



KINGDOM OF LESOTHO

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT

February 2016

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Lesotho, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on September 2, 2015, 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 January 12, 2016.
- An **Informational Annex** prepared by the IMF staff.

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IMF Executive Board Concludes 2015 Article IV Consultation with the Kingdom of Lesotho

On January 29, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with the Kingdom of Lesotho, and considered and endorsed the staff appraisal on a lapse-of-time basis².

Real GDP growth averaged about 4.5 percent a year from 2010 to 2014, before dipping to an estimated 2.6 percent in 2015, mainly reflecting recent weaknesses in the manufacturing and construction sectors and spillovers from slower growth in neighboring South Africa. At the same time, unemployment rates have remained high, especially among the youth, and the incidence of poverty is virtually unchanged from a decade ago. Most health, education, and social indicators have shown little or no improvement, even with considerable government spending in these areas (about 30 percent of GDP a year). Looking ahead, real GDP growth is projected to remain about 2.5-3.0 percent in 2016, but could be lower depending on the severity of the current drought. Inflation is expected to remain moderate at around 5-6 percent, despite rising food prices and the recent depreciation of the South African rand.

Overall Government expenditures remain comparatively high. Government expenditures have amounted to about 60 percent of GDP or more in recent years, with spending becoming increasingly slanted toward recurrent expenditures. The government wage bill rose to 21.5 percent of GDP in 2014/15³—the highest in sub-Saharan Africa—and is budgeted to increase to 23 percent of GDP in the current fiscal year. Lesotho relies heavily on revenues from the Southern African Customs Union (SACU) for government financing, but these

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

³ Fiscal year is April 1–March 31.

revenues have been highly volatile. After a sharp drop in 2010/11-2011/12, SACU revenues rebounded to an average of about 29 percent of GDP a year over the following three years. The rebound in SACU revenues contributed to Lesotho's recovery from a severe fiscal crisis and supported the rebuilding of fiscal and external buffers, with official international reserves reaching 6.3 months of imports by end-March 2015. However, SACU revenues have fallen once again. After slipping to R 6.6 billion (about 26 percent of GDP) this year, Lesotho's allocation will drop sharply to R 4.5 billion (about 16 percent of GDP) in 2016/17, with much of this decline expected to be long-lasting.

Lesotho's current business environment has weakened, partly because of political difficulties around the collapse of the country's first coalition government in 2014. Despite early elections in February 2015 and a smooth transition to a new coalition government, tensions have persisted. Implementation of Lesotho's National Strategic Development Plan (NSDP) has stalled in this environment and investment has slowed. Also, some development partners have dampened their economic support.

Executive Board Assessment

In concluding the 2015 Article IV consultation with the Kingdom of Lesotho, Executive Directors endorsed staff's appraisal, as follows:

Lesotho achieved solid economic growth for several years with only moderate inflation. In recent years, the authorities were able to rebuild fiscal buffers and international reserves, largely due to a temporary rebound in SACU revenues. However, there has been little progress in the fight against poverty and unemployment, despite considerable spending on social sectors and transfers.

Lesotho faces a challenging economic outlook. The imminent sharp drop in SACU revenues could threaten macroeconomic stability, unless a major fiscal adjustment is implemented. While existing buffers provide a cushion to allow an orderly adjustment over the next 2-3 years, it is critical that the authorities take a substantial first step in the upcoming fiscal year to ensure credibility. Containing recurrent expenditures—most importantly, the extraordinarily large government wage bill—should be central to the adjustment effort. In addition, social protection can be better targeted toward the most vulnerable. The measures that the authorities intend to include in the 2016/17 budget would indeed make a significant contribution toward fiscal adjustment.

Reforms to strengthen public service administration and public financial management are urgently needed, not only for a successful fiscal adjustment, but to also improve the delivery of government services. A lack of basic controls—such as the inability to fully reconcile government bank accounts on a regular basis—contributes to severe government inefficiencies. Staff urges the authorities to make good use of extensive technical assistance currently available to build capacity in critical management areas.

To achieve greater inclusiveness, the private sector needs to step up job creation. Implementation of the National Strategic Development Plan, which provides a viable approach for transitioning from government dependence to private sector led growth over the longer term—particularly in sectors with potential for high employment—needs to be restarted. In the near term, to quickly stimulate job growth, measures could be taken to eliminate unnecessary obstacles and bottlenecks to doing business. Continued implementation of the Financial Sector Development Strategy would improve access to credit and financial services.

To ensure financial stability, building capacity for bank and nonbank supervision and coordinating on cross-border supervision need to be continued. While indicators point to a generally sound financial system, the authorities need to remain vigilant regarding weak individual institutions and financial linkages to sectors that would be affected by fiscal adjustment.

The loti's parity with the South African rand has served Lesotho well by supporting macroeconomic stability and integrating the economy with the region. It is critical that an adequate level of international reserves is maintained to ensure this exchange rate regime.

Looking ahead, a rules-based approach to fiscal policy could strengthen fiscal discipline and better manage volatile revenues. Building up the institutional PFM framework, including robust medium-term planning and budgeting, is a necessary first step toward this goal.

Lesotho: Selected Economic Indicators, 2011/12–2016/17

Population (1,000; 2014 est.)	2,109					
GNI per capita (U.S. dollars; 2014 est.):	1,330					
Poverty rate (Percent, 2010 est.):	57.1					
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	Act.	Act.	Act.	Act.	Proj.	Proj.
	(Percentage changes; unless otherwise indicated)					
National account and prices						
GDP at constant prices	4.5	5.3	3.6	3.4	2.6	2.9
GDP per capita at constant prices	4.3	5.0	3.3	3.2	2.4	2.7
Non-Oil GDP at constant prices	4.5	5.3	3.6	3.4	2.6	2.9
GDP deflator	7.0	2.0	7.2	5.9	4.9	4.3
GDP at market prices (Maloti millions)	18,430	19,783	21,975	24,071	25,909	27,804
Consumer prices (average)	6.0	5.5	5.0	3.8	3.9	4.1
External sector						
Terms of trade (deterioration -)	9.2	-9.7	-0.2	5.1	0.5	-1.0
Average exchange rate						
(Local currency per U.S. dollar)	7.4	8.6	9.9	11.3	...	...
Nominal effective exchange rate change (- = depreciation) ²	-1.2	-9.1	-13.0	-9.4	-16.0	...
Real effective exchange rate (- = depreciation) ²	0.6	-5.9	-10.6	-6.51	-12.5	...
Current account balance						
(Including official transfers, percent of GDP)	-15.0	-10.3	-10.6	-8.3	-6.4	-12.9
(Excluding official transfers, percent of GDP)	-34.2	-43.4	-40.1	-39.2	-33.2	-31.4
Gross international reserves						
(Months of imports) ³	3.6	4.9	5.2	6.3	6.3	5.8
(Percent of M1)	239	268	248	290	281	254
Money and credit						
Domestic credit to the private sector	25.1	42.2	10.3	11.8	9.1	8.8
Reserve money	45.5	-1.9	15.2	8.2	8.6	8.4
Broad money	4.9	6.1	31.5	-5.9	8.4	8.7
Interest rate (percent) ⁴	2.8	2.4	2.3	3.0	3.2	...
Savings and investment						
	(Percent of GDP; unless otherwise indicated)					
Gross capital formation ⁵	35.0	36.7	35.0	33.0	33.3	33.2
Public	19.2	20.8	19.6	17.9	17.9	18.1
Private	15.5	15.6	15.0	14.7	15.0	14.8
National savings	20.0	26.5	24.4	24.8	26.9	20.4
Public	9.4	24.9	16.2	17.1	14.9	7.6
Private	10.6	1.6	8.2	7.7	12.0	12.8
Public debt	38.0	40.3	43.4	47.8	53.4	55.8
External public debt	31.9	37.2	41.1	46.2	50.8	50.3
Domestic debt	6.1	3.1	2.2	1.6	2.6	5.5
Central government fiscal operations						
Net lending/borrowing	-10.6	5.0	-2.5	0.6	-3.2	-9.2
(Excluding grants)	-19.1	-3.7	-7.2	-1.4	-6.9	-12.9
Non-SACU fiscal balance	-25.5	-25.2	-30.1	-28.6	-28.9	-24.1
Revenue	52.2	66.5	60.4	60.6	60.2	52.0
<i>Of which: grants</i>	7.8	8.6	4.8	2.1	3.7	3.6
Expenses	47.1	44.3	47.4	45.8	49.0	47.8
Nonfinancial assets	15.7	17.2	15.5	14.1	14.3	13.4
Public debt, net	38.0	40.3	43.4	47.8	53.4	55.8

Sources: Lesotho authorities and IMF staff estimates and projections.

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

² IMF Information Notice System trade-weighted; end of period. For 2015/16 it is the latest observation as of November 2015.

³ Reserve coverage of 5 months of imports is estimated as adequate for maintaining the exchange rate peg and providing a fiscal cushion to avoid abrupt adjustment.

⁴ 12-month time deposits rate. The 2015/16 interest rate is as of end-October 2015.

⁵ Excluding changes in inventories.



KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

January 12, 2016

KEY ISSUES

Context. For several years, Lesotho achieved solid economic growth with only moderate inflation; however, this growth lacked inclusiveness and poverty has remained widespread. Most recently, growth has begun to slow, partly reflecting spillovers from South Africa, as well as uncertainty at home. Lesotho relies heavily on revenues from the Southern African Customs Union (SACU) to finance large government expenditures, but these revenues are highly volatile.

Need for Fiscal Adjustment. SACU revenues will fall sharply in fiscal year 2016/17 (April-March), with much of this fall expected to be long-lasting. Although Lesotho has built substantial international reserves and fiscal buffers, a major fiscal adjustment over the next 2–3 years will be needed to maintain macroeconomic stability. Containing the government wage bill—which at 23 percent of GDP is the largest in sub-Saharan Africa—will be central to a successful adjustment. Progress on reforms to public service administration and public financial management is also critical. Better targeting of government transfers is necessary for social protection.

Enabling Private Sector-Led Growth. To strengthen inclusiveness, the private sector needs to be the engine for job creation. Measures can be taken to improve the business environment in the near-term. Restarting implementation of the National Strategic Development Plan (NSDP) is also a priority.

Increasing Access to Financing. Continued implementation of the Financial Sector Development Strategy (FSDS), along with greater capacity for supervision, is critical for a sound deepening of financial intermediation and easing an important constraint on doing business.

Challenges to the Medium-Term Outlook. A prolonged slowdown in South Africa's economy would further weaken the outlook for Lesotho. In addition, diminished trade preferences could set back Lesotho's international competitiveness.

Approved By
Anne Marie Gulde-Wolf
and Chris Lane

Discussions took place in Maseru during August 20—September 2, 2015, and were followed up with a video-teleconference with the management of the Central Bank of Lesotho on October 21, 2015. The staff team consisted of Mr. Dunn (head), Mr. Abdychev, Mr. Kumar, and Mr. Mu (all AFR), Mr. Andreolli (RES), and Ms. Nkholise (local economist). The team met with Hon. Minister of Finance Mamphono Khaketla, Central Bank Governor Rets'elisitsoe Matlanyane, as well as the Hon. Ministers of Development Planning, Public Service, Health, and Education and Training, Hon. Chairs of Parliamentary Committees, high-level officials, and representatives of the financial sector, business community, civil society, and development partners. Mr. Tlelima (OED) participated in discussions.

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Central Bank of Lesotho (CBL) and the rebuilding of official international reserves (to 6.3 months of imports of goods and services as of end-2014/15). Government's capital spending, however, has fallen in recent years, mainly because of a drop-off in grants from development partners (by several percentage points of GDP) and, most recently, an under execution of the capital budget.³

3. Spillovers from slower growth in neighboring South Africa have begun to weigh on the Lesotho economy. Diminished employment opportunities for migrant workers, particularly in the mining sector, have reduced remittances and consumers' purchasing power at home. Also, with a lag, SACU revenues depend on South Africa's collection of import duties, which fell considerably short of expectations in 2014/15. South Africa is also an important source of private sector investment in Lesotho, which also appears to have fallen. However, beyond water transfers, Lesotho's principal export markets (diamonds, textiles) lie outside the sub-region and are not strongly affected by economic developments in South Africa. Finally, Lesotho's financial system has close linkages with South Africa and under the CMA, South Africa's monetary and exchange rate policies have a direct impact on Lesotho. Most years, several of Lesotho's financial institutions have accumulated assets in South Africa leading to a net outflow of financial resources.

4. Recent political and security developments have weakened implementation of economic policies and the investment climate. Lesotho's first coalition government, which came into power in 2012, collapsed in 2014 amidst much turmoil, including the suspension of parliament and conflict among the security services. Despite early elections in February 2015 and a smooth transition to a new coalition government, tensions once again escalated a few months later, particularly within the army.⁴ In addition, opposition party leaders fled the country. Implementation of Lesotho's National Strategic Development Plan 2012/13-2016/17 (NSDP) has stagnated in this environment, while disruptions in parliamentary procedures have delayed a number of legislative proposals. Business investment has slowed and, most recently, some development partners have expressed concerns that political and security developments could dampen their economic support for Lesotho.

Lesotho's relations with the Fund

5. In September 2013, Lesotho successfully completed a three-year program supported by the Fund's Extended Credit Facility (ECF); the previous Article IV consultation was concluded on June 4, 2014 (Box 1). Under the ECF, Lesotho achieved fiscal consolidation and rebuilt fiscal buffers and international reserves. The authorities also elaborated the Financial Sector Development Strategy (FSDS), which was adopted in early 2014. Although implementation of the FSDS has progressed, in other areas, the structural agenda has largely stalled. Bills for public debt and aid management, public sector audit, anti-money laundering, and a new fiscal regime for the

³ The conclusion of Lesotho's compact with the U.S. Government's Millennium Challenge Corporation (MCC) was an important factor in the drop-off in grants and lower capital expenditures.

⁴ The Southern African Development Community (SADC) established a Commission of Inquiry to investigate these security issues. The Commission's report has yet to be made public.

mining sector are still awaiting consideration by parliament. Implementation of the public financial management (PFM) action plan has also been limited, although the recent establishment of a ministerial-level steering committee could help PFM reform regain momentum.

Box 1. Implementation of Fund Advice	
Key Recommendations	Implementation Status
Create fiscal space to scale up public investment under NSDP, including by containing recurrent expenditures—in particular, the government wage bill.	Implementation of the NSDP has stalled, while the wage bill has continued to grow (to 23 percent of GDP in 2015/16 budget). The capital budget continues to be under executed.
Maintain international reserves at an adequate level (5 months of the following year's imports).	Fiscal surplus in 2014/15 enabled an accumulation of reserves (to over 6 months of imports).
Over the medium term, move toward a rules-based approach to fiscal policy to reduce vulnerability to volatile SACU revenue.	The authorities continue to discuss a rules-based approach to fiscal policy. Progress is needed on public financial management (PFM) reform, especially medium-term budgeting.
Step up efforts to strengthen public financial management framework and improve planning, appraisal, and implementation of public investment projects.	PFM steering committee was recently elevated to the ministerial level and a new PFM reform coordinator was put in place. However, only limited progress has been achieved in strengthening the cash management unit and reconciling government's bank accounts. Project preparation and execution is still weak and undermines implementation of capital expenditure.
Strengthen banking supervision and begin implementation of Financial Sector Development Strategy.	The CBL is building supervisory capacity and continues to strengthen coordination with South Africa's banking supervision. Credit information bureau is operational, a collateral registry is being developed, and insurance regulations have been prepared.

OUTLOOK AND RISKS

6. Lesotho faces a challenging near- and medium-term economic outlook. Real GDP growth is estimated to have fallen to about 2½ percent in 2015 and is projected to remain subdued in 2016, mainly reflecting weaknesses in the manufacturing and construction sectors. Uncertainty about Lesotho's favored access to the U.S. market and an increasingly competitive global

environment have dampened production of textiles, Lesotho's leading manufacturing export,⁵ while construction activity has stalled from lower investment spending by both the public and private sectors. Over the medium term, the underlying weakness in the economy is expected to persist, as a sharp and prolonged decline in SACU revenues will necessitate a major fiscal adjustment that would curtail government demand. Nevertheless, GDP growth is expected to get a boost from the coming on line of a large new diamond mine in 2017 and, in the following year, commencement of construction on phase two of the water transfer component of the Lesotho Highlands Water Project (LHWP-II). Annual inflation is projected to be around 5 percent over the medium term—in line with South Africa's inflation projections. Currently, inflation is still low (4.4 percent as of October 2015), despite sharp increases in food prices. Exchange rate depreciation could add to inflation pressures, although for the time being, low international fuel prices have softened the impact for Lesotho.

7. There are several risks to this outlook—most notably, there could be severe consequences if fiscal adjustment is not implemented in a timely manner. Without an appropriate adjustment, the magnitude and duration of the drop in SACU revenues would lead to unsustainable fiscal deficits, which would jeopardize debt sustainability and the maintenance of international reserves needed to ensure the loti's parity with the rand under the CMA (Box 2). Other significant risks include: (i) spillover effects if emerging market countries, and especially South Africa, experience a prolonged and more severe slowdown in growth than is currently projected; (ii) diminished competitiveness if new trade agreements do indeed cut into Lesotho's relatively favorable access to export markets; and (iii) the prospects of severe drought in the region (Table 7). To some extent, Lesotho's current stock of international reserves mitigates these risks, by providing a cushion against most temporary shocks. The reserves, along with fiscal buffers, would also allow time for an orderly adjustment to more permanent shocks, such as the loss of SACU revenues in the baseline scenario. Finally, while the risks are to the downside, there are also potential upsides to the baseline, notably if Lesotho's policy framework garners greater support from development partners.⁶

⁵In the baseline scenario, textile exports are projected to remain flat due to uncertainty surrounding Lesotho's trade preferences. Total exports dip in 2015/16, mainly because of a temporary drop in production at a major diamond mine.

⁶The baseline scenario does not incorporate any grants under a possible second compact with the Millennium Challenge Corporation or budget support from other development partners.

Box 2. Downside Scenario

Delaying or not fully implementing additional fiscal measures as outlined in the baseline scenario could still threaten macroeconomic stability. As an example, an illustrative downside scenario with fiscal measures that achieve permanent fiscal gains of 1 percent of GDP a year from 2016/17 to 2018/19 (cumulative gain of 3 percent of GDP by 2018/19) would lead to a substantial increase in domestic debt and lower in international reserves. Assuming that the financing of additional fiscal needs is accomplished through the combination of issuance of government securities and running down the government deposits at CBL, by the end of the medium-term projection period (2019/20) international reserves would fall to about 4 months of import coverage and total public debt would reach 60 percent of GDP. In addition, the increased government borrowing leads to some crowding out of credit to the private sector, which negatively affects GDP growth.

DOWNSIDE SCENARIO

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
Additional fiscal measures	...	...	...	...	1.0	2.0	3.0	3.0
Overall fiscal balance	5.0	-2.5	0.6	-3.2	-8.8	-5.1	-5.1	-5.9
Domestic financing								
Government deposits	8.4	1.5	6.2	0.0	-3.4	-0.8	-0.1	-0.6
Government securities	-2.6	-0.6	-0.4	1.2	4.3	3.6	4.1	4.3
Current account balance (including grants)	-10.3	-10.6	-8.3	-6.2	-13.0	-7.5	-9.7	-8.9
Gross international reserves (month of imports)	4.9	5.2	6.3	6.3	5.5	4.9	4.6	4.1
Total debt	40.3	43.4	47.8	53.4	57.0	57.7	58.3	60.2
External debt	37.2	41.1	46.2	50.8	50.3	48.0	45.6	44.2
Domestic debt	3.1	2.2	1.6	2.6	6.7	9.7	12.8	16.0
GDP growth (percent)	5.3	3.6	3.4	2.6	2.5	4.2	4.9	3.2
Inflation (percent)	5.0	5.6	2.6	4.1	5.0	5.0	5.0	5.0
Broad money (annual change)	6.1	31.5	-5.9	8.9	6.8	8.5	9.8	7.7
Credits to private sector (annual change)	42.2	10.3	11.8	9.1	1.3	-0.2	-1.6	-1.2

BASELINE SCENARIO

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.
Additional fiscal measures	...	...	...	...	3.0	6.5	7.0	7.0
Overall fiscal balance	5.0	-2.5	0.6	-3.2	-7.4	0.0	0.0	0.0
Domestic financing								
Government deposits	8.4	1.5	6.2	0.0	-3.3	0.8	1.0	1.0
Government securities	-2.6	-0.6	-0.4	1.2	3.1	0.0	0.0	0.0
Current account balance (including grants)	-10.3	-10.6	-8.3	-6.4	-14.0	-7.5	-9.2	-8.1
Gross international reserves (month of imports)	4.9	5.2	6.3	6.3	5.6	5.4	5.3	5.3
Total debt	40.3	43.4	47.8	53.4	55.8	53.0	50.1	48.3
External debt	37.2	41.1	46.2	50.8	50.3	48.0	45.6	44.2
Domestic debt	3.1	2.2	1.6	2.6	5.5	5.0	4.5	4.1
GDP growth (percent)	5.3	3.6	3.4	2.6	2.9	4.5	5.5	3.6
Inflation (percent)	5.0	5.6	2.6	4.1	5.0	5.0	5.0	5.0
Broad money (annual change)	6.1	31.5	-5.9	8.4	8.7	11.0	12.1	9.9
Credits to private sector (annual change)	42.2	10.3	11.8	9.1	8.8	11.6	12.5	10.5

POLICY DISCUSSIONS

8. Policy discussions focused mainly on the principal challenge facing Lesotho: the ongoing drop in SACU revenues and fiscal adjustment. As highlighted by the Minister of Finance in the 2015/16 budget speech in June, the Lesotho authorities recognize the need for fiscal adjustment to maintain macroeconomic stability, including the necessity to contain the government wage bill. Policy discussions also addressed the need to strengthen Lesotho's business environment and international competitiveness, so that the private sector can step up as the driving force for job creation and more inclusive growth. Financial sector stability and development issues were also discussed, with a view toward enhancing a sound deepening of financial services and intermediation to support growth. Other issues discussed during the Article IV consultation included debt sustainability and structural reforms, particularly in the area of public financial management (PFM), which would be instrumental for paving the way for longer-term fiscal reforms such as decentralization and a rules-based approach to fiscal policy.

A. Fiscal Adjustment and Supporting Reforms to Ensure Macroeconomic Stability

9. Lesotho's SACU revenues are expected to fall by about 12 percentage points of GDP between 2014/15 and 2016/17, with much of this drop expected to be long lasting. After falling by 3½ percentage points of GDP in 2015/16 (to just over 25 percent of GDP), they are projected to plunge another 8½ percentage points to about 16½ percent of GDP the following year.⁷ Although a modest rebound is expected in 2017/18, SACU revenues are projected to remain relatively low (below 20 percent of GDP) over the foreseeable future, largely due to the slowdown in import growth in South Africa, which is the main determinant of the size of the SACU revenue pool.⁸ The government's latest budget projections envisage a modest fiscal consolidation of only a 3 percentage points of GDP over the medium term, implying that additional measures to raise domestic tax and non-tax revenues and curb government spending will be necessary to close a substantial gap. Indeed, considering that government spending has been budgeted to expand in the current year—to over 63 percent of GDP, with the wage bill alone rising to 23 percent of GDP—the task of adjusting the fiscal stance will require a strong reversal of expenditure trends.

10. To reduce the shock to the economy and to allow time for much needed structural reforms, Lesotho's fiscal adjustment could be spread over the next 2-3 years; however, a significant first step would be needed to establish credibility. In the baseline scenario, the path for additional fiscal measures—that is, measures beyond the modest consolidation already reflected

⁷ SACU revenues have fallen from R 7.0 billion in 2014/15 to R 6.6 billion in 2015/16 and R 4.5 billion in 2016/17. The allocation in 2016/17 is derived from the projected base revenue of R 5.5 billion and a negative correction of R 1.0 billion for actual collections in 2014/15 that were lower than projected.

⁸ In addition to South Africa's lower imports, Lesotho's base revenue projection was reduced by a permanent correction (R 0.6 billion) which removes fuel levies from the SACU revenue pool.

in the government's recent budget projections (Text Table 1)—call for adjustments on the order of 3, 3½, and ½ percentage points of GDP in 2016/17, 2017/18, and 2018/19, respectively. Given that domestic revenue collections are already quite high relative to GDP, a larger share (about two-thirds) of the adjustment could come from expenditure measures, particularly by containing the wage bill. Other possible measures include better targeting of social transfers; phasing-out transfers for tuition loans and reforming financial management of the National Manpower Development Secretariat; raising fuel levies; enacting the new mining taxation regime; and broadening coverage of the corporate income tax. With the proposed adjustment, the overall fiscal deficit is projected to widen considerably in 2016/17 (to about 7½ percent of GDP, from just over 3 percent of GDP in 2015/16), before returning to near zero in 2017/18, and beyond. A combination of domestic borrowing and a drawdown of government deposits at the CBL could be used to finance the deficits, while still preserving debt sustainability and reserve adequacy (Annexes 1 and 2). Gross international reserves are projected to fall during the adjustment period, but then stabilize at about 5–5½ months of imports beginning in 2018/19.

Text Table 1. Possible Fiscal Measures (2016–19)		
Measure	Estimated Annual Fiscal Savings	
	<i>In millions of Maloti</i>	<i>In percent of GDP</i>
Maintain wage bill in nominal terms; restrain new hiring (allow hiring in critical areas only)	300-400	1.2-1.6
Payroll audit and eliminate irregularities (“ghost” positions)	390-1285*	1.3-4.3*
Reduce cost on international and domestic travel, including prioritizing international training and workshops	100-150	0.4-0.5
Reduce transfers and ensure self-sufficiency of the National Manpower Development Secretariat (NMDS) through strong enforcement of student loan recovery	500	2.0
Increase fuel taxes (in line with recent increase in South Africa)	150-300	0.5-1.5
Revision of fees, penalties, and charges	25-50	0.1-0.2
Reform of the social transfer system to better target the poor	150-200	0.5-1.0
Strengthening tax and customs administrations	150	0.5
* Estimate by World Bank staff.		

11. Structural reforms—notably, to address the government payroll and the budget process—would be critical for a successful fiscal adjustment with protection for vulnerable segments of the population. Severe weaknesses in public service administration have contributed to the high government wage bill, while poor public financial management has added to the under execution of the capital budget and poor delivery of public services. To overcome capacity issues and enable much needed progress on the structural agenda, the government should work closely

with development partners and technical assistance experts. In particular, the World Bank's project for the modernization of government aims to help clean up and efficiently manage the government payroll and improve the allocation of human resources, using biometric identification for civil servants, improved control systems, and, over time, a functional review of government agencies. To strengthen social protection, while also generating fiscal savings, income transfers and subsidies could be targeted more effectively.⁹ Several development partners provide technical assistance for the action plan for the comprehensive PFM reform, the implementation of which has received a boost from the new ministerial-level steering committee and PFM coordinator. With respect to the wage bill, actions—such as identifying and eliminating “ghost” workers through payroll audits—could generate considerable fiscal savings (1.3-4.3 percent of GDP a year)¹⁰ in the near term. However, in the event that fiscal savings take more time to materialize, the authorities could impose a temporary ceiling to contain the wage bill. Within such a cap, there could be discretion on staffing and wage rate decisions.

12. PFM reforms are also urgently needed to strengthen budget execution and monitoring. In line with past recommendations, professional positions in the Cash Management Unit (CMU) of the Office of the Accountant General (AcG) need to be filled with qualified staff. Full reconciliation of all government bank accounts on a regular basis, including accounts in commercial banks, is a basic prerequisite to establish accountability. A strategy could then be formulated to finally make proper use of the Treasury Single Account at the CBL. Efforts also need to be stepped up in the areas of medium-term planning and budgeting, which are necessary components for a rules-based approach to fiscal policy.

Authorities' views

13. There was broad agreement to undertake the necessary fiscal adjustment in steps, as recommended by Fund staff. The authorities prefer to rely predominantly on spending cuts to achieve fiscal adjustment, particularly focusing on the wage bill and expenditures on goods and services. With technical support from the World Bank, payroll audits in a few pilot ministries—along with steps to strengthen personnel management—could begin in early 2016/17. Procurement procedures will be reviewed with a view to reduce the cost of supplies, while also outsourcing more services with the potential for fiscal savings. In addition, measures to be incorporated in the budget proposal for 2016/17 include:

- Zero adjustment for inflation in government wages and no new hiring, except for key positions (such as, qualified accountants);
- Increases in non-tax revenues (fees, charges, and penalties); and
- Increase in fuel taxes.

⁹ Negotiations on the World Bank's social protection project, which focuses on this issue, are at an advanced stage.

¹⁰ Estimate by World Bank staff.

On PFM reform, the authorities emphasized that the elevated status of the steering committee is a demonstration of their intentions to make good progress on the action plan going forward. It was noted that without improved PFM systems it would be difficult to implement a major fiscal adjustment.¹¹

B. Enabling Private Sector Growth and Job Creation to Bolster Inclusiveness

14. **With the government in need of significant fiscal adjustment, Lesotho must rely on private sector-led growth to generate employment opportunities and improve inclusiveness.**

However, transforming from a heavy dependence on government to a more private sector-led economy will be a lengthy and challenging process. Moreover, Lesotho's international competitiveness is in a precarious position, which suggests that achieving greater export growth will also be a challenge.¹² The NSDP, which was adopted essentially by all political parties in 2012, provides a viable roadmap to more dynamic private sector growth, but implementation has been sketchy at best. In particular, the NSDP identifies manufacturing, tourism, information and communications technology (ICT), and commercial agriculture as sectors with strong potential job creation. Discussions with the authorities and representatives of the business community focused on identifying near-term measures—within the government's budget limitations—that could have an immediate impact on unemployment pressures during the fiscal adjustment.

15. As suggested by the business community, there are a number of relatively low-cost near-term actions that could help eliminate some obstacles to doing business. For example, operating government-leased factory shells on a commercial basis would lead to more effective use of this resource. Currently, there is a waiting list of potentially job creating businesses seeking these facilities, while some existing tenants have become dormant and fallen into arrears on their rent. Other suggestions include exploring options for private industrial parks; providing internationally accepted standards certification services for both agricultural and manufacturing products; encouraging wage contracts (such as, piece-rate wages) that enhance competitiveness; and supporting development of market-demanded skills, including through extension services. Following up on pilot projects under the NSDP—notably, extension services and standards certification for commercial fruit orchards—could lead to rapid private sector development in these areas. Diversifying exports and targeting the sub-region may also be necessary, especially in light of recent trade developments that will likely cut into Lesotho's current favored position.¹³ To support longer-term growth and inclusiveness, step up implementation of the NSDP, particularly by strengthening planning and execution of government's capital budget, not only for much needed infrastructure,

¹¹ With financing from the European Union (EU), the Fund will provide a resident advisor to the AcG's office. The EU is also providing four more long-term experts to support PFM reform.

¹² For a discussion of international competitiveness, see Annex 3.

¹³ The recent agreement on the Trans-Pacific Partnership will give some highly competitive Asian countries access to the US market for textiles.

but also for pilot projects and follow-up support in priority sectors. In general, greater engagement by government with the business community and development partners would help to identify productive measures.

Authorities' views

16. While a number of initiatives are already underway, the authorities agreed that further progress is needed to invigorate the private sector. The Lesotho National Development Corporation (LNDC) is courting suppliers to South African industries to establish plants in Lesotho, in order to diversify export markets more towards the sub-region and to build upon Lesotho's natural comparative advantages. They noted that a recent investment in Lesotho by a supplier to South Africa's auto industry is encouraging. The LNDC also just completed construction of several more factory shells and saw scope for managing existing shells more effectively. Government officials emphasized that in addition to strengthening planning and execution of the capital budget, curbing recurrent spending could provide fiscal space to increase spending on infrastructure. They also plan to hold a long-delayed "Jobs Summit" to focus attention on employment issues and relevant policy actions. To help spur entrepreneurship, they have begun to identify public services that could be outsourced to the private sector at a savings to the budget. Transparency and competitive bidding procedures would be critical to the success of this initiative. As noted in the 2015/16 budget speech, the authorities also aim to explore opportunities for privatization and divestiture of government's equity positions.

C. Financial Sector Stability and Development to support Growth

17. Indicators suggest that Lesotho's banking system overall is adequately capitalized, liquid, and profitable (Table 8), although one bank continues to face difficulties. Three of the sector's four banks are subsidiaries of large South African banks. They account for over 90 percent of total assets and deposits and have been highly profitable. The fourth bank, the government-owned Lesotho Post Bank (LPB), which was established to primarily serve rural areas and the unbanked, has typically incurred losses. For the system as a whole, growth in credit to the private sector has slowed considerably following a surge in 2012.¹⁴ Although nonperforming loans (NPLs) increased after the surge, they remained relatively low as a share of total loans and have largely been provisioned for. The nonbank financial sector is a mixed picture, with some pension funds and insurance companies holding substantial assets and generating profits, while other smaller scale institutions have struggled. Some aspects of the insurance sector—notably brokerage services—have eluded regulatory oversight, which is a potential source of risk. In addition, maintaining the CBL's supervisory capacity of banks and nonbanks has been a challenge, particularly with staff turnover.

18. Looking ahead, there could be risks to the banking system stemming from fiscal adjustment. That is, although an empirical analysis of macro-financial linkages suggest only a small

¹⁴ The 2012 Land Act allowed land to be used as collateral, which led to a surge in credit.

correlation between economic growth and credit to the private sector,¹⁵ two important areas for commercial bank lending are personal loans and construction. With government being a major employer and source of construction contracts—especially for projects financed by development partners—the anticipated cutbacks in government spending during the fiscal adjustment could weigh heavily on banks’ loan portfolios. Beyond highlighting potential risks to the banking system, policy discussions focused on steps to address constraints on access to credit.

19. The CBL’s has continued to make progress on implementing the FSDS, while building capacity for supervision and financial stability reporting has been noteworthy. Ongoing efforts to broaden the use of the new credit reference bureau, establish a collateral registry, and solidify the role of commercial courts to settle credit matters should help to reduce the risk premium in lending rates and improve access to credit for creditworthy borrowers. In addition, given the high profits of the foreign-owned banks, exploring ways to generate greater competition—such as inviting other banks to enter the market—to lower lending rates may be warranted. Building supervisory capacity for both banks and nonbanks, particularly with the implementation of Basle II principles, as well as implementation of new regulations for the insurance sector, would help to reduce risks to the financial system.¹⁶ In addition, the CBL’s continued active engagement with South African banking supervisors, who oversee the parent banks of subsidiaries in Lesotho, is critical, given the extensive cross-border networks of these banks. With a view toward shoring up the LPB, a sizeable component of the loan portfolio that is driven by government policy initiatives, which should be transparent and explicitly reflected in the government budget. Also, alternative options for management and operations of the LPB should be explored.

Authorities’ views

20. The CBL has been proactive on both financial sector supervision and development, and remains dedicated to the implementation of the FSDS. Further technical assistance for capacity building in both supervision and financial stability reporting would be welcomed. On the financial soundness of the LPB, the bank’s income statement has begun to improve—recently recording its first profit. It was emphasized by banking supervision that the government, as owner of the LPB, would need to take the lead role in operational and managerial reforms. Moreover, while the banking system is generally sound, banking supervision would remain vigilant to monitor macrofinancial risks arising from a major fiscal adjustment—such as a possible deterioration of quality on loans to government contractors.

¹⁵ See Annex 4: Development of Macro-Financial Risks and Conditions.

¹⁶ The Fund has provided technical assistance in these areas.

D. Other Surveillance Issues

21. Monetary and Exchange Rate Policy. The loti's parity with the rand under the CMA has served Lesotho well by solidifying expectations of continued macroeconomic stability, even during periods of fiscal difficulties, such as periodic downturns in SACU revenues. The CMA has also facilitated trade and financial integration with South Africa. Fund staff has assessed that the loti exchange rate remains aligned with economic fundamentals, even though some empirical analyses points to a modest undervaluation, especially given the challenges facing Lesotho's international competitiveness (see Annex 3).¹⁷ Moreover, in view of the looming drop in foreign exchange receipts from the sharp reduction in SACU revenues, there is an urgent need to implement the appropriate fiscal measures to ensure that international reserves continue to fully meet commitments under the CMA with adequate buffers.¹⁸ An analysis of reserve adequacy supports the authorities' existing medium-term target of 5 months of import cover (see Annex 2). While monetary policy is largely subsumed by this strong fixed exchange regime, the authorities' intention to develop an effective policy interest rate could be useful in the event temporary pressures on the loti-rand parity arise.

22. Debt Sustainability. Lesotho remains at moderate risk of debt distress (see Annex 1). The principal source of pressure on debt sustainability arises from the authorities' intentions to use debt financing for a major infrastructure project—the power component of LHWP-II—over the next decade. A thorough feasibility study is expected to be completed in the coming year, and will be instrumental in determining the way forward, both on the financing and scope of the project. Given the tendencies around the world for such projects to incur delays and cost overruns, a conservative approach to such a decision would be critical to maintain debt sustainability. Moreover, although the recent depreciation of the South African rand does not fundamentally alter the risk assessment, it does increase Lesotho's external debt vulnerabilities and the need to remain vigilant about debt management, such as limiting external borrowing mostly to concessional loans.

23. Other Structural Reforms. *Fiscal decentralization.* To address issues of poor delivery of public services, the authorities are keen to pursue fiscal decentralization. While decentralization has merit and is encouraged by development partners, it would both require vast improvement in management of the public service and public financial management, before it could be productively implemented. *Rules-based approach to fiscal policy.* Following up on discussions from the previous Article IV consultation, the authorities expressed interest in a rules-based approach to fiscal policy with a view toward achieving greater stability in government spending despite highly volatile revenues (from SACU and mining). While an expenditure-type rule would help to achieve more stable spending, there was a consensus that a fiscal balance-type component would be needed to

¹⁷ With the vast majority of Lesotho's imports coming from South Africa, the recent volatility in the rand has had only limited impact on Lesotho's balance of payments. The main effects are on the cost of fuel imports, which has been dampened by low international oil prices. On the export side, the weakening of the rand should help competitiveness.

¹⁸ The CMA imposes a floor on international reserves equivalent to 100 percent of base money.

ensure consistency with maintaining adequate international reserves.¹⁹ Progress on PFM reform, particularly in the area of medium-term planning and budgeting, would be an essential precondition to successfully implement such a fiscal rule. Moreover, with SACU revenues entering a trough, the timing for introducing an expenditure-type fiscal rule would need to be pushed back considerably.

24. Lesotho maintains one exchange restriction subject to Fund approval. The restriction arises from single discretionary allowances of Maloti 1 million per individual per calendar year, for residents over 18, and of Maloti 200,000 on the same basis for residents under 18. The availability of foreign exchange beyond these limits is subject to a discretionary approval on a case by case basis. This gives rise to an exchange restriction inconsistent with Lesotho's obligations under Article VIII, Section 2(a) of the Articles of Agreement.

25. Anti-Money Laundering and Combating Financing for Terrorism (AML-CFT). The Eastern and Southern Africa Anti-Money Laundering Group recently noted the slow progress in addressing deficiencies in Lesotho's AML/CFT legal framework. The authorities are taking steps to revise the legal framework and to better understand ML/TF risks. They are encouraged to expedite the amendments to the Money Laundering and Proceeds to Crime Act in line with international standards, and to proceed with the assessment of national ML/TF risks.

26. Technical Assistance (TA). Lesotho's use of Fund provided TA has expanded significantly in recent years. In line with Lesotho's macroeconomic policy agenda going forward, TA is being directed toward PFM reform (cash management and medium-term fiscal frameworks), tax policy, revenue administration, bank and nonbank supervision and regulations, financial stability reporting, and economic statistics. This TA has been well-received; however, in some cases delays in the government's recruiting qualified staff have hindered the desired capacity building component.

27. Data provision is broadly adequate for surveillance. However, data shortcomings in national accounts and external sector statistics handicap economic policy making. Progress toward producing quality quarterly national accounts statistics on a timely basis is a top priority.²⁰

STAFF APPRAISAL

28. Lesotho achieved solid economic growth for several years with only moderate inflation. In recent years, the authorities were able to rebuild fiscal buffers and international reserves, largely due to a temporary rebound in SACU revenues. However, there has been little progress in the fight against poverty and unemployment, despite considerable spending on social sectors and transfers.

¹⁹ The authorities expressed interest in a rule to limit recurrent expenditures in favor of capital spending, but staff cautioned them about difficulties with rules relying on expenditure classifications.

²⁰ An ongoing TA program supported by AFRITAC South aims to address this issue.

29. Lesotho faces a challenging economic outlook. The imminent sharp drop in SACU revenues could threaten macroeconomic stability, unless a major fiscal adjustment is implemented. While existing buffers provide a cushion to allow an orderly adjustment over the next 2-3 years, it is critical that the authorities take a substantial first step in the upcoming fiscal year to ensure credibility. Containing recurrent expenditures—most importantly, the extraordinarily large government wage bill—should be central to the adjustment effort. In addition, social protection can be better targeted toward the most vulnerable. The measures that the authorities intend to include in the 2016/17 budget would indeed make a significant contribution toward fiscal adjustment.

30. Reforms to strengthen public service administration and public financial management are urgently needed, not only for a successful fiscal adjustment, but to also improve the delivery of government services. A lack of basic controls—such as the inability to fully reconcile government bank accounts on a regular basis—contributes to severe government inefficiencies. Staff urges the authorities to make good use of extensive technical assistance currently available to build capacity in critical management areas.

31. To achieve greater inclusiveness, the private sector needs to step up job creation. Implementation of the National Strategic Development Plan, which provides a viable approach for transitioning from government dependence to private sector led growth over the longer term—particularly in sectors with potential for high employment—needs to be restarted. In the near term, to quickly stimulate job growth, measures could be taken to eliminate unnecessary obstacles and bottlenecks to doing business. Continued implementation of the Financial Sector Development Strategy would improve access to credit and financial services.

32. To ensure financial stability, building capacity for bank and nonbank supervision and coordinating on cross-border supervision need to be continued. While indicators point to a generally sound financial system, the authorities need to remain vigilant regarding weak individual institutions and financial linkages to sectors that would be affected by fiscal adjustment.

33. The loti's parity with the South African rand has served Lesotho well by supporting macroeconomic stability and integrating the economy with the region. It is critical that an adequate level of international reserves is maintained to ensure this exchange rate regime. Staff does not recommend approval of the exchange restriction under Article VIII, section 2(a) arising from the discretionary allowances, given that this measure was not imposed for balance of payments reasons.

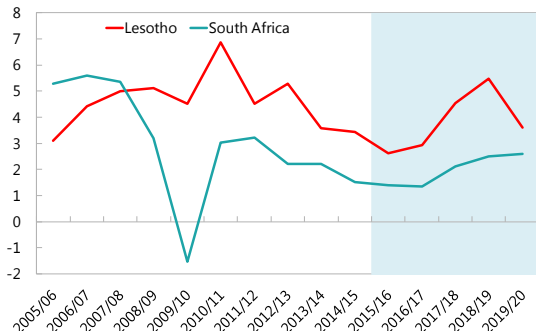
34. Looking ahead, a rules-based approach to fiscal policy could strengthen fiscal discipline and better manage volatile revenues. Building up the institutional PFM framework, including robust medium-term planning and budgeting, is a necessary first step toward this goal.

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

Figure 1. Lesotho: Macroeconomic Developments

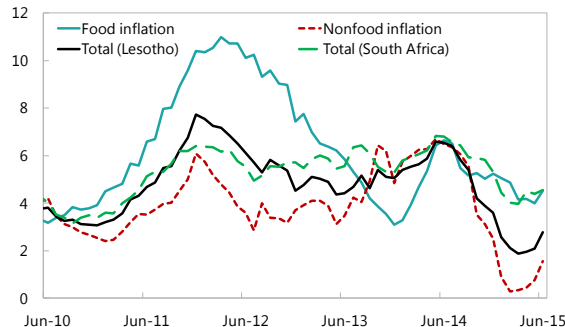
Real GDP growth has slowed in recent years, partly reflecting developments in South Africa.

Real GDP Growth
(percent, year-on-year)



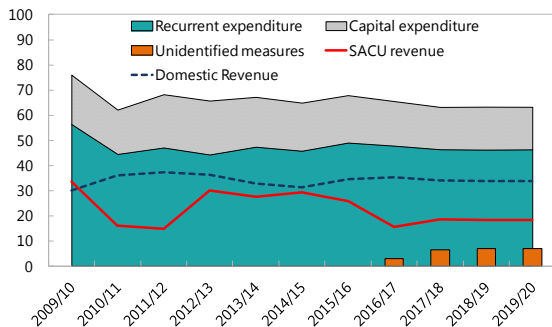
Inflation has declined sharply, driven by drop in fuel prices

Consumer Price
(percent)



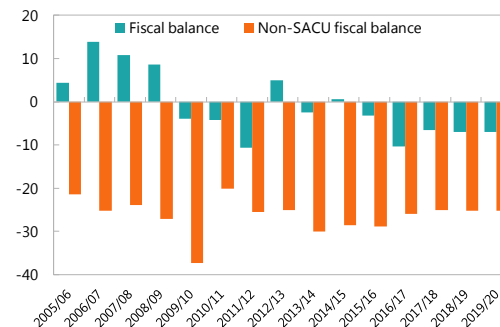
SACU revenues are expected to decline over the next two years, requiring additional measures for fiscal adjustments.

Government Revenue and Expenditure
(percent of GDP)



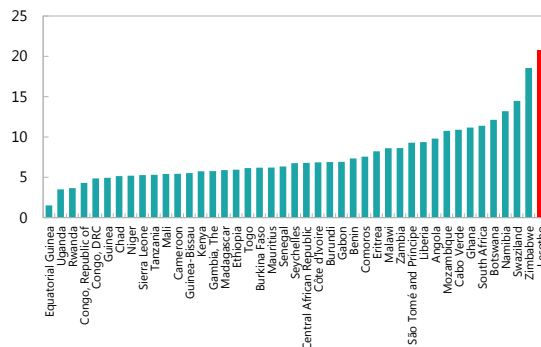
Large fiscal deficits (excluding SACU revenue) jeopardize long-term fiscal sustainability.

Fiscal Balance
(percent of GDP)



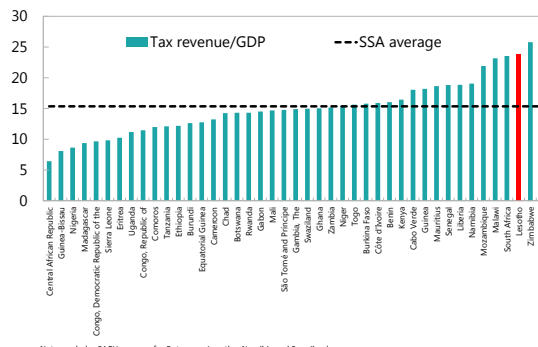
Government's wage spending as a share of GDP is largest in Sub-Saharan Africa.

Compensation of Employees
(percent of GDP)



Tax revenue is much higher than most other countries in the region.

Tax Revenue
(percent of GDP, average 2012-14)



Note: excludes SACU revenue for Botswana, Lesotho, Namibia and Swaziland.

Sources: World Bank, country authorities, and IMF staff calculation.

Figure 1. Lesotho: Macroeconomic Developments (continued)

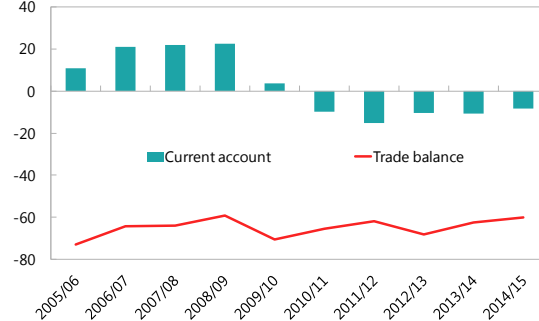
Persistent growth in wages is largest contributor to the growth in recurrent spending.

Contribution to Recurrent Expenditure Growth
(percent)



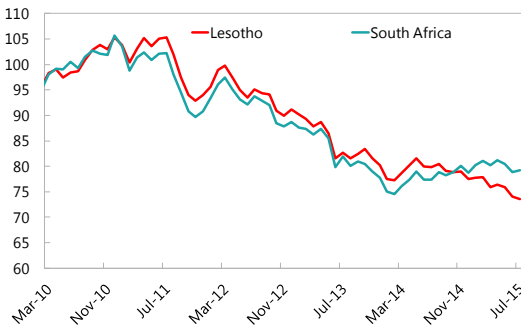
Despite large trade deficits, SACU transfers kept recurrent account balance moderate.

Current Account
(percent of GDP)



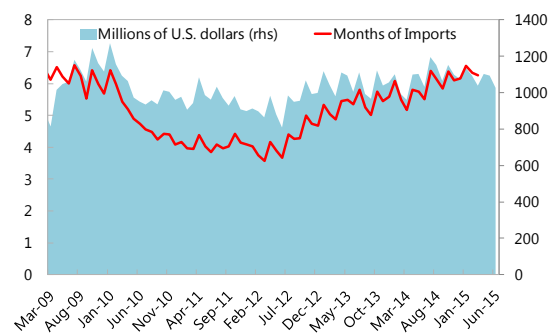
Recent nominal depreciation of Rand has led to the real exchange rate depreciation.

Real Effective Exchange Rate
(2000=100)



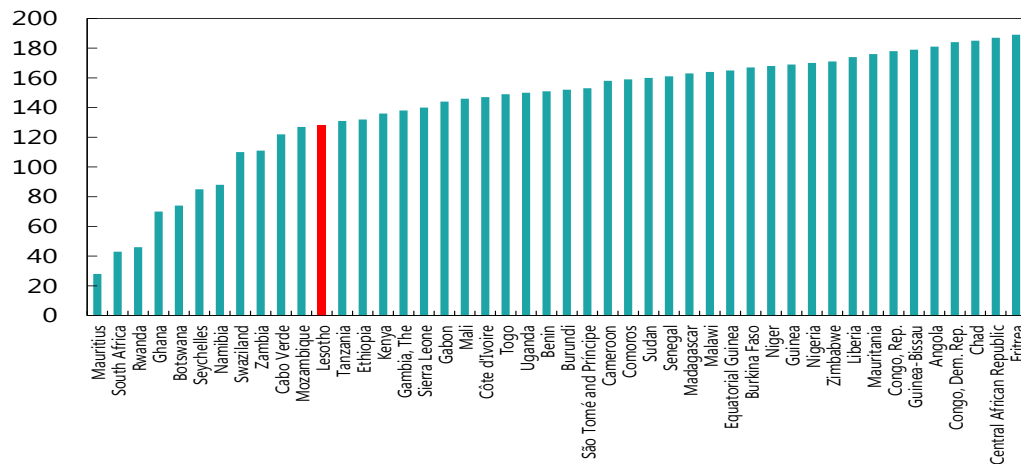
After a sharp fall during the previous SACU crisis, reserves have seen a strong recovery.

International Reserves



While Lesotho compares favorably to many other SSA countries, there is still room to improve business environment and generate private sector growth.

Ease of Doing Business Rank, 2015

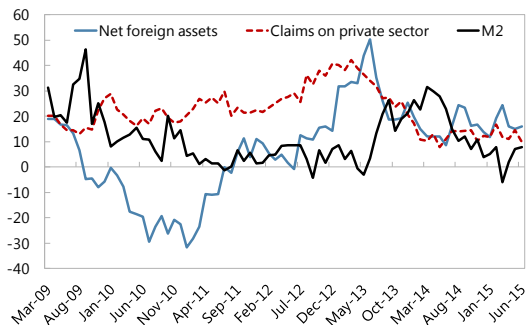


Sources: World Bank, country authorities, and IMF staff calculation.

Figure 1. Lesotho: Macroeconomic Developments (concluded)

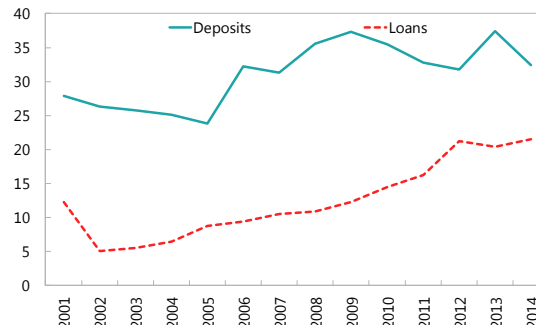
After a temporary surge, growth in private credit has declined...

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



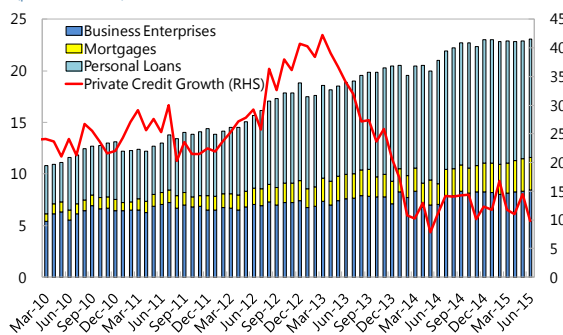
And remained stagnant as a share of GDP.

Lesotho: Commercial Banks
(percent of GDP)



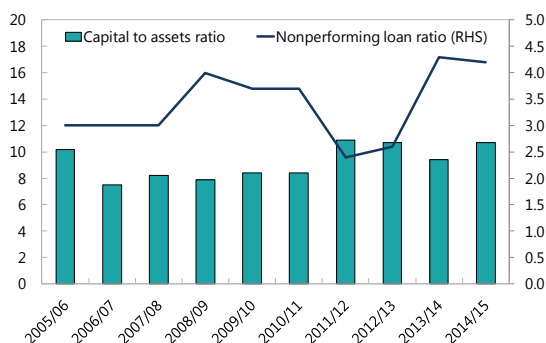
Recent growth in private credit has been largely due to personal loans...

Composition of Bank Loan
(percent of GDP)



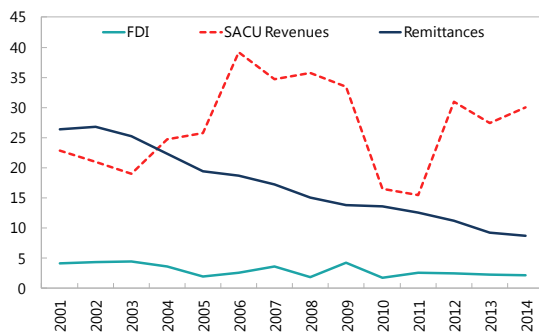
And nonperforming loans ratio has risen.

Capital Adequacy and Non-performing Loans



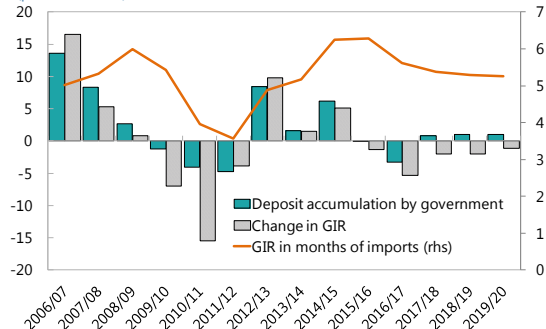
In addition to the volatile SACU revenue, declining remittances have weighed heavily on current account balance.

Lesotho: Transfers, Flows and FDI
(Percent of GDP)



Developments in international reserves are largely a reflection of the government's fiscal position.

Domestic Financing and International Reserves
(percent of GDP)



Sources: World Bank, country authorities, and IMF staff calculation.

Table 1. Lesotho: Selected Economic Indicators, 2012/13–2019/20

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Est.			Projections		
Population (1,000; 2011 est.)	2,194							
GNI per capita (U.S. dollars; 2011 est.):	1,220							
Poverty rate (percent, 2011 est.):	57							
	(Percentage changes; unless otherwise indicated)							
National account and prices								
GDP at constant prices	5.3	3.6	3.4	2.6	2.9	4.5	5.5	3.6
GDP at market prices								
(Maloti millions)	19,783	21,975	24,071	25,909	27,804	30,617	34,032	37,006
Consumer prices (average)	5.5	5.0	3.8	3.9	4.1	5.0	5.0	5.0
Consumer prices (eop)	5.0	5.6	2.6	4.1	5.0	5.0	5.0	5.0
GDP deflator	2.0	7.2	5.9	4.9	4.3	5.3	5.4	5.0
External sector								
Terms of trade (deterioration -)	-9.7	-0.2	5.1	0.5	-1.0	1.3	1.6	1.7
Average exchange rate								
(Local currency per U.S. dollar)	8.6	9.6	11.3	...	...	...	...	...
Nominal effective exchange rate change (- = depreciation) ²	-14.4	-11.5	-3.9	...	...	...	...	...
Real effective exchange rate (- = depreciation) ²	-12.1	-9.3	-4.7	...	...	...	...	...
Current account balance								
(Including official transfers, percent of GDP)	-10.3	-10.6	-8.3	-6.4	-14.0	-7.5	-9.2	-8.1
(Excluding official transfers, percent of GDP)	-43.4	-40.1	-39.2	-33.2	-31.4	-28.6	-29.3	-28.1
Gross international reserves								
(Months of imports)	4.9	5.2	6.3	6.3	5.6	5.4	5.3	5.3
(Percent of M1) ³	268	248	290	281	248	235	222	213
Money and credit								
Domestic credit to the private sector	42.2	10.3	11.8	9.1	8.8	11.6	12.5	10.5
Reserve money	-1.9	15.2	8.2	8.6	8.3	10.8	11.8	9.7
Broad money	6.1	31.5	-5.9	8.4	8.7	11.0	12.1	9.9
Interest rate (percent) ⁴	2.4	2.3	3.0	...	...	...	...	...
	(Percent of GDP; unless otherwise indicated)							
Savings and investment								
Gross capital formation ⁵	36.7	35.0	33.0	33.3	33.2	32.5	34.3	34.5
Public	20.8	19.6	17.9	17.9	18.1	17.9	19.9	20.1
Private	15.6	15.0	14.7	15.0	14.8	14.2	14.0	14.0
National savings	26.5	24.4	24.8	26.9	19.2	25.0	25.0	26.3
Public	24.9	16.2	17.1	14.9	6.4	9.1	8.8	8.8
Private	1.6	8.2	7.7	12.0	12.8	15.9	16.2	17.5
Public debt	40.3	43.4	47.8	53.4	55.8	53.0	50.1	48.3
External public debt	37.2	41.1	46.2	50.8	50.3	48.0	45.6	44.2
Domestic debt	3.1	2.2	1.6	2.6	5.5	5.0	4.5	4.1
Central government fiscal operations								
Revenue and grants	66.5	60.4	60.6	60.2	50.8	52.6	52.1	52.0
Of which: SACU revenue	30.2	27.6	29.2	25.7	15.5	18.6	18.2	18.2
Of which: grants	8.6	4.8	2.1	3.7	3.6	3.5	3.3	3.2
Recurrent expenditure	44.3	47.4	45.8	49.0	47.8	46.4	46.2	46.3
of which: wages, including social contributions	18.9	20.9	21.6	23.1	23.6	23.5	23.4	23.4
Capital expenditure	17.2	15.5	14.1	14.3	13.4	12.7	12.8	12.7
Unidentified fiscal adjustment	...	...	...	...	3.0	6.5	7.0	7.0
Overall balance ⁶	5.0	-2.5	0.6	-3.2	-7.4	0.0	0.0	0.0
(Excluding grants)	-3.6	-7.3	-1.4	-6.9	-11.0	-3.5	-3.3	-3.2

Sources: Lesotho authorities and IMF staff estimates and projections.

¹ The fiscal year runs from April 1 to March 31.² IMF Information Notice System trade-weighted; end of period.³ Reserve coverage of 100 percent of M1 is minimum required under the terms of Common Monetary Area agreement with South Africa.⁴ 12-month time deposits rate.⁵ Excluding changes in inventories.⁶ Including additional fiscal measures.

Table 2. Lesotho: Fiscal Operations of the Central Government, 2012/13–2019/20¹
(Maloti millions)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Est.	Projections				
Revenue	13,150	13,274	14,575	15,592	14,345	16,102	17,725	19,253
Tax revenue ²	4,595	5,148	5,720	6,517	7,024	7,696	8,572	9,321
Taxes on income, profits, and capital gain	2,349	2,680	3,059	3,315	3,576	3,911	4,348	4,728
Taxes on property	150	128	139	162	178	193	215	234
Taxes on goods and services	1,819	1,887	2,344	2,758	2,974	3,268	3,648	3,962
Taxes on international trade	277	451	177	276	291	320	359	394
Grants	1,703	1,047	496	956	1,004	1,057	1,110	1,166
Budget support	196	149	4	0	0	0	0	0
Project grants	1,507	898	491	956	1,004	1,057	1,110	1,166
Of which: MCC	1,122	347	...	...	...	...	...	...
Non-tax revenue	885	1,025	1,325	1,450	1,798	1,656	1,840	2,021
Property Income	109	164	413	489	783	585	651	707
Sales of goods and services	772	856	905	941	1,001	1,060	1,179	1,302
Other non-tax revenue	4	5	8	20	14	10	11	12
SACU	5,966	6,055	7,034	6,668	4,519	5,693	6,203	6,745
Expense	8,764	10,416	11,023	12,707	13,299	14,203	15,739	17,151
Compensation of employees	3,749	4,589	5,211	5,978	6,573	7,184	7,979	8,672
Wages and salaries	3,226	3,938	4,436	5,224	5,698	6,231	6,931	7,533
Social contributions	522	651	744	755	875	953	1,047	1,139
Use of goods and services	2,356	2,970	2,908	3,527	3,335	3,501	3,901	4,235
Interest payments	166	192	227	314	430	434	443	530
Domestic	85	84	96	141	245	245	215	310
External	81	108	131	172	185	189	227	220
Subsidies	253	232	198	281	251	261	290	315
Grants	882	899	1,015	784	833	883	984	1,066
Social benefits	611	762	670	937	988	1,041	1,154	1,255
Other expenses	747	772	794	885	890	898	989	1,079
Gross operating balance	4,386	2,858	3,552	2,885	1,046	1,899	1,986	2,101
Nonfinancial assets	3,396	3,410	3,405	3,710	3,728	3,889	4,367	4,693
Domestically financed	1,627	2,169	1,962	2,280	2,405	2,529	2,873	3,108
Externally financed	1,770	1,241	1,443	1,430	1,324	1,360	1,494	1,585
Additional fiscal measures ³	...	...	...	...	834	1,990	2,382	2,590
Net lending/borrowing (Overall fiscal balance)	989	-552	147	-825	-1,849	1	1	-1
Transactions in financial assets and liabilities	1,747	77	638	-825	-1,849	1	1	-1
Financial assets	1,670	341	1,501	0	-903	248	345	366
Domestic	1,670	340	1,498	-1	-903	247	344	365
Deposits	1,670	340	1,498	-1	-903	247	344	365
Central bank	1,670	333	1,498	-1	-903	247	344	365
Commercial banks	0	8	1	0	0	0	0	0
Loans	0	0	0	0	0	0	0	0
Financial liabilities	-77	264	862	825	946	248	344	367
Domestic	-506	-126	-103	300	635	0	0	0
Foreign	429	390	965	525	311	248	344	367
Disbursements	649	701	1,274	930	745	745	828	901
Amortization	-220	-311	-309	-405	-434	-497	-484	-534
Statistical discrepancy ⁴	-757	-628	-491	0	0	0	0	0
<i>Memorandum items:</i>								
Overall fiscal balance, excluding SACU revenue	-4,977	-6,606	-6,887	-7,493	-6,368	-5,692	-6,202	-6,746
Overall fiscal balance, excluding SACU revenue and foreign-financed capital projects	-4,328	-5,905	-5,613	-6,563	-5,623	-4,947	-5,373	-5,845

Sources: Lesotho authorities and IMF staff estimates and projections.

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

² Other taxes are not shown in the table.

³ New fiscal measures to be introduced in 2016/17 budget.

⁴ The remaining balances on non-Treasury accounts at the end of the fiscal year explain the bulk of the statistical discrepancy.

Table 3. Lesotho: Fiscal Operations of the Central Government, 2012/13–2019/20¹
(Percent of GDP)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.			Projections			
Revenue	66.5	60.4	60.6	60.2	51.6	52.6	52.1	52.0
Tax revenue ²	23.2	23.4	23.8	25.2	25.3	25.1	25.2	25.2
Taxes on income, profits, and capital gain	11.9	12.2	12.7	12.8	12.9	12.8	12.8	12.8
Taxes on property	0.8	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Taxes on goods and services	9.2	8.6	9.7	10.6	10.7	10.7	10.7	10.7
Taxes on international trade	1.4	2.1	0.7	1.1	1.0	1.0	1.1	1.1
Grants	8.6	4.8	2.1	3.7	3.6	3.5	3.3	3.2
Budget Support	1.0	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	7.6	4.1	2.0	3.7	3.6	3.5	3.3	3.2
Of which: MCC	5.7	1.6	0.0	0.0	0.0	0.0	0.0	0.0
Non-tax revenue	4.5	4.7	5.5	5.6	6.5	5.4	5.4	5.5
Property income	0.6	0.7	1.7	1.9	2.8	1.9	1.9	1.9
Sales of goods and services	3.9	3.9	3.8	3.6	3.6	3.5	3.5	3.5
Other non-tax revenue	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0
SACU	30.2	27.6	29.2	25.7	16.3	18.6	18.2	18.2
Expense	44.3	47.4	45.8	49.0	47.8	46.4	46.2	46.3
Compensation of employees	18.9	20.9	21.6	23.1	23.6	23.5	23.4	23.4
Wages and salaries	16.3	17.9	18.4	20.2	20.5	20.4	20.4	20.4
Social contributions	2.6	3.0	3.1	2.9	3.1	3.1	3.1	3.1
Use of goods and services	11.9	13.5	12.1	13.6	12.0	11.4	11.5	11.4
Health care	3.2	4.1	3.9	3.9	3.9	3.9	3.9	3.9
Interest payments	0.8	0.9	0.9	1.2	1.5	1.4	1.3	1.4
Domestic	0.4	0.4	0.4	0.5	0.9	0.8	0.6	0.8
External	0.4	0.5	0.5	0.7	0.7	0.6	0.7	0.6
Subsidies	1.3	1.1	0.8	1.1	0.9	0.9	0.9	0.9
Grants	4.5	4.1	4.2	3.0	3.0	2.9	2.9	2.9
Social benefits	3.1	3.5	2.8	3.6	3.6	3.4	3.4	3.4
Other expenses	3.8	3.5	3.3	3.4	3.2	2.9	2.9	2.9
Gross operating balance	22.2	13.0	14.8	11.1	3.8	6.2	5.8	5.7
Non-financial assets	17.2	15.5	14.1	14.3	13.4	12.7	12.8	12.7
Domestically financed	8.2	9.9	8.2	8.8	8.6	8.3	8.4	8.4
Externally financed	8.9	5.6	6.0	5.5	4.8	4.4	4.4	4.3
Additional fiscal measures ³	...	...	...	...	3.0	6.5	7.0	7.0
Net lending(+)/borrowing (-) (Overall fiscal balance)	5.0	-2.5	0.6	-3.2	-6.6	0.0	0.0	0.0
Transactions in financial assets and liabilities	8.8	0.3	2.7	-3.2	-6.6	0.0	0.0	0.0
Financial assets	8.4	1.6	6.2	0.0	-3.2	0.8	1.0	1.0
Domestic	8.4	1.5	6.2	0.0	-3.3	0.8	1.0	1.0
Deposits	8.4	1.5	6.2	0.0	-3.3	0.8	1.0	1.0
Central bank	8.4	1.5	6.2	0.0	-3.3	0.8	1.0	1.0
Commercial banks	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
Financial liabilities	-0.4	1.2	3.6	3.2	3.4	0.8	1.0	1.0
Domestic	-2.6	-0.6	-0.4	1.2	2.3	0.0	0.0	0.0
Foreign	2.2	1.8	4.0	2.0	1.1	0.8	1.0	1.0
Disbursements	3.3	3.2	5.3	3.6	2.7	2.4	2.4	2.4
Amortization	-1.1	-1.4	-1.3	-1.6	-1.6	-1.6	-1.4	-1.4
Statistical discrepancy ⁴	-3.8	-2.9	-2.0	0.0	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>								
Overall fiscal balance, excluding SACU revenues	-25.2	-30.1	-28.6	-28.9	-22.9	-18.6	-18.2	-18.2
Overall fiscal balance, excluding SACU revenue and foreign-financed capital projects	-21.9	-26.9	-23.3	-25.3	-20.2	-16.2	-15.8	-15.8

Sources: Lesotho authorities and IMF staff estimates and projections.

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

² Other taxes are not shown in the table.

³ New fiscal measures to be introduced in 2016/17 budget.

⁴ The remaining balances on non-Treasury accounts at the end of the fiscal year explain the bulk of the statistical discrepancy.

Table 4. Lesotho: Monetary Accounts, 2013–20^{1, 2}
(Maloti millions; unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019
	Act.	Act.	Act.		Projections		
I. Depository corporations survey							
Net foreign assets	10,123	12,871	14,877	14,393	13,289	14,269	15,474
Central bank	7,985	8,955	11,131	11,365	10,719	11,259	11,937
Commercial banks	2,138	3,915	3,746	3,029	2,570	3,009	3,538
Net domestic assets	-3,201	-3,766	-5,660	-5,112	-3,196	-3,065	-2,916
Central bank	-6,783	-7,570	-9,632	-9,737	-8,957	-9,307	-9,752
Commercial banks	3,974	4,341	4,530	5,153	6,330	6,871	7,543
Claims on central government (net)	-3,423	-3,569	-5,153	-4,852	-3,098	-3,345	-3,688
Central bank	-4,238	-4,250	-5,731	-5,729	-4,825	-5,072	-5,416
Commercial banks	815	681	578	878	1,728	1,728	1,728
Claims on private sector	4,136	4,562	5,101	5,567	6,055	6,759	7,602
Other items (net)	-3,926	-4,771	-5,623	-5,841	-6,169	-6,496	-6,847
Broad money (M2)	6,922	9,105	8,564	9,282	10,093	11,203	12,559
Currency outside banks	792	840	907	1,040	1,127	1,250	1,396
Deposits	6,130	8,265	7,657	8,242	8,966	9,953	11,163
II. Central Bank							
Net foreign assets	7,985	8,955	11,131	11,365	10,719	11,259	11,937
Gross reserves	9,008	10,326	12,533	12,959	12,376	12,971	13,702
Net domestic assets	-6,783	-7,570	-9,632	-9,737	-8,957	-9,307	-9,752
Claims on central government (net)	-4,238	-4,250	-5,731	-5,729	-4,825	-5,072	-5,416
Claims on private sector	45	52	61	66	70	78	86
Other items (net) ²	-2,591	-3,373	-3,963	-4,073	-4,202	-4,312	-4,422
Reserve money	1,202	1,385	1,499	1,628	1,762	1,953	2,184
Currency in circulation	945	984	1,093	1,187	1,285	1,424	1,592
Commercial bank deposits	257	401	406	441	478	529	592
<i>Memorandum items:</i> (12-month percentage change; unless otherwise indicated)							
Reserve money	-1.9	15.2	8.2	8.6	8.3	10.8	11.8
Broad money	6.1	31.5	-5.9	8.4	8.7	11.0	12.1
Narrow money	21.8	24.1	3.8	8.4	8.7	11.0	12.1
Narrow money (M1) (Maloti millions)	3,356	4,164	4,322	4,684	5,093	5,653	6,337
Credit to the private sector	42.2	10.3	11.8	9.1	8.8	11.6	12.5
Credit to the private sector (percent of GDP)	21.5	20.6	21.2	21.5	21.8	22.1	22.3
Velocity (GDP/broad money)	2.8	2.4	2.8	2.8	2.8	2.7	2.7

Sources: Lesotho authorities and IMF staff estimates and projections.

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

² Including valuation changes.

Table 5. Lesotho: Balance of Payments, 2012/13–2019/20¹
(US\$ millions; unless otherwise indicated)

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
	Act.	Act.	Est.		Projections			
Current account	-237	-235	-176	-128	-292	-167	-221	-205
Trade balance	-1,189	-1,053	-979	-838	-819	-781	-819	-828
Exports, f.o.b.	979	820	814	773	812	924	1,005	1,080
Imports, f.o.b.	-2,169	-1,873	-1,793	-1,611	-1,632	-1,706	-1,824	-1,908
Services (net)	-388	-327	-302	-237	-225	-227	-234	-239
Income (net)	417	349	315	283	265	246	251	250
Of which: interest on public debt	-10	-11	-12	-13	-13	-13	-7	-10
Transfers	923	796	791	665	488	595	581	612
Official transfers	764	652	657	541	362	467	478	504
Of which: SACU revenue	696	609	622	518	322	412	435	459
Other transfers	159	144	134	124	126	128	103	108
Capital and financial account	334	33	251	161	248	210	272	255
Capital account	151	73	49	59	94	124	166	150
Financial account	183	-40	202	103	154	87	106	105
Foreign direct	55	49	45	52	52	48	51	54
Portfolio investment	-3	-3	-2	-2	15	14	0	0
Other investment	131	-87	160	53	88	25	54	51
Medium and long-term	131	-87	160	53	88	25	54	51
Of which:								
Public sector (net)	50	39	85	41	23	18	24	25
Disbursements	76	70	113	72	56	54	58	61
Central government	76	70	113	72	56	54	58	61
Other public sector	0	0	0	0	0	0	0	0
Amortization	-26	-31	-27	-31	-32	-36	-34	-36
Short-term	0	0	0	0	0	0	0	0
Errors and omissions	-184	-325	-118	0	0	0	0	0
Overall balance	281	123	194	33	-44	43	51	50
Financing	-281	-123	-194	-33	44	-43	-51	-50
Exceptional financing	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Memorandum items:</i>				(Percent of GDP)				
Current account	-10.3	-10.6	-8.3	-6.4	-14.0	-7.5	-9.2	-8.0
Trade balance	-51.5	-47.7	-46.0	-41.6	-39.4	-35.0	-34.2	-32.2
Capital and financial account	14.5	1.5	11.8	8.0	11.9	9.4	11.4	9.9
Overall balance	12.2	5.6	9.1	1.6	-2.1	1.9	2.1	1.9
Official grants	33.1	29.5	30.9	26.8	17.4	21.1	20.0	20.0
Gross international reserves								
(US\$ millions)	990	959	1,037	957	885	901	925	947
(Months of imports)	4.9	5.2	6.3	6.3	5.6	5.4	5.3	5.3
(in percent of M1)	268	248	290	281	248	235	222	213

Sources: Lesotho authorities and IMF staff estimates and projections.

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

Table 6. Lesotho: Millennium Development Goals

	1990	1995	2000	2005	2012
Goal 1: Eradicate extreme poverty and hunger					
Employment to population ratio, 15+, total (%)	48.0	50.0	46.0	43.0	48.0
Employment to population ratio, ages 15–24, total (%)	39.0	40.0	34.0	29.0	29.0
GDP per person employed (constant 1990 PPP \$)	..	..	..	..	..
Income share held by lowest 20%	..	1.0	..	3.0	..
Malnutrition prevalence, weight for age (% of children under 5)	..	..	15.0	17.0	..
Poverty gap at \$1.25 a day (PPP) (%)	..	26.0	..	21.0	..
Poverty headcount ratio at \$1.25 a day (PPP) (% of population)	..	46.0	..	43.0	..
Vulnerable employment, total (% of total employment)	..	..	69.0	..	..
Goal 2: Achieve universal primary education					
Literacy rate, youth female (% of females ages 15–24)	..	..	97.0	..	..
Literacy rate, youth male (% of males ages 15–24)	..	..	85.0	..	..
Persistence to last grade of primary, total (% of cohort)	..	..	55.0	63.0	..
Primary completion rate, total (% of relevant age group)	58.0	64.0	60.0	60.0	72.0
Total enrollment, primary (% net)	71.0	68.0	78.0	75.0	82.0
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliaments (%)	..	5.0	4.0	12.0	27.0
Ratio of female to male primary enrollment (%)	122.0	112.0	104.0	100.0	98.0
Ratio of female to male secondary enrollment (%)	146.0	142.0	132.0	127.0	139.0
Ratio of female to male tertiary enrollment (%)	125.0	112.0	162.0	134.0	151.0
Goal 4: Reduce child mortality					
Immunization, measles (% of children ages 12–23 months)	80.0	83.0	74.0	85.0	85.0
Mortality rate, infant (per 1,000 live births)	72.0	77.0	88.0	83.0	74.0
Mortality rate, under-5 (per 1,000)	89.0	99.0	127.0	121.0	100.0
Goal 5: Improve maternal health					
Adolescent fertility rate (births per 1,000 women ages 15–19)	83.0	91.0	91.0	90.0	89.5
Births attended by skilled health staff (% of total)	..	..	60.0	..	..
Contraceptive prevalence (% of women ages 15–49)	..	29.0	30.0	37.0	47.0
Maternal mortality ratio (modeled estimate, per 100,000 live births)	520.0	540.0	690.0	720.0	620.0
Pregnant women receiving prenatal care (%)	..	88.0	85.0	90.4	92.8
Unmet need for contraception (% of married women ages 15–49)	..	..	..	..	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Condom use, population ages 15–24, female (% of females ages 15–24)	..	..	..	..	..
Condom use, population ages 15–24, male (% of males ages 15–24)	..	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	184.0	323.0	553.0	639.0	630.0
Prevalence of HIV, female (% ages 15–24)	..	..	..	..	10.7
Prevalence of HIV, male (% ages 15–24)	..	..	..	..	5.8
Prevalence of HIV, total (% of population ages 15–49)	0.8	11.5	22.9	22.7	23.1
Tuberculosis case detection rate (% , all forms)	86.0	91.0	95.0	88.0	83.0
Goal 7: Ensure environmental sustainability					
CO2 emissions (kg per PPP \$ of GDP)	..	..	..	..	..
CO2 emissions (metric tons per capita)	..	..	..	..	..
Forest area (% of land area)	1.3	1.4	1.4	1.4	..
Improved sanitation facilities (% of population with access)	..	24.0	25.0	26.0	..
Improved water source (% of population with access)	80.0	80.0	80.0	79.0	..
Marine protected areas (% of territorial waters)	..	..	..	..	1.8
Net ODA received per capita (current US\$)	87.0	64.0	20.0	35.0	..
Goal 8: Develop a global partnership for development					
Debt service (PPG and IMF only, % of exports, excl. workers' remittances)	4.0	6.0	7.0	6.0	..
Internet users (per 100 people)	0.0	0.0	0.2	2.6	4.6
Mobile cellular subscriptions (per 100 people)	0.0	0.0	1.0	12.0	59.0
Telephone lines (per 100 people)	1.0	1.0	1.0	2.0	2.0
Fertility rate, total (births per woman)	5.0	5.0	4.0	4.0	3.0
Other					
GNI per capita, Atlas method (current US\$)	550.0	660.0	580.0	910.0	1,380.0
GNI, Atlas method (current US\$) (billions)	0.9	1.2	1.1	1.8	2.8
Gross capital formation (% of GDP)	55.7	72.4	41.3	22.0	31.8
Life expectancy at birth, total (years)	59.0	57.0	48.0	44.0	..
Literacy rate, adult total (% of people ages 15 and above)	..	..	86.0	..	..
Population, total (billions)	0.0	0.0	0.0	0.0	0.0
Trade (% of GDP)	140.3	143.7	169.6	169.7	154.5

Source: World Development Indicators.

Table 7. Lesotho: Risk Assessment Matrix ¹

Nature/source of main risks	Likelihood of realization in the next three years	Expected impact on economy if risk is realized	Possible remedial policy
Insufficient fiscal adjustment to the sharp drop in SACU revenues.	MEDIUM	HIGH Large fiscal deficits would require extraordinary financing, which would lead to high levels of debt and a drawing down of government deposits in the CBL. Debt sustainability would be jeopardized and international reserves would fall, which, in the medium term, could undermine the loti's parity with the rand.	Follow through on policy objectives, as outlined in the 2015/16 budget speech.
Structurally weak growth in key emerging markets, including China (the "new mediocre"). Maturing of the cycle, misallocation of investment and excess corporate leverage (including in FX) fueled by a prolonged period of easy global financial conditions, and insufficient progress with reforms leads to a significant medium-term growth slowdown.	MEDIUM	MEDIUM Lower remittances from migrant workers and further decline in SACU revenue would widen the external current account deficit, worsen the fiscal balance, and reduce international reserves.	Further fiscal adjustment; structural reforms to strengthen competitiveness; and rebuild reserves.
Shocks to international competitiveness (loss of trade advantages from the Trans-Pacific Partnership)	HIGH	HIGH - Textile sector, which is a major source of private sector jobs, is highly vulnerable to increased competition from Asian countries included in the Trans-Pacific Partnership. Though less likely, loss of eligibility under AGOA would immediately cripple the sector.	Step up structural reforms to improve competitiveness and diversification. Develop new export markets, particularly in the region.
Drought in the southern African region	HIGH	MEDIUM - Sharp drop in crop production. Real GDP growth could slip by ½ percentage point. Modest depletion of international reserves for increased food imports. - Food shortages for vulnerable segments of the population.	Seek food assistance from development partners and international agencies. Improve targeting of social assistance.

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views at the end of the Article IV consultation mission.

Table 8. Lesotho: Commercial Bank Performance Ratios, 2009–15
(As of end-December; percent)

	2009	2010	2011	2012	2013	2014	Mar-2015
I. Capital adequacy							
a) Basel capital ratio	13.5	14.9	16.0	14.1	12.6	13.9	19.6
b) Nonperforming loans net of provisions to capital	-9.3	0.5	-6.3	-6.6	7.6	11.3	10.9
c) Top 20 exposures to statutory capital and reserves	359	522	528	456	495	580	544
II. Asset quality							
a) Loans to deposit ratio	32.4	35.4	43.6	57.1	55.8	60.4	58.2
b) Earning assets to total assets	86.0	91.3	92.0	87.5	87.4	84.9	89.9
c) Nonperforming loans to total assets	3.2	3.1	2.2	2.5	3.9	4.4	4.4
d) Reserve for losses to total loans	4.3	3.1	2.7	3.0	3.5	3.8	3.8
e) Reserve for losses to nonperforming loans	136.2	98.3	124.0	117.3	89.6	87.3	87.0
III. Liquidity							
a) Liquid assets to total deposits	95	99	96	76	86	86	92
b) Available reserves to total deposits	3.5	3.6	2.3	3.0	3.7	6.8	3.2
c) Liquid assets to total assets	70	72	68	56	59	57	60
d) Current assets to current liabilities	107	108	109	111	109	110	110
IV. Profitability							
a) Net interest margin	6.2	5.2	5.4	6.7	6.7	7.2	1.8
b) Cost to income	56	56	58	59	58	57	55
c) Return on assets (ROA)	2.8	2.7	2.8	3.0	4.5	4.1	1.2
d) Return on equity	33.3	30.9	29.0	30.4	34.3	31.8	7.9

Source: Central Bank of Lesotho.

Annex I. Debt Sustainability Analysis

Lesotho remains at moderate risk of external debt distress. Under the baseline scenario, all indicators are well below their corresponding thresholds throughout the projection period, with the one exception of the present value of external debt-to-GDP ratio, which comes close to its threshold of 40 percent of GDP in 2025, mainly reflecting nonconcessional debt financing for a proposed large hydropower plant under the second phase of the Lesotho Highlands Water Project (LWHP-II). However, Lesotho's debt sustainability is sensitive to the scale and quality of this major project. Negative shocks to exports and the possibility of a large exchange rate depreciation also present risks to debt sustainability.

UNDERLYING ASSUMPTIONS

Lesotho's public debt sustainability analysis is based on the following assumptions:

Macroeconomic assumptions. The baseline scenario builds upon the medium-term macroeconomic projections agreed upon with the authorities during the 2015 Article IV consultation mission. Reflecting the current weakness in the manufacturing and construction sectors, along with the effects of the anticipated fiscal adjustment, real GDP growth is projected to drop to 2½-3 percent a year in 2015/16 and 2016/17. Growth is expected to rebound in following years, driven by the ramping up of production at a new diamond mine (Liqhobong) and the commencement of construction activities related to the water transfer component of LHWP-II. Over the long term, real GDP growth is projected to average about 3½ percent a year, which is relatively conservative compared with average growth of 4½ percent a year used in the previous DSA Update. The downward revision of the long-term growth rate reflects a more sluggish outlook for South Africa, Lesotho's key economic partner, and the assumption of a permanently lower level of SACU revenues, which would undercut public investment program. Annual CPI inflation is expected to increase from 2.6 percent in 2014/15 to around 5 percent in the medium term. In addition, the baseline scenario assumes continued efforts to strengthen public sector efficiency, and sizeable fiscal adjustments in light of falling SACU revenue. Exports are expected to be mainly driven by diamonds while imports are subject to project related activities.

Fiscal assumptions. The fiscal year 2014/15 ended with a surplus of 0.6 percent of GDP. However the expected decline in SACU revenue poses a big challenge and would require greater commitment and efforts to maintain fiscal stability and sustainability going forward. The fiscal balance is expected to fall into a deficit of just over 3 percent of GDP in 2015/16 and 7½ percent of GDP in 2016/17 (assuming fiscal measures are taken). Beyond that an effective implementation of proposed reforms and fiscal measures should ensure a broadly balanced budget.

- Tax performance, especially for income taxes, is expected to increase only marginally as ongoing administrative measures continue to be implemented may result in better tax compliance.

- Non-tax revenue, mainly from mining sector is expected to increase due to increased production at Letseng and Liqhobong diamond mines and adoption of new Mining Policy.
- SACU revenue is expected to fall, to about 25½ percent of GDP in 2015/16 and 15½ percent of GDP in 2016/17, from about 29 percent in 2014/15. Given the prolonged slowdown in South Africa, much of the fall in SACU revenue is projected to be permanent, recovering only marginally in 2017/18 to little above 18 percent of GDP. It is expected to remain at that level over the medium term.
- Additional fiscal measures of 7 percent of GDP, cumulative, over the next three years are assumed. The bulk of the adjustments would come from expenditure side, requiring both expenditure compression and streamlining.
- Financing needs are expected to rise to about 2½ percent of GDP over the medium term and are expected to be met by a mix of domestic debt issuance and drawdown of government deposits.
- Government is expected to raise new domestic debt of about 4½ percent of GDP over the next three years in order to support a gradual fiscal adjustment.

Assumptions regarding Lesotho Highland Project Phase-II. The baseline assumptions regarding the hydropower component of LHWP-II remain broadly the same as those in the previous DSA Update, however, the timing has been push back to 2021–25. The project is assumed to cost about USD500 million with 80 percent financing from commercial sources. However, these assumptions are tentative as the project’s feasibility study is still underway. Moreover, the assumptions on the scale, financing, and costs of the project have a significant impact on debt sustainability. A cost overrun and any deterioration in financing conditions could lead to external debt indicators breaching relevant threshold and endanger risk rating.

Interests Rate. A discount rate of 5 percent is used for present value. ¹

¹ See <https://www.imf.org/external/np/pp/eng/2013/100413.pdf>

Box 1. Analysis of Hydropower Component of LHWP-II¹

Staff discussed with the authorities the macroeconomic effects of investing in the electricity sector, using a variant of the open-economy Debt, Investment, and Growth (DIG) model developed by Buffie, et al (2012). The base model—a full-fledged dynamic macroeconomic

model that allows for investment in infrastructure and government financing through concessional, commercial, or domestic debt, and/or fiscal adjustment—was tailored to Lesotho. In particular, it incorporates investments in the electricity sector—investing in a pump storage hydroelectric power plant within the second phase of LHWP—which sells electricity to both foreign and domestic customers. In the model, increases in domestic energy supply are growth-enhancing while receipts from selling electricity abroad can ease the fiscal burden (tax increases), which is often associated with big investment project. Still, in the transition, debt as well as taxes can rise substantially to pay for this investment.

The model and the investment program were calibrated to capture key characteristics of Lesotho.

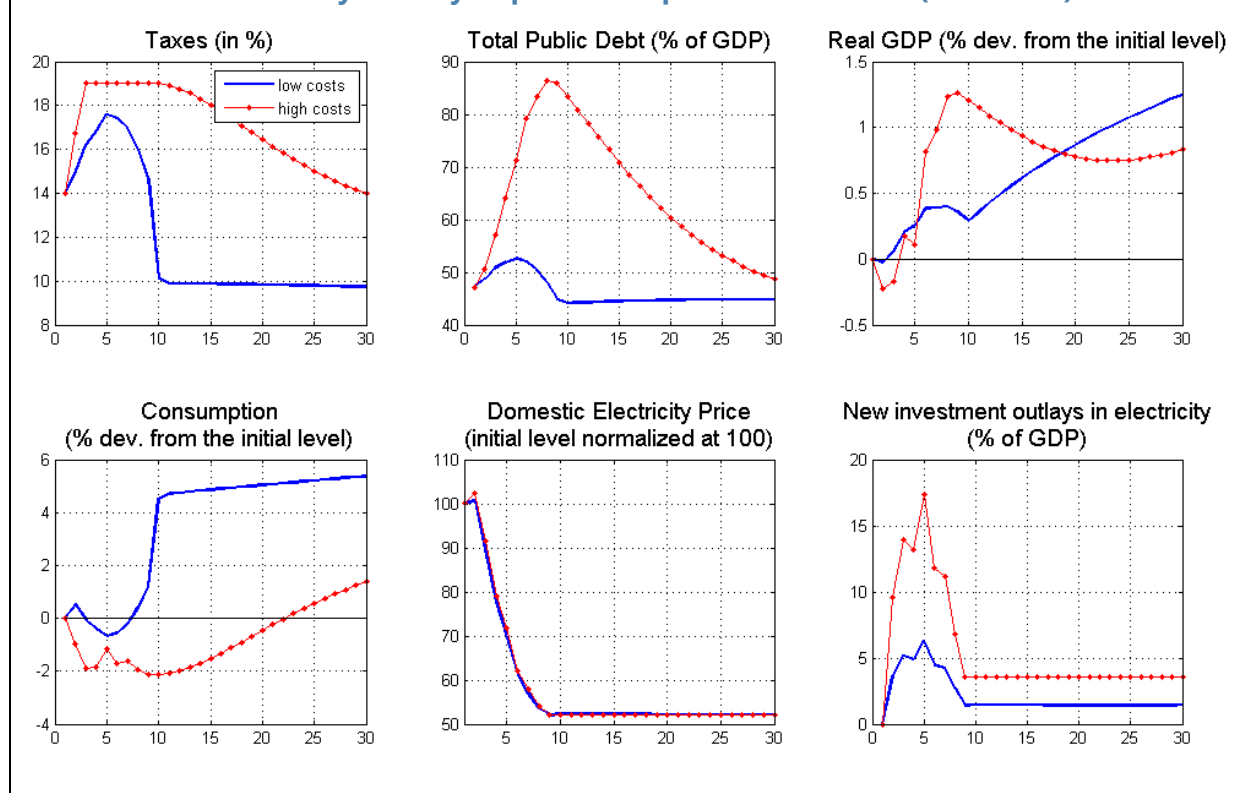
The calibration matches Lesotho's data for initial conditions for the fiscal year 2020/21, when the project is set to start. It also captures the project's main challenges: (i) the costs for the project implementation; and (ii) whether South Africa will purchase enough electricity to make the plant run at a high capacity. Usually costs for similar projects are often underestimated—e.g., the Ingula pump storage scheme in South Africa is currently experiencing costs which are almost three times the feasibility study estimate. To reflect these costs differences, two cost scenarios were considered: a low-cost scenario where costs for the government budget amount to around one billion USD and a high-cost scenario which corresponds to actual costs being 2.5 times higher.²

The analysis revealed that the project can have substantial macroeconomic benefits in Lesotho, as long as low costs and a high electricity demand by South Africa are maintained.

In the low-cost scenario, real GDP increases by 2.5 percent, while consumption increases by 5 percent in the long run. The gain in real GDP is supported by lower domestic electricity prices, which boost domestic production. Taxes increase by a moderate amount in the transition, which explains the small dip in consumption, during construction years (see Figure below). Public debt remains sustainable by increasing solely by 5 percentage points of GDP. In contrast, with higher costs, private consumption is significantly crowded out and stays below its pre-project level for almost two decades, since taxes have to increase by 5 percentage points and remain high throughout the simulation period. And although growth picks up more quickly in the short run, total public debt reaches almost 90 percent of GDP, raising concerns of debt distress and questioning the sustainability of growth prospects. Key in the analysis is the assumption of foreign demand by South Africa. If foreign customers do not agree to purchase enough electricity to keep production high, the results will deteriorate for both cost scenarios.

¹ Prepared by Michele Andreolli (RES).

² Pending the finalization of the feasibility study, DSA assumes the cost of the project at USD500 million (original project assumptions).

Box 1. Analysis of Hydropower Component of LHWP-II (concluded)**EXTERNAL DEBT SUSTAINABILITY****A. Baseline**

All external debt sustainability indicators remain below their corresponding thresholds in the baseline scenario (Table 1a). For example, the present value (PV) of external debt to GDP ratio is expected to remain about 25 percent in medium term, after which time it is expected to rise to 37½ percent in 2025, before subsiding to 23½ percent by 2035. The temporary rise in the external debt trajectory is driven by financing for the construction of the hydropower plant under LHWP-II. Moreover, in the long run a prudent fiscal policy should ensure a stable debt outlook.

These results are sensitive to the assumptions mentioned before and in particular concern about the amount and concessionality of LHWP-II financing, the future of SACU revenues, and the overall fiscal management. The temporary increase in PV of external debt to GDP ratio is driven entirely by higher nonconcessional borrowing for the LHWP-II. The increased borrowing during the construction of the power plant does make Lesotho temporarily more vulnerable to external shocks. The authorities are currently undertaking a feasibility study, results of which would provide a better idea about the cost of the project and financing options. While the baseline assumes that the government revenue would decline from about 60 percent of GDP in 2014/15 to about 52 percent of GDP in 2018 and onwards, largely due to a decline in SACU revenue, a more

abrupt and permanent decline of these revenues—as discussed in the risk assessment matrix (Table 7) in the staff report for Lesotho’s Article IV consultation—would require major fiscal adjustments over the next three years without risking macroeconomic stability.

Under the probability approach² (Figure 3), there exists a breach of the threshold for debt-to-GDP ratio in the baseline scenario. However, the breach is short-lived and not excessive. Again, this breach is mainly driven by the LHWP-II. This approach re-emphasizes the importance of ensuring that authorities should only undertake the project if it is financially and economically viable and implemented effectively with minimal cost overruns and extended delays. Taking this into consideration, staff remains of the view that Lesotho is still under the moderate risk of debt distress.

B. Sensitivity Analysis

Stress tests show that Lesotho’s external debt vulnerabilities would increase significantly, in particular in the event of a major exchange rate depreciation, or if the export growth turned out to be lower than the historical average, (Table 1b). In addition, a 200 basis point increase in interest rates for new public sector loans in 2015–34 would increase the PV of external debt-to-GDP ratio to 47 percent in 2025. Similarly, in the event of a one-time 30 percent depreciation of the nominal exchange rate in 2015, the PV of external debt-to-GDP ratio would increase to 50 percent by 2024/25, gradually falling to below the threshold by 2030 and staying under it thereafter. In a scenario where export value grows at one standard deviation lower than the historical average, the PV of external debt-to-export ratio would rise to 47 percent by 2024. In a scenario in which the key variables are set at their average of the past 10 years, Lesotho’s external debt ratios actually fall relative to the baseline, reflecting an average fiscal surplus over the past years thanks to the large SACU revenue, a decent GDP growth and inflation averaging about 5 percent. However, given the structural break, the historical scenario could be considered less relevant for the analysis.

PUBLIC SECTOR DEBT SUSTAINABILITY

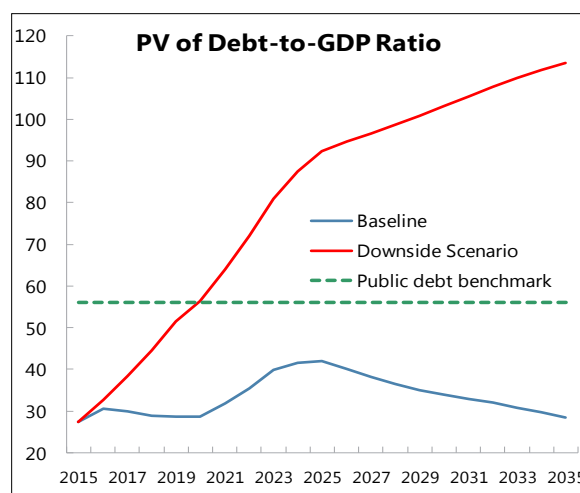
External debt accounts for more than 95 percent of Lesotho’s public debt³, public debt indicators largely mirror those of external debt. However a small increase in domestic debt (about 4 percent of GDP) is projected to facilitate gradual fiscal adjustments in coming years and expected to remain about 5 percent of GDP throughout the projected period.

² The probability approach methodology focuses on the evolution of the probability of debt distress over time, rather than on the evolution of debt burden indicators. This approach provides complementary, country specific information to help decide cases where a country’s risk rating is on the border between two categories – in this case, a ± 5 percent range is nearly breached from below for the present value of debt to GDP ratio in the baseline scenario and for the debt service to exports ratio under extreme shock.

³ Public debt includes central government debt and debt guarantees, excluding potential contingent liabilities from state-owned entities.

The PV of public sector debt stood at below 30 percent in 2014/15 (Table 2a). The standard sensitivity tests for public debt distress point to higher degree of vulnerability of public debt to permanently higher deficit i.e. about 3 percent of GDP projected for 2015 (Table 2b). In addition, lower long-run GDP growth can also shift the debt trajectory higher but would still remain below the critical threshold of 60 percent of GDP.

To assess the implications of the risk of incomplete or delayed fiscal measures, an alternative scenario was undertaken (for details see Box 2 of the staff report). Given the higher fiscal primary deficits of about 6 percent of GDP per year and lower GDP growth, public debt vulnerability increases significantly in the medium term as the present value of debt-to-GDP ratio breaches the threshold of 56 percent in 2020 and continues to rise sharply afterwards. This again underscores the need for early and decisive actions on additional fiscal measures in order to avoid increasing the vulnerability of public debt.



CONCLUSION

Lesotho remains at moderate risk of external debt distress. All external debt and debt service indicators for the baseline remain below their respective thresholds. However, a large exchange rate depreciation or a decline in exports revenue pose major risk to Lesotho's debt sustainability. In addition, there is little scope for additional borrowing (beyond the baseline assumption) for financing the hydropower component of Lesotho High Lands Water Project-Phase II and findings of feasibility study would be important in this regard. The authorities are encouraged to seek bilateral and multilateral concessional sources of financing in order to minimize reliance on commercial borrowing.

The authorities broadly agreed with the assessment of moderate risk of external debt distress. They appreciated that the PV of external debt ratio rises owing to the construction of LHWP-II and agreed that care would be needed to ensure that the financing arrangements do not increase the risk of external debt distress. As part of their medium term debt strategy, the authorities intend to rely on concessional sources of external borrowing (with the exception of financing for LHWP-II). With the view to developing domestic debt market, they expect to expand issuance of government domestic securities.

Next DSA could usefully provide a more in-depth analysis of the extent of public debt vulnerabilities, including potential contingent liabilities, currency composition, and more updated data on LHWP-II. For example, in view of the recent developments with South Africa Rand, a continued exchange rate depreciation would increase debt service pressures for Lesotho.

Table 1a .Lesotho: External Debt Sustainability Framework, Baseline Scenario, 2012–35¹ (In percent of GDP, unless otherwise indicated)

	Actual			Historical ^{6/} Standard ^{6/}		Projections							2015-2020		2021-2035	
	2012	2013	2014	Average	Deviation	2015	2016	2017	2018	2019	2020	Average		Average		
												2025	2035	2025	2035	
External debt (nominal) 1/	37.2	41.1	41.1			45.4	45.1	44.4	43.1	43.2	43.0			55.3	35.4	
<i>of which: public and publicly guaranteed (PPG)</i>	37.2	41.1	41.1			45.4	45.1	44.4	43.1	43.2	43.0			55.3	35.4	
Change in external debt	37.2	3.9	-0.1			4.3	-0.3	-0.7	-1.4	0.1	-0.1			0.4	-2.2	
Identified net debt-creating flows	...	10.1	7.8			2.7	10.3	3.5	4.8	4.5	4.2			2.4	2.4	
Non-interest current account deficit	9.9	10.2	7.7	-2.9	15.2	6.2	13.7	7.2	8.9	7.8	7.4			5.1	5.4	5.7
Deficit in balance of goods and services	-155.8	-138.9	-138.9			-132.2	-130.4	-130.9	-130.1	-130.0	-125.6			-124.4	-122.6	
Exports	43.7	38.2	39.3			39.4	40.1	42.7	43.0	43.8	41.4			42.7	42.9	
Imports	-112.0	-100.7	-99.6			-92.8	-90.3	-88.2	-87.1	-86.2	-84.2			-81.7	-79.7	
Net current transfers (negative = inflow)	-40.0	-36.0	-37.2	-37.2	6.0	-33.0	-23.5	-26.8	-24.3	-24.3	-24.7			-24.2	-24.2	-24.2
<i>of which: official</i>	-33.1	-29.5	-30.9			-26.8	-17.4	-21.1	-20.0	-20.0	-20.4			-19.9	-20.0	
Other current account flows (negative = net inflow)	205.6	185.1	183.8			171.4	167.6	164.9	163.4	162.0	157.7			153.7	152.2	
Net FDI (negative = inflow)	-2.4	-2.2	-2.1	-2.5	0.8	-2.6	-2.5	-2.2	-2.2	-2.2	-2.2			-2.2	-2.2	-2.2
Endogenous debt dynamics 2/	...	2.2	2.1			-1.0	-1.0	-1.5	-1.9	-1.1	-1.1			-0.6	-0.9	
Contribution from nominal interest rate	...	0.5	0.6			0.1	0.3	0.4	0.4	0.4	0.4			1.2	0.3	
Contribution from real GDP growth	0.0	-1.4	-1.5			-1.1	-1.3	-1.9	-2.3	-1.5	-1.4			-1.8	-1.2	
Contribution from price and exchange rate changes	0.0	3.1	3.0			...	...	...	...	...	...			...	...
Residual (3-4) 3/	...	-6.2	-7.8			1.7	-10.6	-4.2	-6.2	-4.4	-4.3			-1.9	-4.5	
<i>of which: exceptional financing</i>	...	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0			0.0	0.0	
PV of external debt 4/	...	...	21.5			24.8	25.0	24.9	24.3	24.5	24.6			37.6	23.4
In percent of exports	...	...	54.7			62.9	62.4	58.3	56.5	55.9	59.4			87.9	54.6
PV of PPG external debt	...	...	21.5			24.8	25.0	24.9	24.3	24.5	24.6			37.6	23.4
In percent of exports	...	...	54.7			62.9	62.4	58.3	56.5	55.9	59.4			87.9	54.6
In percent of government revenues	...	...	36.8			43.9	51.9	48.5	47.6	47.9	48.0			73.4	45.8
Debt service-to-exports ratio (in percent)	3.3	4.6	4.3			0.8	3.6	3.8	3.9	4.2	4.4			9.0	4.6	
PPG debt service-to-exports ratio (in percent)	3.3	4.6	4.3			0.8	3.6	3.8	3.9	4.2	4.4			9.0	4.6	
PPG debt service-to-revenue ratio (in percent)	2.5	3.2	2.9			0.6	3.0	3.2	3.3	3.6	3.6			7.5	3.9	
Total gross financing need (Millions of U.S. dollars)	206.5	214.4	156.3			80.1	263.9	147.2	201.5	188.5	190.5			238.9	317.2	
Non-interest current account deficit that stabilizes debt ratio	-27.4	6.2	7.8			1.9	14.0	7.8	10.3	7.7	7.6			4.7	7.6	
Key macroeconomic assumptions																
Real GDP growth (in percent)	5.3	3.6	3.4	4.6	1.1	2.6	2.9	4.5	5.5	3.6	3.6	3.8	3.5	3.5	3.5	
GDP deflator in US dollar terms (change in percent)	-11.4	-7.6	-6.9	0.9	10.4	-7.7	0.3	2.0	2.1	1.8	2.8	0.2	2.0	2.0	2.0	
Effective interest rate (percent) 5/	...	1.3	1.3	1.3	0.0	0.3	0.7	1.0	0.9	0.9	0.9	0.8	2.4	0.9	1.5	
Growth of exports of G&S (US dollar terms, in percent)	-10.5	-16.4	-0.8	2.3	13.0	-5.1	5.0	13.5	8.6	7.4	0.5	5.0	5.0	5.6	5.8	
Growth of imports of G&S (US dollar terms, in percent)	-2.7	-14.0	-4.8	3.0	11.4	-11.7	0.5	4.1	6.4	4.3	4.0	1.3	5.1	5.6	5.2	
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	44.7	42.3	42.3	42.2	42.3	42.1	42.7	26.2	42.3	34.6
Government revenues (excluding grants, in percent of GDP)	57.9	55.6	58.5			56.5	48.2	51.3	51.2	51.2	51.2			51.2	51.2	
Aid flows (in Millions of US dollars) 7/	273.1	170.5	149.5			116.3	120.5	148.8	149.8	172.7	181.7			244.9	274.9	
<i>of which: Grants</i>	198.8	105.3	43.8			74.3	75.1	76.6	77.9	79.4	81.6			107.1	184.1	
<i>of which: Concessional loans</i>	74.4	65.3	105.7			42.0	45.4	72.2	71.8	93.3	100.0			137.8	90.9	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			4.6	4.5	4.8	4.5	4.7	4.6			4.6	3.7
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			80.1	78.2	72.0	72.1	68.8	67.8			51.5	80.9
Memorandum items:																
Nominal GDP (Millions of US dollars)	2308.4	2208.8	2127.3			2014.3	2079.4	2217.6	2389.1	2520.1	2681.8			3516.6	6046.9	
Nominal dollar GDP growth	-6.7	-4.3	-3.7			-5.3	3.2	6.6	7.7	5.5	6.4	4.0	5.6	5.6	5.6	
PV of PPG external debt (in Millions of US dollars)	...	...	428.8			467.3	486.8	516.7	544.2	578.6	617.2			1236.7	1326.0
(Pvt-Pvt-1)/GDPt-1 (in percent)	...	...	...			1.8	1.0	1.4	1.2	1.4	1.5	1.4	2.2	0.0	1.5
Gross workers' remittances (Millions of US dollars)	251.9	204.9	180.5			180.1	189.5	210.8	200.1	201.8	241.2			290.9	547.8	
PV of PPG external debt (in percent of GDP + remittances)	...	...	19.8			22.7	22.9	22.7	22.4	22.7	22.6			34.7	21.5
PV of PPG external debt (in percent of exports + remittances)	...	...	45.0			51.2	50.8	47.7	47.3	47.3	48.8			73.6	45.1
Debt service of PPG external debt (in percent of exports + remittances)	...	...	3.6			0.7	2.9	3.1	3.3	3.6	3.7			7.5	3.8

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - \rho(1+g)] / (1+g+\rho+g)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

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

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

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

Table 1b. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–35
(In percent)

	Projections							2025	2035
	2015	2016	2017	2018	2019	2020			
PV of debt-to GDP ratio									
Baseline	25	25	25	24	24	24	37	23	
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2015-2035 1/	25	12	5	-4	-11	-18	-33	-64	
A2. New public sector loans on less favorable terms in 2015-2035 2	25	24	25	25	26	26	47	34	
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	25	23	23	23	23	23	35	21	
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	25	28	37	36	36	36	46	22	
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	25	26	29	28	29	29	43	26	
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	25	19	16	16	16	16	29	20	
B5. Combination of B1-B4 using one-half standard deviation shocks	25	20	26	26	26	26	39	23	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	25	33	33	32	33	33	49	30	
PV of debt-to-exports ratio									
Baseline	63	62	58	56	56	59	87	53	
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2015-2035 1/	63	31	12	-9	-26	-44	-77	-149	
A2. New public sector loans on less favorable terms in 2015-2035 2	63	60	57	57	58	64	110	80	
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	63	58	54	53	52	55	81	49	
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	63	81	130	125	123	129	162	77	
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	63	58	54	53	52	55	81	49	
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	63	46	37	36	36	38	67	48	
B5. Combination of B1-B4 using one-half standard deviation shocks	63	53	72	70	69	73	108	64	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	63	58	54	53	52	55	81	49	
PV of debt-to-revenue ratio									
Baseline	44	52	49	47	48	48	73	45	
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2015-2035 1/	44	25	10	-7	-22	-36	-65	-125	
A2. New public sector loans on less favorable terms in 2015-2035 2	44	50	48	48	50	51	92	67	
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	44	48	46	45	45	45	68	41	
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	44	57	72	70	70	70	91	43	
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	44	54	57	55	56	56	84	51	
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	44	39	31	30	31	31	56	40	
B5. Combination of B1-B4 using one-half standard deviation shocks	44	42	51	50	51	51	77	46	
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	44	69	65	63	64	64	96	58	

Table 1b. Lesotho: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2015–35 (concluded)
(In percent)

	Projections							
	2015	2016	2017	2018	2019	2020	2025	2035
Debt service-to-exports ratio								
Baseline	1	4	4	4	5	5	9	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	1	4	4	3	3	3	4	-11
A2. New public sector loans on less favorable terms in 2015-2035 2	1	4	4	5	5	5	7	7
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	1	4	4	4	5	5	9	4
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	1	5	7	8	8	8	16	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	1	4	4	4	5	5	9	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	1	4	4	4	4	4	8	4
B5. Combination of B1-B4 using one-half standard deviation shocks	1	4	5	6	6	6	11	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	1	4	4	4	5	5	9	4
Debt service-to-revenue ratio								
Baseline	1	3	4	4	4	4	8	4
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2015-2035 1/	1	3	3	3	3	2	3	-9
A2. New public sector loans on less favorable terms in 2015-2035 2	1	3	4	4	4	4	6	6
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2016-2017	1	3	4	4	4	4	8	4
B2. Export value growth at historical average minus one standard deviation in 2016-2017 3/	1	3	4	4	5	5	9	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2016-2017	1	4	4	5	5	5	10	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2016-2017 4/	1	3	3	3	4	4	7	3
B5. Combination of B1-B4 using one-half standard deviation shocks	1	3	4	4	4	4	8	5
B6. One-time 30 percent nominal depreciation relative to the baseline in 2016 5/	1	5	5	5	6	6	11	5
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	31	31	31	31	31	31	31	31

Sources: Country authorities; and staff estimates and projections.

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

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

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

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

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

**Table 2a. Lesotho: Public Sector Debt Sustainability Framework,
Baseline Scenario, 2012–35**
(In percent of GDP, unless otherwise indicated)

	Actual			Average ^{5/}	Standard Deviation ^{5/}	Estimate					Projections				
	2012	2013	2014			2015	2016	2017	2018	2019	2020	2015-20 Average	2025	2035	2021-35 Average
Public sector debt 1/	40.3	43.4	42.7			48.1	50.6	49.5	47.6	47.3	47.3		60.0	41.2	
<i>of which: foreign-currency denominated</i>	37.2	41.1	41.1			45.4	45.1	44.4	43.1	43.2	43.0		55.3	35.4	
Change in public sector debt	34.3	3.0	-0.7			5.4	2.6	-1.2	-1.9	-0.3	0.0		0.5	-2.1	
Identified debt-creating flows	...	4.7	0.3			5.4	5.8	-3.3	-3.7	-2.6	-2.4		-2.7	-1.9	
Primary deficit	-5.9	1.8	-1.3	-2.8	7.5	2.9	6.9	-0.8	-0.8	-0.7	-0.2	1.2	-1.0	-0.3	-0.6
Revenue and grants	66.5	60.4	60.6			60.2	51.8	54.8	54.4	54.4	54.2		54.2	54.2	
<i>of which: grants</i>	8.6	4.8	2.1			3.7	3.6	3.5	3.3	3.2	3.0		3.0	3.0	
Primary (noninterest) expenditure	60.5	62.2	59.2			63.1	58.7	53.9	53.6	53.6	54.0		53.2	53.9	
Automatic debt dynamics	...	2.9	1.6			2.5	-1.0	-2.4	-2.9	-1.8	-2.2		-1.6	-1.6	
Contribution from interest rate/growth differential	...	-1.4	-1.4			-1.2	-1.5	-2.4	-2.9	-2.0	-2.0		-1.6	-1.6	
<i>of which: contribution from average real interest rate</i>	...	0.0	0.0			-0.1	-0.2	-0.2	-0.4	-0.4	-0.3		0.4	-0.2	
<i>of which: contribution from real GDP growth</i>	-0.3	-1.4	-1.4			-1.1	-1.4	-2.2	-2.6	-1.7	-1.6		-2.0	-1.5	
Contribution from real exchange rate depreciation	...	4.3	3.0			3.7	0.5	-0.1	0.0	0.2	-0.2		...	...
Other identified debt-creating flows	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	...	-1.6	-0.9			0.0	-3.3	2.1	1.8	2.3	2.4		3.2	-0.1	
Other Sustainability Indicators															
PV of public sector debt	...	...	23.1			27.4	30.5	29.9	28.8	28.7	28.8		42.3	29.2
<i>of which: foreign-currency denominated</i>	...	...	21.5			24.8	25.0	24.9	24.3	24.5	24.6		37.6	23.4
<i>of which: external</i>	...	...	21.5			24.8	25.0	24.9	24.3	24.5	24.6		37.6	23.4
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	-3.7	4.0	0.7			3.4	9.0	1.7	1.8	2.0	2.5		3.9	3.0	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	38.2			45.6	58.9	54.6	53.0	52.7	53.2		78.0	53.8
PV of public sector debt-to-revenue ratio (in percent)	...	...	39.5			48.5	63.3	58.3	56.4	56.0	56.3		82.6	57.0
<i>of which: external 3/</i>	...	...	36.8			43.9	51.9	48.5	47.6	47.9	48.0		73.4	45.8
Debt service-to-revenue and grants ratio (in percent) 4/	3.4	3.7	3.4			0.8	4.1	4.7	4.7	5.0	4.9		9.2	6.1	
Debt service-to-revenue ratio (in percent) 4/	3.9	4.1	3.5			0.9	4.4	5.0	5.0	5.3	5.2		9.7	6.5	
Primary deficit that stabilizes the debt-to-GDP ratio	-40.2	-1.2	-0.6			-2.5	4.3	0.3	1.1	-0.5	-0.2		-1.6	1.8	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	5.3	3.6	3.4	4.6	1.1	2.6	2.9	4.5	5.5	3.6	3.6	3.8	3.5	3.5	3.5
Average nominal interest rate on forex debt (in percent)	...	1.3	1.3	1.3	0.0	0.3	0.7	1.0	0.9	0.9	0.9	0.8	2.4	0.9	1.5
Average real interest rate on domestic debt (in percent)	7.3	1.9	3.3	4.7	2.6	4.3	4.9	3.8	3.8	4.2	4.2	4.2	4.2	4.2	4.2
Real exchange rate depreciation (in percent, + indicates depreciation)	18.4	11.9	7.6	3.1	12.6	9.2
Inflation rate (GDP deflator, in percent)	2.0	7.2	5.9	6.6	3.1	4.9	4.3	5.3	5.4	5.0	4.9	5.0	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	2.9	6.4	-1.5	0.9	2.2	9.3	-4.2	-4.0	5.0	3.6	4.3	2.3	3.4	3.5	3.5
Grant element of new external borrowing (in percent)	44.7	42.3	42.3	42.2	42.3	42.1	42.7	26.2	42.3	...

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

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

3/ Revenues excluding grants.

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

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

Table 2b. Lesotho: Sensitivity Analysis for Key Indicators of Public Debt 2015–35
(In percent)

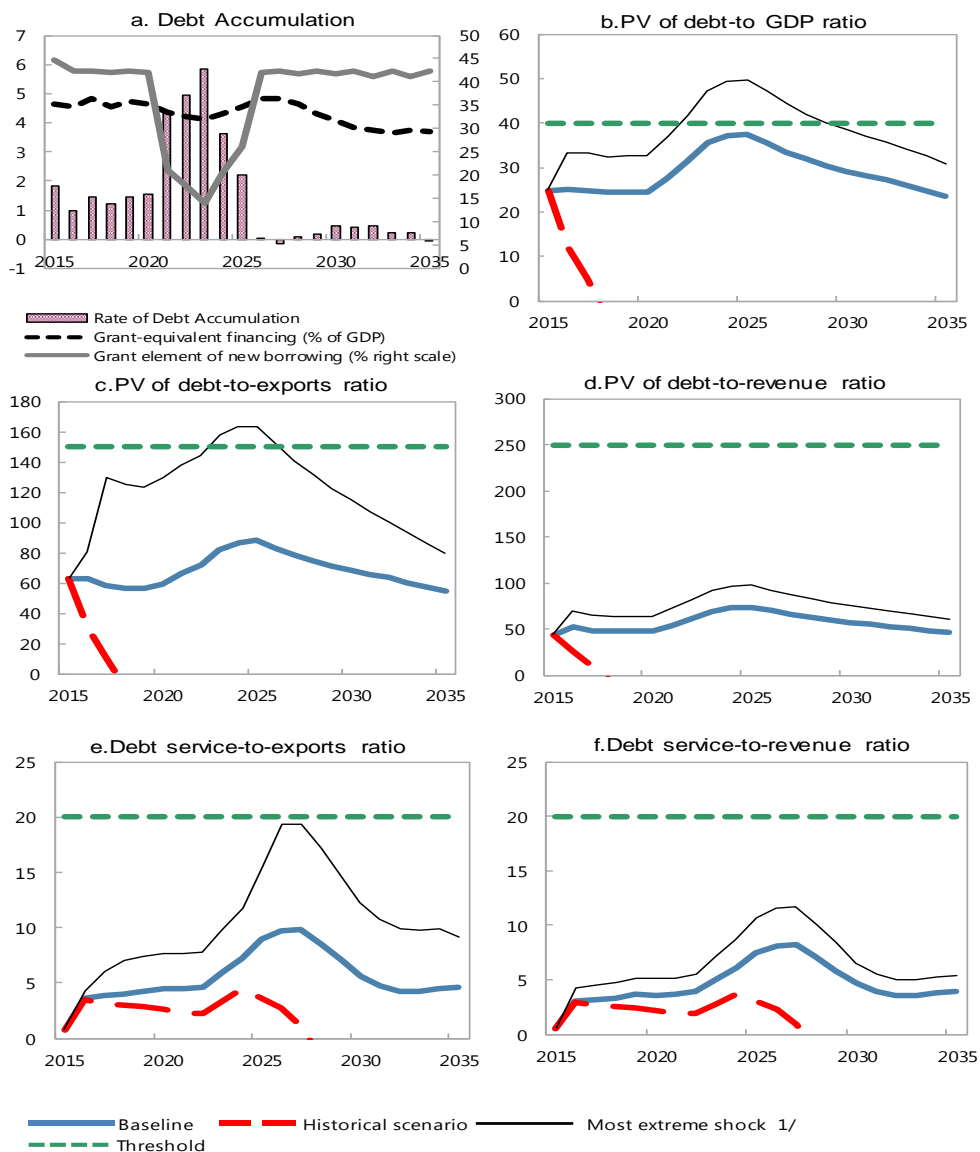
	Projections							
	2015	2016	2017	2018	2019	2020	2025	2035
PV of Debt-to-GDP Ratio								
Baseline	27	31	30	29	29	29	42	29
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	27	24	22	20	19	17	23	-1
A2. Primary balance is unchanged from 2015	27	28	30	32	34	36	62	66
A3. Permanently lower GDP growth 1/	27	31	30	29	30	30	47	46
A4. Alternative Scenario : Insufficient Fiscal Measures	27	33	38	45	52	56	92	114
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-20:	27	30	30	29	29	29	43	31
B2. Primary balance is at historical average minus one standard deviations in 2016-201	27	29	32	31	31	31	44	30
B3. Combination of B1-B2 using one half standard deviation shocks	27	26	27	26	26	26	38	24
B4. One-time 30 percent real depreciation in 2016	27	42	40	38	37	36	49	38
B5. 10 percent of GDP increase in other debt-creating flows in 2016	27	37	37	35	35	35	48	32
PV of Debt-to-Revenue Ratio 2/								
Baseline	46	59	55	53	53	53	78	53
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	46	46	40	37	34	31	42	-2
A2. Primary balance is unchanged from 2015	46	54	55	58	63	67	114	122
A3. Permanently lower GDP growth 1/	46	59	55	54	55	56	87	84
A4. Alternative Scenario : Insufficient Fiscal Measures	46	63	73	86	99	108	177	218
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-20:	46	58	55	53	53	54	80	57
B2. Primary balance is at historical average minus one standard deviations in 2016-201	46	56	59	58	57	57	82	56
B3. Combination of B1-B2 using one half standard deviation shocks	46	51	50	48	47	47	70	44
B4. One-time 30 percent real depreciation in 2016	46	80	73	70	68	67	90	70
B5. 10 percent of GDP increase in other debt-creating flows in 2016	46	72	67	65	64	65	88	60
Debt Service-to-Revenue Ratio 2/								
Baseline	1	4	5	5	5	5	9	6
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	1	4	5	5	5	4	8	2
A2. Primary balance is unchanged from 2015	1	4	5	5	6	6	10	11
A3. Permanently lower GDP growth 1/	1	4	5	5	5	5	10	8
A4. Alternative Scenario : Insufficient Fiscal Measures	1	4	5	7	10	13	25	29
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2016-20:	1	4	5	5	5	5	10	6
B2. Primary balance is at historical average minus one standard deviations in 2016-201	1	4	5	5	6	6	9	6
B3. Combination of B1-B2 using one half standard deviation shocks	1	4	5	5	5	5	9	5
B4. One-time 30 percent real depreciation in 2016	1	5	7	7	8	7	14	10
B5. 10 percent of GDP increase in other debt-creating flows in 2016	1	4	5	6	6	6	10	7

Sources: Country authorities; and staff estimates and projections.

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

2/ Revenues are defined inclusive of grants.

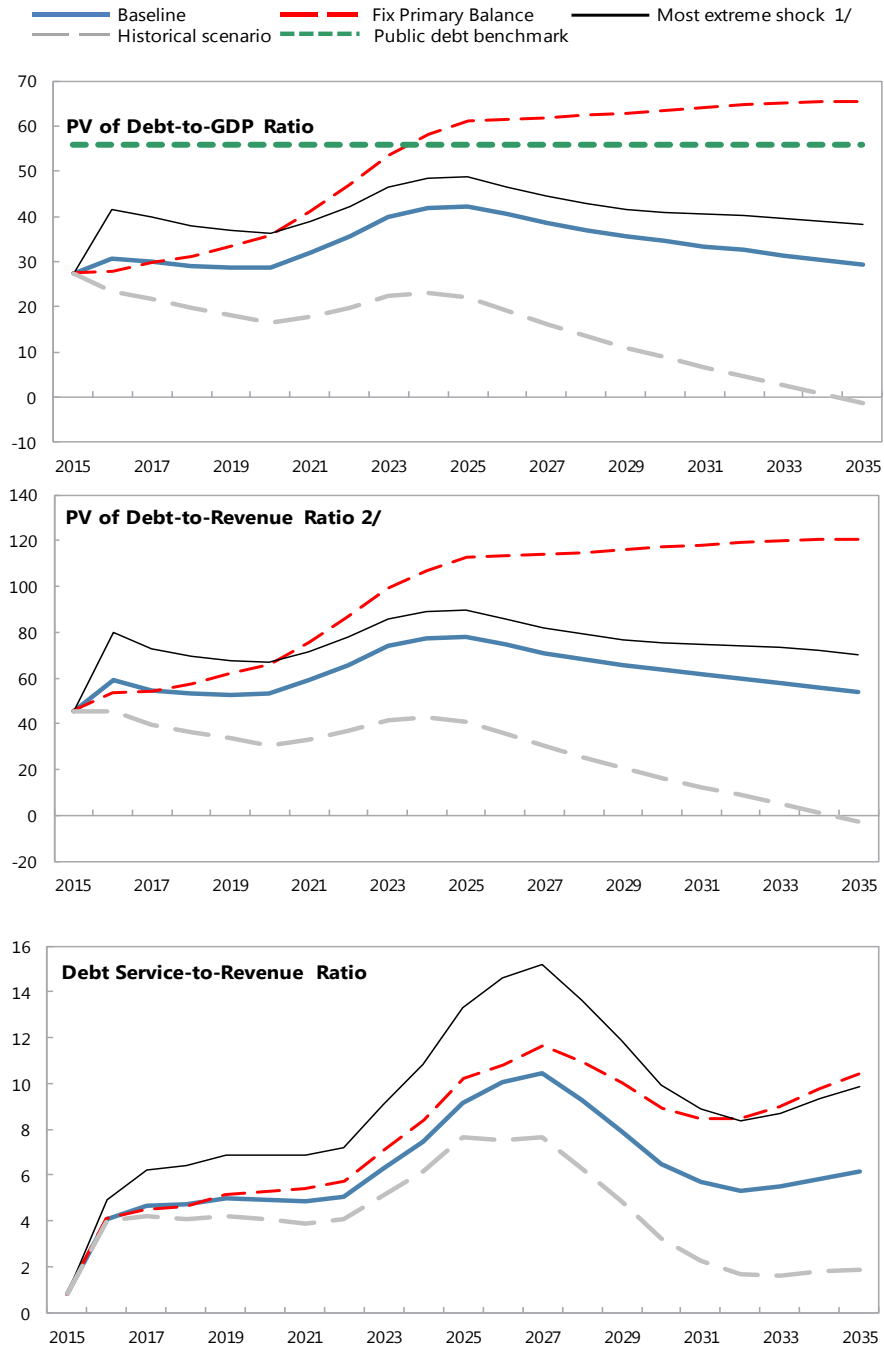
Figure 1. Lesotho: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2015–35¹



Sources: Country authorities; and staff estimates and projections.

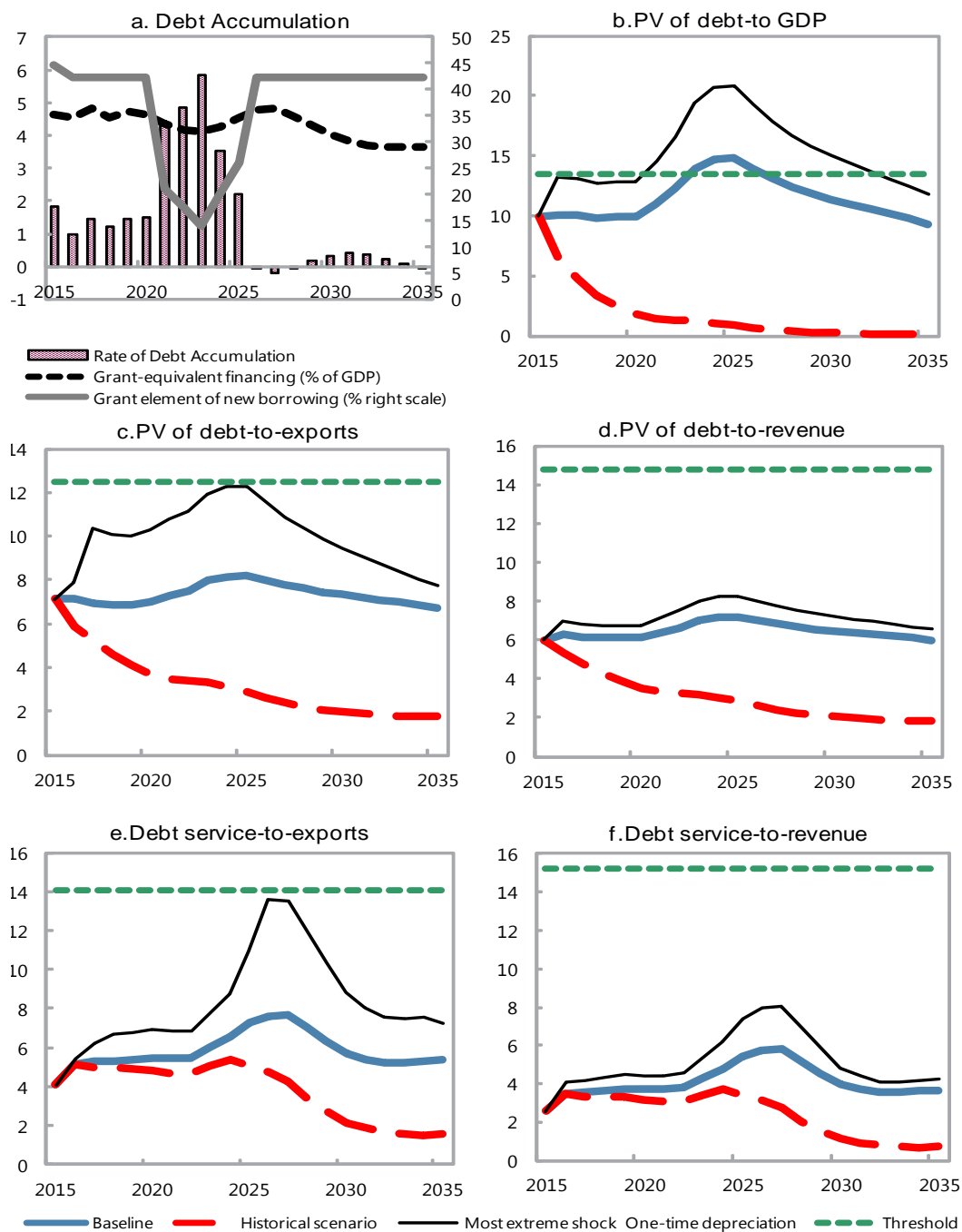
¹ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

Figure 2. Lesotho: Indicators of Public Debt Under Alternative Scenarios, 2015–35¹



Sources: Country authorities; and staff estimates and projections.
 1/ The most extreme stress test is the test that yields the highest ratio on or before 2025.
 2/ Revenues are defined inclusive of grants.

Figure 3. Lesotho: Probability of Debt Distress of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2015–35¹



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a One-time depreciation shock

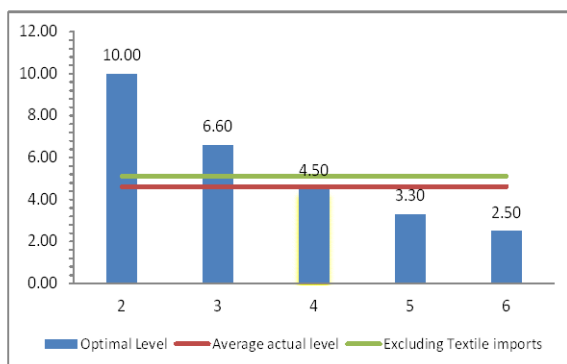
Annex II. Reserve Adequacy

The optimal level of reserves –which constituting a lower bound for precautionary motives that can be rationalized in terms of self-insurance against adverse potential external shocks faced by Lesotho’s economy— is estimated to be around 5 months of next year’s imports. This estimate is slightly higher than that reflected in the staff report for the 2014 Article IV Consultation because of a relatively higher fiscal deficit over the medium term.

Lesotho’s foreign reserves remain significantly above the minimum threshold of the traditional metrics (3 months of import, 100 percent of short-term debt, and 20 percent of broad money). As of end June 2015, the stock of reserves stood at US\$1021 which represents almost 6.5 months of next year’s imports, 1.2 times broad money, 2.5 times M1, and [24.7] times short-term debt.

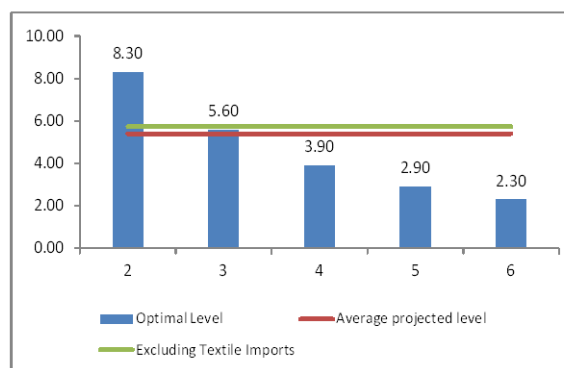
Using the cost-benefit model proposed by Dabla-Norris *et al.* (2011), and assuming that the opportunity costs of reserve holdings is 4 percent, under the weak fiscal position scenario, a reserves level covering 4.5 months of imports is considered adequate as a precautionary motive against potential external shocks. As the fiscal position improves, a projected level of reserves covering 3.9 months of imports would be appropriate. Given these results, the authorities’ existing medium-term target to maintain reserve coverage of at least 5 months of imports appears to be somewhat conservative, but appropriate.

Figure 1. Optimal and average Level of Reserves 2010-2014
(Months of Next year’s imports)



Source: Lesotho authorities and IMF staff estimates

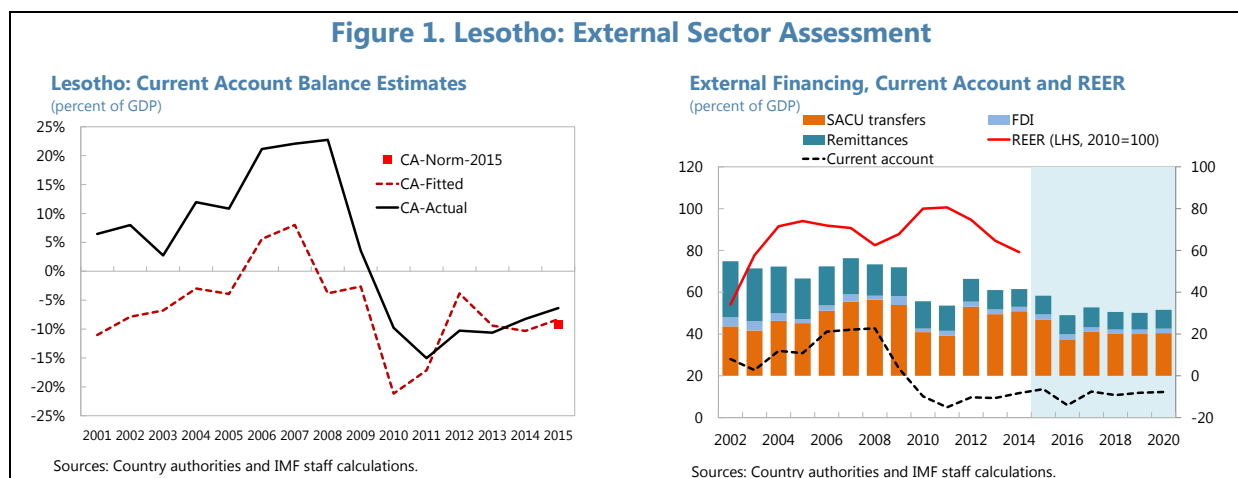
Figure 2. Optimal and average Level of Reserves 2015-2019
(Months of Next year's imports)



Annex III. External Sector Assessment

The estimates based on two EBA-lite models, current account and IREER, show a mixed picture, there is a big difference between the results suggested by the two models. Using EBA-lite current account framework indicates an undervaluation of about 8 percent with a higher CA deficit norm at about 9 percent of GDP, compared to the projected deficit of about 6½ percent in 2015/16. The estimate based on IREER framework indicates an undervaluation of 23 percent.

EBA-lite CA framework		EBA-lite IREER framework	
Projected CA	-6.4%	REER actual	4.33
Cyclically adjusted CA	-6.8%	REER norm	4.57
CA norm	-9.2%	REER Gap	-23%
CA gap	2.8%	Policy gap	0.01
o/w Policy gap	0.9%		
Elasticity	-0.35		
REER gap	-8.1%		



EBA-lite CA Approach: The current account norm from EBA –lite is based on a cross country panel regression, cyclical factors and desirable medium term policy levels. The EBA-lite Current account methodology has been developed as a successor to CGER framework, which was used for previous year assessment, and takes into account a broader set of factors such as desirable level of policies, cyclical factors, aid and remittances.

Using the parameters from EBA-lite CA framework, it suggests a gap of about 3 percent of GDP between the model based CA norm and the staff projected current account deficit for 2015/16 and with a REER elasticity to current account as -0.35 results in an undervaluation of about 8 percent.

The one-third of the gap (about 1% of GDP) is caused by policy gap, mainly fiscal deficit, reflecting Lesotho's relative position to the countries in the sample (Table 1).

EBA-lite I-REER Approach: The I-REER (index-REER) approach is based on empirical studies of exchange rate that would be consistent with the economy's productivity, external positions and other factors. In the case of Lesotho, the REER estimates based on the I-REER framework are volatile and biased upward as the big dip in REER in 2002 resulted in higher country fixed effects. To normalize this effect, staff recalculated the country fixed effect using data from 2002. But there still remain issues with the estimates based on the I-REER model.

The loti is pegged with South African Rand and a change in reserves does not accurately reflect pressures on the peg but purely a reflection of volatility associated with fiscal outcomes⁴. However the change in the reserves position has a sizeable impact on the fitted values from the model and is a major factor behind the large volatility with a standard deviation of about 23 percent for the gap between the actual and the fitted REER.

Staff views:

Given these difficulties in modeling the equilibrium REER for Lesotho using the IREER framework, staff put higher weights on estimates based on CA framework for their assessment. However, the estimates based on current account framework are also susceptible to uncertainties pertaining to current account projections as the quality of the data for variables used in the model and volatility associated with SACU transfers are major concerns. SACU revenue is an important source of external and fiscal financing and therefore has a substantial influence on Lesotho's economy.

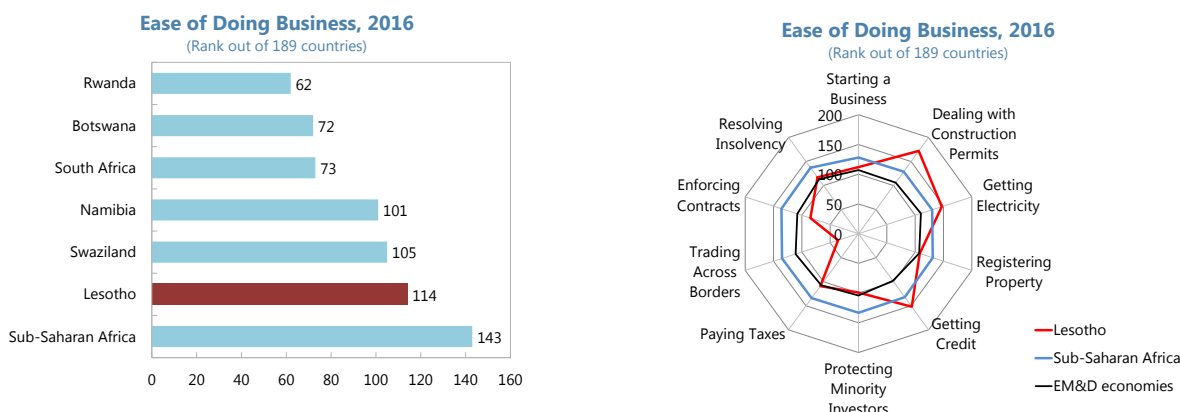
Given these difficulties with EBA-lite models and the current state of the Lesotho's economy, staff believe that the **loti is broadly in line with the current fundamentals** and an improvement in structural factors such as improving the business environment and the overall competitiveness of the economy) should help Lesotho further strengthen its external position.

Non-Price Competitiveness Indicators: The non-price competitiveness indicators produced by the World Bank and the World Economic Forum indicate Lesotho's lack of competitiveness and an unfavorable business climate for the private sector. According to the World Bank's Doing Business indicators (2016), Lesotho rank significantly behind the SACU neighbors in the overall "Ease of Doing Business", and slipped further down by four places in 2015/16 at 114 in 2016 from 110 in 2015 (Figure 2).

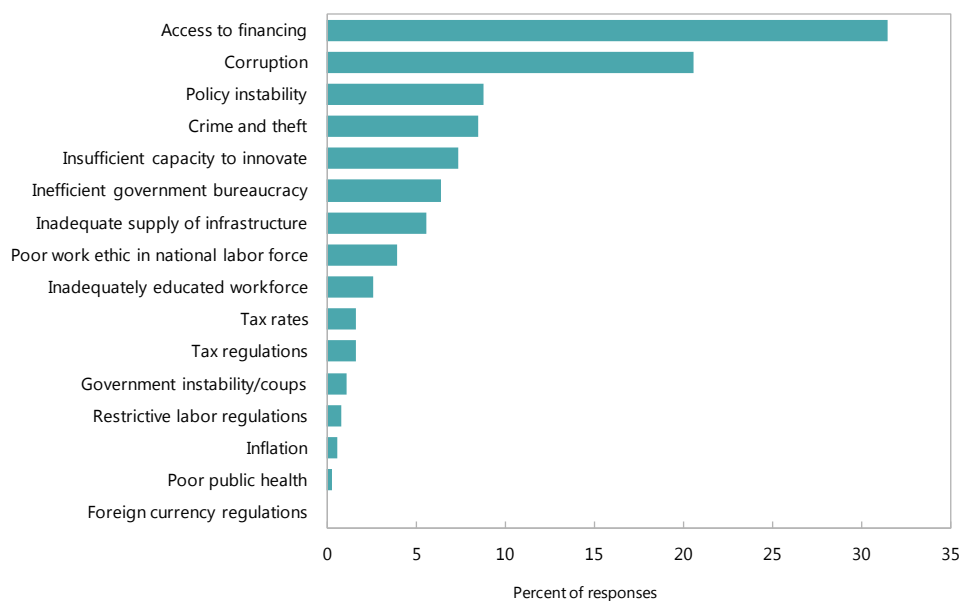
The survey results indicate that Lesotho is doing badly in dealing with construction permits, getting electricity and providing access to finance for private sector and ranked behind most of the countries in the region in these areas (Figure 2).

⁴ International reserves are mostly government deposits and accumulated out of SACU transfers.

Figure 2. Lesotho: Non-price Competitiveness



Factors Hindering Business



Note: From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between one (most problematic) and five. The bars in the figure show the responses weighted according to their rankings.

Sources: Doing Business Indicators, World Bank and Global Competitiveness Report, World Economic Forum.

Similarly, another indicator of competitiveness, the World Economic Forum’s Global Competitiveness Index ranked Lesotho six positions down at 113 in 2015/16 as compared to 2014/15. Out of 140 countries covered, Lesotho ranked dismally low in health and primary education and financial market development standing at 130 and 127 respectively. Access to finance, corruption and Policy instability are cited as most problematic factors for doing business (Figure 2). As per the survey

conducted by the World Economic Forum asking respondents to rank up to top five problems in the economy, about one-third of them ranked access to finance as one of the major problem.

In the environment of weak global demand, particularly a prolonged slowdown in South Africa, and increased competition from within the region, Lesotho faces a big task in achieving exports and private sector led growth, as envisaged under the National Strategic Development Plan.

The authorities are aware of these challenges and have implemented several measures to improve the business climate. Substantial progress has been made in reducing the obstacles to doing business through several measures, including a one-stop facility for investors, measures to reduce the cost and time required to open up a business; and the creation of a credit bureau and a commercial court. However the overall progress has been slow and efforts to create a business-friendly environment should be pushed aggressively to give confidence to the private sector.

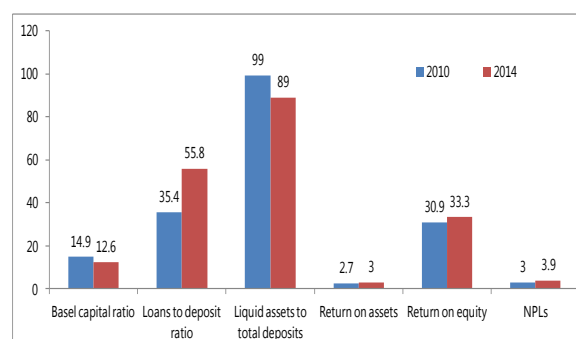
Conclusion: Further strengthening external stability will require significant improvements in non-price competitiveness indicators. Several indicators measuring the business environment (including the World Bank's Doing Business, the Global Competitiveness Index) rank Lesotho relatively poorly. Difficulties in access to financing, corruption, inadequate infrastructure and lack of skilled labor force are among the main factors contributing to this. Besides improving on these measures, adopting policies to provide greater scope for the private sector will be important going forward. In this context, consideration should be given to greater reliance on the private sector not only to generate employment, but also to improve the country's competitiveness.

Annex IV. Macro-Financial Risks and Conditions

This note discusses two methodologies to help assess macro-financial linkages and risks to the banking system in Lesotho. First, we empirically examine the feedback between credit to private sector and economic performance in Lesotho using quarterly data over the period 2002–2014. We use a standard reduced form Vector Auto Regressions (VARs) and rely on impulse response functions (IRFs) to examine the interrelations among variables. Second, we apply the Country Financial Stability Map methodology developed by the MCM department to Lesotho banking system.

Overview of the Banking System

Lesotho’s banking system is comprised of four banks, three of which are subsidiaries of South African banks and account for over 90 percent of total assets and deposits. The government formed the first indigenous bank in 2004, the Lesotho Post Bank, to enhance access for the rural and unbanked segments of the population. Indicators of financial soundness suggest that banks are on average adequately capitalized, profitable, and liquid. The non-performing loan (NPL) ratio is at a low level by international comparison, but it has increased to an average of 4.5 percent of total loans from 3.0 percent over the last four years.



However, the financial sector is not immune to risks. Personal loans account for the largest share of banks’ assets, and there is potential vulnerability from cross-border contagion from South Africa. The financial system also suffered some negative repercussions of the financial crisis, despite its relative isolation from the global capital markets, largely due to the crisis’ impact on the South African economy. A significant drop of remittances from South Africa would also likely have negative impact of the personal loans’ quality in Lesotho.

Macro-Financial Linkages

Macro shocks affect the financial sector through increased credit risk that could undermine the solvency of banks. Since a growing economy increases business opportunities and capacity to service debt, a positive shock to the economy is expected to be positively correlated with credit to private sector growth. On the other hand, a negative shock to the economy can lead to increased non-performing loans (NPLs) which in turn would erode banks’ earnings. Anecdotally, one major bank, reported that a slowdown in smaller-scale construction contracts, notably for building health clinics and schools that were financed by assistance from development partners, has greatly reduced

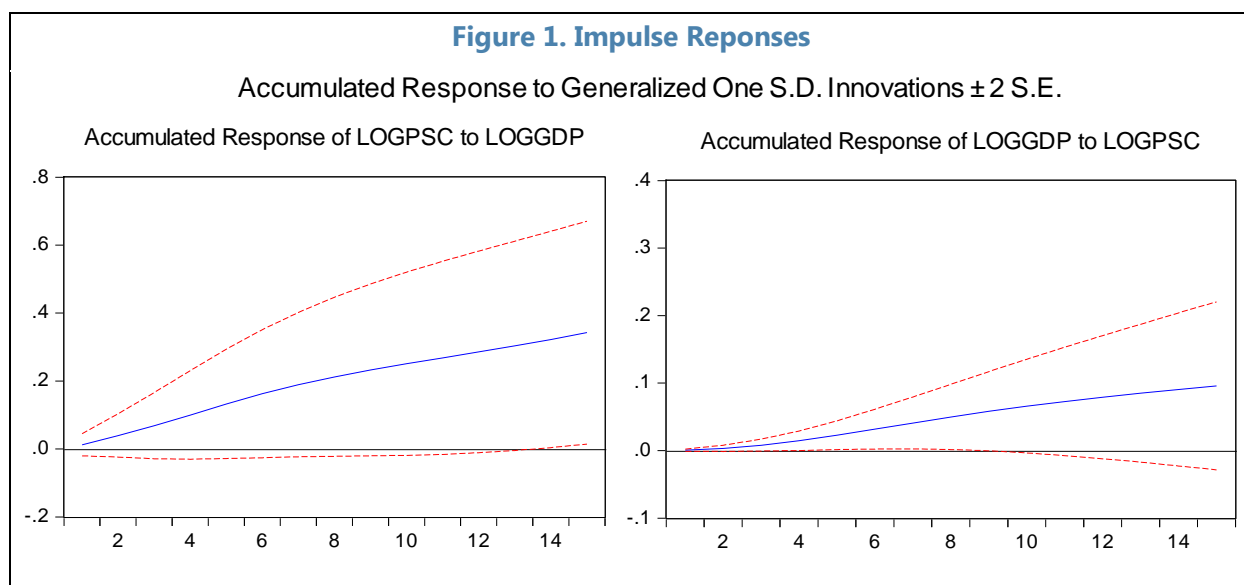
demand for credit by businesses. Shocks to the banking sector may also feedback to the macro-economy through consumption and investment.

To analyze the correlations between credit to private sector and economic growth, we use the following reduced from VAR:

$$y_t = \alpha + A_1 y_{t-1} + \dots + A_p y_{t-p} + \varepsilon_t$$

Where y_t is a set of endogenous variables with p lags. Due to lack of data, we considered the following variables: Credit to private sector, GDP, inflation rates, exchange rates, and prime lending rates over the period 2002-2014. To inform model specification, we conduct the Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) unit root tests to test for stationarity of the variables. The results of these tests show all our variables are integrated of order one. Also, the results for cointegration tests implying that there is at least one cointegration equation at the 5.0 percent confidence level in each model.

All impulse-responses in our VAR analysis come from a typical estimation where we chose the lag order of two.¹ The IRFs presented in Figure 1 show that credit to private sector both affects on and responses to GDP. A positive shock to GDP leads to an increase in private sector credit, and vice versa. When GDP increases by one standard deviation, credit to private sector increase by 0.01 percentage point during the first quarter. By the fourth quarter, GDP is 0.1 percentage point higher than before the shock to private sector credit.



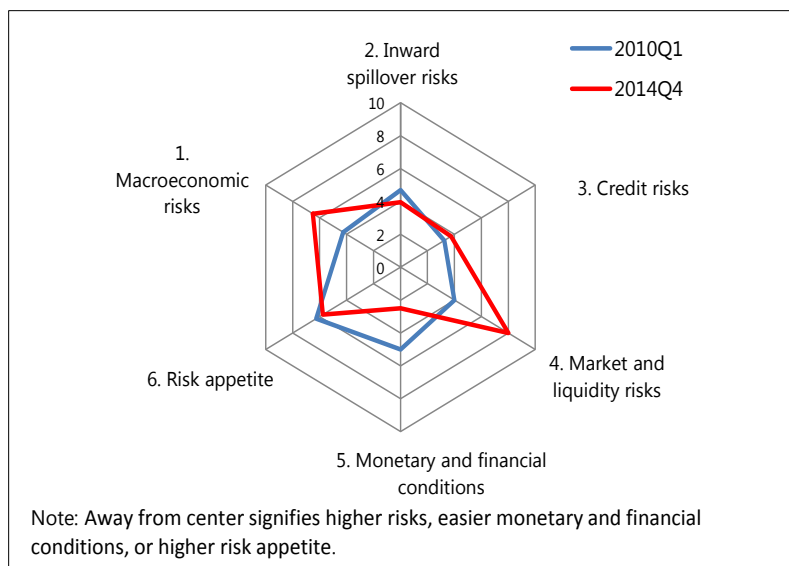
¹ In the IRFs analysis, our examination of interrelation among variables is based on generalized IRFs, in which the ordering of variables does not matter.

Financial Stability Map

In this section, we use the Country Financial Stability Map methodology developed by the Monetary and Capital Markets (MCM) department to Lesotho banking system. It describes the development of macro-financial risks and conditions, with four risk indices (macroeconomic risks; inward spillover risks; credit risks; and market and liquidity risks) and two macro-financial condition indices (risk appetite; and monetary and financial conditions). It also compares changes in financial stability for Lesotho versus other SACU members.

The Lesotho financial stability risks moderately rise and rotate. Market and liquidity risks, macroeconomic risks, and credit risks have elevated in 2014 compared to 2010 while inward spillover risks have improved. Monetary and financial conditions have become tighter, and risk appetite has become higher.

- *Macroeconomic risks* are elevated as the economic growth remains low. This is mainly driven by deteriorated fiscal and external positions, and higher inflation.
- *Inward spillover risks* have improved, mainly driven by lower trade and financial linkages (e.g., lower shares of exports to GDP and gross foreign assets of banking sector to GDP).



- *Credit risks* are higher compared to 2010, owing in part to the increase in NPLs, which has led to low profitability and weakened bank balance sheets, as well as a higher public debt to GDP ratio.
- Monetary and financial conditions have tightened, mainly driven by tighter availability of domestic bank credit.
- Market and liquidity risks appear to have increased significantly, mainly driven by increased loan to deposit ratio and higher gross foreign liability of banking sector to GDP.
- Risk appetite slightly increased, mainly driven by higher volatility of exchange rate movement and higher share of gross portfolio inflows to GDP.



KINGDOM OF LESOTHO

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 12, 2016

Prepared By

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

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RELATIONS WITH THE FUND

(As of October 31, 2015)

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

General resources account:	<u>SDR Million</u>	<u>Percent Quota</u>
Quota	34.90	100.00
Fund holdings of currency	31.06	89.01
Reserve position in Fund	3.84	11.00
SDR Department:	<u>SDR Million</u>	<u>Percent Allocation</u>
Net cumulative allocation	32.88	100.00
Holdings	46.49	141.40
Outstanding purchases and loans:	<u>SDR Million</u>	<u>Percent Quota</u>
ECF ¹ arrangements	50.61	145.00
Financial arrangements:		

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

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

	Forthcoming				
	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>
Principal	0.78	2.13	4.70	8.42	10.12
Charges/Interest		0.00	0.00	0.00	0.08
Total	<u>0.78</u>	<u>2.13</u>	<u>4.71</u>	<u>8.42</u>	<u>10.20</u>

¹ Formerly PRGF.

Safeguards Assessment

An update safeguards assessment, completed in November 2012, confirmed that the CBL has taken steps to strengthen safeguards since the 2010 assessment, but also that risks remain. Deloitte (South Africa), appointed as the CBL's external auditor in 2010, has since completed the audits of financial years 2010 to 2014 within the three-month statutory deadline and issued an unqualified audit opinion following each audit. Since the 2012 assessment, aspects of the monetary data reporting process have been strengthened with IMF technical assistance. However, audit oversight and internal audit remain areas where improvements are needed to strengthen overall governance and accountability.

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. Lesotho maintains one exchange restriction arising from single discretionary allowances of M1 million per individual per calendar year, for residents over 18, and of M200,000 on the same basis for residents under 18. The availability of foreign exchange beyond these limits is subject to a discretionary approval on a case by case basis. As of October 30, 2015, the maloti rate per U.S. dollar was M13.88.

Article IV consultation:

The 2014 Article IV consultation was concluded by the Executive Board on June 4, 2014. Lesotho is on the standard 12-month Article IV consultation cycle.

Technical assistance

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

Fiscal Affairs Department

Public financial management	Short-term	2015
Tax policy	Short-term	2014
Improving revenue administration fundamentals	Short-term	2014
Resources and non-mining taxation	Short-term	2013
Tax policy and mining fiscal regimes	Short-term	2013
Developing cash management	Short-term	2013
Large taxpayers	Short-term	2012
Develop the post control audit function in customs	Short-term	2012
Develop risk management function	Short-term	2012
Public financial management	Short-term	2011
Revenue administration	Short-term	2011

Strengthening arrears management and expenditure central	Short-term	2011
Public financial management	Short-term	2010

Legal Department

Banking laws and regulation	Short-term	2008
Financial sector regulations	Short-term	2008

Monetary and Capital Markets Department

Insurance supervision	Short-term	2015
Financial stability data management and analysis	Short-term	2015
Financial soundness indicators	Short-term	2014
Financial stability	Short-term	2014
Risk management framework	Short-term	2014
Payment system modernization	Short-term	2014
Enhancing banking supervision	Short-term	2014
Payment systems oversight	Short-term	2014
Strengthening insurance supervision	Short-term	2014
Financial soundness indicators	Short-term	2014
Strengthening liquidity management and capacity building for financial stability analysis and reporting	Short-term	2013
Establishment of a risk management function	Short-term	2012
Assessing Banking system stability	Short-term	2012
Financial statistics	Short-term	2013
Risk management framework	Short-term	2013
Monetary and financial statistics	Short-term	2013
Financial stability assessment	Short-term	2012
Liquidity management framework	Short-term	2012
National payment systems	Short-term	2012
Money market development and capacity building for financial stability analysis and reporting	Short-term	2012
Strengthening Insurance supervision	Short-term	2012
Banking system stability	Short-term	2012
Financial supervision	Short-term	2012
Monetary and Financial Statistics	Short-term	2011
Monetary and financial statistics	Short-term	2011
Financial sector supervision	Short-term	2011
Money markets	Short-term	2009
Money markets	Short-term	2008
Payment systems modernization	Short-term	2008
Bank supervision	Short-term	2008
Payment systems	Short-term	2008
Payment systems	Short-term	2008
Nonbank supervision	Short-term	2008
Bank supervision	Short-term	2008
Monetary operations/Bank supervision	Short-term	2008

Statistics Department

National accounts statistics	Short-term	2015
Streamline data submission	Short-term	2014
National accounts statistics	Short-term	2014
External sector statistics	Short-term	2014
External sector statistics	Short-term	2013
National accounts statistics-follow up	Short-term	2013
External sector statistics	Short-term	2012
National accounts statistics	Short-term	2011
SRF data development	Short-term	2011
Balance of payments	Short-term	2010
Monetary and financial statistics	Short-term	2009
Balance of payment	Short-term	2008
Government Finance Statistics: GDDS Project for Anglophone African Countries	Short-term	2008

THE JMAP BANK-FUND MATRIX

(As of September 30, 2015)

Title	Products	Provisional Timing of missions	Expected Delivery date
A. Mutual information on relevant work programs			
Bank work program in next 12 months	<ul style="list-style-type: none"> HIV/AIDS Project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> Implementation ongoing
	<ul style="list-style-type: none"> Second Private Sector competitiveness and Economic Diversification project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> Implementation ongoing
	<ul style="list-style-type: none"> Water Sector Improvement Project Phase 2 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> June 2016 (closing date)
	<ul style="list-style-type: none"> Smallholder Agriculture Project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> Implementation ongoing
	<ul style="list-style-type: none"> Maternal and Newborn Health PBF 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> Implementation ongoing
	<ul style="list-style-type: none"> Public Financial Management Reform Support Project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> Implementation ongoing
	<ul style="list-style-type: none"> Public Sector Modernization Project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> March 2016
	<ul style="list-style-type: none"> Regional TB Project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> March 2016
	<ul style="list-style-type: none"> Social Protection Project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> December 2016
	<ul style="list-style-type: none"> Education Improvement Project 	<ul style="list-style-type: none"> Ongoing regular missions 	<ul style="list-style-type: none"> FY 2017
IMF work program in next 12 months	Surveillance		
	<ul style="list-style-type: none"> Staff visit 	<ul style="list-style-type: none"> March 2016 	<ul style="list-style-type: none"> Ongoing
	<ul style="list-style-type: none"> Article IV mission 	<ul style="list-style-type: none"> Sep/Oct 2016 	<ul style="list-style-type: none"> December 2016
	Technical assistance		
	<ul style="list-style-type: none"> Public financial management reform 	<ul style="list-style-type: none"> April 2016 	<ul style="list-style-type: none"> Ongoing
	<ul style="list-style-type: none"> Tax policy and revenue administration 	<ul style="list-style-type: none"> June 2016 	<ul style="list-style-type: none"> Ongoing
<ul style="list-style-type: none"> Insurance regulation 	<ul style="list-style-type: none"> October 2016 	<ul style="list-style-type: none"> Ongoing 	

Title	Products	Provisional Timing of missions	Expected Delivery date
	• Risk management framework	• March 2016	• Ongoing
	• Financial stability	• August 2016	• Ongoing
	• Risk-based supervision	• April 2016	• Ongoing
	• National accounts statistics	• March 2016	• Ongoing
	• External sector statistics	• September 2016	• Ongoing
B. Requests for work program inputs			
Fund request to Bank	• Periodic updates on the business climate; private sector development; the review of civil service; and capacity building in project appraisal.	Ongoing	
Bank request to Fund	• Periodic updates on macroeconomic framework; the status of Fund relations with Lesotho, and a follow-up program	• Ongoing	
C. Agreements on joint products and missions			
Joint products in next 12 months	• Debt sustainability analysis	• Ongoing	•

Lesotho—Statistical Issues Appendix As of end-October 2015

Assessment of Data Adequacy for Surveillance

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

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

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

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

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

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

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

Data Standards and Quality

Lesotho is a GDDS participant. GDDS metadata have been posted on the Fund's Dissemination Standards Bulletin Board since August 2003. Currently, Lesotho participates as a pilot country in enhanced GDDS (e-GDDS).

Lesotho: Table of Common Indicators Required for Surveillance

As of April 30, 2014

	Date of Latest Observation	Date Received	Frequency of Data ¹	Frequency of Reporting ¹	Frequency of Publication ¹	Memo Items:	
						Data Quality – Methodological Soundness ⁸	Data Quality – Accuracy and Reliability ⁹
Exchange Rates	Oct-31-2015	Oct-31-2015	D	D	I		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ²	Oct-31-2015	Oct-31-2015	D	D	Q		
Reserve/Base Money	Oct-31-2015	Oct-31-2015	D	D	Q		
Broad Money	Oct-31-2015	Nov-25-2015	M	M	Q		
Central Bank Balance Sheet	Oct-31-2015	Nov-25-2015	D	D	Q		
Consolidated Balance Sheet of the Banking System	Oct-31-2015	Nov-25-2015	M	M	Q		
Interest Rates ³	Oct-31-2015	Oct-31-2015	M	M	Q		
Consumer Price Index	Oct-31-2015	Nov-25-2015	M	M	M		
Revenue, Expenditure, Balance and Composition of Financing ⁴ — General Government (GG) ⁵	N.A.	N.A.	N.A.	N.A.	N.A.		
Revenue, Expenditure, Balance and Composition of Financing ⁴ – Central Government	Mar-31-2015	Nov-2015	A	I	A		
Stocks of Central Government and Central Government-Guaranteed Debt ⁶	Jun-30-2015	Aug-2015	M	I	A		
External Current Account Balance	Jun-30-2015	Aug-2015	Q	Q	Q		
Exports and Imports of Goods and Services	Jun-30-2015	Aug-2015	Q	Q	Q		
GDP/GNP			A	A	A		
Gross External Debt	Jun-30-2015	Aug-2015	<u>M</u>	<u>I</u>	<u>A</u>		
International Investment Position ⁷	Jun-30-2015	Aug-2015	Q	Q	Q		

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

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

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

⁴ Foreign, domestic bank, and domestic nonbank financing.

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

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

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

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

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