INTERNATIONAL MONETARY FUND

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KINGDOM OF LESOTHO

December 2012

Fourth Review Under the Three-Year Arrangement Under the Extended Credit Facility, Request for Waiver of Nonobservance of Performance Criterion, and Request for Modification of Performance Criteria

In the context of the fourth review under the three-year arrangement under the Extended Credit Facility, request for waiver of nonobservance of performance criterion, and request for modification of performance criteria, the following documents have been released and are included in this package:

- **Staff Report** for the Fourth Review Under the Three-Year Arrangement Under the Extended Credit Facility, Request for Waiver of Nonobservance of Performance Criterion, and Request for Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on October 3, 2012, with the officials of Lesotho on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 12, 2012. 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.
- **Press Release** summarizing the views of the Executive Board as expressed during its November 27, 2012 discussion of the staff report that completed the request and/or review.
- **Statement by the Executive Director** for Lesotho.

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

Letter of Intent sent to the IMF by the authorities of Lesotho*
Memorandum of Economic and Financial Policies by the authorities of Lesotho*
Technical Memorandum of Understanding*

*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

November 12, 2012

FOURTH REVIEW UNDER THE THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY, REQUEST FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION, AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA

Extended credit facility arrangement: The Executive Board approved a three-year ECF arrangement for SDR 41.88 million (120 percent of quota) in June 2010, against the backdrop of a sharp fall in revenues from the Southern African Customs Union (SACU). The second and third reviews under the Extended Credit Facility (ECF) arrangement were concluded on April 9, 2012. The Board also approved an augmentation of access equal to 25 percent of quota, which has led to a total access of SDR 50.605 million (145 percent of quota) in order to cushion the impact of the 2010–11 flood damage and high international commodity prices.

Review: The ECF-supported program is broadly on track. All but one quantitative performance criteria (PCs) for end-March 2012 were met. The ceiling on the amount of new nonconcessional external debt contracted or guaranteed by public sector was breached. All structural benchmarks by June-2012 were implemented. In the attached Letter of Intent (LOI) and Memorandum of Economic and Financial Policies (MEFP), the authorities review program implementation and outline their policies for 2012/13 and beyond. In view of the program performance and measures to improve debt management, staff supports the authorities' requests for a waiver of a missed PC and a modification of PCs, and recommends the completion of the fourth review under the ECF arrangement.

Publication: The authorities have consented to publication of the staff report and the program documents.

Approved By
Anne-Marie Gulde-Wolf, AFR, and Chris Lane, SPR

The mission visited Maseru July 2–12, 2012 and September 27–October 3, 2012 and met with the recently appointed Finance Minister Ketso; Central Bank of Lesotho Governor Matlanyane; other senior government officials; and representatives of the donor community, and the private sector. The staff team comprising J. Honda (head), N. Koliadina, D. Benicio, and I. Masha (all AFR) was assisted by M. Tharkur, resident representative.

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EXECUTIVE SUMMARY

Lesotho's economic growth has weakened, compared with the earlier forecast, due to adverse exogenous shocks. Specifically the recent drought, a fall in revenues from the Southern African Customs Union (SACU) during 2010–11 and floods in early 2011 weighed on Lesotho's growth momentum. Real GDP growth is estimated at 3–4 percent in 2011/12–2012/13, partly helped by enhanced mining investment and ongoing public infrastructure projects. The recent exogenous shocks adversely affected external balances, leading to a fall in the reserves to the equivalent of 3⅓ months of import coverage by June 2012.

While international reserve buffers are expected to be rebuilt in the coming years, Lesotho's economic outlook is clouded by downside risks. A renewed downturn in the global economy could adversely affect exports, SACU revenues, and foreign direct investment. Furthermore, the recent drought is expected to significantly reduce crop production, which raises serious concerns about food security. An international appeal has been launched by the government and the UN to adequately respond to the humanitarian and agricultural crisis.

Continued fiscal consolidation efforts—through enhanced revenue collection and tight expenditure management—have helped to mitigate the pressures on reserves. The non-SACU fiscal deficit (excluding externally financed capital projects) in 2011/12 is estimated at about 23⅓ percent of GDP, broadly in line with the program projection. For 2012/13, the new government—formed following the general elections in May 2012—is committed to maintaining the fiscal consolidation path, while ensuring social spending and addressing additional spending needs related to the drought. With a recovery in SACU revenues and enhanced tax collection (with strengthening of revenue administration), the fiscal balance in 2012/13 is expected to improve sharply to an overall surplus of 2⅓ percent of GDP.

To achieve sustained growth and increase employment, reform efforts to promote private sector development have continued. The Industrial Licensing Bill has been submitted to Parliament, while the new Companies Act 2011 has been enacted recently. These efforts are reflected in the recent improvement in Lesotho's doing business indicators. Structural measures focus on improving the business climate and encouraging financial sector development, in line with the priorities set out in the National Strategic Development Plan (NSDP).

Performance under the ECF-supported program has been satisfactory. All performance criteria at end-March and indicative targets at end-June 2012 were met, with the exception of the ceiling on newly contracted nonconcessional external debt. Two structural benchmarks (SBs) by end-March 2012 were implemented on time, namely the front office revenue receipting system in four pilot cases and the audit of domestic arrears, while two SBs by end-September 2012—a comprehensive inventory of government accounts and the submission of the Industrial Licensing Bill to Parliament—were completed with delay.

Based on performance under the program and policy commitments for 2012/13, staff supports the completion of the fourth review under the ECF, a waiver of nonobservance for the end-March performance criterion, and modification of performance criteria. Risks to the program can be mitigated by continued implementation of sound policy and reforms, in coordination with Lesotho's development partners.

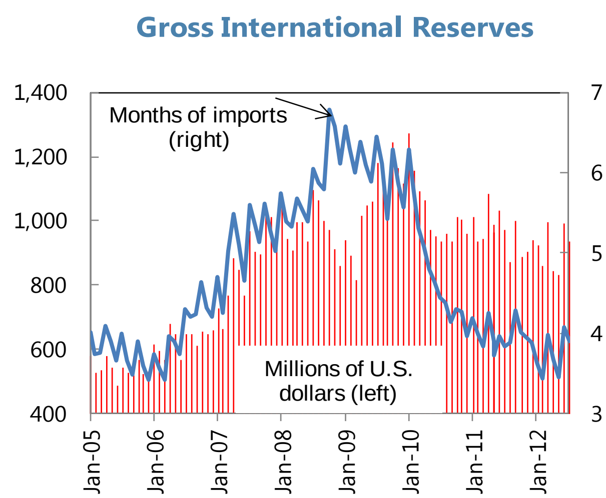
RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

1. **In 2011/12, despite the weather-related shocks (floods), robust growth (3¼ percent per annum) was maintained.** While agricultural production declined following the floods in early 2011, the mining sector grew rapidly in response to strong international demand and the resumption of operations of two mines. Mining investment, as well as ongoing public infrastructure projects, also contributed to the expansion in the construction sector.

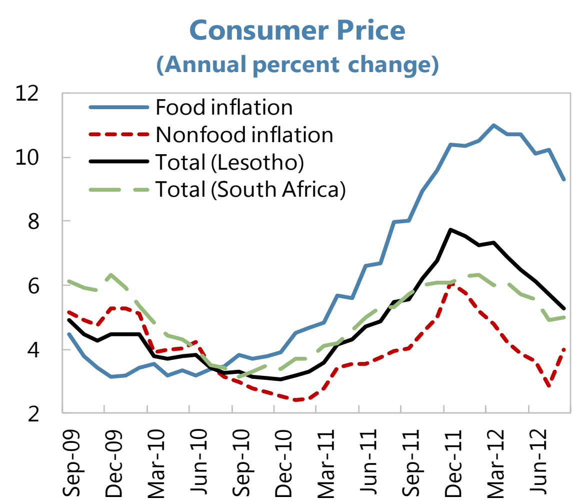
2. **High international commodity prices added pressures on domestic prices and external balances, though inflation has started to decline recently.** The consumer price index (CPI) peaked at 7.7 percent in December 2011, reflecting high international commodity prices and flood-related agricultural supply shortages in early 2011. Price pressures have, however, moderated since early 2012, partly reflecting easing in international commodity prices. The current account deficit widened to 25 percent of GDP in 2011/12, and international reserves fell to the equivalent of 3⅓ months of import coverage at end-June 2012.

Lesotho: International Reserves and Inflation

Exogenous shocks have put increasing pressure on international reserves…



Inflation continues to decline.



Sources: Lesotho authorities, South African Reserve Bank, and IMF staff estimates.

3. **Fiscal consolidation continued in 2011/12, in line with program expectation.** The non-SACU fiscal deficit (excluding capital projects financed by external loans) in 2011/12 is estimated at 23⅓ percent of GDP, broadly in line with the program projection. Though capital expenditures increased owing to the faster-than-expected progress in implementation of domestically-financed infrastructure projects, the government was successful in further containing recurrent expenditures and in enhancing revenue collection from mining companies.

Fiscal Performance 2009/10–2016/2017[1 2]

	2009/10	2010/11	2011/12		2012/13		2013/14	2014/15	2015/16	2016/17
	Act.	Prel.	EBS/12/44	Proj.	EBS/12/44	Proj.	Proj.	Proj.	Proj.	Proj.
	(in percent of GDP)									
Revenue and Grants	62.8	52.5	51.5	52.2	65.5	66.0	57.9	52.5	50.6	49.6
Tax Revenue	21.4	21.5	21.6	23.1	21.5	23.8	23.6	23.0	23.0	23.0
Non-tax revenue	5.2	7.6	6.3	6.3	6.0	4.5	4.5	4.9	4.6	4.7
SACU	33.1	16.1	15.2	15.0	29.0	29.0	25.1	22.4	20.9	20.0
Core SACU	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Non-core SACU	18.1	1.1	0.2	0.0	14.0	14.0	10.1	7.4	5.9	5.0
Grants	3.0	7.4	8.5	7.8	9.0	8.7	4.7	2.1	2.0	2.0
Budget support	0.0	2.3	1.1	1.6 .	1.5	1.5	1.3	0.5	0.4	0.4
Project grants	3.0	5.1	7.4	6.2 .	7.5	7.3	3.4	1.7	1.6	1.6
Flood support			0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Total Expenditure	66.7	57.5	62.1	62.6	65.3	63.8	56.6	50.2	46.8	45.6
o/w Drought-related (reallocated from the original budget)	…	…	…	…	…	0.6	…	…	…	…
Recurrent	48.0	39.1	41.4	40.6	40.7	40.8	38.3	36.5	33.3	31.9
Capital expenditure	18.7	18.4	20.7	21.9	24.6	22.9	18.3	13.7	13.6	13.7
o/w Domestically funded	13.8	11.6	10.9	13.8	11.8	11.6	10.6	9.9	9.3	9.9
Overall Balance, incl. grants	-3.9	-5.0	-10.5	-10.4	0.2	2.3	1.3	2.3	3.8	4.0
Overall Balance, excl. grants	-6.9	-12.4	-19.0	-18.2	-8.8	-6.5	-3.4	0.2	1.8	2.0
Core-SACU Fiscal balance (excl. foreing-financed capital projects) [3]	-20.2	-9.4	-8.3	-8.4	-8.6	-8.2	-4.0	-2.4	0.5	1.2
Non-SACU Balance (incl. foreign-financed capital projects)	-37.0	-21.2	-25.6	-25.3	-28.8	-26.8	-23.8	-20.1	-17.2	-16.0
Non-SACU Balance (excl. foreign-financed capital projects) [3]	-35.2	-20.4	-23.3	-23.4	-23.6	-23.2	-19.0	-17.4	-14.5	-13.8
Financing	-1.2	2.1	10.5	7.2	-0.2	-2.3	-1.3	-2.3	-3.8	-4.0
Domestic (net)	-1.4	2.5	9.0	6.5	-4.3	-4.7	-4.9	-4.0	-5.5	-5.5
Foreign (net)	0.1	-0.4	1.5	0.7	4.1	2.4	3.6	1.7	1.7	1.5
Statistical Discrepancy [4]	5.2	3.0	0.0	3.1	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Ministry of Finance and Fund staff estimates.
1 The fiscal year runs from April 1- March 31.
2 Based on the GFSM 1986 format.
3 The figures for EBS/12/44 are revised to incorporate the correction of the amount of foreign financed capital projects.
4 The fiscal discrepancy partly reflects the difficulty associated with IFMIS with some revenues under-recorded in the system.

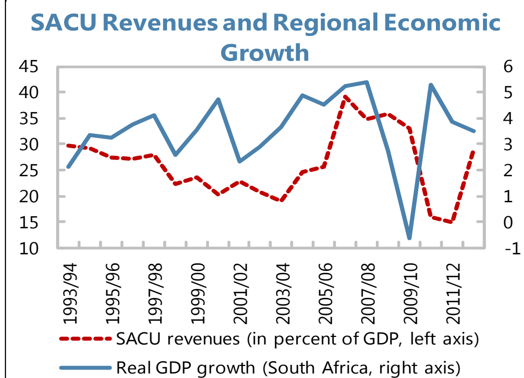
4. **For 2012/13, the growth outlook is slightly weakened from the previous forecast owing to an expected decline in textile and agricultural production, but external balances are expected to improve.** The growth of the textile sector has slowed down owing to the shortfall in export orders associated with the uncertain prospect for the Third Country Fabric Provision (TCFP) under the US African Growth and Opportunity Act (AGOA), prior to the decision for the extension in August 2012.[1] Furthermore, recent drought is expected to further reduce crop production by over 70 percent, which raises serious concerns about food security.[2] Despite these setbacks, the authorities remain committed to continue their fiscal consolidation efforts. These efforts, combined with higher-than-expected SACU revenues, are expected to result in an overall fiscal surplus in 2012/13. As a result, pressures on international reserves are expected to further ease, and the import coverage is projected to recover to 3⅔ months of imports by the end-March 2013.

[1] The AGOA was signed into law on May 18, 2000 and is scheduled to expire in 2015. Under the Act, Lesotho has specifically benefitted from the TCFP, through which countries can import inputs from nonmembers of AGOA without repercussions for their free access to the US market. As the TCFP had originally been set to expire in September 2012, export orders from the US market had weakened until August 2012 when the U.S. Congress decided to extend the TCFP till 2015.

[2] According to the Vulnerability Assessment conducted by the Disaster Management Authority (DMA), about 725,519 people (out of a population of about two million) are estimated to need humanitarian assistance in 2012/13.

5. Going forward, significant downside risks persist. The main risks arise from the uncertain global and regional economic outlook that could adversely affect SACU revenues and external demand for Lesotho's exports—both diamonds and textiles (Box 1). With new mines coming on stream, diamond production (which accounts for about 10 percent of GDP) is still projected to reach 18 percent of GDP by 2015/16. This projection, however, is subject to high risk because of uncertain prospects for global demand. Exports of textile are also subject to downward risks over the medium-term, in light of prospective expiration of the AGOA.

SACU revenues are volatile, in line with regional economic growth trend.



Source: Data from the authorities and staff estimates.

POLICY DISCUSSIONS

6. Against this background, Lesotho continues to face the challenge of rebuilding its international reserve cushion while keeping up the growth momentum and addressing critical social needs. Given Lesotho's small size and close integration with South Africa, maintaining the peg is considered a desirable policy goal. Implicitly, in an uncertain economic environment with likely future exogenous shocks, the key medium-term challenges remain rebuilding international reserve cushion, ensuring fiscal and external sustainability and increasing the country's long-term growth potential to ensure poverty reduction, through the removal of bottlenecks to private sector growth and development.

A. Tracing an Adjustment Path toward Macroeconomic Stability

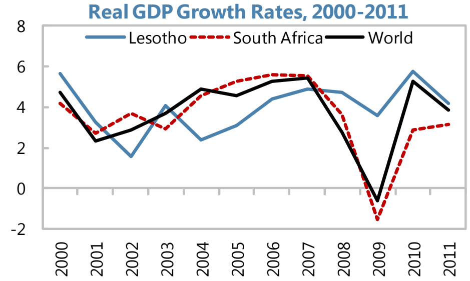
7. For 2012/13, the authorities are committed to further progress in fiscal consolidation, while addressing social and key development needs. Despite making a budgetary contribution to the emergency response needs of the drought (M 117 million, 0.6 percent of GDP),[3] the non-SACU fiscal deficit (excluding externally financed capital projects) is targeted at 23¼ percent of GDP, lower than the level (23½ percent) agreed to during the last review of the ECF-supported program. The authorities are committed to preserving the overall budgetary envelope and coping with any new spending needs through reallocations within the existing budget. With these adjustment efforts, as well as with an expected recovery in SACU revenues, the overall fiscal position is projected to record a surplus—for the first time since the crisis emerged in 2008/09. In addition, the authorities have requested donors to assist financing additional costs of addressing the emergency humanitarian and food crisis.

[3] To enhance agricultural production, the authorities have decided to extend financial support to the agricultural sector in the amount of M 117 million in 2012/13 to expand land cultivation.

Box 1. Lesotho: Channels of Possible Spillover from Global and South African Economy[1]

Lesotho's open economy, proximity to South Africa and the monetary integration in the Common Monetary Area (CMA) foster close integration to both the regional and global economies, allowing the country to benefit positively from growth spillovers and at the same time, increasing its vulnerability to adverse developments in the external environment. Though the impact of the 2009 global economic crisis on growth was not as pronounced as it was on its major trading partners, there were sizable impacts on external balances, mainly through a drop in SACU revenues and exports. In the medium term, Lesotho's economy remains vulnerable through the following channels:

Lesotho, South Africa, and the World: Real GDP Growth Rates, 2000-2011

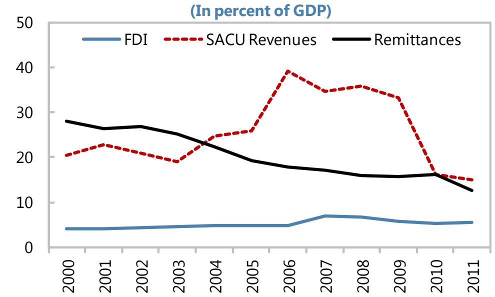


Source: WEO and staff estimates.

Trade. Domestic demand conditions of US, Europe and South Africa— Lesotho's key export markets—were important contributors to past growth performance. With enhanced mining production in recent years, exports are estimated at 43 percent of GDP in 2011/12. A pronounced slowdown in Europe could also affect the demand for diamond, while the recent decline in international fuel prices could somewhat ease the pressures on international reserves.

Official and Nonofficial Flows and Transfers. SACU revenue receipts and remittances reached 15 percent and 14.5 percent of GDP, respectively, in 2011/12 contributing to fiscal and balance of payments viability. But both flows are proven to be highly correlated with South Africa's business conditions, and a downturn in South African economy would have a pronounced negative impact on both fiscal and external balances.

Lesotho: Transfers, Flows and FDI, 2000-2011
(In percent of GDP)

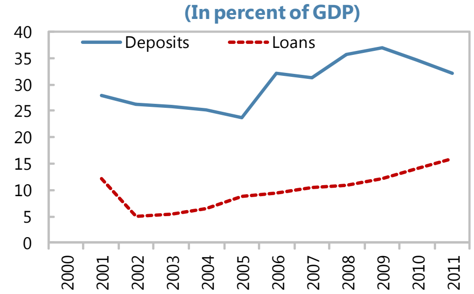


Source: WEO and staff estimates.

Foreign Direct Investment (FDI). Lesotho has benefited from FDI flows, which reached 8 percent of GDP in 2011/12. Enhanced investments in mining sector are expected in coming years, in light of the current high demand for Lesotho's high quality diamonds. Given the current economic difficulty in Europe, however, negative investor sentiments may affect the investment plans.

Banking spillovers. Lesotho's membership in the CMA facilitates cross-border trade and financial flows, and the banking system is dominated by South African banks. Though Lesotho banks are well capitalized and loan to deposit ratio is low, if South African parent banks were to encounter severe liquidity problems or capital shortfalls, it would generate significant spillover effects to Lesotho. According to the recent IMF staff report for the Article IV consultation for South Africa, its banking system remains well capitalized and liquid.

Lesotho: Commecial Banks, 2000-2011
(In percent of GDP)



Source: WEO and staff estimates.

[1] South Africa's spillover effects to the rest of sub-Saharan Africa are also discussed in the Regional Economic outlook: sub-Saharan Africa (October 2012).

8. To help achieve the fiscal consolidation targets, the authorities plan to implement the following structural measures:

- **On the expenditure side, the authorities are committed to restraint.** This would be achieved by improving the quality of spending and reducing nonpriority outlays through stricter expenditure controls resulting from the improved functioning of the Integrated Financial Management Information System (IFMIS). In light of large statistical discrepancy in the fiscal accounts (3 percent of GDP in 2011/12), emphasis is also placed on strengthening cash management, facilitating reconciliation of government accounts at the central bank and commercial banks (structural benchmark, MEFP, Table 3).[4]

- **On the revenue side, the authorities plan to step up efforts to strengthen revenue administration (Box 2).** Based on technical assistance from the IMF, the authorities will complete a full restructuring of the Lesotho Revenue Authority (LRA) in 2012/13, including the operationalization of a full-service Large Tax Payer Unit by end- 2013 (structural benchmark, MEFP, Table 3). In the event that revenues turn out higher than expected in 2012/13, the authorities plan to use the additional resources to rebuild their deposits at the Central Bank of Lesotho (CBL).

9. To address weather-related shocks (the floods through early 2011 and drought in 2012), the authorities have sought external assistance from Lesotho's international partners. In the wake of the recent drought, a national food crisis was declared in August 2012. According to the Disaster Management Authority (DMA), the total costs to address the crisis are estimated at M 1.4 billion (6.7 percent of GDP).[5] The government has sought external assistance, and thus far the UN has pledged US$6.2 million (about M 50 million). The current appeal follows the earlier requests by the government in mid-2011 for assistance to cover flood-related cost (about 3 percent of GDP).[6]

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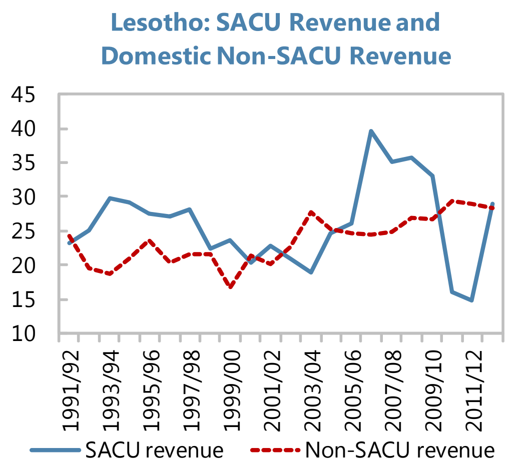
[4] The fiscal discrepancy partly reflects the difficulty associated with IFMIS with some revenues under-recorded in the system.

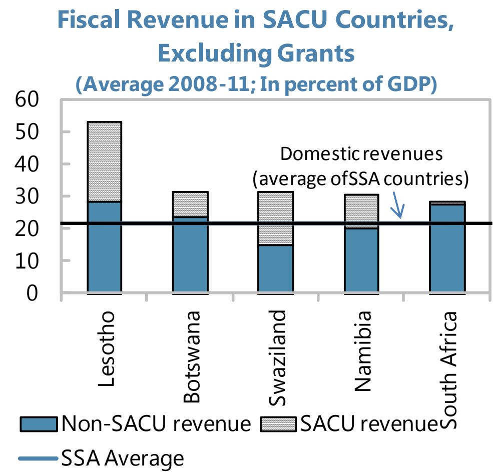
[5] In terms of the costs to address the drought, the DMA estimated the total emergency response needs at M 1.4 billion, while the UN estimated the financing needs of US$38.5 million (1.5 percent of GDP).

[6] Following the establishment of a disaster fund, Lesotho's development partners pledged US$3 million.

Box 2. Enhancing Non-SACU Revenue: Reform Prospects

The SACU revenues have generated 30–60 percent of Lesotho's government revenues in 2005–11, but their high volatility has been a source of fiscal vulnerability. SACU revenues reached 35–40 percent of GDP during 2006/07-2008/09, followed by a sharp decline to less than 20 percent in 2010/11–2011/12, caused by the weakened business conditions in the region and the need to repay previous years' overpayments to the Common Revenue Pool (CRP).[1] To enhance non-SACU revenue, the authorities have been stepping up their efforts in the following areas:





Source: Data from the authorities and staff estimates.

- **Completing the restructuring of the LRA**. Its organizational structure is being upgraded to ensure better coordination and a clear division of responsibilities between units, with the focus on large taxpayers. Creating a full-service large taxpayer unit (LTU), initially managing 100–120 largest taxpayers, would improve LRA's capacity to manage taxpayers. Revamping the large taxpayer services is underway, with the assessment of positions completed and the operational structure to be approved before the year's end.

- **Collecting more revenues from the mining sector**. Recent expansion of the mining sector, which generated 10 percent of GDP in 2011/12, has not led to a corresponding increase in government revenues, with its share remaining low and highly volatile. The taxation of the diamond sector is plagued by exemptions and transfer pricing, which would be alleviated following the planned review of the taxation of the mining sector. At present, the government levies a 6 percent royalty on the value of extracted diamonds, in addition to a corporate income tax and dividends paid by companies. The authorities have requested IMF technical assistance to review the mining taxation regime with a view to aligning it with international best practices.

- **Alleviating tax breaks and introducing a simplified regime for small businesses**. The LRA has been exploring prospects for eliminating reduced VAT rates for selected goods and services. The LRA has also been considering the pros and cons of a simplified regime for small taxpayers.

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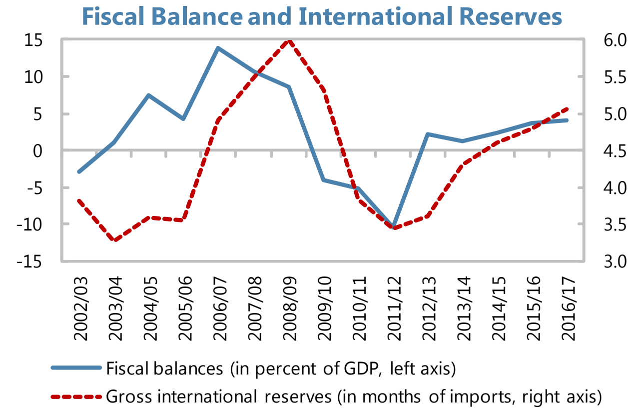
[1] The lower-than-projected South Africa's imports in 2008/09 and 2009/10 led to an overpayment to the CRP, since the transfers are made on the basis of projected imports, and adjusted retroactively in future years, when the data for actual imports become available.

10. Over the medium-term, the authorities are committed to keeping these fiscal adjustment efforts, in order to build sufficient international reserve cushion. The authorities continue to aim at bringing international reserves to the equivalent of five months of imports over the medium-term.[7] Further fiscal consolidation efforts would aid reserve accumulation. Recurrent expenditures are projected to decline over the medium-term, and dependence on SACU revenues would be reduced significantly. The non-SACU fiscal deficit (excluding externally financed capital projects) is expected to steadily decline and reach 13¾ percent of GDP by 2016/17, about half of the current level.

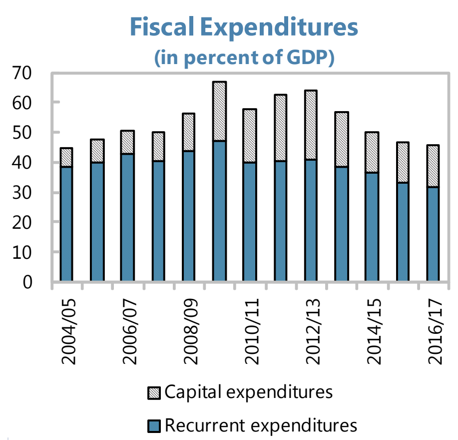
Fiscal consolidation is expected to help build international reserves



Source: Data from the authorities and staff estimates.

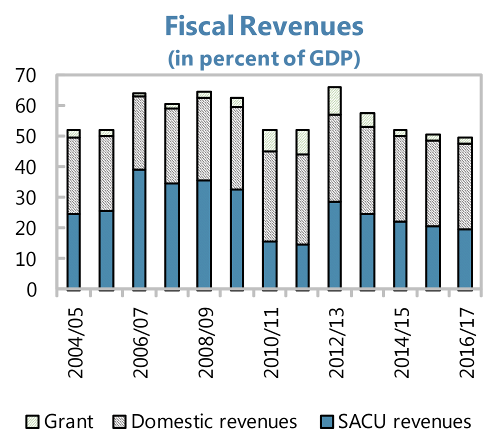
Lesotho: Medium-Term Fiscal Adjustment

Recurrent expenditures are expected to decline further over the medium-term.



Source: Data from the authorities and staff estimates.

The total revenues would be trending down, with projected decline in SACU revenues.



11. The fiscal stance is compatible with maintaining a moderate risk of debt distress over the medium term. While the public debt to GDP ratio is projected to increase temporarily to 40 percent of GDP in the medium-term on account of large infrastructure projects (including the Metolong Dam and under Lesotho Highlands Water Project Phase II), it would decline to 36½ percent by 2016/17. According to staff's recent assessment, the PV of public debt relative to GDP and to revenues would gradually rise through 2022, but remain below the respective indicative thresholds, broadly unchanged from the last debt sustainability analysis (published in May 2012).

[7] Lesotho had successfully accumulated reserves covering 5–7 months of imports in 2007–09, providing an effective cushion against the recent drop in SACU revenues. To prepare for future shocks, international reserves are targeted at the equivalent of five months of imports.

The risk of debt distress therefore remains moderate. To ensure sound debt management, the authorities are seeking technical assistance from the IMF to review and modernize the 1967 legal framework for debt management (structural benchmark, MEFP, Table 3). They also plan to formulate a broader debt management reform plan, with assistance of the World Bank in early 2013, and intend to continue to seek external financing through grants and concessional loans while saving any unplanned inflows.[8]

12. Given the limited international reserve cushion, the authorities are prepared to take further adjustment measures, should global/regional economic conditions further deteriorate. To keep the fiscal balance targets, they are working on contingency plans that would rely on larger reductions of recurrent expenditures, in case of any shortfall in non-SACU revenues. In the event of additional exogenous (e.g., lower SACU revenues from 2013/14, drop in global diamond prices), further efforts would be made to achieve fiscal adjustments—involving the postponement of capital projects of less priority. Mobilizing external assistance from Lesotho's development partners would also be called for in order to keep international reserves from falling further from the current level (3⅓ months of imports) and to safeguard critical social and infrastructure spending. The staff advised the authorities to stay vigilant on Lesotho's external environment and be prepared to take such contingency plans in a timely fashion.

B. Promoting Private Sector Development

13. The authorities continue to commit to implementing reforms to improve the business climate to support private sector-led growth and economic diversification. The Industrial Licensing Bill (structural benchmark, MEFP, Table 3), which has been submitted to Parliament, is expected to improve the licensing process, further reducing delays and making the whole procedure transparent. The Companies Act 1967 has been reviewed and the new Companies Act 2011 came into operation in June 2012, introducing a simple and cost effective mechanism for incorporation and registration of companies. Furthermore, under the recently launched National Strategic Development Plan (NSDP), several key reforms are envisaged. The authorities commit to improving the process for obtaining work and residence permits to facilitate foreign investment (e.g., creating an overarching investment policy, fully implementing the 2010 Land Act and the new Companies Act). The NSDP views the private sector as the engine of growth and employment creation, while acknowledging "uncompetitive business environment," as one of the most binding constraints to the sector. Specifically those constraints include high regulatory burden to open and close business and difficult access to credit.

14. These reforms have led to recent improvement in the business climate, though Lesotho still lags behind other countries in the region. Lesotho's ranking in the World Bank Doing Business Indicators improved to the 136th in the 2013 indicator from the 153rd of the previous

[8] Spending commitments under Lesotho Highlands Water Project Phase II (LHWP2) remain uncertain and the authorities are assessing medium-term financing options. It is unlikely, however, that financing will be available on concessional terms. Thus, provisions for additional nonconcessional financing may need to be considered in the future. Furthermore, in light of additional financing needs for the Metolong Dam Project, a financial package of loans and grant from several sources are being negotiated, with a view to making the overall package concessional.

year, largely driven by improvements in starting business and protecting investors. This level, however, is still the lowest among regional peers and relative to other countries at its per capita GDP level.

World Bank Doing Business Indicators; Lesotho and Neighboring Countries (Ranking out of 186 countries)

	Indicators	Ease of Doing Business Rank	Starting a Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Enforcing Contracts
South Africa	2013	39	53	39	150	79	1	10	32	82
Botswana	2013	59	99	132	90	51	53	49	39	68
Namibia	2013	87	133	56	87	169	40	82	112	41
Zambia	2013	94	74	151	151	96	12	82	47	89
Swaziland	2013	123	165	41	156	129	53	128	58	174
Mozambique	2013	146	96	135	174	155	129	49	105	132
Angola	2013	172	171	124	113	131	129	70	154	183
Zimbabwe	2013	172	143	170	157	85	129	128	134	111
Lesotho	2012	153	144	138	136	150	152	147	97	154
Lesotho	2013	136	79	140	133	157	154	100	95	139

Source: World Bank the 2013 Doing Business Report.

15. The authorities are embarking on financial sector development reforms.[9] The banking sector is stable, though access to banking services for households and small enterprises remains limited (Box 3). The CBL is in the process of restructuring and building its capacity to effectively implement the new Financial Institutions Act (FIA). Furthermore, the Insurance Act of 1976 has been reviewed and will be amended soon to strengthen supervision and regulation for the sector, based on technical assistance from the IMF (structural benchmark, MEFP, Table 3). The authorities, supported by development partners, have also been implementing reforms to improve access to financial services, including through the establishment of a partial guarantee scheme. With technical assistances from the Fund and the Bank, the CBL has embarked on the preparation of a Financial Sector Development Strategy (FSDS). Enhanced access to financial services under proper supervisory oversight—supporting private sector development—would help achieve the program objective of broad-based growth for poverty reduction.

[9] The FIA has been enacted since April 2012. It would address vulnerabilities in the financial sector and help deal with the problems of Ponzi schemes, by enhancing the CBL's investigative powers and its ability to grant timely protection to depositors and customers against unlawful credit and banking business.

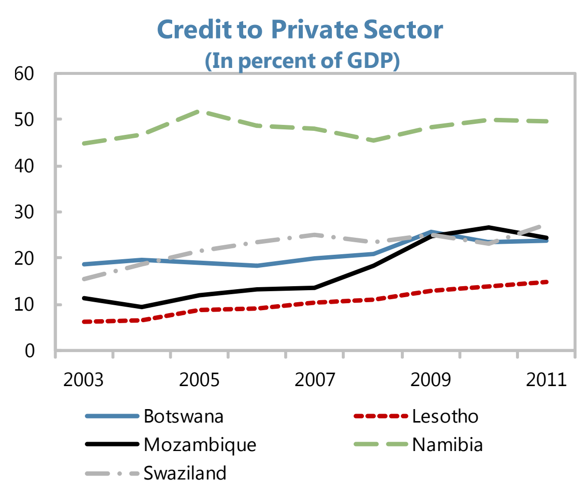
Box 3. Performance of Banking System

Lesotho's banking system—characterized by the dominance of subsidiaries of South African banks—has been stable. Performance indicators suggest that banks are well capitalized, liquid and profitable, and indicators of asset quality do not signal any obvious weaknesses (Table 6).

The system, however, could be subject to several risks. Domestic risks exist in the form of concentration risk in banks' loan books and among depositors, and some element of credit risk. The most significant risk is cross-border contagion from South Africa in the event of serious distress of a parent bank. Stress test results confirm that both solvency and liquidity of the banks are largely contingent on the shock absorbing capacity of their South African parents.

To address risks to the banking system, the CBL has made good progress in upgrading its supervisory infrastructure, policies and procedures. In April 2012, the Financial Institutions Act was enacted, updating supervision and regulation for banks and nonblank institutions. In light of the dominance of the subsidiaries of South African banking groups, the cross-border cooperation of national authorities has been strengthened through formulating a Memorandum of Understanding (MOU) with the South African Reserve Bank (SARB). A Risk Based Supervision (RBS) regime has also been introduced, with enhanced on-site examination and off-site surveillance.

Access to banking services for households and small enterprises has been limited, compared with other countries in the region. Credit to private sector, though recovering gradually, has been low. **The authorities have recently stepped up their efforts to improve access to credit by the private sector.** Supported by development partners, reforms to improve access to financial services have been implemented, including through the establishment of a partial guarantee scheme. Furthermore, based on technical assistances from the Fund and the Bank, the CBL plans to prepare a FSDS as a part of the private sector development strategy to stimulate economic growth and reduce poverty.



Source: Data from the authorities and staff estimates.

PROGRAM PERFORMANCE, PROGRAM MONITORING, AND SAFEGUARDS ASSESSMENT

A. PROGRAM PERFORMANCE

16. The ECF-supported program is broadly on track. All but one quantitative performance criteria (PCs) and indicative targets for end-March 2012 and end-June 2012 were met (MEFP, Table 1). The target for newly contracted nonconcessional external debt was missed by \$92 million (3¾ percent of GDP), largely owing to the lapse of proper internal control over contracting external debt (e.g., insufficient information sharing within the public sector).[10] Net domestic financing of the government and net international reserves were well within the targets, reflecting the authorities' stepped-up adjustment efforts. The indicative target for the floor on social spending was also met. Finally, spending on key social programs, such as the school feeding program, old-age pensions, and HIV/AIDS, have been preserved, with the floor increased to M 732 million, equivalent to 3½ percent of GDP.

17. The authorities request a waiver for the missed cumulative quantitative performance criterion on new nonconcessional external debt contracted or guaranteed by the public sector, based on the corrective measures taken (MEFP, Page 2). The authorities have taken measures to strengthen debt management and monitoring, including reactivating the high level Debt Management Committee to screen all proposed loans and guarantees and to make recommendations to the Minister of Finance and Cabinet consistent with the government's legal obligations and external agreements. To strengthen the monitoring of concessionality of all proposed loans and guarantees, the authorities have started sharing all draft loan contracts with IMF staff. Going forward, the authorities are requesting that, in view of their moderate risk of debt distress and to support growth, the debt ceiling on nonconcessional external loans with a maturity of more than one year and a grant element of less than 35 percent be raised to US$274 million. This higher ceiling would accommodate nonconcessional debts already contracted from the beginning of the ECF-supported program, including the loan to finance a telecommunication networks project (the National Network Phase II Project).[11] Staff assesses that the risk of debt distress remains moderate; the fiscal position also remains consistent with achieving the program objectives.

18. Structural reforms are progressing. Two structural benchmarks (SBs) due for the fourth review (by March 2012) were implemented on time (MEFP, Table 2), while two SBs due by September 2012—a comprehensive inventory of government accounts and the submission of the Industrial Licensing Bill to Parliament—were implemented with delay. Notably, the front office revenue receipting system in three pilot ministries and one sub-accountancy was implemented, with a view to expanding the system to other ministries. The delayed audit of domestic arrears has now been completed.[12]

B. Program Monitoring

19. The PCs and benchmarks are proposed as shown in MEFP, Table 1. The authorities are requesting modification of four quantitative PCS (on net domestic assets of the central bank, net domestic financing, net international reserves, and nonconcessional external borrowing) for end-

[10] Two new nonconcessional external loans with the total amount of $92 million were contracted in 2010 and 2011. The loan of US$32 million had the grant element slightly lower than 35 percent and was used to finance a priority development project, while the second loan in the amount of US$60 million was already terminated and repaid.

[11] The project will expand, upgrade, and modernize urban and rural telecommunication infrastructure. It is a critical infrastructure project, identified as one of the priority areas in the NSDP.

[12] The recently completed audit report identified arrears in the amount of M65 million as of end-March 2012. Most arrears, except for the outstanding arrears of M 0.2 million, were cleared by end-October 2012. The arrears are of technical nature, associated with the implementation of the IFMIS.

March 2013. The modifications reflect the better-than-programmed fiscal performance for 2012/13 and higher-than expected recovery of international reserves through mid-2012. Completion of the fifth and sixth reviews of the arrangement by February 20, 2013, and May 20, 2013, respectively, will be based on the observance of quantitative PCs through end-September 2012 and end-March 2013, respectively (MEFP, Table 1). The targets for end-December 2012 will be indicative. Structural benchmarks have been established through end-December 2012, and new structural benchmarks on (i) the amendments of the Loans and Guarantees Act, (ii) the establishment of a full-service Large Tax Payers Unit, and (iii) the submission of the Insurance Bill to Parliament are proposed (MEFP, Table 3). The definitions of the variables monitored as quantitative PCs are provided in the Technical Memorandum of Understanding (TMU), Appendix III.

C. Safeguards Assessment

20. An update safeguards assessment is being conducted in connection with the augmentation of the ECF arrangement. The assessment, which is substantially complete, confirmed that the CBL has taken steps to strengthen safeguards since the 2010 assessment, but also that risks remain. Deloitte (South Africa) has been appointed as external auditor for 2010–12. The 2010 and 2011 audits were completed within three months after year-end. Aspects of the monetary data reporting process have been strengthened with Fund technical assistance, but the recommended internal audits of test date data have not been fully conducted. The update assessment identified a foreign loan that breaches the program's performance criterion for new nonconcessional borrowing, indicating remaining vulnerability in internal controls. Audit oversight and internal audit remain areas where improvements are needed to strengthen overall governance and accountability.

STAFF APPRAISAL

21. Lesotho achieved robust growth performance, despite exogenous shocks. For the last two years, robust growth was maintained, while the shocks were absorbed through the authorities' adjustment efforts and drawdown of reserves (from a high level). To maintain a favorable growth trend over the long-term, timely implementation of structural reforms, as set out in the NSDP, is called for. Specifically it is important to promote private sector development through fast-tracking of structural reforms, focusing on improving business climate and enhancing access to credit.

22. In view of the low level of international reserves, it is important to maintain fiscal consolidation efforts. Staff welcomes the authorities' stepped-up consolidation efforts, which resulted in larger-than-originally programmed accumulation of international reserves, despite exogenous shocks (e.g., floods and high international commodity prices in 2011, followed by a severe food crisis now). In light of the estimated magnitude of the shocks, further efforts are encouraged to mobilize additional donor support. Building on this achievement, the authorities should maintain the adjustment path, particularly in light of significant downside risks, mainly stemming from the uncertain global economic outlook. In this regard, staff welcomes the new government's continued commitment to the program.

23. The planned fiscal consolidation path is appropriate to achieve the medium-term target on international reserves. Staff continues to support the authorities' objective of building up the international reserve cushion to a minimum of five months of imports. To achieve this objective, staff welcomes the new government's commitment to staying the course on fiscal consolidation. The fiscal consolidation measures (including enhanced revenue administration efforts and tightly controlled recurrent spending while maintaining key infrastructure spending), if implemented as planned, should help achieve the growth and reserve objectives. In the event of a global economic slowdown, additional adjustment efforts should be sought to alleviate potential pressures on Lesotho's external balance, while safeguarding critical social and infrastructure spending. The authorities should stay vigilant over external developments.

24. Structural fiscal reforms remain important to aid the consolidation effort. Specifically stepped-up efforts are called for to strengthen public financial management. Following the completion of an audit of domestic arrears, the authorities should focus on completing the reconciliation of government accounts and strengthening cash management. Staff also welcomes the authorities' interest in pursuing a comprehensive PFM reform plan based on technical assistance from the IMF and the support of donors. On the revenue side, staff welcomes the ongoing efforts to restructure the LRA, including the operationalization of a full-service Large Tax Payer Unit by end-March 2013. Swift progress in these restructuring efforts should be maintained.

25. Staff welcomes the corrective measures to strengthen debt management. In particular, it is critical to make the Debt Management Committee fully functional, while strengthening the broader debt management framework (e.g., the legal framework for debt management) based on technical assistance from the IMF and Lesotho's development partners.

26. The pace of reforms to develop a sound financial sector should be maintained. Following the enactment of the new Financial Institutions Act (FIA), the CBL has been rightly embarking on restructuring and building its capacity to effectively implement the FIA, assisted by its development partners. In light of Lesotho's relatively low financial intermediation, further efforts are called for to improve access to financial services under proper supervisory oversight. Staff welcomes the CBL's plan to formulate a financial sector development strategy (FSDP), with technical assistances from the Fund and the Bank.

27. All but one quantitative PCs for the fourth review under the ECF were met, and staff supports the authorities' requests for the completion of the review and the modifications of the four quantitative PCs (on net domestic assets of the central bank, net domestic financing, net international reserves, and nonconcessional external borrowing) for end-March 2013. Given the corrective measures adopted, it supports the authorities' request for a waiver of the missed continuous PC on nonconcessional borrowing. It also supports their request to raise the nonconcessional debt ceiling to $274 million because the impact on the additional burden would be limited in an environment of continued modest risk of debt-distress; such loans would allow for financing of priority infrastructure projects. Risks to the program can be mitigated by sound policies and reforms, in coordination with Lesotho's development partners.

Table 1. Lesotho: Selected Economic Indicators, 2009/10–16/17 [1]

Population (in 1,000; 2011 est.)	2,194
GNI per capita (in U.S. dollars; 2011 est.):	1,220
Poverty rate (percent, 2005 est.):	56.6

	2009/10	2010/11	2011/12		2012/13		2013/14	2014/15	2015/16	2016/17
	Act.	Est.	EBS/12/44 [2]	Est.	BS/12/44 [2]	Proj.	Projections			
(Percentage changes; unless otherwise indicated)										
National account and prices										
GDP at constant prices	3.6	5.7	4.2	3.2	5.2	4.0	4.7	4.8	3.7	3.9
GDP deflator	4.8	3.8	6.7	9.3	7.8	7.5	7.1	7.5	6.9	7.0
GDP at market prices										
(Maloti millions)	14,865	16,310	18,136	18,395	20,559	20,568	23,063	25,968	28,782	31,976
Consumer prices (average)	5.9	3.4	5.6	6.2	5.2	5.7	5.2	4.6	4.6	4.7
External sector										
Terms of trade (deterioration -)	-4.4	4.0	-2.5	7.8	1.3	-5.3	0.5	0.5	1.4	1.3
Average exchange rate										
(local currency per U.S. dollar)	7.8	7.2	…	7.4	…	…	…	…	…	…
Nominal effective exchange rate change (– = depreciation) [3]	31.5	4.0	…	-7.1	…	…	…	…	…	…
Real effective exchange rate (– = depreciation) [3]	33.4	4.8	…	-3.1	…	…	…	…	…	…
Current account balance										
(including official transfers, in percent of GDP)	-3.2	-14.8	-16.6	-25.3	-11.2	-8.7	-14.6	-5.1	-1.1	1.3
(excluding official transfers, in percent of GDP)	-37.5	-36.9	-36.2	-45.2	-45.2	-42.2	-42.7	-29.4	-23.8	-20.5
Gross international reserves										
(months of imports)	5.3	3.8	3.0	3.4	3.5	3.6	4.3	4.6	4.8	5.1
(percent of M1)	176.0	144.4	116.3	138.7	130.7	145.0	158.8	139.4	151.1	164.3
Money and credit [4]										
Domestic credit to the private sector	20.7	26.9	21.9	25.1	…	…	…	…	…	…
Broad money	11.9	1.1	12.3	5.0	…	…	…	…	…	…
Interest rate (percent) [5]	3.4	2.7	…	2.3	…	…	…	…	…	…
(Percent of GDP; unless otherwise indicated)										
Savings and investment										
Gross capital formation	28.6	28.5	36.9	35.3	46.1	42.7	45.7	34.0	33.6	32.7
Government	11.4	13.4	18.6	19.8	23.7	21.5	17.8	15.0	17.7	17.0
Private	17.0	15.4	18.1	15.4	22.3	21.1	27.8	18.9	15.7	15.6
National savings	25.5	13.7	20.3	10.0	35.0	34.0	31.2	28.9	32.5	34.0
Government	11.3	6.4	8.8	10.0	23.4	23.1	17.8	14.5	15.6	15.5
Private	14.2	7.3	11.5	0.0	11.5	10.9	13.4	14.3	16.9	18.5
Public debt	37.2	35.2	39.6	40.4	42.2	38.8	39.7	38.2	37.5	36.4
External public debt	33.7	30.4	33.7	34.5	35.9	33.3	34.9	33.9	33.6	32.9
Domestic debt	3.5	4.8	6.0	5.8	6.3	5.4	4.8	4.3	3.9	3.5
Central government fiscal operations										
Net lending/borrowing	-3.9	-5.0	-10.5	-10.4	0.2	2.3	1.3	2.3	3.8	4.0
(excluding grants)	-6.9	-12.4	-19.0	-18.2	-8.8	-6.5	-3.4	0.2	1.8	2.0
Non SACU fiscal balance [6]	-35.2	-20.4	-23.3	-23.4	-23.6	-23.2	-19.0	-17.4	-14.5	-13.8
Revenue	62.8	52.5	51.6	52.2	65.5	66.0	57.9	52.5	50.6	49.6
Of which: grants	3.0	7.4	8.5	7.8	9.0	8.7	4.7	2.1	2.0	2.0
Expenses	55.8	45.7	47.7	47.1	47.3	47.8	43.2	40.4	37.7	36.5
Nonfinancial assets	10.9	11.8	14.4	15.5	18.0	16.0	13.5	9.7	9.1	9.2

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Values as in the first ECF review. Calendar year projections.

[3] IMF Information Notice System trade-weighted; end of period.

[4] Percent of beginning-of-period broad money.

[5] 12-month time deposits rate.

[6] Excluding externally financed capital project.

Table 2. Lesotho: Fiscal Operations of the Central Government, 2009/10–2016/17 [1]

(Maloti millions)

	2009/10	2010/11	2011/12		2012/13		2013/14	2014/15	2015/16	2016/17
	Actual	Actual	EBS/12/44 [2]	Est.	EBS/12/44 [2]	Proj.	Projections			
Revenue	9,328	8,559	9,366	9,604	13,470	13,581	13,364	13,635	14,566	15,875
Tax revenue	3,185	3,499	3,920	4,258	4,414	4,896	5,443	5,979	6,631	7,343
Taxes on income, profits, and capital gain	1,772	1,957	2,205	2,395	2,560	2,686	2,954	3,235	3,567	3,951
Taxes on property	96	106	138	125	142	148	178	212	251	279
Taxes on goods and services	1,290	1,414	1,497	1,565	1,522	1,861	1,974	2,071	2,230	2,444
Taxes on international trade	21	18	78	151	186	200	330	454	575	661
Other taxes	6	109	2	22	4	1	7	7	8	8
Grants	445	1,200	1,549	1,437	1,846	1,792	1,094	556	582	637
Budget support	0	372	207	290	300	300	300	120	120	120
Project grants	445	828	1,336	1,147	1,546	1,492	794	436	462	517
Of which: MCC	270	295	739	575	1,030	1,027	254	0	0	0
Non-tax revenue	780	1,232	1,145	1,156	1,244	926	1,036	1,274	1,329	1,497
Property Income	217	652	411	433	437	120	173	354	354	389
Sales of goods and services	502	530	703	692	758	757	818	875	932	1,060
Other non-tax revenue	61	50	32	31	49	49	45	46	44	48
SACU	4,918	2,628	2,753	2,753	5,966	5,966	5,791	5,826	6,024	6,398
Of which: volatile component	2,688	181	43	-7	2,883	2,881	2,331	1,930	1,707	1,602
Expense	8,293	7,459	8,645	8,660	9,729	9,830	9,953	10,504	10,864	11,657
Compensation of employees	3,144	3,199	3,601	3,614	4,062	4,084	4,336	4,612	4,835	5,207
Wages and salaries	2,677	2,881	3,203	3,102	3,572	3,594	3,807	4,072	4,177	4,515
Social contributions	465	319	438	513	490	490	586	625	658	692
Use of goods and services	2,549	1,918	1,994	2,179	2,965	2,946	2,813	2,856	2,923	3,299
Interest payments	118	96	151	137	223	172	197	211	228	239
Domestic	51	43	77	68	90	95	103	107	107	107
External	67	53	75	69	133	77	94	104	121	132
Subsidies	273	232	283	237	310	273	255	255	239	251
Grants	984	707	1,076	962	731	896	901	938	934	886
Social benefits	555	600	577	587	717	739	696	841	873	933
Other expenses	670	707	962	943	720	720	756	790	832	842
Gross operating balance	1,035	1,100	722	944	3,741	3,751	3,411	3,131	3,703	4,218
Nonfinancial assets	1,616	1,923	2,618	2,848	3,698	3,287	3,103	2,529	2,616	2,937
Net lending/borrowing	-581	-822	-1,897	-1,904	43	464	308	602	1,087	1,281
Transactions in financial assets and liabilities	185	-337	-1,897	-1,331	43	464	308	602	1,087	1,281
Financial assets	-178	-663	-1,359	-870	1,061	1,010	1,129	1,039	1,580	1,753
Domestic	-179	-663	-1,361	-870	1,060	1,008	1,128	1,037	1,578	1,752
Deposits	-179	-666	-1,357	-870	1,063	1,011	1,129	1,039	1,578	1,752
Central bank	-163	-646	-1,357	-870	1,063	1,011	1,129	1,039	1,578	1,752
Commercial banks	-16	-21	0	0	0	0	0	0	0	0
Loans	0	3	-4	0	-3	-3	-1	-1	0	0
Financial liabilities	-363	-326	538	461	1,018	545	822	437	493	472
Domestic	-382	-253	272	323	172	45	0	0	0	0
Foreign	20	-73	266	138	846	500	822	437	493	472
Disbursements	274	128	444	359	1,080	733	1,106	705	761	717
Amortization	-254	-201	-178	-221	-233	-232	-285	-268	-268	-245
Statistical discrepancy	-766	-485	0	-573	0	0	0	0	0	0
Memorandum items:										
Recurrent expenditure	7,136	6,385	7,510	7,472	8,374	8,396	8,839	9,474	9,574	10,201
Capital expenditure	2,774	2,996	3,753	4,035	5,053	4,720	4,217	3,558	3,905	4,393
Domestically financed	2,055	1,884	1,973	2,538	2,427	2,376	2,451	2,564	2,683	3,159
Externally financed	719	1,112	1,780	1,497	2,626	2,344	1,767	994	1,223	1,234
Non SACU fiscal balance, including foreign financed capital projects	-5,499	-3,450	-4,650	-4,657	-5,923	-5,502	-5,483	-5,223	-4,937	-5,117
Non SACU fiscal balance, excluding foreign financed capital projects [3]	-5,226	-3,323	-4,206	-4,298	-4,844	-4,769	-4,377	-4,519	-4,176	-4,400
Core SACU fiscal balance (ex. volatile SACU and foreign project loans) [3, 4]	-2,996	-876	-1,496	-1,539	-1,760	-1,684	-917	-624	141	396

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Values as in the Second and Third ECF review.

[3] The figures for EBS/12/44 are revised to incorporate the correction of the amount of foreign financed capital projects.

[4] Core SACU revenue is set at 15 percent of GDP, the lowest historical level.

Table 3. Lesotho: Fiscal Operations of the Central Government, 2009/10–16/17 [1]

(Percent of GDP)

	2009/10	2010/11	2011/12		2012/13		2013/14	2014/15	2015/16	2016/17
	Actual	Actual	EBS/12/44 [2]	Est.	EBS/12/44 [2]	Proj.	Projections			
Revenue	62.8	52.5	51.6	52.2	65.5	66.0	57.9	52.5	50.6	49.6
Tax revenue	21.4	21.5	21.6	23.1	21.5	23.8	23.6	23.0	23.0	23.0
Taxes on income, profits, and capital gain	11.9	12.0	12.2	13.0	12.5	13.1	12.8	12.5	12.4	12.4
Taxes on property	0.6	0.6	0.8	0.7	0.7	0.7	0.8	0.8	0.9	0.9
Taxes on goods and services	8.7	8.7	8.3	8.5	7.4	9.0	8.6	8.0	7.7	7.6
Taxes on international trade	0.1	0.1	0.4	0.8	0.9	1.0	1.4	1.7	2.0	2.1
Grants	3.0	7.4	8.5	7.8	9.0	8.7	4.7	2.1	2.0	2.0
Budget Support	0.0	2.3	1.1	1.6	1.5	1.5	1.3	0.5	0.4	0.4
Project grants	3.0	5.1	7.4	6.2	7.5	7.3	3.4	1.7	1.6	1.6
Of which: MCC	1.8	1.8	4.1	3.1	5.0	5.0	1.1	0.0	0.0	0.0
Non-tax revenue	5.3	7.6	6.3	6.3	6.0	4.5	4.5	4.9	4.6	4.7
Property income	1.5	4.0	2.3	2.4	2.1	0.6	0.7	1.4	1.2	1.2
Sales of goods and services	3.4	3.3	3.9	3.8	3.7	3.7	3.5	3.4	3.2	3.3
Other non-tax revenue	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
SACU	33.1	16.1	15.2	15.0	29.0	29.0	25.1	22.4	20.9	20.0
Of which: volatile component	18.1	1.1	0.2	0.0	14.0	14.0	10.1	7.4	5.9	5.0
Expense	55.8	45.7	47.7	47.1	47.3	47.8	43.2	40.4	37.7	36.5
Compensation of employees	21.1	19.6	19.9	19.6	19.8	19.9	18.8	17.8	16.8	16.3
Wages and salaries	18.0	17.7	17.7	16.9	17.4	17.5	16.5	15.7	14.5	14.1
Social contributions	3.1	2.0	2.4	2.8	2.4	2.4	2.5	2.4	2.3	2.2
Use of goods and services	17.1	11.8	11.0	11.8	14.4	14.3	12.2	11.0	10.2	10.3
Health care	1.9	1.8	…	2.8	…	3.8	3.6	3.4	3.4	3.4
Interest payments	0.8	0.6	0.8	0.7	1.1	0.8	0.9	0.8	0.8	0.7
Domestic	0.3	0.3	0.4	0.4	0.4	0.5	0.4	0.4	0.4	0.3
External	0.4	0.3	0.4	0.4	0.6	0.4	0.4	0.4	0.4	0.4
Subsidies	1.8	1.4	1.6	1.3	1.5	1.3	1.1	1.0	0.8	0.8
Grants	6.6	4.3	5.9	5.2	3.6	4.4	3.9	3.6	3.2	2.8
Social benefits	3.7	3.7	3.2	3.2	3.5	3.6	3.0	3.2	3.0	2.9
Other expenses	4.5	4.3	5.3	5.1	3.5	3.5	3.3	3.0	2.9	2.6
Gross operating balance	7.0	6.7	4.0	5.1	18.2	18.2	14.8	12.1	12.9	13.2
Non-financial assets	10.9	11.8	14.4	15.5	18.0	16.0	13.5	9.7	9.1	9.2
Net lending(+)/borrowing (-)	-3.9	-5.0	-10.5	-10.4	0.2	2.3	1.3	2.3	3.8	4.0
Transactions in financial assets and liabilities	1.2	-2.1	-10.5	-7.2	0.2	2.3	1.3	2.3	3.8	4.0
Financial assets	-1.2	-4.1	-7.5	-4.7	5.2	4.9	4.9	4.0	5.5	5.5
Domestic	-1.2	-4.1	-7.5	-4.7	5.2	4.9	4.9	4.0	5.5	5.5
Deposits	-1.2	-4.1	-7.5	-4.7	5.2	4.9	4.9	4.0	5.5	5.5
Central bank	-0.1	-4.0	-7.5	-4.7	5.2	4.9	4.9	4.0	5.5	5.5
Commercial banks	-1.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities	-2.4	-2.0	3.0	2.5	5.0	2.7	3.6	1.7	1.7	1.5
Domestic	-2.6	-1.6	1.5	1.8	0.8	0.2	0.0	0.0	0.0	0.0
Foreign	0.1	-0.4	1.5	0.7	4.1	2.4	3.6	1.7	1.7	1.5
Disbursements	1.8	0.8	2.4	2.0	5.3	3.6	4.8	2.7	2.6	2.2
Amortization	-1.7	-1.2	-1.0	-1.2	-1.1	-1.1	-1.2	-1.0	-0.9	-0.8
Statistical discrepancy	-5.2	-3.0	0.0	-3.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:										
Recurrent expenditure	48.0	39.1	41.4	40.6	40.7	40.8	38.3	36.5	33.3	31.9
Capital expenditure	18.7	18.4	20.7	21.9	24.6	22.9	18.3	13.7	13.6	13.7
Domestically financed	13.8	11.6	10.9	13.8	11.8	11.6	10.6	9.9	9.3	9.9
Externally financed	4.8	6.8	9.8	8.2	12.8	10.8	8.2	4.4	4.2	3.9
Non SACU fiscal balance, including foreign financed capital projects	-37.0	-21.2	-25.6	-25.3	-28.8	-26.8	-23.8	-20.1	-17.2	-16.0
Non SACU fiscal balance, excluding foreign financed capital projects [3]	-35.2	-20.4	-23.3	-23.4	-23.6	-23.2	-19.0	-17.4	-14.5	-13.8
Core SACU fiscal balance (ex. volatile SACU and foreign project loans) [3, 4]	-20.2	-5.4	-8.3	-8.4	-8.6	-8.2	-4.0	-2.4	0.5	1.2

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Values as in the Second and Third ECF review.

[3] The figures for EBS/12/44 are revised to incorporate the correction of the amount of foreign financed capital projects.

[4] Core SACU revenue is set at 15 percent of GDP, the lowest historical level.

Table 4. Lesotho: Monetary Accounts, 2011–13 [1, 2]

(Maloti millions; unless otherwise indicated)

	2011 Mar.	2012 Mar.		2012 June		2012 Sept.		2012 Dec.		2013 Mar.	
	Act.	EBS/12/44[3]	Est.	EBS/12/44[3]	Proj.	EBS/12/44[3]	Proj.	EBS/12/44[3]	Proj.	EBS/12/44[3]	Proj.
					Depository Corporations Survey						
Net foreign assets	9,304	8,349	8,801	8,170	8,727	8,251	8,871	8,651	9,037	9,641	9,586
Central bank	5,801	4,940	5,975	4,836	5,924	4,786	6,068	5,176	6,234	6,319	6,712
Commercial banks	3,503	3,409	2,827	3,335	2,803	3,465	2,803	3,475	2,803	3,322	2,874
Net domestic assets	-3,091	-1,370	-2,277	-1,350	-1,879	-949	-1,821	-1,238	-2,242	-1,968	-2,229
Claims on central government (net)	-2,922	-1,378	-1,729	-1,295	-2,327	-1,216	-2,503	-1,525	-2,731	-2,219	-2,695
Central bank	-3,477	-2,148	-2,568	-2,065	-3,168	-1,987	-3,366	-2,295	-3,593	-3,239	-3,579
Commercial banks	555	770	839	770	841	770	863	770	863	1,020	884
Claims on private sector	2,326	2,836	2,909	2,930	3,143	3,144	3,375	3,208	3,513	3,215	3,454
Other items (net)	-2,501	-2,831	-3,458	-2,992	-2,698	-2,896	-2,712	-2,925	-3,038	-2,968	-2,990
Broad money	6,213	6,979	6,525	6,820	6,848	7,302	7,050	7,413	6,796	7,673	7,357
Currency outside banks	529	786	643	636	722	774	699	711	577	843	655
Deposits	5,683	6,193	5,881	6,184	6,127	6,528	6,351	6,702	6,218	6,830	6,702
Memorandum items:				(12–month percentage change; unless otherwise indicated)							
Broad money	1.1	12.3	5.0	8.2	8.6	4.1	0.5	4.4	1.4	9.9	12.8
Credit to the private sector	26.9	21.9	25.1	20.4	29.2	20.1	28.9	16.9	30.8	13.4	18.7
Credit to the private sector (in percent of GDP)	12.6	13.8	14.1	14.3	15.3	15.3	16.4	15.6	17.1	14.7	15.0
Velocity (GDP/broad money)	3.0	2.9	3.2	3.0	3.0	2.8	2.9	2.8	3.0	2.9	3.1

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Including valuation changes.

[3] Values as in the joint second and third ECF reviews.

Table 5. Lesotho: Balance of Payments, 2009/10–16/17 [1]

(US$ millions; unless otherwise indicated)

	2009/10	2010/11	2011/12		2012/13		2013/14	2014/15	2015/16	2016/17
	Act.	Est.	EBS/12/44 [3]	Est.	EBS/12/144 [3]	Proj.	Projections			
Current account	-60	-336	-407	-629	-296	-227	-407	-155	-34	46
Trade balance	-951	-1,062	-1,088	-1,095	-1,288	-1,284	-1,329	-948	-742	-753
Exports, f.o.b.	779	951	1,103	1,106	1,242	1,122	1,284	1,527	1,700	1,806
Imports, f.o.b	-1,730	-2,013	-2,191	-2,200	-2,530	-2,406	-2,614	-2,475	-2,442	-2,560
Services (net)	-417	-495	-490	-528	-504	-476	-471	-469	-473	-487
Income (net)	512	551	516	319	422	406	356	303	251	327
Of which: interest on public debt	-8	-7	-10	-8	-14	-10	-11	-12	-12	-14
Transfers	796	671	654	674	1,074	1,127	1,037	958	930	960
Official transfers	652	501	480	497	899	874	786	732	733	754
Other transfers	144	169	174	177	174	253	251	226	197	206
Capital and financial account	25	15	253	286	444	333	547	228	153	142
Capital account	84	55	157	144	171	166	84	45	49	50
Financial account	-58	-40	96	142	274	167	463	183	105	91
Foreign direct	109	120	200	138	332	299	517	299	223	236
Portfolio investment	0	0	0	0	0	0	0	0	0	0
Other investment	-167	-159	-105	4	-58	-132	-54	-116	-118	-145
Medium and long-term	-167	-159	-105	4	-58	-132	-54	-116	-118	-145
Of which:										
Public sector (net)	2	-10	36	19	109	63	100	51	55	51
Disbursements	35	18	60	49	139	93	134	82	85	77
Amortization	-32	-28	-24	-30	-30	-29	-35	-31	-30	-26
Errors and omissions	-6	70	0	372	0	0	0	0	0	0
Overall balance	-40	-250	-154	29	148	106	140	73	119	188
Financing	40	250	154	-29	-148	-106	-140	-73	-119	-188
Memorandum items:					(Percent of GDP)					
Current account	-3.2	-14.8	-16.6	-25.3	-11.2	-8.7	-14.6	-5.1	-1.1	1.3
Trade balance	-50.0	-46.9	-44.4	-44.0	-48.6	-49.2	-47.5	-31.3	-23.0	-21.8
Capital and financial account	1.3	0.7	10.3	11.5	16.8	12.8	19.6	7.5	4.8	4.1
Overall balance	-2.1	-11.0	-6.3	1.1	5.6	4.1	5.0	2.4	3.7	5.4
Gross international reserves										
(US$ millions) [4]	1,105	961	779	816	918	962	1,091	1,156	1,255	1,418
(months of imports)	5.3	3.8	3.0	3.4	3.5	3.6	4.3	4.6	4.8	5.1

Sources: Lesotho authorities and IMF staff estimates and projections.

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

[2] Values as in the original ECF request. Calendar year projections.

[3] Values as in the first ECF review. Calendar year projections.

[4] Including the SDR allocation in 2009.

Table 6. Lesotho: Commercial Bank Performance Ratios, 2005–12

(As of end-December; percent)

	2005	2006	2007	2008	2009	2010	2011	2012 [1]
I. Capital adequacy								
a) Basel capital ratio	22.0	19.0	14.0	13.7	13.6	15.0	16.2	18.1
b) Nonperforming loans net of provisions to capital	0.3	-5.4	-13.4	-13.5	-9.3	0.5	-1.3	-7.5
c) Top 20 exposures to statutory capital and reserves	220	386	469	314	364	523	536	509
II. Asset quality								
a) Loans to deposit ratio	29.0	24.9	28.6	29.1	32.4	35.4	38.6	49.7
b) Earning assets to total assets	93.0	90.3	91.9	93.4	88.8	93.2	91.0	95.0
c) Nonperforming loans to total assets	2.0	2.0	2.0	4.0	3.1	3.1	2.9	2.3
d) Reserve for losses to total loans	3.0	2.8	2.6	4.0	4.3	3.1	3.0	2.9
e) Reserve for losses to nonperforming loans	167.0	131.8	193.0	195.7	136.2	98.3	104.3	123.4
III. Liquidity								
a) Liquidity assets to total deposits	120	101	95	101	99	102	97	87
b) Available reserves to total deposits	8.0	3.5	3.4	1.9	3.5	3.6	3.8	2.9
c) Liquid assets to total assets	77	78	76	76	72	74	70	65
d) Current assets to current liabilities	86	105	107	106	107	108	108	110
IV. Profitability								
a) Net interest margin	…	4.5	5.5	6.4	6.0	5.1	5.3	3.3
b) Cost to income	…	65	61	57	56	56	59	59
c) Return on assets (ROA) [2]	2.0	0.3	1.7	2.7	2.8	2.7	2.6	1.8
d) Return on equity [2]	15.0	4.5	21.0	36.2	33.2	30.9	28.1	16.8

Source: Central Bank of Lesotho.

[1] Data as of June 2012.

[2] The return on assets and equity at end-June 2012 were affected by dividend payments.

Table 7. Lesotho: Indicators of Capacity to Repay the IMF[1]

	2011/12 Est.	2012/13 Proj.	2013/14 Proj.	2014/15 Proj.	2015/16 Proj.	2016/17 Proj.	2017/18 Proj.	2018/19 Proj.	2019/20 Proj.	2020/21 Proj.	2021/22 Proj.	2022/23 Proj.	2023/24 Proj.
IMF obligations based on existing credit													
(Millions of SDRs)													
Principal	4.6	1.1	1.8	0.4	0.8	2.1	4.7	11.4	6.7	5.9	4.6	2.0	0.0
Charges and interest	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
IMF obligations based on existing and prospective credit[2]													
(Millions of SDRs)													
Principal	4.6	1.1	1.8	0.4	0.8	2.1	4.7	13.7	10.1	9.4	8.0	5.4	0.6
Charges and interest	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.0	0.0	0.0
Total obligations based on existing and prospective credit													
Millions of SDRs	4.6	1.1	1.8	0.5	0.9	2.3	4.8	13.9	10.2	9.4	8.0	5.4	0.6
Millions of US$	7.4	1.7	2.8	0.7	1.4	3.6	7.6	22.0	16.1	14.8	12.7	8.6	0.9
Percent of exports of goods and services	0.6	0.1	0.2	0.0	0.1	0.2	0.4	1.0	0.7	0.6	0.4	0.3	0.0
Percent of debt service	15.2	3.3	4.8	1.3	2.6	6.8	15.1	44.6	29.0	30.5	24.2	15.6	1.6
Percent of GDP	0.3	0.1	0.1	0.0	0.0	0.1	0.2	0.5	0.4	0.3	0.2	0.2	0.0
Percent of gross international reserves	0.9	0.2	0.3	0.1	0.1	0.3	0.5	1.3	1.0	0.9	0.7	0.4	0.0
Percent of quota	13.2	3.0	5.0	1.3	2.6	6.4	13.8	39.9	29.3	27.0	23.0	15.6	1.6
Outstanding IMF credit													
Millions of SDRs	18.0	47.0	51.0	50.6	49.8	47.7	43.0	33.4	23.3	14.0	6.0	0.6	0.0
Millions of US$	28.8	74.7	80.8	80.1	78.7	75.3	67.8	52.8	36.8	22.1	9.4	0.9	0.0
Percent of exports of goods and services	2.5	6.5	6.1	5.1	4.5	4.1	3.5	2.4	1.5	0.8	0.3	0.0	0.0
Percent of debt service[3]	59.3	145.7	138.3	143.6	141.7	144.4	134.0	107.0	66.2	45.4	18.0	1.6	0.0
Percent of GDP	1.2	2.9	2.9	2.6	2.4	2.2	1.7	1.3	0.8	0.5	0.2	0.0	0.0
Percent of Gross International Reserves	3.5	7.8	7.4	6.9	6.3	5.3	4.3	3.2	2.2	1.3	0.5	0.0	0.0
Percent of quota	51.7	134.8	146.0	145.0	142.8	136.7	123.2	95.8	66.8	40.1	17.1	1.6	0.0
Net use of IMF credit (millions of SDRs)	1.1	30.4	3.9	-0.4	-0.8	-2.1	-4.7	-13.7	-10.1	-9.4	-8.0	-5.4	-0.6
Disbursements	5.7	31.4	5.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repayments	4.6	1.1	1.8	0.4	0.8	2.1	4.7	13.7	10.1	9.4	8.0	5.4	0.6
Memorandum items:													
Exports of goods and services (millions of US$)	1,139	1,156	1,320	1,564	1,738	1,844	1,922	2,194	2,448	2,675	2,921	3,191	3,487
Debt service (millions of US$)[3]	48	51	58	56	56	52	51	49	56	49	52	55	56
Nominal GDP (millions of US$)	2,490	2,607	2,796	3,023	3,226	3,451	3,900	4,176	4,473	4,791	5,131	5,495	5,885
Gross international reserves (millions of US$)	816	962	1,091	1,156	1,255	1,418	1,571	1,662	1,664	1,672	1,839	2,005	2,172
Quota (millions of SDRs)	35	35	35	35	35	35	35	35	35	35	35	35	35

Sources: IMF staff estimates and projections.

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

[2] ECF disbursements of SDR 7.78 million (22.3 percent of quota) June 9, 2010; six sucessive disbursements of SDR 5.68 million (16.3 percent of quota) upon completion of each of the six reviews, through May 2013; and an additional SDR 8.73 million (25 percent of quota) to the third disbursement from augmentation of access; in total SDR 50.61 million (145 percent of quota) during 2010-13.

[3] Total debt service includes IMF repayments.

Table 8. Lesotho: Schedule of ECF Disbursements and Reviews, 2011–13[1]

Date	Conditions	Original ECF disbursement		ECF augmentation		Total disbursement	
		Millions of SDRs	Percent of quota [2]	Millions of SDRs	Percent of quota [2]	Millions of SDRs	Percent of quota [2]
9-Jun-10	Executive Board approval	7.800	22.3	-	-	7.800	22.3
4-Apr-11	Completion of the first review on a lapse-of time basis, based on observance of performance criteria through September 30, 2010	5.680	16.3	-	-	5.680	16.3
9-Apr-12	Completion of combined second and third reviews, based on observance of performance criteria through end-March 31, 2011, and end-September 30, 2011	11.360	32.6	8.725	25.0	20.085	57.6
27-Nov-12	Completion of fourth review, based on observance of performance criteria through March 31, 2012	5.680	16.3	-	-	5.680	16.3
20-Feb-13	Completion of fifth review, based on observance of performance criteria through September 30, 2012	5.680	16.3	-	-	5.680	16.3
20-May-13	Completion of sixth review, based on observance of performance criteria through March 31, 2013	5.680	16.3	-	-	5.680	16.3
Total		41.880	120.0	8.725	25.0	50.605	145.0

Source: IMF staff estimates.

[1] Disbursements are expected to take place shortly after Board meeting.

[2] Lesotho's quota is SDR 34.9 million.

Table 9. Lesotho: Millennium Development Goals

	1990	1995	2000	2005	2010
Goal 1: Eradicate extreme poverty and hunger					
Employment to population ratio, 15+, total (%)	48	50	59	55	54
Employment to population ratio, ages 15–24, total (%)	39	40	47	42	41
GDP per person employed (constant 1990 PPP $)	..	..	..	..	..
Income share held by lowest 20%	..	1	..	3	..
Malnutrition prevalence, weight for age (% of children under 5)	14	..	15	17	..
Poverty gap at $1.25 a day (PPP) (%)	..	26	..	21	..
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	..	46	..	43	..
Vulnerable employment, total (% of total employment)	..	..	..	..	..
Goal 2: Achieve universal primary education					
Literacy rate, youth female (% of females ages 15–24)	..	..	97	..	98
Literacy rate, youth male (% of males ages 15–24)	..	..	85	..	86
Persistence to last grade of primary, total (% of cohort)	..	..	55	63	..
Primary completion rate, total (% of relevant age group)	58	64	60	60	70
Total enrollment, primary (% net)	71	68	78	75	73
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliaments (%)	..	5	4	12	24
Ratio of female to male primary enrollment (%)	122	112	104	100	98
Ratio of female to male secondary enrollment (%)	146	142	132	127	138
Ratio of female to male tertiary enrollment (%)	125	112	162	134	..
Goal 4: Reduce child mortality					
Immunization, measles (% of children ages 12–23 months)	80	83	74	85	85
Mortality rate, infant (per 1,000 live births)	72	77	88	83	65
Mortality rate, under-5 (per 1,000)	89	99	127	121	85
Goal 5: Improve maternal health					
Adolescent fertility rate (births per 1,000 women ages 15–19)	..	94	91	80	68
Births attended by skilled health staff (% of total)	..	50	60	55	62
Contraceptive prevalence (% of women ages 15–49)	23	29	30	37	47
Maternal mortality ratio (modeled estimate, per 100,000 live births)	370	340	470	570	530
Pregnant women receiving prenatal care (%)	..	88	85	90	92
Unmet need for contraception (% of married women ages 15–49)	..	..	..	31	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Condom use, population ages 15-24, female (% of females ages 15–24)	..	..	..	26	..
Condom use, population ages 15-24, male (% of males ages 15–24)	..	..	..	44	..
Incidence of tuberculosis (per 100,000 people)	184	323	553	639	633
Prevalence of HIV, female (% ages 15–24)	..	..	..	..	14.2
Prevalence of HIV, male (% ages 15–24)	..	..	..	..	5.4
Prevalence of HIV, total (% of population ages 15–49)	0.8	14.3	24.5	23.6	23.6
Tuberculosis case detection rate (%, all forms)	84	89	90	82	85
Goal 7: Ensure environmental sustainability					
CO2 emissions (kg per PPP $ of GDP)	..	..	..	..	..
CO2 emissions (metric tons per capita)	..	..	..	..	..
Forest area (% of land area)	1.3	..	1.4	1.4	1.4
Improved sanitation facilities (% of population with access)	32	31	29	28	29
Improved water source (% of population with access)	61	64	74	83	85
Marine protected areas (% of territorial waters)	..	..	..	..	..
Net ODA received per capita (current US$)	85	63	19	33	57
Goal 8: Develop a global partnership for development					
Debt service (PPG and IMF only, % of exports, excl. workers' remittances)	4	6	11	6	2
Internet users (per 100 people)	0	0	0.2	2.6	3.9
Mobile cellular subscriptions (per 100 people)	0	0	1	12	32
Telephone lines (per 100 people)	1	1	1	2	2
Fertility rate, total (births per woman)	5	5	4	4	3
Other					
GNI per capita, Atlas method (current US$)	540	640	530	840	1,040
GNI, Atlas method (current US$) (billions)	0.9	1.1	1	1.7	2.2
Gross capital formation (% of GDP)	56.1	76.4	44.2	25.1	33.7
Life expectancy at birth, total (years)	59	57	48	44	47
Literacy rate, adult total (% of people ages 15 and above)	..	..	86	..	90
Population, total (billions)	0	0	0	0	0
Trade (% of GDP)	141.3	151.6	137.6	156	163

Source: World Development Indicators.

Appendix: The Kingdom of Lesotho: Letter of Intent

November 12, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431
United States of America

Dear Ms. Lagarde:

The government of the Kingdom of Lesotho, led by the Right Honorable Prime Minister Dr. Thomas Motsoahae Thabane, is determined to successfully implement the economic and financial program supported by the Extended Credit Facility (ECF) of the International Monetary Fund (IMF), which was approved by the Executive Board in June 2010.

Lesotho weathered well the unfavorable external environment resulting from a fall in revenues from the Southern African Customs Union (SACU), high international commodity prices and floods in early 2011. Lesotho's macroeconomic prospects, however, remain challenging, in view of the recent drought and uncertain global economic outlook. We remain firmly committed to the reform program aimed at achieving macroeconomic stability consistent with sustained growth and poverty reduction.

Our performance under the program supported under the ECF has remained generally favorable (Table 1). All but one performance criteria through end-March 2012 were met. We breached the continuous performance criterion on the ceiling of newly contracted nonconcessional external debt, owing to inadequate internal controls. The indicative target for the floor on social spending was also met. Two structural benchmarks (SBs) due for the completion of the fourth review were implemented on time (Table 2).

Following our discussions and consultations with the IMF staff, we hereby transmit this Letter of Intent and the attached Memorandum of Economic and Financial Policies, in which we review the implementation of the program in 2011/12 and set out the government policy commitments in 2012/13 and beyond.

To avoid future breaches of the continuous performance criterion on the ceiling of newly contracted nonconcessional external debt we have taken the appropriate corrective measures, including the resuscitation of the Debt Management Committee and steps to review the legislation regarding government loans and guarantees, and the latter is proposed as end-March 2013 structural benchmark (structural benchmark, Table 3). We have also been sharing with the Fund staff draft loan contracts under negotiations. We, therefore, request a waiver for the non-observance of the performance criterion and the completion of the fourth review of the ECF-supported program based on overall performance under the program and the Government's policy intentions going forward. We also request modification of the performance criteria for end-March 2013 to reflect the better-than-programmed fiscal performance for 2012/13 and higher-than expected recovery of international reserves through mid-2012.

We believe that the policies set forth herein are adequate to achieve the objectives of our program, notwithstanding the new macroeconomic challenges we face. The Government is committed to ensuring that the program remains on track and will continue to monitor implementation. We will continue to consult with the IMF on any new measures and/or revisions to the policies described in this letter. We will also continue to provide the IMF with timely information required to monitor progress in program implementation. We consent to the publication, including on the IMF website, of this Letter of Intent, the attached MEFP, and the accompanying staff report.

Yours sincerely,

/s/	/s/
Hon. Dr. Leketekete Victor Ketso, Minister of Finance	Dr. Rets'elisitsoe Matlanyane Governor of the Central Bank of Lesotho

Attachments

Attachment I. Memorandum of Economic and Financial Policies

I. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Lesotho has been resilient to shocks, including a decline in the SACU revenues, high international commodity prices and floods in early 2011. Nonetheless, it maintained robust growth in 2011/12, mainly driven by the mining and construction sectors. Meanwhile, inflation—though steadily rising throughout 2011—has recently subsided, consistent with regional trend. However, international reserves continued to decline, reaching US$827million, equivalent to 3.3 months of imports by end-June 2012.

We continued our fiscal consolidation efforts in 2011/12. The core SACU fiscal deficit (excluding externally financed capital projects), estimated at 8½ percent of GDP, was broadly in line with that agreed to under the third review.[1] We accommodated flood-related capital outlays and priority social spending (2.2 percent of GDP). Notwithstanding significant capital spending, we kept recurrent spending consistent with the program, while revenue collection from the mining sector further increased.

Lesotho’s macroeconomic prospects remain challenging, owing to the recent severe drought and the uncertain global economic outlook. Steady economic growth is expected, with the expansion of mining activities and the implementation of large infrastructure projects (including the Metolong dam), but downside risks are heightened, with the drought. International reserves remain low, and the uncertain global economic outlook poses risks to future SACU revenues and external demand for Lesotho’s key exports—diamonds and textiles.

We have stepped up our efforts to seek additional external support to address recent weather-related shocks (floods in early 2011 and the recent drought). The Disaster Risks Reduction Fund (DRRF), established in late 2011, has so far secured the total pledge of US$3 million by the UN Central Emergency Response, UNDP, Ireland, People’s Republic of China, and OCHA. The Government fully expended its commitment of 2.2 percent of GDP to help mitigate the disaster.

[1] The core SACU fiscal balance—defined as the fiscal balance excluding the volatile component of SACU revenues and foreign-financed project loans—is the key policy anchor for fiscal consolidation efforts. The volatile component of SACU revenues is defined as the total SACU revenues minus the core component equivalent to 15 percent of GDP, which is the lowest annual SACU receipt in the last two decades.

Owing to continued poor weather conditions, including drought and early frost in 2012, Lesotho's food insecurity situation has worsened. Over 70 percent reduction in domestic agricultural production is now expected to affect 725,000 people (over a third of the population) between September 2012 and mid 2013. Following an international appeal, the United Nations has announced funding of US$6.2 million to respond to the mounting humanitarian crisis. These funds will be allocated from the UN Central Emergency Response Fund (CERF).

II. PERFORMANCE UNDER THE PROGRAM

Performance under the program remained generally favorable. We have met all performance criteria for end-March 2012 and indicative targets for end-June 2012, with the exception of the ceiling on newly contracted nonconcessional external debt (Table 1). The indicative target for the floor on social spending was also met. Structural reforms are progressing. Two out of three structural benchmarks (SBs) through June 2012 were implemented on time, namely the front office revenue receipting system in three pilot ministries and one sub-accountancy, and the audit of domestic arrears. A comprehensive inventory of Government accounts was completed in September 2012 (Table 2).

The ceiling on the contracting of nonconcessional external loans was missed, owing to the lapse of proper internal control over contracting external debt. In light of this, we are committed to sharing future loan contracts with the IMF staff before signing. Furthermore, we have been taking corrective measures to improve the monitoring of external borrowing. Those measures include: (i) resuscitating the Debt Management Committee (comprising the Principal Secretaries of the Ministries of Finance and Development Planning, the Attorney General and the Governor), which undertakes due diligence for all new loans and guarantees and advises the Minister of Finance accordingly; (ii) strictly adhering to the legal requirements for contracting external borrowing and guarantee set out in the 2011 Public Financial Management and Accountability Act (e.g., prior cabinet approval for all external borrowing); and (iii) modernizing the debt management legal framework and bringing it in line with best international practices with the assistance of our development partners, including the IMF (structural benchmark, Table 3).

III. MACROECONOMIC POLICIES UNDER THE PROGRAM

We remain committed to a program aimed at achieving fiscal and external sustainability over the medium term while addressing our development and social needs. In light of the current uncertainty surrounding global economic outlook, we will step up fiscal consolidation efforts to restore macroeconomic stability. We consider it to be critical for accumulating an adequate level of international reserves and supporting our exchange rate peg. To prepare for future shocks, we will rebuild international reserves buffer, raising its level above five months of imports in the medium term. The current account imbalance is expected to narrow over the medium-term, in line with fiscal consolidation, supported by strong performance in the mining sector.

We will promote private sector development to achieve our objective of sustainable economic growth as the most effective route for poverty reduction. Accordingly, we will continue to enhance access to credit and improve the business climate with a view to expanding employment opportunities. In this regard, the government has committed to implementing a set of comprehensive reforms under the National Strategic Development Plan (NSDP).

Maintaining fiscal consolidation

We will step up our fiscal consolidation efforts in 2012/13, through enhanced revenue collection, while protecting spending for vulnerable groups and some priority infrastructure and ensuring efficiency in public service delivery. We are targeting an overall fiscal surplus of 2⅓ percent of GDP, and a core SACU fiscal deficit (excluding externally financed capital projects) of 8¼ percent of GDP. This target, which exceeds our earlier program commitments, is consistent with restoring macroeconomic stability. We will achieve these objectives by reducing non-priority outlays through stricter expenditure control and enhancing revenue collection efforts.

In 2012/13 we will keep the original budget envelope and accommodate any new spending needs, including the cost of addressing emergency response needs for the drought (providing M 117 million for agricultural inputs, in addition to the already budgeted subsidy of M 18 million) and setting up the three new ministries, by reallocating spending within the existing 2012/13 budget envelope. Any revenue over-performance this fiscal year, compared with our program projection, will be saved to build up deposits at the CBL. We will take additional adjustment measures, should pressures on international reserves intensify. If warranted, such measures would include the postponement of less priority projects and containing recurrent expenditure, where possible.
To aid in our fiscal consolidation objectives, we are pressing forward with comprehensive structural reforms.

- Revenue administration. A full restructuring of the Lesotho Revenue Authority (LRA) is currently underway and will be completed by December 2012, including the operationalization of a full-service Large Tax Payer Unit (structural benchmark, Table 3). Furthermore, the LRA is undertaking further efforts to improve recovery of unpaid taxes, expand the taxpayer's registration, and strengthen compliance and service delivery. A circular will be issued to ensure that all the government revenues will be properly recorded and paid into a single government's revenue account. We plan to expand the front office revenue receipting system to all ministries by December 2012. In light of relatively low level of tax revenues collected from mining sector, we will review the mining taxation regime, with technical assistance from the IMF.

- PFM reforms. A comprehensive inventory of all government accounts, including those at commercial banks, has been completed. However, the incompatible CBL and Treasury systems made it difficult to undertake timely reconciliation of accounts. Stepped-up efforts, including enhanced coordination with the CBL and commercial banks, are being undertaken to ensure monthly reconciliation of all Treasury accounts starting from November 2012.
- Elimination of arrears. An audit of domestic arrears has been completed. The arrears, amounting to M65 million at end March 2012, were mostly cleared by end-September 2012. Furthermore, to help prevent the emergence of new domestic arrears, outstanding payables are now reported on a monthly basis. To improve the cash management system, circulars have been issued to ensure that line ministries properly record expenditures in the system and submit monthly reports to the Ministry of Finance on time.
- Debt management. We aim to review our outdated legal debt management framework with a view to proposing legislative reforms to ensure debt sustainability and sound debt management. Based on the forthcoming DEMPA report, we will develop a reform plan and a medium-term debt management strategy, with the assistance from the World Bank. In view of our moderate risk of debt distress, we will continue to seek external financing through grants and concessional loans to support the implementation of the National Strategic Development Plan (NSDP). In light of additional financing needs for the Metolong Dam Project, we have been negotiating a financial package loans and grant from several sources, with a view to making the overall package concessional. Looking forward, we are assessing options for the medium-term financing of the second phase of the Lesotho Highlands Water Project, which may not be available on concessional terms.

Supporting financial sector development

We will continue our efforts to strengthen the legal and regulatory frameworks of the financial sector. The new Financial Institutions Act (FIA) has empowered the CBL to deal effectively with unlawful business practices, including Ponzi schemes, and to regulate and supervise nonbank financial institutions (money lenders, foreign exchange bureaus, microfinance, and cooperative banks). To effectively implement the FIA, work is underway to prepare regulations for nonbank financial institutions by December 2012. Based on technical assistance from the IMF, we will improve supervision and regulation of the insurance sector and formulate a new Insurance Bill, in line with international standards (structural benchmark, Table 3). In addition, the Credit Reporting Act and the Data Protection Act have been enacted. In accordance with the NSDP, we aim to review and improve other related legal frameworks, including pension legislation; bankruptcy; and leasing laws. These measures will help improve confidence in the financial system, and further spur financial sector development. To deepen financial intermediation and promote private sector development and inclusive growth, the CBL, with assistance from the IMF and World Bank, is also undertaking a comprehensive diagnostic assessment of the financial sector to formulate the Financial Sector Strategic Development Plan (FSSDP).

Improving investment climate

The implementation of strategies spelt out in the NSDP will help improve the business climate and facilitate private sector development. Partial Credit Guarantee Scheme was launched in August 2011, with a view to allowing greater access to credit by small and medium enterprises. The Companies Act 1967 has been amended and the new Companies Act 2011 has come into operation since June 2012; the new Act has introduced a short, simple and cost effective mechanism for incorporation and registration of companies. Reform efforts have been paying back as indicated by the Doing Business ranking for Lesotho which has moved up to the 136th place, from the 153rd place last year. We are determined to make faster progress in this area (e.g., creating an overarching investment policy, fully implementing the 2010 Land Act and the new Companies Act). Furthermore, we submitted the Industrial Licensing Bill to Parliament in early November 2012 (structural benchmark, Table 3), which would streamline the process of granting manufacturing/industrial licenses.

IV. PROGRAM ISSUES

Safeguard assessment. The CBL remains committed to implementing all the 2010 safeguards recommendations and those from the 2012 update assessment that was conducted in connection with the augmentation of the ECF arrangement. To address the weaknesses in the external audit identified in 2010, Deloitte (South Africa) was appointed to audit 2010-2012. We commit to continue the appointment of international audit firms with experience in auditing central banks for the duration of the program and any successor arrangements and thereafter for as long as Fund credit remains outstanding. We also commit to publish the audited annual financial statements within one month after audit completion and introduce the recommended internal audits of the monetary program data as an additional safeguard. Finally, resources will be earmarked in the 2013 budget to strengthen internal audit capacity in the near term.

Program monitoring. Completion of the fourth, fifth and sixth reviews of the arrangement, by November 30, 2012 and March 20, 2013, and May 20, 2013, respectively, will be based on the observance of quantitative performance criteria through end-March 2012, end-September 2012, and end-March 2013, respectively (Table 1). The targets for end-December 2012 will be indicative. The definitions of the variables monitored as quantitative performance criteria are provided in the Technical Memorandum of Understanding (TMU).

Table 1. Lesotho: Quantitative Performance Criteria, Benchmarks, and Indicative Targets, March 2011–March 2013

	2011						2012								2013	
	March		Status	Sep.		Status	March		Status	Jun.		Sep.	Dec.		Mar.	
	PC	Act.		PC	Act.		PC	Act.		IT	Act.	PC	IT	Proposed IT	PC	Proposed PC
Ceiling on the domestic financing requirement of the central government [1, 2]	1,453			1,435			1,629			148		227	-81	-1,002	-891	-966
Adjusted benchmark [3]	1,670	1,231	Met	1,385	482	Met	1,564	1,284	Met	139	-581					
Ceiling on the net domestic assets of the Central Bank of Lesotho [1, 2]	1,335			1,314			1,275			-43		118	-260	-284	-652	-499
Adjusted benchmark [3]	1,551	1,397	Met	1,264	9	Met	1,210	515	Met	-52	-315					
				(US$ millions)												
Floor on the stock of net international reserves of the Central Bank of Lesotho [2]	805			634			736			722		723	754	920	911	987
Adjusted benchmark [3]	776	897	Met	641	892	Met	745	851	Met	723	876					
Ceiling on the stock of external payments arrears [4]	0	0	Met	0	0	Met	0	0	Met	0	0	0	0	0	0	0
Ceiling on the amount of new non-concessional external debt contracted or guaranteed by the public sector (cumulative from end-March 2010) [2, 4]																
Maturity of less than one year	0	0	Met	0	0	Met	0	0	Met	0	0	0	0	0	0	0
Maturity of one year or more	182	242	Not Met [6]	182	242	Not Met [6]	182	274	Not Met [6,7]	182	274 [6,7]	182	182	274	182	274
				(Maloti millions)												
Indicative targets:																
Floor on the central government social expenditures [5]	170	205	…	170	170	…	170	170	…	183	184	183	183	183	183	183
***Memorandum items*:**																
Net disbursements [1,2]	304	272	…	-18	32	…	-122	-57	…	-88	-79	-65	-129	-104	-157	-104
General budget support	552	530	…	154	162	…	207	302	…	0	0	120	180	180	300	300
Debt service payments	249	258	…	172	131	…	329	359	…	88	79	185	309	284	457	404
SACU receipts [1]	2,628	2,628	…	1,376	1,376	…	2,752	2,752	…	1,492	1,492	2,983	4,475	4,475	5,966	5,966

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

[1] Values are cumulative from April 1st (beginning of the fiscal year).

[2] Definitions and program adjusters are specified in the TMU.

[3] Adjusted for lower budget support.

[4] Continuous performance criteria.

[5] Includes spending on school feeding program, old age pension and HIV/AIDS.

[6] Includes a USD 60 million nonconcessional loan for which wavers have been requested.

[7] Includes a USD 32 million nonconcessional loan for which wavers have been requested.

Table 2. Structural Benchmarks for June 2012

Benchmarks	Test date	Status
Implement the front office revenue receipting system in 3 pilot ministries and 1 sub accountancy	End-March 2012	Met
Complete an audit of domestic arrears and prepare a time bound plan for elimination	End-March 2012	Met
Undertake a comprehensive inventory of Government accounts, including those in commercial banks	End-June 2012	Met with delay

Table 3. Structural Benchmarks through March 2013

Benchmarks	Test date	Macroeconomic rationale
I. Public Financial Management		
Reconcile all Treasury (Revenue and Expenditure) Accounts on a monthly basis and produce a monthly monitoring report.	End-November 2012	Support expenditure efficiency and medium-term fiscal consolidation
Establish a Cash Management Unit in the Treasury.	End-December 2012	Support expenditure efficiency and medium-term fiscal consolidation
II. Debt management		
Submit to Parliament the amendments of the Loans and Guarantees Act	End-March 2013	Strengthen debt management
II. Revenue Collection		
A full-service Large Tax Payers Unit established, which provides the full range of tax administration functions.	End-December 2012	Support revenue collection and medium-term fiscal consolidation
III. Financial Sector Regulation		
Submit to Parliament the Insurance Bill.	End-December 2012	Strengthen financial sector stability
IV. Other Structural Reforms		
Submit to Parliament the Industrial Licensing Bill, which will improve the process of licensing industrial enterprises [1]	End-September 2012	Improve the business climate to facilitate private sector-led growth, and enhance competitiveness

[1] Previously end-March 2011 structural benchmark.

Attachment II: The Kingdom of Lesotho—Technical Memorandum of Understanding

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

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

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

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

operations. The Central Bank of Lesotho will also provide a table showing the details of government debt by type and holder. The Ministry of Finance will provide detailed monthly budget operation reports and tax arrears reports.

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

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

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

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

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

7. Definition. The net international reserves (NIR) are defined as the Central Bank of Lesotho's liquid, convertible foreign assets minus its short-term foreign liabilities. Pledged or otherwise encumbered assets, including, but not limited to, assets used as collateral or as guarantee for third-party external liabilities are excluded from reserve assets. Reserve assets include cash and balances held with banks, bankers' acceptances, investments, foreign notes and coins held by the Central Bank of Lesotho, Lesotho's reserve position in the Fund, and SDR holdings. Reserve liabilities include nonresident deposits at the Central Bank of Lesotho, use of IMF credit, and any other short term

liabilities of the central bank to nonresidents. The stock of NIR at the end of each quarter is defined in U.S. dollars and will be calculated using the program exchange rates.[1]

8. Supporting material. The Central Bank of Lesotho will provide data on its NIR on a monthly basis within three weeks of the end of the month. The NIR data will be provided in a table showing the currency breakdown of the reserve assets and reserve liabilities of the Central Bank of Lesotho converted into U.S. dollars and maloti at the program exchange rates.

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

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

10. Definition. A loan is concessional if its grant element is at least 35 percent of the value of the loan, calculated using a discount rate based on commercial interest reference rates (CIRRs) reported by the OECD. For loans of maturity of at least 15 years, the grant element will be based on the ten-

[1] Program cross exchange rates are: South African rand per U.S. dollar: 7.3; U.S. dollars per pound sterling: 1.5; U.S. dollars per euro: 1.3; Swiss francs per U.S. dollar: 1.1; Swedish kronor per U.S. dollar: 7.3; and Botswana pula per U.S. dollar: 6.8. SDR per U.S. dollar: 0.648; Program maloti per U.S. dollar exchange rate: 7.3.

year average of OECD CIRRs. For loans of maturity of less than 15 years, the grant element will be based on the six-month average of OECD CIRRs. Margins for differing repayment periods would be added to the CIRRs: 0.75 percent for repayment periods of less than 15 years, 1 percent for repayment periods of 15 to 19 years, 1.15 percent for repayment periods of 20 to 29 years, and 1.25 percent for repayment periods of 30 years or more.

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

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

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

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

F. Ceiling on the Stock of External Payments Arrears

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

15. Supporting material. Details of arrears accumulated on interest and principal payments to creditors will be reported within one week from the date of the missed payment.

G. Floor on the Central Government Social Expenditures

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

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

H. Adjusters

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

A. Southern African Customs Union Revenues

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

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

19. Supporting material: The Central Bank of Lesotho will provide data on SACU receipts on a quarterly basis within the first month of the quarter.

B. Budgetary Support net of Debt Service[2]

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

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

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

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

C. Unused Metolong loan balance

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

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

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

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

21. Supporting material: Data on the Metolong project loan balance under the government's accounts will be compiled by the Central Bank of Lesotho and will be provided on a quarterly basis, to be submitted no later than six weeks after the end of each reporting period.

22. The above supporting data and reports required for program monitoring by IMF staff will be transmitted by the authorities to the IMF Resident Representative to Lesotho.

INTERNATIONAL MONETARY FUND

KINGDOM OF LESOTHO

November 12, 2012

FOURTH REVIEW UNDER THE THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY, REQUEST FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION, AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERIA—INFORMATIONAL ANNEX

Prepared By | African Department

CONTENTS

RELATIONS WITH THE FUND

As of September 30, 2012

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

II. **General resources account**:	SDR Million	Percent Quota
Quota	34.90	100.00
Fund holdings of currency	31.24	89.52
Reserve position in Fund	3.66	10.50

III. **SDR department:**	SDR Million	Percent Allocation
Net cumulative allocation	32.88	100.00
Holdings	32.52	98.91

IV. **Outstanding purchases and loans**:	SDR Million	Percent Quota
ECF[1] arrangements	36.72	105.20

V. **Financial arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
ECF	06/02/2010	06/01/2013	50.61	33.57
ECF[1]	03/09/2001	10/31/2004	24.50	24.50
Stand-By	09/23/1996	9/22/1997	7.17	0.0

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

	Forthcoming				
	2012	2013	2014	2015	2016
Principal	0.35	1.75	1.05	0.78	2.13
Charges/Interest	…	0.00	0.09	0.08	0.08
Total	**0.35**	**1.75**	**1.14**	**0.86**	**2.21**

[1] Formerly PRGF.

VII. **Safeguards assessment**

An update safeguards assessment has been conducted in connection with the augmentation of the ECF arrangement. The CBL has made progress in strengthening safeguards since the 2010 assessment, but certain risks remain. Deloitte (South Africa) was appointed as external auditor for three years in 2010, and completed the 2010 and 2011 audits within three months. Aspects of the monetary data reporting process have been strengthened with Fund's technical assistance. However, the recommended internal audits of the monetary data provided for the test dates have not been completed. The assessment learned that a foreign loan contracted in January 2011 resulted in the breach of the program's performance criterion for new non-concessional borrowing. The loan was repaid in full in May 2011, but the process by which this loan was contracted raises concerns over governance and transparency. The authorities are taking steps to address these issues. In this context, audit oversight and internal audit remain areas where improvements are needed to strengthen overall governance and accountability at the CBL.

VIII. **Exchange arrangement**:

Lesotho is a member of the Common Monetary Area (CMA) and the Lesotho loti is both *de facto and de jure* pegged at par to the South African Rand, which is also legal tender in the country. Lesotho has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Articles of Agreement and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions. As of August 31, 2012, the maloti rate per U.S. dollar was M.8.41.

IX. **Article IV consultation**:

The 2012 Article IV consultation was concluded by the Executive Board on April 9, 2012. Lesotho is on the standard 24-month Article IV consultation cycle.

X. **Technical assistance missions**:

Technical assistance provided in 2010-11			
Balance of Payments	STA	short-term	2010
Public Financial Management	FAD	short-term	2010
Financial sector regulations	LEG	short-term	2010
Payment systems	MCM	short-term	2010
Monetary and Financial Statistics	MCM	short-term	2011
Public Financial Management	FAD	short-term	2011
Financial sector supervision	MCM	short-term	2011
Revenue administration	FAD	short-term	2011
SRF data development	STA	short-term	2011

Missions planned for 2012			
Enhanced Insurance Supervision	MCM	short-term	2012
Risk management	MCM	short-term	2012
Bank regulation	MCM	short-term	2012
Bank supervision and implementation of risk-based supervision	MCM	short-term	2012
Financial stability assessment	MCM	short-term	2012
Payment systems	MCM	short-term	2012
Compliance with Basel Core Principles	MCM/AFS	short-term	2012
Balance of payments	STA	short-term	2012
Risk management function	FAD/AFS	short-term	2012
Post control audit function in customs	FAD	short-term	2012
Capacity to manage MTEF	FAD/AFS	short-term	2012
Limit the accumulation of arrears	FAD/AFS	short-term	2012
Customs administration training	FAD	short-term	2012
MTFF	FAD/AFS	short-term	2012
PFM Reform program	FAD	short-term	2012
Review of mining taxation	FAD	short-term	2012
Review of legal framework for debt management	LEG	short-term	2012

Missions planned for 2013			
Financial stability	MCM	short-term	2013
Payment systems	MCM	short-term	2013
Insurance supervision	MCM	short-term	2013
Bank regulation	MCM	short-term	2013
Bank supervision and implementation of risk-based supervision	MCM/AFS	short-term	2013
Compliance with Basel I and move to Basel II	MCM/AFS	short-term	2013
Capacity to manage MTEF	FAD/AFS	short-term	2013
Risk management (follow-up TA)	FAD/AFS	short-term	2013
MTFF	FAD	short-term	2013

XI. **Resident Representatives:** The new IMF resident representative office in Maseru headed by Mr. Michael Tharkur was opened in May 2012

LESOTHO: THE JMAP BANK-FUND MATRIX

(As of September 28, 2012)

Title	Products	Provisional Timing of missions	Expected Delivery date
A. Mutual information on relevant work programs			
Bank work program in next 12 months	• Poverty Reduction Support Credit-1 • Private Sector competitiveness and Economic Diversification project • Water Sector Improvement Project Phase 2 • Public Expenditure Review • Social safety net review • Maternal and Newborn Health PBF	• Nov. 2012 • Ongoing regular missions • Ongoing regular missions • Feb. 2012 • Sep. 2012 • Sept. 2012	• May 2013 • Implementation ongoing • Implementation ongoing • Aug. 2012 • Dec. 2012 • April 2013
IMF work program in next 12 months	**Macroeconomic policy analysis and advice and IMF program** • Fourth review of the ECF • Fifth review of the ECF **Technical assistance** • Insurance Supervision • Financial sector risk management • BOP: Improve data timeliness and quality • Capacity to manage MTEF • Training functions in customs • PFM reform plan • Review of debt legislation • Review of mining taxation code	• Oct. 2012 • Jan. 2013 • Feb. 2012 • Apr. and Jul. 2012 • Mar. 2012 • Mid 2012 • Mid 2012 • Late 2012-2013 • Late 2012-2013 • Late 2012-2013	• Nov. 2012 • Early 2013 • Ongoing • Early 2012 • Ongoing • Ongoing • Ongoing • Ongoing
B. Requests for work program inputs			
Fund request to Bank	• Updates on policy reform work: improving the business climate, economic diversification, private sector competitiveness and development, PPP capacity building, increasing revenue efficiency • Updates on budget support programs	• Ongoing • Ongoing	
Bank request to Fund	• Updates on the ECF program	• Ongoing	
C. Agreements on joint products and missions			
Joint products in next 12 months	• Debt sustainability analysis • JSAN	• November 2011	• March 2012 • July 2012

Statement by Mr. Saho on Kingdom of Lesotho
November 27, 2012

1. On behalf of my Lesotho authorities, I would like to thank staff for their support and policy advice to the Government of Lesotho. The authorities are especially thankful to the Executive Board and Fund Management for their continued engagement and policy guidance against the backdrop of a challenging global economic environment. The new coalition government that was formed after the general elections in May 2012, assumed power amid high expectations and challenges. Notwithstanding significant post-election pressure, the new government is committed to the broad macroeconomic framework and fiscal consolidation path that were agreed with the previous administration. They are determined to address the challenges the country is facing, with the support of the Fund and other development partners. In this regard, the authorities are broadly in agreement with the main messages of the staff report (12/142) and the Managing Director's (MD's) report (12/143), which are a fair representation of the issues relating to their engagement with the Fund staff.

Request for waiver of non-observance of performance criterion

2. In the normal information-sharing between staff and the authorities during the fourth review mission of the three-year Extended Credit Facility (ECF) and safeguards assessment mission in July 2012, it was discovered that Lesotho missed a *cumulative quantitative performance criterion on new nonconcessional external debt contracted or guaranteed by the public sector*. This was subsequently confirmed in a letter by the Minister of Finance to the MD dated October 30, 2012, which is also included as part of the MD's report. As elaborated in the Minister's letter, two loan agreements that did not meet the program conditions were contracted between December 2010 and March 2012.

3. The first loan amounting to US$60 million with the African Export-Import Bank was contracted by the Central Bank of Lesotho (CBL) and guaranteed by the Government of Lesotho in December 2010. This was a commercial facility with no grant element, intended to be on-lent to eligible textile companies through the local banks. The loan agreement was terminated on May 4, 2011 and fully repaid, after the authorities concluded that it could no longer be justified.

4. The second loan to the tune of CNY200 million with the Export-Import Bank of China was contracted by the Government of Lesotho on December 12, 2011. The purpose of the loan was to expand, upgrade and modernize Lesotho's telecommunications infrastructure, one of the priority areas identified in the National Strategic Development Plan 2012/13 – 2016/17 (NSDP). However, it turned out that this loan, which was concluded without following the required internal review process, has a grant element of 31 percent, slightly below the 35 percent threshold under the ECF arrangement.

5. As the Minister's letter further clarifies, the authorities have responded swiftly to address the observed shortcomings. Among others, all future external loan agreements under negotiation will be shared with the Fund staff, to ensure compliance with the ECF program conditions. The authorities have also resolved to re-activate their Debt Management Committee, a structure that served the Lesotho well in the past but has become inactive recently. Furthermore, adherence to the existing legal procedures will be strictly enforced, while a comprehensive review of the legal

framework for debt management is being considered, with technical assistance from the Fund. The authorities also intend to request support from the World Bank to formulate a broad debt management plan.

Program performance

6. As explained in the memorandum of economic and financial policies, and well-captured in the staff report, Lesotho's performance under the three-year ECF remained generally strong. All performance criteria (PC) for end-March 2012 and indicative targets (IT) for end-June 2012 were met, with the exception of the ceiling on newly contracted non-concessional external debt. At the same time, the end-March 2012 structural benchmarks (SBs) were implemented as expected, while two end-September 2012 SBs were implemented with a delay.

7. In addition, the authorities have revised upwards the IT for December 2012 on the floor of net international reserves from US$754 million to US$920 million. This was made possible by strong growth in receipts from the Southern African Customs Union (SACU) Revenue Pool, as well as enhanced domestic revenue collection. Accumulation of international reserves is consistent with the authorities' intention to rebuild a strong buffer against exogenous shocks. Moreover, in the context of Lesotho's foreign exchange rate policy, CBL is required to hold sufficient international reserves to maintain the parity between Lesotho's loti and the South African rand.

8. My authorities are, in this regard, requesting the support of the Executive Board for the completion of the fourth review of the ECF program, and the waiver for the non-observance of the ceiling on the amount of new nonconcessional external debt contracted or guaranteed by the public sector.

Recent economic developments and outlook

9. Despite its vulnerability to external shocks, Lesotho's economic performance remained relatively strong in 2011/12, driven mainly by the mining and construction sectors. Recently released data show that the rate of inflation rose from 5.3 percent in August 2012 to 5.8 percent in September 2012, in line with price developments in the rest of the SACU region. Much of the observed inflation was driven by currency depreciation, and food and fuel prices. However, given the exchange rate peg with the rand, inflation in Lesotho is not expected to deviate from trends in South Africa, where an inflation target range of 3 - 6 percent applies. Meanwhile, international reserves rebounded sharply and reached $1.1 billion on November 19, 2012. Although this is a reflection of the quarterly SACU receipt at the beginning of October, it is also an indication of the authorities' determination to maintain tight control on government spending.

10. The country also tends to be susceptible to sporadic, severe weather conditions. As highlighted during the Board sitting in April 2012, a sharp reduction in SACU revenue in the aftermath of the 2008 financial crisis was followed by floods in early 2011. Subsequently, the country has been subjected to drought that compelled the authorities to declare a national food crisis in August 2012, and put out an appeal to the international community for assistance.

11. My authorities share the views of staff on the growth outlook and risks associated with the uncertain global economic environment. In particular, as demonstrated by the experience of the post-2008 financial crisis, adverse global developments could impact negatively on SACU revenue and demand for Lesotho's exports in international markets. In this regard, the authorities continue to undertake reforms to boost domestic revenue in order to increase the fiscal space and reduce the government's reliance on external sources of revenue.

Macroeconomic policies and structural reforms

Fiscal Policies

12. In the face of significant spending pressures, the Lesotho authorities remain committed to a set of policies geared towards fiscal consolidation and structural reforms. Fiscal consolidation efforts will continue to revolve around enhanced revenue collection and stricter expenditure control, while protecting spending on vulnerable groups and priority infrastructure. These measures will be supported by a set of structural reforms, as outlined in the MEFP.

13. Of particular significance, my authorities have solicited the IMF's technical assistance to review Lesotho's mining taxation regime. This is consistent with the Board's recommendations during the April 2012 sitting, following observations that tax revenue from the mining sector does not match the contribution of the sector to aggregate output.

Financial sector reforms

14. As we reported to the Board in April, the government is committed to the implementation of reform measures in line with its NSDP. One of the key reforms was the enactment of the new Financial Institutions Act. To effectively implement the Act, the CBL, with the Fund's TA, is now in the process of formulating regulations for nonbank financial institutions. In an effort to deepen financial intermediation and promote private sector development, CBL is also enlisting the IMF's and World Bank's assistance to undertake a comprehensive assessment of the country's financial sector, and to formulate the strategic development plan for the sector.

Improving investment climate

15. Within the NSDP framework, Lesotho is also committed to creating and improving an enabling environment for private sector growth and employment creation. A notable development in this regard is the enactment of the new Companies Act, which came into operation in June 2012. This Act simplifies the process of incorporation and registration of companies. Further complementary reforms are in the pipeline, including submission of the Industrial Licensing Bill to Parliament, expected to streamline the process and enhance transparency in granting manufacturing and industrial licenses.

Program Issues

16. The CBL has committed to the full implementation of the recommendations of the safeguards assessment exercise by the Fund staff. This includes the introduction of the recommended internal audits of the monetary data.

Conclusion

17. In conclusion, my authorities continue to demonstrate very strong commitment to the implementation of the ECF arrangement. Notwithstanding the non-observance of the PC on the ceiling on the contracting or guaranteeing of new nonconcessional external debt, the Government of Lesotho has maintained overall strong program performance. In efforts to address their developmental aspirations, the authorities consider the Fund's and other development partners' policy advice and financial assistance critical. In this context, my Lesotho authorities are requesting the support of the Executive Board for the completion of the fourth review under the ECF-supported program and the waiver of their non-observance of the PC on the ceiling of new nonconcessional external debt.

Press Release No. 12/462
FOR IMMEDIATE RELEASE
November 27, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under Extended Credit Facility Arrangement for the Kingdom of Lesotho, and Approves US$ 8.7 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of the Kingdom of Lesotho's economic performance under a program supported by the Extended Credit Facility (ECF) arrangement. In completing the review, the Board also approved a waiver for the missed continuous cumulative quantitative performance criterion on new nonconcessional external debt contracted or guaranteed by the public sector. The Board's decision will enable an immediate disbursement of an amount equivalent to SDR 5.68 million (US$8.7 million), bringing total disbursements under the arrangement to an amount equivalent to SDR 39.245 million (US$60.2).

The three-year ECF arrangement for the Kingdom of Lesotho in an amount of SDR 41.9 million (120 percent of quota) was approved by the IMF's Executive Board on June 2, 2010 (see Press Release No. 10/224). On April 9 2012, the Board approved an augmentation of access equal to 25 percent of quota, which has led to a total access of SDR 50.605 million (145 percent of quota) in order to cushion the impact of the 2010–11 flood damage and high international commodity prices.

Following the Executive Board's discussion on Lesotho, Mr. Min Zhu, Deputy Managing Director and Acting Chair, issued the following statement:

"Lesotho has maintained robust growth despite adverse weather shocks while inflation continues to moderate, partly reflecting easing in international commodity prices. Though international reserves fell as a result of adverse exogenous shocks, strong fiscal adjustment efforts have been made to restore fiscal and external sustainability. Additional donor assistance is being sought to address the weather-related shocks and cushion their impact on the balance of payments.

"The 2012/13 budget is appropriately targeted at further increasing the surplus, largely through enhanced tax collection. Further efforts are needed to improve public financial management, while safeguarding critical social and development spending. Considering downside risks associated with the global and regional economic outlook, and given the desirability of maintaining the exchange rate peg, the fiscal consolidation path should be maintained to rebuild international reserves.

"The authorities have made further progress in implementing structural reforms to support private sector–led growth and economic diversification, through enacting the new Companies Act and finalizing the Industrial Licensing Bill. These reforms will help to further improve the business climate and boost external competitiveness.

"Steps are being taken to develop a sound financial sector. Key measures include adopting regulations for the new Financial Institutions Act, reinforcing the supervisory role of the central bank, and broadening access to financial services. With technical assistance from the Fund and the World Bank, the Central Bank of Lesotho plans to formulate a financial sector development strategy.

"Inaccurate data on public sector new nonconcessional external debt, provided for the previous reviews under the ECF arrangement, resulted in noncomplying disbursements. In view of the authorities' corrective actions taken and planned to strengthen debt management and monitoring, the Board decided to waive the nonobservance of the performance criterion that gave rise to the noncomplying disbursements," Mr. Zhu added.