emphasized the need for a prudent fiscal strategy, in view of the high uncertainty regarding future SACU receipts and the fact that, under the exchange rate parity arrangement, the burden of safeguarding macroeconomic stability falls on fiscal policy and structural reforms. They supported the use of further exceptional SACU receipts for reducing nonconcessional debt and increasing poverty-related spending, but encouraged the authorities to strictly contain the wage bill and other recurrent outlays. Directors also considered that the 2007/08 budget should aim at maintaining fiscal sustainability. They cautioned that pension reform and a new medical aid scheme should be introduced as part of a broader civil service reform that would set personnel-related budgetary expenditures on a sustainable path. Directors also called on the authorities to offset the revenue impact of the company tax cut through sustained improvement in tax administration.

Directors encouraged the authorities to continue their efforts to improve public financial management. They welcomed the wider application of the medium-term fiscal framework and other steps to improve budget planning and execution. While supporting the objective of improving public service delivery at the local level, Directors encouraged the authorities to take prompt action to ensure that the implementation is broadly budget-neutral. They underscored the importance of increasing the execution rate of capital expenditure to support economic growth and increase aid absorption.

Directors stressed that, to achieve higher growth and diversify the production base, the authorities need to press ahead with structural reforms aimed at improving Lesotho’s attractiveness as a location for private investment. In this context, Directors considered that the exchange rate peg under the Common Monetary Area has generally served Lesotho well, but noted that the real appreciation of the loti in recent years heightens the need for sustained actions to reduce structural impediments and enhance the economy’s flexibility and competitiveness. They therefore urged the authorities to implement without delay the reforms to remove red tape and other regulatory impediments, and increase competitiveness by enhancing labor productivity, infrastructure, and institutions. The launching of the Trade and Investment Facilitation Center was seen as an important step in this direction. Directors also supported the Central Bank of Lesotho’s efforts to improve private sector access to bank credit and to strengthen the regulatory framework for the nonbank financial sector.

Directors agreed that Lesotho will continue to need international support in order to make progress toward the MDGs and address pressing social challenges, including combating HIV/AIDS prevalence. They stressed the need to mobilize additional donor support for the strengthened implementation of Lesotho’s Poverty Reduction Strategy.

Directors saw scope to further improve the quality and timeliness of Lesotho's statistics for enhancing policy analysis and surveillance.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report for the Article IV consultation with Lesotho may be made available at a later stage if the authorities consent.

Lesotho: Selected Economic Indicators, 2002/03-2006/07 [1]

	2002/03	2003/04	2004/05	2005/06 Est.	2006/07 Proj.
	(Annual percent change, unless otherwise indicated)				
Real Economy					
Real GDP growth (percent)	3.6	3.2	2.6	1.3	2.5
Nominal GDP (millions of maloti)	7,541	8,249	8,930	9,405	10,141
Inflation (percent)	12.2	6.4	4.7	3.6	4.5
	(Percent of GDP)				
National Accounts					
Gross domestic investment	43.0	43.9	34.4	28.1	30.0
Gross national savings	25.0	33.1	31.3	26.2	25.3
Central Government					
Revenue and grants	44.2	43.9	51.0	48.8	55.6
Revenue	40.2	41.7	48.4	47.7	52.8
Total grants	3.9	2.2	2.5	1.0	2.8
Total expenditure and net lending	48.5	43.1	42.1	44.8	54.8
Overall balance (excluding grants)	-8.3	-1.4	6.3	2.9	-2.1
Overall balance (including grants)	-4.4	0.8	8.8	3.9	0.8
	(Annual percent change, unless otherwise indicated)				
Money and Credit					
Net domestic assets [2]	73.4	16.5	-27.9	-0.2	-8.4
Money and quasi-money (M2)	2.7	5.3	6.2	4.7	6.7
	(Percent of GDP)				
External Sector					
Current account balance (excluding grants)	-34.6	-25.7	-21.9	-22.3	-28.4
Current account balance (including grants)	-18.0	-10.8	-3.0	-1.8	-4.7
External debt [3]	81.8	61.4	49.8	47.2	47.1
External debt-service ratio [4]	11.8	9.2	7.3	10.9	1.9
Gross official reserves (millions of US dollars)	408.4	436.9	507.7	564.0	626.2
Gross official reserves (months of imports)	4.3	3.7	4.4	4.9	4.8

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

[1] Fiscal year beginning in April.
[2] Change in percent of M2 at the beginning of the period.
[3] Government only. The appreciation of the loti significantly affected the debt-to-GDP ratio in 2003/04.
[4] In percent of exports of goods and services.

Statement by Peter Gakunu, Executive Director for Kingdom of Lesotho
Leonia 'Moi Lephoto, Advisor to Executive Director
October 6, 2006

1. Introduction

On behalf of our Lesotho authorities we would like to thank staff for the constructive dialogue during the last Article IV consultations and the board and management for their continued support. The authorities appreciate the advice proffered by the fund and are in general agreement with the thrust of the staff report. As indicated in the staff report, the authorities' commitment to prudent macroeconomic management has contributed to maintaining macroeconomic stability. However, high and sustained economic growth necessary for meaningful poverty reduction has remained elusive. Lesotho has been experiencing several exogenous shocks in the last few years which have made macroeconomic management more challenging: the lapsing last year of the Multifibre Agreement resulted in closures of textile factories and increased unemployment; there is concern about the prospects of erosion of preferences under AGOA, which may also worsen the performance of the textile industries; ongoing massive retrenchments of mine workers by South African mines has cut-off the main source of remittances from abroad; and, there are uncertainties surrounding the future of the government's main source of revenue, SACU receipts. These developments have impacted adversely on the prospects for growth and have compounded poverty. In addition, Lesotho's debt, especially multilateral, remains high, yet the country does not qualify for debt relief, thus depriving the country of the necessary fiscal space for achieving the MDGs. Going forward the authorities are dedicated to implementing the policies and reforms aimed at preserving stability and promoting sustainable growth and poverty reduction.

2. Recent Economic Developments

Lesotho's economic performance continued to show sustained improvements towards macroeconomic stability. The fiscal balance registered a surplus for the third consecutive year. At 3.9 percent of GDP during 2005/06, the fiscal surplus reflected a significant growth in total revenue and grants as a result of higher than expected Southern African Customs Union (SACU) revenues, as well as the lower than budgeted expenditure. The surplus enabled Government to repay more of its non-concessional debt, thus further improving the country's external debt position to 53.1 percent of GDP. This further demonstrates the government's commitment to prudent and sustainable fiscal policies.

The external position remained favorable in 2005, with a build-up in gross official reserves to about 5.8 months of import coverage. The growth in reserves was facilitated by a significant improvement in the current account balance from a deficit of 2.9 per cent of GDP in 2004 to a surplus of 1.2 per cent in 2005 as a result of higher SACU receipts.

In line with regional developments and despite the higher oil import prices inflationary pressures remained subdued in 2005. The CPI based inflation rate declined from an average of 5.1 per cent registered in 2004 to 3.5 per cent.

Economic growth, however, declined further from 3.1 per cent in 2004 to 1.2 per cent in 2005, largely as a result of a contraction in manufacturing output. Performance of the manufacturing sector has been adversely affected by removal of textile quotas and the resultant increase in competition, for the US market, from low-cost producers such as China, and the relative strength of the loti against the US dollar. The unemployment situation worsened in 2005 with manufacturing sector employment declining significantly due to the closure of some textile and clothing firms and the continued fall in Basotho mineworker employment by the South African mines.

3. Macroeconomic outlook and policies

Macroeconomic prospects for Lesotho are clouded by the current deterioration in output as a result of external shocks as well as the uncertainty surrounding future SACU revenues. The deterioration in economic growth has worsened the unemployment problem and threatens to worsen the already wide spread poverty levels. The high levels of HIV prevalence in the country could also affect labor productivity negatively thus exacerbating the growth problem and making it even more difficult for the country to reach the MDGs. The uncertainty of SACU revenue poses a challenge to fiscal management as these receipts continue to account for the bulk of government revenue.

The continued retrenchment of the Basotho workers from the South African mines also has negative effects, reducing remittances and affecting the balance of payments, as well as increasing unemployment and exacerbating poverty.

Fiscal policy

Lesotho’s membership of the CMA shifts the burden of macroeconomic management to fiscal policy. Therefore, the importance of prudent fiscal policy cannot be overstated. The core objective of Lesotho’s fiscal strategy is to maintain fiscal sustainability. Throughout most of the 1990s and early 2000s the authorities have been successful in achieving this objective with fiscal surpluses being consistently realized. The authorities continued to exercise prudence in managing these surpluses and used them to retire some of the country’s commercial and domestic debt, thereby improving debt sustainability and reducing the fiscal burden of future interest payments. The surpluses are expected to continue up to 2007/08 due to higher SACU revenue but fiscal prospects may deteriorate thereafter, as these receipts begin to taper off. The authorities are conscious not to use the additional resources from SACU in a manner that will create future expenditures. They will continue to use them to settle some of the public debt and for critical once off expenditures. These will include the expenditure on the repair of the physical infrastructure that was destroyed by the heavier than normal rains that were experienced earlier this year.

The authorities are aware of the challenges that the potential fall in future SACU revenue poses to maintaining the current policy stance and are committed to undertake expenditure reforms to dampen its impact. They plan to improve the quality of public expenditure by targeting high priority activities as identified in the poverty reduction strategy. The authorities appreciate the potential fiscal impact of the pension and medical reform for civil servants. They are currently studying the options available for their execution and undertake to limit their costs to the minimum possible. These reforms are necessary as the pension reform aims to replace the current unfunded defined benefit scheme with a funded defined benefit or defined contribution scheme. The medical benefit scheme is also necessary to keep up with regional labor market developments and alleviate the problem of brain drain. Measures to improve the public financial management are also being undertaken that include, widening the use of the medium term fiscal framework, improving service delivery at local levels and introduction of the integrated financial management information system.

On the revenue front, the authorities continue to be committed to undertake domestic revenues enhancing measures through continuous improvements in revenue administration by the Lesotho Revenue Authority (LRA).

Monetary policy and Financial sector issues

The conduct of monetary policy in Lesotho is limited by the country's membership in the CMA, which provides for the loti to be pegged at par to the South African rand and for free movement of capital within the CMA. In this regard, monetary policy in Lesotho aims at maintaining a strong external reserve position that is adequate to support the exchange rate peg as well as to meet the country's external obligations. The central bank currently holds a level of reserves that is more than adequate to cover these objectives.

The banking sector in Lesotho continues to be sound and well capitalized. The authorities continue to implement measures geared towards improving prudential supervision and to facilitate the development of the banking sector as well as the non-bank financial sector. However, the banking sectors' reluctance to extend credit to the private sector remains a major concern for the authorities. To address this issue the Central Bank has embarked on a number of reforms to improve financial intermediation and make conditions more conducive for credit extension. These include the review of the laws that affect the financial sector, which was initiated in 2005 and is expected to be completed in 2006. The review is expected to harmonize and improve the legal and regulatory framework for the financial sector. The Financial Institutions Act (FIA) is also being revised to accommodate the implementation of the tiered banking system. The authorities have also developed an Anti Money Laundering bill which is expected to be enacted into law before the end of 2006.

The Central Bank, in collaboration with the banking sector, is also embarking on a project to modernize the National payments systems. The legal framework for the payments system is being developed and the drafting of the law, with the technical assistance of the Fund, has been completed. The Real Time Gross Settlement (RTGS) system has been installed and was successfully launched on August 25, 2006. The RTGS will mainly deal with settlement of large value time critical transactions and is expected to be instrumental in reducing settlement risks. Subsequent to the deployment of the RTGS, the authorities plan to also implement an automated clearing house for low value high volume transactions in order to reduce their settlement time.

Promotion of private sector led growth

Promotion of private sector led growth is crucial for Lesotho to reduce poverty. The government of the Kingdom of Lesotho, cognizant of the need to improve the investment climate and incentives as well as enhance international competitiveness, reduced company tax rates starting from the 2006/07 fiscal year. The trade and investment facilitation centre was also established to serve as a one stop shop for potential investors and this will serve to reduce the regulatory impediments and facilitate investment. The authorities also plan to take measures to improve labor productivity, economic infrastructure as well as to diversify markets in order to reduce the country’s vulnerability to shocks.

4. Conclusion

The authorities remain committed to implementing measures to safeguard macroeconomic stability and to promote growth. They seek the continued support of the Fund and the international community in general in mitigating the enormous challenges that they face in their pursuit of these objectives. This is particularly important for the country to reduce poverty and make headway towards achieving the MDGs.